



A Re-Define Policy Paper

For the

German Government

Domestic Resource Mobilization

Focus

Tackling cross-border tax flight

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Domestic Resource Mobilization and the centrality of developing country taxation

Developing countries need financing for a whole gamut of development related activities all the way from providing basic services such as healthcare and education to their citizens to investing in infrastructure to trigger growth.

The central contribution of the financial for development (FfD) conference at Monterrey in 2002 was to put Domestic Resource Mobilization (DRM) at the heart of the development finance agenda.

The main idea behind the DRM discussion is that sustainable development is only possible if a country can marshal sufficient finances from mostly in-country sources and use them for development. While in principle resources both in the private and public sector can and do contribute to development, the focus in this paper is mostly on public sources of development expenditure which are critical especially in low income countries.

Public domestic resources can be mobilized from three main sources

- Taxes – direct and indirect such as corporate and income (d) and VAT and import tariffs (i)
- Royalties – on natural resource extraction and the auction of public commons such as radio spectrum etc
- Borrowing – when the government borrows from domestic actors

Of these debts have to be repaid, so taxes and royalties are the main sources of domestic resource mobilization.

Domestic Resource Mobilization (DRM) - is the process of marshalling finances from in-country sources mostly through various forms of taxes and royalties. It is the key source of development financing for most developing countries.

The process of financing development in poor countries can be split into 4 R's for the purpose of this paper. These are

- **Raising** domestic resources (mostly through taxes)
- **Retaining** domestic resources (there is no use if taxes once raised are then siphoned off)
- **Recovering** lost domestic resources (which have been siphoned off in the past)
- **Reinforcing** domestic resources mostly in the form of external support through aid etc

Even though the 4th R, overseas development aid (ODA), gets by far the most attention in discussions of development financing it is critical to highlight that from an overall development finance perspective, aid plays, at best a supporting role.

As a percentage of the GNI of (recipient) all developing countries 'real ODA' has only averaged at about 0.4% – 0.5% of GNI. At an aggregate level, it is clear that ODA flows are not the major source of funding for developing countries. Domestic tax revenue, on the other hand, ranges between 12% - 18% of GNI for most developing countries and provides a much more significant source of finance.

This is borne out by the table below which presents the average revenue and aid statistics as a percentage of the GNI for a typical group of developing countries. Even for countries that receive large amounts of aid (relative to the GDP) there are only a few where aid exceeds what is raised from domestic resources.

What is more important is that there remains a tremendous potential to raise more domestic resources through taxation and this should be a focal area for the international development community. The Tax/GDP ratio for most developing countries is still close to 20% or less whereas the number for developed countries is a much higher 30%. Even a small increase in Tax/GDP can raise substantial new resources for development.

| C o u n t r y | R e v (% G N I) | A i d (% G N I) | R e v / A i d (%) |
|-----------------------------|-------------------|-------------------|---------------------|
| B h u t a n | 1 8 . 5 | 9 . 2 % | 2 0 2 % |
| B u r u n d i | 1 7 . 4 | 7 . 0 % | 2 4 7 % |
| C o n g o , D e m . R e p . | 5 . 5 | 1 . 9 % | 2 9 5 % |
| C o t e d ' I v o i r e | 1 7 . 4 | 3 . 7 % | 4 7 1 % |
| I n d i a | 1 1 . 6 | 0 . 1 % | 1 0 2 6 8 % |
| K e n y a | 2 1 . 0 | 1 . 5 % | 1 4 1 5 % |
| K y r g y z R e p u b l i c | 1 6 . 7 | 3 . 6 % | 4 6 9 % |
| N e p a l | 1 0 . 3 | 2 . 7 % | 3 8 5 % |
| N i c a r a g u a | 1 8 . 2 | 9 . 8 % | 1 8 5 % |
| P a k i s t a n | 1 6 . 0 | 0 . 3 % | 5 3 3 1 % |
| P a p u a N e w G u i n e a | 2 2 . 4 | 4 . 4 % | 5 0 7 % |
| S e n e g a l | 1 7 . 0 | 6 . 8 % | 2 5 2 % |
| T a j i k i s t a n | 9 . 7 | 4 . 9 % | 1 9 9 % |
| U g a n d a | 1 1 . 1 | 5 . 9 % | 1 9 0 % |
| Z a m b i a | 1 8 . 7 | 1 0 . 1 % | 1 8 5 % |

In terms of sheer importance for sustainable development, developing country tax policy is perhaps by far the most important theme under discussion at the Financing for Development conference. While, as has been discussed, developing country taxes & royalties constitute the biggest source of development finance flows, their importance on development goes much further beyond size alone.

The importance of Tax policy can be discussed using 4 more R's. These are

- **Revenue** – which is central to financing development expenditure – developing countries, on average are able to mobilize (as a % of GNI) much less revenue than OECD countries so the need and scope for increasing tax revenue is higher
- **Redistribution** – which lies at the heart of fair and progressive tax systems where each is made to pay as per their capacity and publicly financed services are made available to everyone and wealth is distributed towards the poor at the bottom of the income pyramid. Here it is important to note that while pre tax inequality is more or less similar across the developing and developed worlds it is the redistributive power of the tax system that accounts for the significantly lower final income inequality in the developed world. In short, developing country tax systems need to become far more progressive.
- **Repricing** – which means using tax policy as a tool for encouraging certain types of activities such as investment in backward regions and discouraging certain others such as smoking or polluting
- **Representation** – it has become abundantly clear that the process of levying taxes and the resultant incentives for the population to hold their government to account is a central part of formation of civilized society and few societies lacking the 'social contract' between governments and citizens have been able to engender good governance.

In summary, developing country taxation is absolutely fundamental to the financing of development and the development of good governance.

The threat to developing country taxation – tax flight and tax competition

The threat to developing country taxation

Developing country taxation exists in a context where an increasing amount of the tax revenue, even from domestic sources, is in some way or the other related to the international economy for example because

- The actors are international – such as Multinational corporations (MNCs) with operations in the country
- The actors have significant international economic relationships – such as exporters and importers
- The actors are purely domestic but have access to international economic activity - rich individuals (the access could be legal or illegal)

The changing international economic context has been characterized by

- An exponential increase in cross border financial flows
- A significant increase in the trade of goods & services
- A large increase in cross border investments
- An increase in the complexity of MNC structures and international production networks
- A mushrooming of tax havens which legislate to help actors avoid regulatory and tax obligations in other jurisdictions and the tools they offer for reducing taxes
- A large increase in the offshore financial activity associated with these tax havens, the complexity and breadth of tax reduction products being marketed
- Little change in the secret spaces available – behind bank secrecy, sham trusts, shell companies and anonymous foundations
- The progressive deregulation of exchange restrictions and other controls on cross-border flows
- The advent of the internet where at the click of the mouse one can get access to the international financial sector including tax havens and associated offshore financial centres

All of these significantly increase the opportunities for economic actors to (legally or illegally) reduce their domestic tax payments substantially. Unfortunately while cross-border trade, investment and financial flows have grown exponentially, tax policy has stayed stubbornly national.

What is worse, the tax system suffers from an acute lack of cross-border co-operation.

Globalization and internationalization of economic activity without a matching internationalization of tax governance or co-operation has given rise to opportunities for economic actors to try and minimise their tax payments. This undermines domestic resource mobilization both in developed and in developing countries.

“...without greater bilateral and multilateral co-operation, offshore tax evasion will continue to grow and undermine the integrity of national tax systems” – Jeffery Owens, Director OECD Centre for Tax Policy and Administration

Tax flight

Tax flight from developing countries, which is the focus of this paper, is best understood as the loss of tax revenue due to cross border tax evasion or tax avoidance.

There is often confusion as to the difference between tax evasion and tax avoidance.

There is, in fact, a continuum across the spectrum from tax evasion – which is outright illegal through tax avoidance which may comply with the letter but not the spirit of law to tax compliance where an entity complies with both the letter and the spirit of law.

- **Tax evasion** is an illegal activity undertaken to reduce an entity's tax bill. This is often done through
 - Non disclosure of income or assets which are taxable
 - Shifting profits, income and assets illegally to other lower tax jurisdictions
 - Completely disguising transactions
- **Tax compliance** is the other end of the spectrum from tax evasion. When an entity seeks to be tax compliant it does the following:
 - Seeks to comply with tax law in all the countries in which it operates;
 - Makes full disclosure of all relevant information on all its tax claims;
 - Seeks to pay the right amount of tax required by law (but no more) at the right time and in the right place.
- **Tax avoidance.** Tax avoidance is the grey area between tax compliance and tax evasion. It usually works through
 - Seeking legal loopholes to exploit
 - Often disguising part of the transaction

Tax competition, which refers to the competitive lowering of tax rates and offering of tax concessions with a stated purpose to stimulate and especially attract investment, also causes significant tax losses to developing countries. It is usually driven by the beliefs that

- That lower taxes will attract significant new investments
- These investments will have significant positive development impacts

Recent research has shown that

- While tax rates might be important under some circumstances, in most instances they are not a very important determinant in the decision to make investments
- Investments, especially in the extractive sector, have a positive development impact only under certain conditions.

However there is another powerful reason for tax competition beyond these erroneous beliefs. This is that both companies and individuals are more likely to use cross-border tax evasion and tax avoidance to move profits, income and assets from a developing country to a low tax jurisdiction the higher the differential between the two rates.

Hence, efforts targeted at reducing **cross-border tax flight** from developing countries, the focus of this paper, will also help at least partly address the pernicious problem of tax losses due to tax competition. For more on tax competition, see Appendix III.

The problem of cross border tax flight

While the process is complex and has many dimensions, the terms of reference of this study and limitations of time and space mean that this paper will focus primarily on tackling the aspect of tax flight that relates to the use of

tax haven jurisdictions and their associated offshore financial centres by economic actors. This is also the most major component of tax flight.

Cross border tax evasion and tax avoidance are accomplished mostly through

- shifting income (by individuals) and profits (by corporations) and
- shifting assets (by both)

outside the country of origin mostly into low tax jurisdictions called tax havens. This shift could be real (for example diamonds could be smuggled or money could be wired out) or it could simply be legal where the income and assets do not move but the ownership of assets, reporting of income and recording of profits is shifted to foreign entities often based in tax havens.

“Individuals have, for example, used offshore accounts, offshore trusts or shell companies in offshore financial centres or other countries to conceal taxable assets or income, as well as credit cards held in offshore jurisdictions to provide access to concealed assets; businesses of all sizes have created shell companies offshore to shift profits abroad often taking recourse to over or undervaluation of traded goods and services for related party transactions and some multinational enterprises (including financial institutions) have use more sophisticated cross-border schemes and/or investment structures involving misuse of tax treaties, the manipulation of transfer pricing to artificially shift income into low tax jurisdictions and expenses into high tax jurisdictions which go beyond legitimate tax minimization arrangements” – communiqué from the OECD Forum on Taxation Administration meeting in Seoul

Taxation can be complicated. Sometimes the payment of taxes for firms is a simple matter of making choices between various options quite deliberately made available within taxation law about how a transaction may be treated. On other occasions, especially for MNCs, the issues and range of choices might be quite complex.

To understand this it is important to note that whilst MNCs like to appear to be one entity, and indeed will publish accounts that suggest this is the case, MNCs are typically consist of large numbers of separate companies. A parent company usually owns all or most of the others, and controls all the others because ownership of a company's shares provides that right in company law. The companies that the parent owns are called its subsidiaries. There can be just a few of these. There may be thousands. For example, a recent count at British Petroleum suggested it had more had more than 3,000 subsidiary companies around the world. This is not unusual.

This means that whilst the corporation may like to present a single front to the world, and one published glossy set of accounts, the reality is that when it comes to taxation there is no such thing as an MNC. Each company that makes it up is taxed separately.

The flipside of this is that the MNC will need to make a number of decisions which will impact where it pays its tax, when it pays its tax and how much tax it pays.

Some of these decisions are

- Where it will incorporate its head office;
- Where it will incorporate its subsidiary companies;
- Whether it will use tax havens or not;
- What companies it will, or will not include in its group structure
- On what terms it will trade between group companies.
- Where it will record its sales;
- Where it will incur its costs;
- Where it will locate its assets;
- Where it will employ its staff;
- Where it will borrow money;
- Where it will locate its intellectual property;
- How it will structure its operations;
- Whether it will seek special tax privileges.

The OECD has estimated that 60% of world trade is intra firm where subsidiaries that are part of the same MNC group trade with each other. So the tax implications of decisions such as “on what terms will the firm trade between group companies” can be enormous. Legally, the transactions between these related entities are supposed to work on an ‘arms length principle’ meaning that the prices should reflect what two independent firms would pay for good and services.

However, in many cases the traded items do not have a readily comparable market price (being intermediate goods), are intangible services where it is not simple to fix the price (such as on the use of patents). In other instances, it might just be very difficult for tax authorities to check. In either case, firms have a large leeway in determining these transfer prices which can then be set to shift profits from high tax to low tax jurisdictions.

Evidence is that many firms are engaging in what has been variously referred to, in Australia, as “aggressive tax planning”, in South Africa as “impermissible or abusive tax avoidance” and in New Zealand and the United Kingdom as “unacceptable tax avoidance”.

The Guardian newspaper recently reported the results of an investigation into the affairs of three MNCs Fresh Del Monte, Dole and Chiquita, which between them control over two thirds of the world banana trade. Bananas are the biggest UK import from Latin America and the market is worth hundreds of million pounds every year.

The Guardian’s summary of the typical transactions being carried out by these firms was as follows. For every 60 pence worth of Bananas sold to the UK supermarkets. Also see <http://www.guardian.co.uk/flash/page/0,,2201916,00.html>

- 13p to the growing country: 1.5p is labour, 10.5 p is costs and 1 p profit;
- 8p to a Cayman company for use of the ‘purchasing network’;
- 8p to Luxembourg for use of ‘financial services’;
- 4p to Ireland for ‘use of the brand’;
- 4p to the Isle of Man for insurance;
- 6p to Jersey for management services;
- 17p to Bermuda for ‘use of the distribution network’;
- This gives rise to a 60p sale price into the UK.
- 1 p of profit is declared in the UK;

So the transactions of these firms are structured in such a way as so minimize tax liability both in the producing and the consuming countries where the bulk of the economic activity takes place.

“The investigation reveals that large corporations are creating elaborate structures to move profits through subsidiaries to offshore centers such as the Cayman Islands, Bermuda and the British Virgin Islands, to avoid handing money over to tax collectors in the countries where their goods are produced, and in those where they are consumed. Governments at both ends of the chain are increasingly being deprived of the ability to raise tax for development or services.”

A number of additional examples are discussed in the Appendix III.

Similarly a number of opportunities also exist for individuals, especially in the fast growing High Net worth Individual (HNWI) category, to minimize their tax payments. Whether they comply with tax or try and evade it depends on

- Whether they will declare income and assets
- Whether they decide to move capital offshore
- Whether they disguise their source of income

It has been estimated that individuals hold as much as \$12 trillion of assets offshore outside the country of their origin and that a significant proportion of these remain undeclared to the proper tax authorities. Assets from developing countries, estimated to be as much as a third of these, are growing as emerging markets produce new breeds of the rich and super rich.

Of course, many of these offshore holdings and arrangements are undertaken for sound commercial and legitimate tax planning reasons, without any intent to conceal income or assets from the home country tax authorities. The experiences of tax authorities, however, lead them to believe that much of this money is there to evade or avoid tax.
– Jeffery Owens, head OECD centre for tax policy and administration

A recent US senate investigation uncovered some ingenious ways that individuals have used to evade taxes. Many of these were helped by the LGT bank in Liechtenstein which recently came into the limelight in Germany for having helped hundreds of German citizens evade taxes. In fact, much of the senate investigation was based on leads provided by the German authorities to the United States.

LGT helped set up a secret foundation for a Mr Wu. In 1997, three months after forming his foundation, Mr. Wu pretended to sell his home in New York to what appeared to be an unrelated party from Hong Kong. In fact, the buyer, Tai Lung Worldwide Ltd., was a British Virgin Islands company with a Hong Kong address, and it was wholly owned by a Bahamian corporation called Sandalwood International Ltd., which was, in turn, wholly owned by Mr. Wu's Liechtenstein foundation.

LGT also helped do the same for his sister where documents indicate that her Liechtenstein foundation was the sole owner of a bearer share corporation formed in Samoa, called Manta Company Ltd., which owned a Hong Kong corporation called Bowfin Co. Ltd. which, in turn, held real estate, a vehicle, a mobile telephone, and two bank accounts. LGT documentation indicates that the bank was fully aware of these arrangements and expressed no concerns.

LGT documents also show that Mr. Wu transferred substantial sums to his foundation and, over the years, withdrew substantial amounts, ranging from \$100,000 to \$1.5 million at a time. In one instance, LGT arranged for Mr. Wu to withdraw \$100,000 using a HSBC bank check drawn on an LGT correspondent account, which made the funds difficult to trace.

Based on this and a number of other cases the investigation concludes that

"These LGT accounts together portray a bank whose personnel too often viewed LGT's role as, not just a guardian of client assets or trusted financial advisor, but also a willing partner to clients wishing to hide their assets from tax authorities, creditors, and courts. In that context, bank secrecy laws have served as a cloak not only for client misconduct, but also for bank personnel colluding with clients to evade taxes, dodge creditors, and defy court orders."

The senate investigation has also targeted the Swiss bank UBS, which is also under investigation by the US justice department. Here it was found that UBS has about 19,000 undeclared Swiss accounts for US citizens with almost \$20 billion in hidden assets. UBS was also found to have taken elaborate measures to keep these accounts secret.

In a sworn deposition Mr Birkenfield, an ex UBS banker revealed that UBS advised U.S. clients to withdraw funds from their accounts using Swiss credit cards that "could not be discovered by United States authorities"; to "destroy all off-shore banking records existing in the United States"; and to "misrepresent the receipt of funds from the Swiss bank account in the United States as loans from the Swiss Bank." He also disclosed that, on one occasion, **"at the request of a U.S. client, he purchased diamonds using that U.S. client's Swiss bank account funds and smuggled the diamonds into the United States in a toothpaste tube,"** presumably so that the U.S. client could obtain possession of his Swiss assets without alerting U.S. authorities.

It is clear from this section that cross-border tax flight is a very serious issue that undermines efforts by both developing and developed countries to mobilize domestic resources. The choice of examples from developed countries is deliberate as the point being made is that under the onslaught of tax havens, aggressive offshore operators and rule stretching MNCs even the relatively sophisticated and well-equipped tax authorities of developed states are struggling. The plight of developing countries and the scope for cross-border tax evasion from them is much greater.

There are several examples of both corporations and individuals in developing countries using similar tools to avoid and evade taxes due. See <http://christianaid.org.uk/images/F1593PDF.pdf> for example.

Three other aspects came out prominently during this discussion

- The prominent role of tax havens
- The prominent role of offshore operators such as LGT and UBS
- The importance of secrecy

These are discussed briefly in the next section

Tax havens, offshore financial centres and their tools

The functional definition of a Tax Haven is a jurisdiction that creates legislation designed to assist a person (legal or real) – to avoid the regulatory obligations imposed upon them in the place where they undertake the substance of their economic transactions.

Tax havens are also often associated with an environment of secrecy that allows the user of the structures created using its law to do so either wholly anonymously, or largely so.

Other arrangements are commonplace to ensure secrecy is maintained. Few tax havens require the identity of the real owners of companies to be disclosed; they allow nominee directors to manage such concerns so that those really operating them remain hidden from view and few tax havens require accounts to be placed on public record. The arrangements for trusts and foundations are even less transparent.

Most of all, many tax havens guarantee secrecy by making it very hard indeed for a foreign government to make enquiry about the ownership details of a bank account, company, foundation or trust registered in their domain, or about its income.

What it is important to stress is that secrecy is key to most tax haven operations. Without it many of those using tax haven structures would not do so. This is either because, in the case of those using them for criminal purpose, including tax evasion, they fear they would be too easily identified and so pay for the consequences of their crime, or in the case of those using them for regulatory avoidance (which may be legitimate, but is often ethically questionable) because of the damage that discovery would do to their reputations.

In this context low tax rates and lax regulation, with both designed to undermine obligations elsewhere, are the lure to attract business to tax havens. It is however the secrecy that guarantees that a sale of tax haven services takes place. It is impossible to imagine one without the other.

Offshore financial centres (OFCs) are not the same as tax havens. OFCs are the commercial communities hosted by tax havens that exploit the structures that can be created using that tax havens legislation for the benefit of those who are resident elsewhere. In other words, the offshore financial centre is made up of the accountants, lawyers, bankers and their associated trust companies that sell services to those who wish to exploit the mechanisms the tax haven has created.

It is of course a moot point that OFCs and tax havens work closely together – often accountancy firms which are part of the OFCs suggest and write legislation which the tax havens then enact.

In the offshore world transactions are recorded in one place (a tax haven) on behalf of parties who are actually elsewhere in the world (offshore). Those transactions might have the legal form of taking place in the tax haven in which they are recorded. The reality is that their substance, and benefit, occurs elsewhere. The offshore world is designed to make things appear other than they are, and by and large succeeds in doing so.

It is the tools offered by tax havens and their associated offshore financial centres that enable much of cross border tax flight to take place.

Some of these tools are

- Low or zero taxation for foreign persons
- Low or zero taxation for corporations which do not have domestic operations in the haven
- A lax regulatory regime
- A host of highly flexible legal tools such as
 - Shell banks
 - Corporations including shell companies, protected cell companies and limited liability partnerships etc including sometimes with the provision for bearer shares
 - Flexible sham trusts where control can be exercised by the grantor of the trust
 - Foundations which can be run anonymously
- Poor transparency and a provision of secret spaces through
 - The use of bank secrecy
 - The use of nominee shareholders, directors and trustees
 - The non recording of beneficial ownership
 - The refusal to exchange information in a way that would be useful for the authorities of foreign jurisdictions trying to ensure that their laws are not violated
 - The use of increasingly cynical legal tools such as redomiciliation or flee clauses where the act of a preliminary enquiry being made makes a company, trust or foundation to automatically relocate to another tax haven without leaving a trace and thus frustrating all investigations. For example, it is believed that several of the Liechtenstein foundations being investigated as a result of the LGT scandal might have fled under such clauses.
- The use of jurisynergy, under which an offshore operator arranges to combine various legal tools in different tax haven jurisdictions to build additional layers of secrecy (as was done by LGT in the examples quoted in the previous section)

It is clear that tax havens and their associated financial centres are playing a cat and mouse game with the tax and regulatory authorities of both developing and developed countries and are constantly devising new legislative tools (such as flee clauses) and practices (such as jurisynergy) to keep gaining financial advantage.

Even though individual transaction fees may be low (for example in the Isle of Man the annual fee for a non-resident company is £320 a year) the sheer number of legal entities and transactions mean that many of the havens (especially the smaller ones) may depend on tax haven related transactions for more than half their budgets. The British Virgin Islands, for example, is estimated to have as many as 800,000 registered companies. A US senate investigation found that a single location, Uglan House, in Cayman houses 12,748 post box companies.

For accountancy firms, trust companies, law firms and other ancillary services, the advantages that accrue from tax havens and offshore finance are enormous. In fact, one of the identifying features for suspicious tax avoidance transactions is when the fees paid for the transaction has been high!

A US senate investigation revealed cynicism within KPMG with the uncovering of an email showing that a KPMG tax adviser had engaged in cost-benefit analysis of a potential breach of the rules, and decided that the financial rewards outweighed the penalties. The executive had noted that even if the regulators took action against their sales strategies over a tax shelter known as the Offshore Portfolio Investment Strategy (OPIS), the 'average deal... would result in KPMG fees of US\$360,000 with a maximum penalty exposure of only US\$31,000'.

For banks, the benefits that accrue from aiding and abetting such tax and regulatory arbitrage are too lucrative to resist. For example, the nearly \$20 billion of undeclared US citizen accounts at UBS discussed in a previous section is believed to have earned it \$200 million every year.

So tax havens, their associated financial centre firms and their correspondent onshore firms all have a strong financial interest in keeping these practices going.

As do the corrupt, criminal actors and those who engage in tax flight. Unfortunately, these profits don't come from nowhere. They have a heavy cost.

Australians who seek to conceal their tax obligations leave other Australians to bear a greater tax burden. There is no philosopher's stone that, through alchemy, transforms Australian or foreign source income derived by an Australian resident into non-taxable income in Australia by the mere transmission through, or concealment in, a tax haven. Abusive arrangements of this kind, if left unchecked, undermine community confidence in our tax system as well as the system's integrity. - Michael D'Ascenzo Commissioner of Taxation

Of course the cost is borne by the rest of us including citizens of developing and developed countries who have to pay higher taxes as a result or put up with worse public services. The burden is heaviest for citizens of developing countries where often cross border tax flight makes the difference between life and death for hundreds of thousands if not millions.

And we also end up in a system where financial instability (as evidenced by the current crisis where offshore vehicles have played a central role) corruption (as shown by the recent case at Siemens) and crime are higher than they would otherwise be.

This needs to change.

Tax flight and capital flight

A number of references have been made to the increasing cross border flow of money. Among the exponentially increasing legitimate cross border financial flows are hidden flows which may not be legitimate. These flows are sometimes referred to as capital flight.

While these terms may be used differently by different experts, all references to them include a number of shared implicit characteristics which can be broadly listed as

- these flows are largely unrecorded (not captured by the BoP and other official statistics)
- these flows are often associated with active attempts to hide origin, destination & true ownership etc (they seek secrecy)
- these flows are usually associated with public loss and private gain because no (or little) tax is paid on them or because they may be comprised of bribes paid

- these flows constitute domestic wealth permanently put beyond the reach of domestic authorities in the source country
- these flows are not part of a 'fair value' transaction and would not stand up to public scrutiny if all information about them was disclosed

In most cases, these flows violate some law or the other in their origin, movement or use.

Sometimes, such as when exports are under-priced or when bribes are paid into offshore accounts, there is no actual cross-border flow of money. Capital has fled nonetheless.

In short capital flight refers to the illicit and largely unrecorded (or mis-recorded) movement of resources (assets) and money abroad (mostly to a secretive low tax jurisdiction).

The most common mechanism for this is capital flight through the use of use mis-priced or unrecorded trade and financial transactions. This allows individuals and actors to underreport profits and income in the source developing country hence reducing tax payments.

It's obvious that capital and tax flight are closely related. Money might be secretly taken out of a country for a number of reasons - it may be a bribe or profits from crime for example. Now it is unlikely that whoever has received a bribe will pay tax on it (hence attracting the attention of the authorities who might ask where the money came from) So when this is taken out of the country in the form of capital flight it is largely untaxed.

The same goes from money which results from criminal pursuits.

In any case, it has been estimated that of the as much as \$500-\$800 billion that flows out of developing countries every year in the form of capital flight, as much as 60% is primarily related to commercial tax reducing motives. So the relationship between capital flight and tax flight can be used interchangeably - tax flight could refer to the tax loss on capital flight – for example if \$100 is taken out and a 30% tax is payable then the tax flight component is \$30.

What is the motivation behind capital and tax flight?

The motivation to engage in capital flight comes from two main factors. These are

The Push factors

- The wealth was acquired illegitimately and could be proceeds of corruption or other crimes so there is a chance it would be confiscated by authorities
- The wealth is legitimate but the actor (individual or corporate) does not want to pay taxes on it
- The actor is trying to circumvent other domestic regulations such as restrictions on foreign exchange or investments abroad

The Pull factors

These are usually provided by tax havens and other financial centres most of which offer the combination of following factors which are highly attractive to those engaging in capital flight

- There is zero or low taxation which is financially lucrative and lax regulation
- There is partial or total anonymity provided through bank secrecy or anonymous shell companies or unregistered offshore trusts which means that the risk of detection is negligible
- This is usually combined with a total or partial absence of co-operation on tax matters with the authorities of the source country which minimises the risk of prosecution
- The regulations with regard to movement of money etc are extremely lax which means that once the wealth is in the tax haven, it can easily be moved around

Empirical and anecdotal evidence has shown that the tax evasion motive is responsible for by far the largest proportion of capital flight accounting for about two thirds of all capital flight from developing countries. Hence for the purpose of this paper we use tax flight and capital flight interchangeably.

Which mechanisms are used in tax flight, how big is it and who are the main actors involved?

The mechanisms

Some of the most common mechanisms used for tax flight (both by individuals and corporations) which have a low risk of detection 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 tax havens and other financial centres.
- **Transfer mis-pricing** - When mis-pricing of the kind described above happens between international affiliates of the same multi national firm, 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 is to mis-price financial transfers such as payments of interest, royalties and licence fees etc and payments relating to asset and 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 source and 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 and it depresses tax revenues.
- **The payment of bribes and corrupt monies offshore** - The payment of a bribe always means that the recipient country will not get a fair value on the commercial activity undertaken by the firm paying the bribe so it will lose scarce resources

The actors

Capital flight is driven by a complex web of perpetrators and facilitators who exploit an increasingly sophisticated but poorly regulated and poorly co-ordinated international financial and trading system to their unfair advantage.

These perpetrators include multinational corporations 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 western world, the means and incentives for capital to flee would not exist. These facilitators include:

- **complicit business counterparts** in western countries (for domestic exporters and importers using trade mis-pricing);
- **lawyers, accountants and company formation agents** who design aggressive tax evasion & transfer mis-pricing strategies and incorporate dummy corporations and sham trusts etc
- **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 with nominee directors
- **bankers and financiers** who solicit and enable the flight of capital and manage the illicit wealth once it has fled

The size

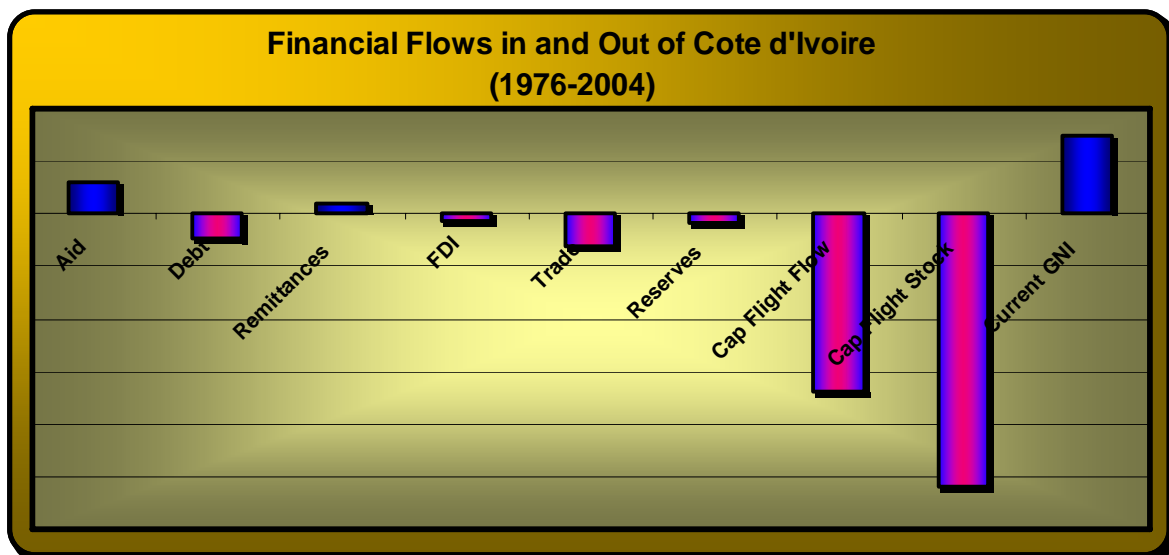
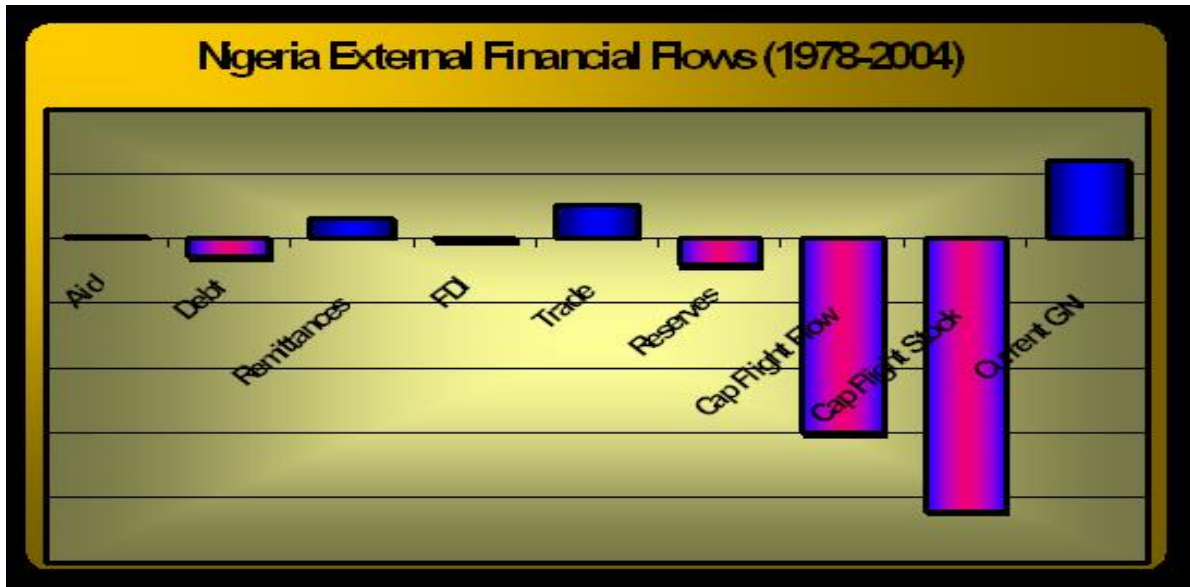
Country level estimates of capital flight show that it is not unusual for a developing country to lose as much as 5% - 10% of GDP annually to capital flight. Globally, one set of estimates arrives at figure of \$539 billion - \$829 billion of annual capital flight from developing countries, which dwarfs the annual aid inflow of \$100 billion.

South Africa, for example, is 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).

Cumulatively, more than \$230 billion is believed to have fled Nigeria and the following graph shows how this figure dwarfs other channels of inflows and outflows from Nigeria.

It is important to remember that 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 passed through tax havens and has been invested in various financial centres in assets such as real estate, hedge funds, stock markets and interest bearing deposits so has been generating return. It is estimated that the stock of this wealth which has been accumulated illicitly is close to \$4-\$5 trillion for developing countries.

Based on various capital flight flow and stock estimates that exist for developing countries, there is probably a resultant annual tax loss to developing countries of at least \$500 billion (tax flight). Clearly this undermines financing for development.



What is the impact of Capital Flight / Tax Flight on developing countries?

Capital and Tax flight undermine

- investment, economic growth and sustainable development
- government revenue, social expenditure and meeting the MDG targets
- a fair distribution of wealth
- good governance in both the public and private sector
- the development of systems of accountability and a vibrant democracy

Capital flight undermines sustainable development by increasing dependence on external resources such as aid that are needed to replace the gap left by the fleeing of domestic capital. Where resources stay within a country, they can be locally consumed or invested to promote economic activity. The escape of such funds depresses economic activity and has a negative impact on long-term growth rates. Tax losses through capital flight (tax flight) are worse than tax losses due to domestic tax evasion as at least if the money stays in the country and is spent locally it can generate economic multiplier effects. They also worsen the distribution of income by shifting taxation away from capital and onto less mobile factors, especially labour and consumption.

The flight of domestic resources abroad undermines the development of an accountable and participative relationship between the state and its citizens. This is reached when citizens' resources are mobilised to fulfil domestic needs – in other words, citizens pay taxes and then hold their governments to account to ensure that the money is utilised properly towards priorities defined by them. If a large amount of such wealth is transferred offshore, incentives to participate in the establishment of a just and functioning domestic society diminish significantly. Also, as aid increases partly to replace lost domestic revenues, countries can become aid dependent which skews the accountability of governments towards donors and away from citizens. It has also been conclusively shown that if the public perceives that rich and powerful actors such as corporations and business and political elite are dodging their taxes then voluntary compliance amongst the rest of the public suffers significantly. This has negative repercussions for revenue and governance.

The infrastructure that facilitates capital flight by allowing vast amounts of capital to flow across borders unchecked and in secret, is also vulnerable to being used by terrorist and criminal networks. This infrastructure also makes it easier to engage in corrupt behaviour, especially through the payment of bribes to, and the diversion of funds by, domestic political and business elites. Such funds are usually stashed offshore, protected by secrecy and privacy which makes detection difficult and hence increases the rewards that can be earned by engaging in corrupt behaviour. Their actions increase within country inequality, reinforce power imbalances, undermine democracy and the rule of law and lead to a deteriorating economic and social situation under which ordinary law-abiding citizens suffer.

Capital and tax flight from developing countries deprive their citizens of a future. The poorest and most vulnerable are those most affected when resources that could otherwise have been used for life-saving and life-sustaining expenditure on basic healthcare and other essential services are illicitly taken out of a country.

What can be done to tackle these flows?

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 – A number of developing countries still do not have proper legislative frameworks for addressing tax flight. Putting in place a comprehensive legislative framework adapted to local conditions increases the risk for those engaging in tax flight and reduces rewards. For example, many developing countries do not have proper legislation in place to check transfer mis-pricing.
- Addressing gaps in legislation – which should also include better legislation for example on the taxation of the extractive sector where on average rich developed countries are able to retain a much higher share of the proceeds compared to poor developing countries which sometimes enact improper legislation with too low a royalty rate (0.6% in Zambia until recently for example) or fiscal stabilization clauses which take away their freedom to change tax regimes.
- Addressing gaps in legislation – most developing countries do not have proper legislation in place to help initiate and assist stolen asset recovery. They should enact this legislation and include tax flight as stolen wealth. Adding tax flight to provisions under the Anti Money Laundering regime and the UN convention on corruption regime would also be very useful.
- Addressing a lack of capacity and expertise - Most developing countries do not have the capacity to catch and prosecute those engaging in tax flight. Providing training, technical assistance and resources to tax and customs authorities, prosecutors and the judiciary increases the risks associated with tax flight. Again, for example, there is been till date, no successful prosecution for transfer mis-pricing in all of Africa. This despite the fact that the practice is widespread.
- Addressing a lack of capacity and expertise – typically when an investment contract is being negotiated especially (but not only) in the extractive sector the MNCs investing in developing countries are at a big relative advantage wrt knowledge about other country regimes, knowledge about the quality and quantity of resource and wrt human resources (many come with team of tens of accountants, lawyers and experts) compared to the developing country (especially when it is relatively new at the game) so they end up getting a raw deal. The international community needs to support developing countries with in house expertise and external truly independent experts to help them get a better deal. Moreover, MNC home countries have an obligation to ensure that the firms from their territories behave in an ethical and responsible way.

- Adopting successful unilateral measures – Many countries both developing and developed, have experimented successfully with a variety of innovative unilateral legislative and operational measures which should be adapted to local circumstances and replicated. Some of these are listed below
 - 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
 - adopting special reporting requirements and fewer exemptions for investments and financial flows to and from tax havens (Argentina and Spain) (reducing rewards and increasing risks)
 - requiring firms to register tax shelters before using them (USA and UK) (increasing risks)
 - introducing a special transaction tax on financial transactions with tax havens (discussed in Germany) (reducing rewards)
 - having a minimum alternate tax on turnover so firms do not have a very strong incentive to under-report profits (India) (reducing rewards)
 - requiring individuals who own luxury goods (such as a car in India) to file tax returns whether or not they have earned a minimum level of income (increasing risks)
 - initiating a cross-departmental program of the kind that exists in Australia (Project Wickenby – which is 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 (increasing risks)
 - starting a program to track and analyse financial transaction data to help tackle tax flight and other criminal activities as is currently done in Australia by the Australian Transaction Reports and Analysis Centre (AUSTRAC) which collaborates closely with the tax office (increasing risks)
 - aiming for legal rulings (as done in the UK and Ireland) which would require banks to report customers with undeclared offshore bank accounts (increasing risks)
 - sharing suspicious activity reports collected under the AML regime with tax authorities. The US and Australia (now the UK) give full access to their tax authorities to all information collected and this has proven to be very useful. This practice should be widely replicated (increasing risks)
 - including a general anti-avoidance principle into taxation law to ensure that those abusing the spirit of the law do not benefit. Countries such as Australia have used it successfully. (increasing risks)

In transit

Capital flight cannot take place without the active facilitation of intermediaries both at the source and destination. In a previous section we have seen how important a role these intermediaries play. These 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 will significantly increase the risks for those engaging in tax flight.

- Ensuring that tax crimes committed in foreign jurisdictions is reportable offence
- Targeting these intermediaries to report suspected tax flight transactions at the risk of prosecution and personal liability if they don't would be a very effective way of tackling tax flight.
- Including tax flight in the Anti Money Laundering regime (to which most countries have signed up) will make it obligatory for intermediaries to report tax flight and capital flight related transactions
- Working up professional codes of conduct which include not facilitating tax flight and ensuring that such behaviour gets reprimanded with possible disqualification to practice would also be very useful tool

At the destination

- Pushing for a complete recording of beneficial ownership information by tax havens. Such requirements need to extend to bank accounts, trusts, foundations, companies and all other legal vehicles. Havens should be pressured into maintaining public registers on such real ownership interests so relevant authorities from other jurisdictions can access them. This would seriously reduce anonymity and the benefits its offers.
- Pushing for a better sharing of information on ownership of and financial flows/assets associated with bank accounts, investments, companies, foundations & trusts registered in these territories significantly increases the risks of detection & 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 the only effective tool
- Increasing the uncertainty of protection behind secrecy through a barrage of actions of the kind taken by Ireland, the UK, Australia and now the United States who through legal tools, summons and subpoenas have forced financial institutions to disclose some details of their offshore operations. This increases the risks of getting caught and is likely to reduce tax flight. The actions of the kind taken by the BND in

paying an ex employee to get hands on data from the LGT bank in Liechtenstein have set off a debate about how far countries should go in pursuit of tax cheats. But irrespective of the legality of the action, there is little doubt that it has contributed significantly to the perception that all layers of secrecy can be breached and it is likely that it will alter behaviour and reduce tax flight.

- Sharing 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. Below are a number of steps that can change the present risk-reward ratios in a way that will significantly reduce tax flight

- The adoption of a country by country accounting standard on trading and tax can help generate information flows which can have a devastating impact in the fight against tax flight.
- The extension of existing OECD and EU information sharing agreements to developing countries
- Restructuring and upgrading the UN Committee on Tax Experts and increasing its resources and authority
- Including the fair payment of taxes in all corporate social responsibility discussions
- Making the IMF and WB focus on the problem of tax flight
- Setting up a UN trust fund to compensate tax havens which agree to stop being havens
- To target intermediaries based in OECD countries or with OECD country qualifications
- Redefining the AML regime to include tax flight as a reportable offence
- Reinterpreting the UNCAC to include tax flight as corruption
- Extending the remit of the Stolen Asset Recovery (STAR) initiative to include fled capital associated with tax evasion. Taxes are, after all, assets stolen from the government
- 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
- Expanding and deepening the mutual assistance in the enforcement of tax policy as provided for in the UN treaty
- Constructing a policy map for successful unilateral policies which can be replicated
- Ensuring that the inappropriateness of the race to the bottom in offering incentives for foreign direct investment is highlighted and that this race is stopped
- Introducing the fair payment of developing country taxation into all discussions of CSR and include a fair payment of taxes into the OECD guidelines for MNCs and the EU code on business taxation
- Adopting a UN code of conduct on co-operation in combating capital flight and international tax evasion
- Push for countries to remove tax haven and harmful practices from the domestic regime (for example USA and Delaware, the UK and its domicile rule etc)
- Develop a multilateral effective automatic exchange of information regime
- Give the issue a higher public profile including through governments producing estimates of their tax gaps and the percentage attributable to tax flight
- **Focus on increasing transparency in cross border financial flows as a means to reduce tax flight, corruption and crime and improve financial supervision and financial stability and highlight inter-linkages – This could link up to the Common Agenda initiative suggested in Appendix IV**

Which institutions are relevant to tackling tax flight and what should they be doing?

- **UN** – The UN has several treaties including the UNCAC (convention against corruption) which can be used to target tax flight. The UNCAC is not self executing so has to be enshrined into national law and can be interpreted to include tax flight within the purview of corruption. When the convention opens to revision in 2010, bringing tax flight into the fold should be one of the primary objectives. This would also help the joint **UN-WB STAR initiative** to target a broader set of assets (such as the product of tax flight) for recovery
- **UN** – The UN also has other conventions such as the UNCTOC – United Nations Convention against Transnational Organized Crime and the UNCITNDPS – United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances and the UN Vienna convention which have given the mandate to the **Anti Money Laundering** regime under the aegis of the **Financial Action Task Force (FATF)**.

- **The FATF** – Should work on including tax flight in the AML regime as a reportable offence. This is quite a potent weapon to generate and share information about suspected tax flight related activities. This could be done either at a country by country level unilaterally (less useful) or through a new UN treaty or an expansion of the UNCAC to include tax flight within its purview.
- **UN** – The ongoing Financing for Development (FfD) process is the appropriate fora to push for the recognition of the seriousness of tax flight and the urgent need for increased international tax co-operation. The **UN Committee of Tax Experts (CTE)** which was upgraded from an ad hoc level following the recommendations from the Monterrey FfD summit still does not have enough resources and has unrepresentative membership with too many tax haven members. In the absence of political will to launch an International Tax Organization, the CTE should be upgraded to a full intergovernmental body (reporting to ECOSOC), should have increased resources and should be restructured to better reflect developing country interests by having fewer tax haven members.
- **OECD** – Through its committee for fiscal affairs the OECD has been leading on the technical aspects of international tax co-operation. However its sole focus on the interests of its members means that thus far it has not played any significant role in helping tackle tax flight from developing countries. The OECD also lost the public relations battle against tax havens which were able to successfully portray its harmful tax competition initiative as a bullying move unfairly targeting poor small island developing countries. However, it can offer significant technical resources both to developing countries and to the upgraded UN Committee of Tax Experts and other relevant fora where tax flight from developing countries might be tackled
- **OECD** - It is in the OECD's own interest now to take up the cause of tackling tax flight from developing countries. The solutions to tackling tax flight from OECD member countries and developing countries (more transparency and information sharing etc) are the same and pitting the interests of sub Saharan African countries against small island tax havens is much better for public relations. There are some signs that the OECD is starting to recognize this.
- **OECD** – The OECD sponsored forum on tax administration should work closely with and preferably under the umbrella of the upgraded committee of tax experts and have tackling tax flight from developing countries as one of its explicit aims.
- **IMF** – The IMF has most expertise on financial flows and taxation but till date has stayed aloof from the problems of tax flight. The IMF should be mandated to track, identify and assist on the repatriation of fled capital and to have tackling tax flight as a core part of its mandate especially when it deals with tax havens and developing country tax systems. It needs to include the degree of financial transparency and co-operation in tackling tax flight when it evaluates tax havens through its ROSC (review of standards and codes) program.
- **The World Bank** has a development mandate but has somehow failed to address the serious undermining of development through tax flight. Moreover the WB and other regional development banks have actually lost most of the in house tax expertise they had. Tackling tax flight and its negative development impact needs to be driven up the World Bank's agenda and it should, for example, do work to compare reducing tax flight to other forms of development finance. Another useful piece of work would be to look at the tax footprint of development moves on trade and investment.
- **The ITD - International Tax Dialogue** – It is a collaborative arrangement involving the IDB, IMF, OECD, UN and World Bank Group to encourage and facilitate discussion of tax matters among national tax officials, international organisations, and a range of other key stakeholders. However it does not include the African development bank and the Asian development bank which would be natural partners. This shortcoming should be addressed and the ITD should be subsumed within the enhanced UN CTE. As a second best, it should meet more frequently have higher capacity and a better political profile. It has the potential to be a good technical resource and a forum for exchange of ideas.
- **The EU/EC** – The European Union has an EU Savings tax directive which though it is full of loopholes has still set a precedent for an automatic exchange of tax related information. Unfortunately this only applies to the tax matters of EU citizens and this should be extended to include sharing information with developing countries with regard to the tax matters of their citizens so tax flight from developing countries can be mitigated. Of course, the loopholes, which include being limited only to European financial centres, looking only at interest income and not looking at trusts, corporations and foundations need to be addressed.
- **The JISTIC - Joint International Tax Shelter Information Centre** – is a recently established (2004) body that brings together the tax administrations of Australia, Canada, Japan, UK and USA to help identify and curb tax shelters used for cross border tax evasion and tax avoidance. The JISTIC should expand its membership or share its work, findings and expertise with developing countries so developing country tax bodies can also tackle the relevant tax shelters used for tax flight from their jurisdictions. As an alternative, the JISTIC should report regularly to the upgraded (to an intergovernmental level) UN committee of tax experts and co-ordinate its work with other bodies such as the ITD, and FTA.

- **The Leeds Castle group** was launched in 2006 and superseded the Pacific Association of Tax Administrators. Group members are Australia, Canada, China, France, Germany, India, Japan, South Korea, the United Kingdom (UK), and the United States of America (USA). The commissioners of these tax administrations meet annually to consider issues of global and national tax administration, particularly mutual compliance challenges. This is one of the very few bodies where developing and developed countries work together on tax related issues and has set a good precedent. The group should be expanded or integrated with or subsumed into one of the other multilateral groups and should have the capacity to focus on international tax administration and compliance (already one of the focus areas) and tackling cross border tax flight in particular.
- **The Seven-country working group on tax haven** - In this forum, Australia, Canada, Germany, France, Japan, the UK and the USA cooperate to improve each country's capacity to deal with the risks tax havens pose to their tax systems. Members bilaterally exchange information at a case and promoter level, share research and information on the schemes encountered and strategies adopted, and conduct joint training sessions. This group should expand its membership to developing countries and support them technically and politically with advice on how to tackle tax flight to tax havens.
- **The Illicit finance task force** – which has been working under the aegis of the Leading group of countries and has been led by Norway has done some excellent work on tackling the issues and raising their profile. However its mandate is about to expire and the ad hoc and transient nature of the task force and limited capacity has been a problem limiting its impact. There needs to be some institutional memory of its work.
- **An integration of multiple groupings** – There are too many bodies working on tax issues and too few working on tax flight from developing countries. Many of these bodies can amalgamate and the suggestion is to bring them under the purview of an upgraded UN CTE. In order to ensure continuity some of these can continue to live on as sub-committees working on specific issues, for instance tax havens albeit with an expanded membership and an additional explicit mandate to address tax flight from developing countries.
- **Launching a permanent secretariat** – with the purpose of co-ordinating and making coherent the tax flight related work across all the institutions and becoming an information sharing, political action and developing technical solutions and technical assistance programs would be an excellent idea which could help successfully tackle tax flight. More ideas on this are in Appendix IV.

Which are the politically realistic and feasible policy measures that Germany should advocate and adopt?

A list of some of the politically feasible measures is provided below. Some of these Germany can enact unilaterally. Some others would work better with a group of like minded donors such as Norway and the Netherlands. Others would need to happen at a multilateral level either at the EU or the OECD or FATF. Still others would require action at the United Nations.

- **Unilateral German action** - Germany could start by
 - sharing any information it might have on developing country citizens from the Liechtenstein list with those countries
 - it should also seek to identify and share appropriate information on all developing country owned assets in Germany that might be linked to tax flight with the authorities in those countries
 - it should also instruct its customs authorities to target the identification of mis-priced trade transactions from developing countries and sharing the information with the appropriate authorities to help tackle tax flight. This can be done with existing tools with very little additional expense
 - it should push Germany based or German licensed intermediaries to disclose the tax flight related activities of their clients
 - it should push for German corporations to adhere to better standards on tax compliance in developing countries
 - it should enact legislation to include tax flight in the AML and UNCAC regimes
 - it should expand the technical assistance it provides in the area of tax administration
- **Technical assistance** - Germany should push for an expansion of technical assistance targeted at tackling tax flight through completing the legislative framework and building capacity would be very effective. In particular, the development of a simple audit/expansion tool suggested by Simon Pak (Appendix III) could be very effective.
- **Technical assistance** – a very small percentage 1-4% of technical assistance goes towards tax policy and administration and much larger amounts are spent on the expenditure side. This needs to change. It should push for an expanded technical assistance for the area of tax administration. Germany should

also push for there to be much more technical assistance from truly independent experts to help developing countries negotiate contracts with investors especially in the extractive sector.

- **EU/EC** - Germany should push for
 - The expansion of the EU Savings Tax Directive to cover the assets of developing country citizens. This, even if agreed just in principle, could prove to be very effective in helping reduce tax flight from developing countries
 - The sharing of EU customs data involving mis-priced trade with developing countries would perhaps be an even more cost efficient and less contentious tool to help tackle tax flight.
 - The EU to make disclosure of tax flight related activities mandatory for intermediaries located and licensed there.
- **OECD** – As suggested above, Germany should push the OECD to warp its harmful tax competition work in development colours. This would prove to be a win-win proposition for both OECD countries and developing countries both of which suffer from tax flight as the solutions to tackle the problem are similar.
- **G8** – Germany, along with France should push the G-8 to put the issue of tax flight and tax havens on the G8 agenda. Preferably this should be done in a way that also highlights the development aspects and pin points the shared interests of G8 members and developing countries in tackling this problem. The next G8 in Canada is a good opportunity to do this. It could do this under the ‘enhanced financial transparency’ agenda (see Appendix IV)
- **G8/Financial Stability Forum(FSF)/European Central Bank/IMF** – Germany should highlight the inter-linkages between the prevalence of secrecy provided by tax havens and anonymous corporate and trust vehicles and the threat to the financial system from insufficient regulatory oversight (the sub prime crisis and off balance sheet risks), the expanded possibilities for hiding risks and manipulating profits (aka Enron) corruption (aka Elf, BAE, Siemens, Suharto) and tax flight from both rich and poor countries (aka Liechtenstein).
- **IMF/WB** – Germany should use its position to drive tax flight up their agenda as suggested above
- **FATF** – Germany should push for tax evasion to be made a predicate offence under Money Laundering legislation
- **UNCAC** – Germany should push for corruption to include tax flight under UNCAC provisions into its domestic laws and also push for other countries to do the same. When the UNCAC opens for revision, Germany should lead the charge to redefine corruption to explicitly include tax flight
- **IASB** – Germany should push the International Accounting Standards Board to adopt the country by country reporting standard that has been discussed at the European parliament recently
- **Corporations** – Germany should call for a stricter application of the OECD guidelines on MNCs and always use paying full and fair taxes in all discussions on corporate social responsibility
- **Germany should use its membership of the UN, OECD, Leeds castle group, seven country working group and the IMF/WB and Regional development banks to integrate their work better especially with regard to tackling tax flight from developing countries**
- **New Initiatives** – Germany should seriously consider launching the initiatives discussed briefly in Appendix IV

Additional Recommendations for the Doha Financing for Development Process – Germany should

- Increase the focus on creating an enabling environment for Domestic Resource Mobilization, Retention and Recovery
- Seek to highlight the enormous magnitude of the problem – with discussions on various estimates for the loss of domestic resources through illicit financial flows, statistics on mis-pricing, and losses due to tax flight and tax competition etc
- Discuss more explicitly the inter-linkages between the lack of international tax co-operation and capital flight on the one hand and trade and investment on the other. More specifically, the issues of tax competition, trade mis-pricing, transfer mis-pricing and profit shifting should be discussed and debated
- Make a stronger reference to the need for a greater transparency of financial flows, highlight the links between tax flight, capital flight, international corruption and other illicit financial flows and how tools used to address one can be used to tackle others.
- Also highlight the important possibilities for plugging current leaks as well as recovering fled capital as a means of mobilizing domestic resources, financing development expenditure and reducing inequality. The links between corruption and tax flight should be emphasized along with a call for the expansion of the definition of corruption
- Discuss 1) the international financial and economic money flow landscape in the form of increased financial liberalization, trade liberalization, trade of services, cross-border investments, use of intangibles such as under TRIPS, complexity and speed of international financial transactions etc as well

as the 2) regulatory landscape in the form of WTO, free trade agreements, bilateral investment treaties, tax treaties etc are having on the fiscal space in developing countries.

- Highlight the pernicious impact secrecy and the lack of international regulatory co-operation as a systemic problem
- **Push for the Committee of Tax Experts (CTE) to be upgraded to a full inter governmental body, with greater resources and an expanded developing country representation and the authority to be the international apex body for matter relating to increasing international tax co-operation**

End

About the Author

Sony Kapoor is the Executive Director of DEFINE – The Development, Environment & Finance International Exchange, a soon to be launched new international Think Tank. He has a professional background in investment banking and in development finance. Sony has been a key adviser to several governments and international organizations.

Appendix I – Relevant UN fora discussions relevant to tackling tax flight

Doha draft text

- 10) We will strengthen efforts to increase tax revenues through more effective tax collection and modernization of tax legislation including through simplification of the tax system, broadening of the tax base, and strongly combating tax evasion. To support individual country efforts in these areas, it will be important to enhance international cooperation in tax matters and broaden participation in the development of international tax norms and rules. We will consider strengthening the United Nations Committee of Experts on International Cooperation on Tax Matters by upgrading it to an intergovernmental body.
- 11) Capital flight is a major hindrance to the mobilization of domestic resources for development and efforts should be strengthened to address the various factors that contribute to this. It is vital to address the problem of illicit financial flows. Additional measures should be sought to prevent the transfer abroad of stolen assets and to assist in their recovery, as well as to prevent capital flows that have criminal intent, such as the financing of terrorism.
- 12) Corruption is a phenomenon that can affect developed and developing countries, and the public and private sectors, alike. The Monterrey Consensus underlined that fighting corruption at all levels is a priority. We are thus determined to combat corruption in all of its manifestations. This requires strong institutions at all levels, including the strengthening of the legal and judicial systems.
- 17) Measures should be devised to avoid over-exploitation of natural resources, while enhancing transparency and accountability of revenues from extractive industries, both national and foreign-owned, taking into account, where appropriate, the implementation of relevant initiatives on extractive industries.
- 51) Enhanced financial information and transparency in the financial operations of public and private financial institutions, particularly banks, are key elements for a well functioning international financial system. National regulators should enhance financial information and transparency at the domestic level. We will further endeavour to strengthen cooperation among national regulators to adopt adequate common standards, as financial resources flow increasingly across borders.
- 52) The emergence of new and highly globalize financial instruments is changing the nature of risks in the world economy. It is important that regulatory agencies in cooperation with the IMF, the Financial Stability Forum (FSF) and other agencies, both public and private, examine the factors that might increase systemic risks and trigger systemic crisis, in particular the various unregulated activities in international financial markets, with a view to assess whether further regulation at the national and international levels is necessary.
- 56) Most efforts in the formulation of standards and codes have taken place outside the multilateral system. It is crucial to ensure an effective and equitable representation of developing countries in standards and norms-setting bodies. While these bodies have increased consultation with some countries, more should be done to broaden the participation. We recognize that the implementation of standards and codes in developing countries with less advanced financial systems should be flexible.

Some Comments on the Doha draft text

Overall the text is an improvement on the Monterrey text in terms of highlighting the importance of tax flight related issues and the need for action. However, it still leaves a lot to be desired.

- The text should highlight that Domestic Resource Mobilization is the most important and central source of development finance. Furthermore it should highlight the importance of tax and royalties.
- It should highlight that this mobilization can happen only under an enabling international environment where cross border tax flight needs to be addressed.
- Furthermore it needs to highlight the complementarity between domestic resource mobilization, retention and recovery.
- Para 10 should add cross border tax flight to tax evasion, beef up the “consider strengthening” to strengthen or upgrade add significantly to enhance international co-operation in tax matters
- Para 11 should talk about retention and repatriation of domestic resources and explicitly include tax flight in stolen assets
- Para 12 should add include tax flight in the category of corruption
- Para 17 should add an explicit reference to the adoption of a country by country accounting standard
- Para 51 should make an explicit reference to the need to enhance transparency of financial flows
- Para 52 should make reference to the role of tax havens and non transparent corporate structures in triggering financial instability
- Para 53 should make an explicit reference to the need for a UN code on taxation
- The problems of lack of co-operation on tax issues as well as the lack of transparency in international financial flows should also be part of the systemic chapter

Issues that are partially addressed

- The Doha draft has no mention of the need to have a global tax body despite the fact that the Zedillo report and other background documents for the conference had an extensive discussion of the need and the potential role for such a body.
- On the positive side the draft talks about the need to enhance international co-operation in tax matters and broadening participation in the formulation of international tax norms and rules
- The draft refers to the possibility of strengthening the UN CTE by upgrading it to an inter-governmental body
- However the UN committee of tax experts, while fulfilling a very useful role no doubt, simply does not have the resources, staff, profile and legitimacy to take on the challenges. Repeated calls have been made for the UN to broaden and deepen its work on issues of international tax co-operation.
- While the Doha draft makes progress in recognizing that capital flight undermines domestic resource mobilization and talks about the need to address the various factors that contribute to it, it does not explicitly link the problem to the lack of international tax co-operation and the endemic lack of transparency in international financial flows. These linkages need to be made explicit. In addition, the links between capital flight and cross border tax evasion on the one hand and other illicit financial flows such as money laundering, terrorist financing and international corruption on the other should be made explicit.
- Again progress has been made on highlighting the need to prevent the expatriation of stolen assets and to assist in their recovery. It might be useful at this point to try and expand the definition of stolen assets which has suffered from a rather narrow interpretation up until now.
- For none of these action does the draft point to a specific responsibility for an institution – this is a shortcoming
- Progress has been made on talking about the need for greater transparency of extractive revenues and subscribing to the implementation of relevant initiatives – but nothing is said about fairness or ensuring that developing countries benefit from the extractive sector or the country by country reporting standard
- While there is mention of the need for enhanced transparency in financial institutions, no reference is made to the need for greater transparency of corporate and other legal vehicles such as trusts which are critical both for the protection of financial stability as well as for the prevention of capital flight
- The strong inter-linkages that exist between tax regimes and international tax co-operation on the one hand and trade and investment flows on the other receive no mention in the original financing for development discussion
- The emphasis on better tax collection, modernization of tax legislation (simplification should go – its not obvious that the tax code needs to be simplified), broadening of the tax base and combating tax evasion is good. As is the idea of supporting countries in doing this.

- Reference should be made to the magnitude of capital flight – as it was in the high level dialogue 2007 - Referring to the issue of large net transfers out of developing countries - as it adds to the urgency of addressing capital flight which is not captured by these numbers and by some estimates is as large as the recorded net outward transfers of \$500 bn - \$750 bn seen in recent years
- The high level dialogue also asked for a special focus on reducing cross border tax avoidance and tax evasion and increasing transparency in international financial transactions to curtail capital flight, money laundering and terrorist financing – this was very significant as it clearly established the links (in the channels used) between tax evasion, capital flight, money laundering and terrorist financing all of which thrive in an environment which lacks transparency
- All references to a progressive tax system have been purged. No mention of tax competition and tax incentives offered for investments
- Even the EU draft says To support an enabling fiscal policy, reform of tax policies and tax administrations (i.e. to enhance progressivity, diversity and stability of tax revenues) play a crucial role and can potentially improve several dimensions of economic, financial and political governance at the same time and might also be suitable to address income inequalities.

Issues that are not addressed at all

- **The magnitude problem – while improvements on all the chapters of Doha (DRM, FDI, Trade, ODA, Debt etc) will have a positive development impact, no effort has been made to highlight the relative importance of each of these chapters for financing development.** While the magnitudes of FDI, Trade, ODA and Debt etc are well-known and widely discussed, the same is simply not true of Domestic Resource Mobilization - especially the opportunity cost of the lack of international tax co-operation and the losses inflicted on developing country finances by capital flight.

Because these are not as widely discussed and debated and because data and estimates are hard to come by, the lack of any mention of the size of the problem means that while fine words would be forthcoming on the need to act – real action by policy makers themselves would continue to focus on the more tangible and traditional development finance issues of FDI, Debt, Aid and Trade. This could be one of the reasons why developing country groups, including the G-77, have been relatively passive about the issues of capital flight and lack of international tax co-operation and instead have continued to focus much of their energy and attention on the more ‘traditional’ issues.

Recent estimates of the (admittedly imputed) losses to developing countries have consistently generated eye popping numbers which when brought into the current discussion can help shake them out of their complacency. It is clear that progress on tackling capital flight and increasing international tax co-operation can reap significant development finance dividends which additionally have the advantage of reducing developing country dependence on north to south flows such as aid which almost always restrict policy space through the use of conditionalities.

- **While one of the big achievements of the FfD discussion was that a comprehensive range of issues were discussed under the various chapters, one of its biggest shortcoming was that many of the important and critical inter-linkages between the issues covered by the various chapters were missed out.** This is especially important w.r.t. the issues under discussion in this paper. The inter-linkages with trade and investment issues is particularly important

For example, the issue of tax competition where developing countries are offering tax holidays, lowering their statutory tax rates and sometimes offering preferential tax treatment to foreign investors is of particular importance. Many studies have shown that tax regimes play only a limited role in investment decisions so this current race to the bottom is the result of a failure of co-ordination and can be substantially addressed by increased international tax co-operation. This current state of affairs is partly the result of the scramble to attract real investments and private capital flows which is extremely fashionable but not sufficiently well thought out.

The development impact of private financial flows including FDI is determined at least to a substantial degree by their impact on the fiscal balances and the external balances of the host country so not highlighting this in the discussion at the FfD discussions was a serious oversight. Perhaps a more balanced discussion of the fiscal impacts of investment policy as well as the recognition of the potential threat to the domestic private sector from over favouring foreign investments would lead to better investment policy making and increase the availability of financing for development. Increased round tripping, where domestic investors engage in capital flight from their home country and then bring the money back in the guise of foreign investment to take advantage of special tax breaks is an example of the distortions resulting from lack of discussion of these inter-linkages.

The lack of discussion of the fiscal impact of changing trade patterns is another serious oversight which was only partly addressed in later documents when the negative fiscal impacts of tariff reduction were discussed. For example, the mis-pricing of trade transactions, which is the largest channel for the flight of capital (and therefore a channel for cross border tax evasion and tax avoidance), was not even mentioned. The principal of reciprocity supposedly applies to trade discussions so leaving out the serious capital flight and tax evasion elements which result from the mis-pricing of the ever growing volume of trade transaction ignores a serious element of the cost-benefit analysis.

The confluence of investment, trade and fiscal issues which is happening as a result of the increased prevalence of global integrated production networks where substantial amounts of trade is in the form of intermediate goods between MNC affiliates and other related corporate entities, is another issue that needs to be urgently addressed. Again, it has not been on the horizon for the ongoing and current discussions on financing for development. These production networks substantially increase the scope for transfer mis-pricing and profit shifting which has serious negative impacts on the ability of developing countries to mobilize resources domestically.

International Conference on Financing for Development – A/CONF/198/1, 2002

- Perhaps the biggest contribution of Monterrey was to recognize that domestic resources could not be mobilized effectively in the absence of an enabling environment which in turn could only come about through the support of the international community, on international tax co-operation in particular.
- The decision to prioritize the negotiation and ratification of the UN convention against corruption and include language on improving transparency and information about financial flows was also significant.
- It suggested that there was a need to “Strengthen international tax cooperation, through enhanced dialogue among national tax authorities and greater coordination of the work of the concerned multilateral bodies and relevant regional organizations, giving special attention to the needs of developing countries and countries with economies in transition;”
- *Following Monterrey, the UN ad hoc committee on international co-operation in tax matters was upgraded to the UN Committee of Experts on International Cooperation in Tax Matters (CTE) in and in 2007 the UN convention against corruption finally came into force.*

Subsequent UN meetings such as the two discussed below reemphasised the Monterrey perspective on the central role of Domestic Resource Mobilization and the need for enhanced international co-operation on tax matters and capital flight. Participants at these meetings build on the agreements reached at Doha and they further enriched the discussion by

High-level Dialogue on Financing for Development - A/62/550, 2007

- Emphasising the need for improving the tax base, making the tax system more progressive the need for better tax administration – *all of which are central to domestic resource mobilization and require significant progress in international tax co-operation*
- Referring to the issue of large net transfers out of developing countries - *as it adds to the urgency of addressing capital flight which is not captured by these numbers and by some estimates is as large as the recorded net outward transfers of \$500 bn - \$750 bn seen in recent years*
- Drawing attention to the good work being done by the UN committee on tax experts but highlighting that for this work to be effective there was a need to both broaden and intensify work on international tax co-operation
- Suggesting that for this work to be effective the UN CTE might need to be upgraded to an inter-governmental body or that discussions on having an ‘international tax organization’ should be revived
- Asking for a special focus on reducing cross border tax avoidance and tax evasion and increasing transparency in international financial transactions to curtail capital flight, money laundering and terrorist financing – *this was very significant as it clearly established the links (in the channels used) between tax evasion, capital flight, money laundering and terrorist financing all of which thrive in an environment which lacks transparency*
- Additionally asking for a special focus on the repatriation of proceeds of corruption

Follow-up to and implementation of the outcome of the International Conference on Financing for Development - A/62/217, 2007

- Highlighting the importance of expanding the fiscal space of developing countries

- Recognizing the significance of the contribution that fees and royalties, especially from natural resource exploitation, can make to expanding this fiscal space
- Critically recognizing the inter-relationships between fiscal issues and trade policy by making reference to the fiscal impact of rapid trade liberalization
- Reiterating the need for developing countries to make their tax systems more progressive, diverse and stable and how such systems have a role to play in reducing inequality
- Calling on the global community to more effectively co-operate to help curb international corruption
- Recognizing the need for an equitable tax yield from investment and trade
- Drawing attention to the fact that international tax evasion/avoidance can distort the playing field in favour of large multinational firms over domestic small and medium enterprises
- Highlighting that international co-operation against tax evasion can also help tackle international crime and terrorism
- Recognizing the small but nonetheless significant differences between the OECD and the UN approaches to international tax treaties which roughly represent the developed country developing country divide
- Calling for the UN to broaden and deepen its work in the field of international tax co-operation especially by addressing emerging issues and issues of particular relevance to developing countries

Other UN summits such as the 2005 World Summit which resolved to "...support efforts to reduce capital flight and measures to curb the illicit transfer of funds" have also contributed to expanding, legitimizing and deepening the discussion on the need for international co-operation on tax and related matters.

Appendix II - Foreign Direct Investment and Domestic Resource Mobilization

Tax competition and foreign direct investment

" the idea that FDI responds to rather than creates success has met with resistance and the notion that it may carry costs as well as benefits almost completely ignored" UNCTAD, World Investment Report 2005

In many countries, attracting investment has become the sum total of industrial policy. Under the original 'Washington consensus' and its subsequent variations, foreign investment is regarded as the central engine for economic growthⁱ.

Given the insistence of key donors like the US, the IMF and the World Bank on the Washington Consensus, attracting FDI is now at the top of the economic policy agenda for most developing countries. For years developing countries have been told that to get more FDI they have to liberalise their investment regimes and deregulate.

In the global competition for FDI most countries have now opened up most of their economies to foreign sectors. This has been accompanied by a number of measures to actively attract FDI, usually involving incentives, such as subsidies, cheap land, tax holidays and breaks, and exemptions from regulations, including environmental and labour standards. Between 1991 and 2002, 95% of changes to investment regimes globally were designed to attract FDIⁱⁱ.

The Bolivian oil and gas industryⁱⁱⁱ

In 1996 the Bolivian gas and oil industry was privatised, under heavy pressure from the IMF^{iv}. The government negotiated a deal with a consortium of companies from the USA and Europe, offering them generous financial incentives to invest and the state company YPFB was sold off for a total of \$835 million^v.

The companies paid very little tax on the value of the gas and oil extracted at the wellhead^{vi} - only 18% of the market price for the new reserves which made up 95% of Bolivia's reserves, and 25% on the rest. The government hoped these low rates would increase investment in gas and thereby boost production. However, while production did increase dramatically at these low tax rates Bolivia's earnings barely rose. The companies involved, including British Gas, BP and others continued to enjoy healthy profits, while rapidly depleting Bolivia's main non-renewable resource. Only 8,737 people were employed in the sector^{vii}. In addition, despite having very low local production costs^{viii}, Bolivians were paying US\$1.60 per gallon for petrol, almost as much as US consumers.

As the Bolivian example shows, offering tax incentives is often likely to carry an immediate opportunity cost in terms of lost government revenues and 'could be considered equivalent to a (hidden) subsidy that developing countries are providing to MNCs^{ix}.

Chile Copper mining^x

Chile under Pinochet followed fiscally permissive economic policies and did not charge royalties for the use of natural resources. These policies over-stimulated investment and resulted in overexploitation of natural resources in the short run. As Chile is the largest producer of copper these policies have contributed to a long cycle of overproduction and low prices in the world copper market, with several negative implications for the domestic economy, employment in the mining sector and government revenues.

Copper production tripled in the 1990s, so now Chilean exports account for about 40% of the world market. Finally, following the initiative of a group of members of the National Congress, the Chilean government introduced, on 5 July 2004, a 3 per cent royalty on the sales of copper producers.

Facing revenue shortfall, the developing countries, which are trying to attract investment and stimulate growth, are being played off each other by MNCs who demand increasing tax concessions. Economically, this competition amongst countries is a zero sum game with MNCs and mobile capital being the prime beneficiaries.

Drastically reduced corporate tax rates and ever more generous tax breaks and tax holidays have meant that MNC's have reduced their tax liability dramatically. In some cases such as Honduras, most foreign investors have no tax liability. In Senegal, Jamaica and Namibia firms have been granted permanent tax exemptions and tax holidays in export promotion zones in many countries such as Sri Lanka are now being stretched to as much as 20 years^{xi}. In some countries such as Guatemala, where state expenditure barely reaches about 10% of GDP tax revenues is so low that the state is in danger of disintegrating.

In particular cases, especially in Africa, certain investment projects have been associated with 'negative rates of taxation' where states already offering zero tax rates have tried to outdo each other in the provision of subsidies. More than 120 countries now have some form of investment promotion policy in place most of them including tax breaks.

This has happened despite the fact that evidence linking tax breaks to increased long term investment is at best ambiguous^{xii}. Though there are, no doubt, individual cases where tax rates have swayed locational decisions, there is overwhelming evidence that MNCs rank quality of infrastructure, well-educated workforce and a local dynamic market far higher in their list of priorities. All evidence points to the idea that governments have conceded too much to MNCs in exchange for too little^{xiii}.

Hence, severe tax competition means that the potentially positive benefits of FDI are being heavily undermined and the negative impacts (through provision of subsidies, the competitive disadvantage for local firms, the erosion of government revenue and a restriction of policy space) are being amplified. Below is a table of some concessions offered to MNCs for investing in Tanzania.

| The concessions | | | |
|--|---|--|--|
| <ul style="list-style-type: none"> • The right to deduct 100 per cent of capital expenditure from taxable income in the year in which it is incurred, even though this means no tax will be paid in early years of mining operations because losses can be carried forward and offset against future liabilities. • The right to increase the claim for capital expenditure by 15 per cent a year if they declare a taxable loss. This inflated expenditure is then carried forward for offset against income in future years. Under this scheme the chances of taxable income | <ul style="list-style-type: none"> • arising are significantly reduced. • A royalty rate of 3 per cent on gold exports. Other gold-exporting countries in Africa, such as South Africa and Ghana, charge similar amounts: Ghana a minimum of 3 per cent and South Africa 2.1 per cent, although in both cases more profitable companies pay more. The figure also compares badly to the 10 per cent Botswana charges for diamond extraction. • Payment of the royalty can be deferred if the 'cash operating margin' (that is, revenue minus operating costs such as capital expenditure and interest on | <ul style="list-style-type: none"> • loans) falls below zero. • Exemption from corporation tax of 30 per cent of profits, if operating at a cash loss. • Zero per cent import duty on capital goods and fuel. • Five per cent import duty on spare parts for first year but then zero thereafter. Similar arrangement for mining exploration equipment such as explosives and lubricants. • Exemption from capital gains tax. • Exemption from VAT on imports and local supplies of goods and services. • Stamp duty on buying property or shares reduced from standard 4 per cent to | <ul style="list-style-type: none"> • a maximum of 0.3 per cent. • Right to keep accounts in US dollars, which offers protection from currency exchange costs. • The right to repatriate 100 per cent of profits. • Foreign firms guaranteed 100 per cent ownership of mines. • The right to employ unlimited numbers of foreign nationals. • Losses are not 'ring-fenced' within the country, which allows companies to combine costs and income from one mine with those of other mines when calculating tax liability. |

Tax Avoidance and Profits Laundering

Anecdotal evidence also suggests that in addition to aggressively negotiating for tax concessions some MNCs also engage in aggressive tax avoidance strategies. Some of the most common ones are:

- 1) Using inaccurate prices to value inter-subsidiary trade transactions in such a way so as to maximise profits in a low tax jurisdiction (transfer mis-pricing). This is dealt with in the next section on trade.
- 2) Using intra-corporate or parent subsidiary financial transactions such as loans from parent to subsidiary at exaggerated interest rates to shift profit out of the host country.
- 3) Using exaggerated values for intangibles such as goodwill or patents and royalties etc. to underreport profit.
- 4) And a whole host of other such practices such as mis-invoicing the quality and or quantity of imports and exports.

"The tricks are simple. World bouquet plc, let's call it, imports flowers to sell in Britain from a Colombian associate—and pays a "transfer price" that is double the real price. Or maybe World bouquet (Antilles) raises \$500m and lends it on to the British company—at an excessive rate of interest. In either case, the result is fat profits abroad, none in London^{xiv}."

High interest inter-corporate loans used for tax avoidance in Chile Copper Mining^{xv}

Despite record levels of copper extraction in Chile, private mining companies, with only two exceptions, paid no taxes until recently. Private companies extracted and exported 20.8 million tonnes of copper between 1993 and 2002, roughly equivalent to two years'—worth of world consumption. The value of these exports amounted to more than \$34 billion, with the net income of private companies roughly half that sum.

Meanwhile, they have paid just \$1.7 billion in taxes, while accumulating \$2.6 billion in tax credits, thus holding the Chilean state liable for a net \$900 million. *Compañía Minera Disputada de Las Condes*, a mine owned by Exxon, ostensibly operated at a loss for 23 years. Therefore, it did not pay any taxes at all and, on the contrary, accumulated \$575 million in tax credits. Nevertheless in 2002, Exxon (by then Exxon Mobil) sold this "money-losing" operation for \$1.3 billion. Exxon had engaged in the practices mentioned above, and exported the mining operation's substantial profits, mostly disguised as interest payments to Exxon Financials, a subsidiary in Bermuda.

Microsoft using royalty payments for tax avoidance^{xvi}

Microsoft, which has set up an Irish subsidiary, is being accused by the Inland Revenue Service of the United States of having avoided hundreds of millions in taxes. The IRS says that Microsoft has transferred the ownership of hundreds of its patents over to its Irish subsidiary for a below market value and the Irish subsidiary is now charging significant royalty costs for the use of these patents from Microsoft entities world wide and avoiding taxes in many countries.

Microsoft subsidiaries in the developing world also have to pay these substantially higher royalties which means that they too are reporting lower profits than they otherwise would. This has a negative impact on taxes paid in developing countries.

The Wall Street Journal wrote that "a law firm's office on a quiet downtown street [in Dublin, Ireland] houses an obscure subsidiary of Microsoft Corp. that helps the computer giant shave at least \$500 million from its annual tax bill. The four-year-old subsidiary, *Round Island One Ltd.*, has a thin roster of employees but controls more than \$16 billion in Microsoft assets. Virtually unknown in Ireland, on paper it has quickly become one of the country's biggest companies, with gross profits of nearly \$9 billion in 2004."

The use of transfer pricing, shell companies and tax havens to avoid taxes^{xvii}

Volcafe is the world's second largest trader of raw coffee and has a market share of 13%. The papers [uncovered by an investigation] reveal a hidden world in which Volcafe transfers millions of dollars from its subsidiaries in the coffee-producing countries to a 'phantom' operation in Jersey called Cofina. It is a complex structure in which Volcafe buys beans from small co-operatives in developing countries at the market price, say 80 cents a pound of coffee. It then 'sells' the raw coffee to Cofina in Jersey at a similar price. Cofina sells this on

to customers such as Nestlé and, in the past, Starbucks. By trafficking the beans through the tax haven island, the bulk of Volcafe's profits are made there, which means it pays minimal tax to the developing countries.

The Observer has seen confidential details of Cofina's 1998 accounts showing that while most of Volcafe's subsidiaries in developing countries made marginal profits and paid no tax, Cofina sold \$408 million (£224m) worth of coffee and made a gross profit of \$27m. The firm paid no tax because the profit was booked in Jersey.

Yet Cofina does not really exist: it is just a postbox operation with one or two administrative staff. The beans Volcafe buys from farmers are delivered straight from the coffee countries to the end customers such as Nestlé.

Company documents reveal that the firm goes out of its way to keep everything top secret. Volcafe employees are told to identify themselves as staff of Cofina, although they are not. One document states: 'You should program your fax machine in a way that your name does not appear on faxes dispatched in the name of COF [Cofina].'

A significant percentage of FDI is channelled through tax havens to provide zero tax jurisdictions to accumulate profits through the mechanisms such as those discussed in the boxes above. An equally important for using these jurisdictions is the secrecy they provide which makes detection very difficult and minimise the likelihood of success of any investigation by tax authorities.

Cayman islands, a tax haven of 70,000 people for example, had an inward FDI stock of \$25 billion in 2000. While this is very high for such a small population the real story unfolds when we look at the stock of outward FDI which was more than \$20 billion. So investment is merely being routed through tax havens. Liberia, one of the poorest and most inhospitable countries in the world had an inward FDI stock 483% of its GDP in 2004. Of course, the only reason it is so attractive for foreign investors is because it too is a tax haven. Outward FDI stock for 2004 was also a staggering 280% of GDP.

Appendix III - A tool for tackling tax/capital flight through the trade mis-pricing channel

This tool has been suggested and this appendix written by

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In June 2005, the U.S. imported 32,000 GM of scrap gold from Mexico and paid US\$825,000. What is interesting about this import is that the unit value of the scrap gold US\$25.78/GM (equivalent to US\$801.85/oz) is substantially higher than the price of pure gold at the time, about US\$14.16/GM (equivalent to US\$440.85/oz.) The U.S. importer clearly overpaid for the scrap gold, sending capital to Mexico and reducing taxable income.

In August 2005, the U.S. imported 46 million GM of gold doré from Peru at US\$1.79/GM (equivalent to US\$55.54/oz), paying a total of US\$82 million. The median price for gold doré is US\$12.47/GM based on an analysis of the 2005 U.S. import data. The Peruvian exporter sold gold doré at an abnormally low price, sending capital to the U.S. in the form of valuable commodity equivalent to about US\$574 million in value for a mere US\$82 million payment and reducing taxable income.

The two examples above are not particularly unusual. A detailed statistical analysis of the U.S. merchandise import and export data published by the U.S. Government reveals abnormally low priced U.S. imports and abnormally high priced exports are quite common

For example, total exports from the Czech Republic to the U.S. were reported to be US\$2.21 billion in 2005. This sum did however represent an estimated underreported amount through abnormally low prices of US\$1.25 billion when calculated as deviations from lower quartile prices. Congo's 2005 total export to the U.S. were reported to be US\$262 million with an estimated underreported amount of about US\$35 million. In fact, the total underreported amount in all of the U.S. imports from all countries was estimated at approximately US\$202 billion in 2005 through abnormally low priced imports. [See table 1]

In 2005, the Philippines imported a total of US\$6.9 billion worth of merchandise from the U.S. The estimated over-reported value of the Philippines' imports from the U.S. was US\$1.1 billion through abnormally high priced imports from the U.S. when measured as deviations from upper quartile prices. Similarly, Malaysia's 2005 imports from the U.S. included approximately US\$1.4 billion as an estimated over-reported amount. In fact, the total

over-reported amount in all of the U.S. exports to all countries was estimated as approximately US\$50 billion in 2005 through abnormally high priced exports. [See table 2]

The underreported amount of US\$202 billion in the 2005 U.S. merchandise imports and the over-reported amount of US\$50 billion in the 2005 U.S. merchandise exports represent 12.1 per cent of total U.S. imports and 5.5 per cent of total U.S. exports respectively.

Abnormally priced imports and exports may be due to recording or clerical errors in customs documents, heterogeneity of products within a given harmonized commodity code classification, or false invoicing. Physical inspection and/or investigation by the customs authority are necessary to determine the exact explanation for each abnormally priced trade.

False invoicing facilitates capital movement, money laundering, and duty or income tax avoidance. Abnormally high priced import transactions may be used to avoid income taxes by reporting high cost of goods sold resulting in a smaller amount of taxable profits reported. They may facilitate capital flight and money laundering through remittances disguised as seemingly legitimate payments for merchandise imported which has substantially lower value than being reported. They may also conceal illegal commissions that are hidden in the inflated prices.^{xix}

Abnormally low priced import transactions may reflect attempts to avoid or reduce import duties or the dumping of foreign produced goods at below market prices as a means of driving out domestic competition.^{xx}

Similarly, abnormally low priced export transactions may be utilized to avoid income taxes by reporting lower revenue resulting in a smaller amount of taxable profits reported. They may facilitate capital flight and money laundering by shipping valuable merchandise at prices substantially lower than true market value. This has the effect of sending valuable merchandise instead of money through seemingly legitimate export transactions. Abnormally high priced exports may also be used to exploit export subsidies available from several developing countries with export incentives.

Abnormally priced import and export transactions can be detected easily using a statistical approach, such as "price filter matrix." A price filter matrix can be constructed by calculating median price, upper quartile price, and lower quartile price for each harmonized commodity code by country using the most detailed import and export database collected and maintained by a customs agency of a country. Mean and standard deviation of prices may be calculated instead of median and upper/lower quartile prices.

The price filter matrix constructed may then be used to set an upper bound and a lower bound of prices to determine each import and export transactions as abnormally high or abnormally low.

The price filter matrix can be built for each commodity code and trading country combination, may be effective in identifying abnormally priced import and export transactions, can be used for real-time inspection of cargo, and can also be used to estimate the amount of over- and under- pricing in export/import transactions. The steps described above can be automated through the use of computerized processes. Once an import or export transaction is flagged as abnormally priced, the customs agency will need to inspect physically and investigate the flagged transaction in detail to determine if the price of the flagged transaction is due to false invoicing or not. This approach will facilitate efficient customs clearance and fast movement of merchandise cargo at the ports.

A price filter matrix is calculated and used in estimating the amounts of capital movement and income shifting for 2005 U.S. imports and exports in tables 1 and 2. The dollar amounts are computed by aggregating the amount deviated from lower quartile price for every abnormally low priced U.S. import and the amount deviated from upper quartile price for every abnormally high priced U.S. export.

Countries adopting the statistical approach using a price filter matrix will be able to control and determine, by adjusting the upper and lower price bounds, both the level of physical inspection and the means of inspection that will result in the cost effective monitoring of their international trade flows.

When a country plans to implement the statistical approach in monitoring the transaction prices of international trade in an effort to minimize capital flight, duty and income tax avoidance, and money laundering, the following steps may be considered:

- i) Generate and update the relevant statistical price filter matrix regularly;
- ii) Employ a network of workstations and servers at the country's ports to facilitate the computerized analysis of international trade prices in real time;

- iii) Use a printed price filter matrix if the country does not currently have computerized trade data entry system and need to implement the system manually;
- iv) Decide who will conduct the audit of trade documents and the physical inspection of cargo with suspected transactions prices. This can be done by a private inspection firm or its customs agency.

Appendix IV - Brief ideas for a World Bank event and initiatives that could be launched at Doha

Which way ahead for the Financing for Development Agenda?

Suggested event for the WB/IMF meetings

(or there could be one focusing more on DRM or its specific inter-relationship with the other chapters etc)

Lessons since Monterrey, New Issues and the role of the International Financial Institutions

There is widespread agreement that aid, debt, foreign direct investment and other private capital flows such as migrant remittances can, under the right circumstances, help finance development. These various forms of cross border capital flows are of course inter-related and inter-dependent.

Yet almost all discussions of development finance focus on one issue at a time and thus risk painting an incomplete or worse inaccurate picture on what policies can help deliver financing for development. Discussions on aid, for example, take place mostly under the aegis of the OECD DAC, debt at the IFI meetings and trade within the WTO framework. Capital Flight is almost never talked about.

That is why the ongoing Financing for Development Process leading up to Doha is so critical. It helps provide a framework for a holistic discussion of all the important development finance issues. Policy makers are likely to be able to make better informed policy decisions on the basis of such a framework. Looking at the evolution of development finance in the six years since Monterrey and tracing the main trends can yield invaluable lessons.

What does a more complete picture of development finance flows look like? What is the relative size of the various flows relative to each other? Is there a substantial difference between the aggregate flows and the flows at a country level? What are the main trends?

The Monterrey consensus was clear in highlighting that domestic resource mobilization lay at the heart of financing development. Yet the focus of most development discussions and major decisions since has been on external sources of finance. Aid, debt, trade, foreign direct investment and migrant remittances have all been widely discussed while domestic resource mobilization has not been quite that prominent on the international development agenda.

It is clear, of course, that external flows of resources in and out of the country have a significant footprint on domestic resource mobilization. For example, exports of natural resources can generate significant revenue through royalties and the sale of concessions. The cancellation of debt frees up tax revenues and foreign investment can generate multiplier effects as well as additional tax revenue. On the other hand, capital flight undermines domestic revenue mobilization.

How significant is domestic resource mobilization compared to external sources of financing? What are the main inter-relationships between domestic resources and the channels for external inflows and outflows?

Private capital flows into developing countries now dominate both bilateral aid flows as well as transfers from the international financial institutions. However, most commentators agree that the IFIs have a central role in catalyzing and facilitating the development process. But there is as yet no clear consensus on what role they should play with respect to, for example, foreign direct investment, new borrowing from emerging lenders such as China and India, migrant remittances and innovative sources of finance.

What role do the IFIs have in this changing development finance landscape? How can they best help maximise the development impact of financial flows that are not being channelled through them? What role do they have in formulating country level and international policies on domestic resource mobilization and various external financial flows?

Another key aspect of the FfD process is the discussion of systemic issues such as the need for a sovereign bankruptcy framework, increased international tax co-operation, increasing financial stability and helping deliver

global public goods such as tackling climate change and environmental degradation. Clearly the IFIs will need to play a central role in delivering results on these fronts.

What role do the IFIs have in helping deliver on the systemic reform agenda especially the reform of the international financial system? What are the key new issues such as financing climate mitigation and adaptation that have emerged since Monterrey? How can the IFIs, which some consider being global public goods themselves, help deliver on the global public goods agenda?

The success of the Financing for Development process is critical to meeting the Millennium Development Goals as well as furthering the co-operation between the developing and developed world. This co-operation is now needed to help address financial imbalances, prevent financial crisis, fight climate change and control global pandemics.

This seminar, which will be co-organized by DEFINE, the BMZ, the Centre for Global Development and the World Bank will help address some of the fundamental questions raised above.

Suggested Panellists

Heidemarie Wiecek-Zeul, German Federal Minister for International Development or Michael Hofmann, Executive Director for Germany at the World Bank

Jose Antonio Ocampo, Professor, Columbia University and former Under Secretary General, United Nations or Jomo KS, Deputy Under Secretary General, United Nations

Danny Leipziger, Vice President, Poverty Reduction and Economic Management, World Bank or Carlos Braga, Director of Poverty Reduction and Economic Management, World Bank

Nancy Birdsall, President, Centre for Global Development or Dennis de Tray, Vice President, Centre for Global Development

Chaired by Sony Kapoor, Executive Director, DEFINE – Development Environment Finance International Exchange

Some ideas for joint work between like minded countries

Idea 1 - Increasing financial transparency - A common agenda

Background

The current financial crisis which necessitated the rescue of a German bank, the Liechtenstein scandal which featured prominent Tax evading Germans, the Siemens bribery scam which has undermined confidence in corporate governance and many other scandals related to cross-border crime and the diversion of developing country resources all have one element in common - the lack of transparency of cross – border financial flows.

This and the fact that most of these also feature tax haven jurisdictions which are notorious for their secrecy. Clearly there is a need for some urgent action.

Some of what has happened is

- Tax evasion by individuals from rich countries – for example the BND recently got hold of a list of account holders having secret accounts at a Liechtenstein which had not been reported to their domestic tax authorities as required by law. A number of wealthy citizens from Germany, the Netherlands, Norway and a number of other countries were all implicated. It is clear that this is just the tip of the iceberg with total annual tax losses to rich countries in the hundreds of billions of dollars
- Tax evasion by individuals from developing countries – it is well known, for example, that the offshore (mostly undeclared) assets of citizens from developing countries far exceed their national public debts. While some of the funds stashed in tax havens are related to corruption by leaders such Mobutu of Congo or Suharto of Indonesia much of the money is related to tax evasion.
- Tax avoidance by MNCs as has recently been highlighted by the case of Del Monte (mis-pricing bananas to divert profits from Latin America and the UK to tax havens) and the Danzer group (under pricing logging exports from the Congo to move money to Switzerland)
- Bribery – a number of high profile cases have recently uncovered the extensive use of offshore slush funds for the payment of and secret bank accounts for the receipt of bribes. These have been related to

arms trade, trying to buy political influence, rigging competitive bidding and a whole host of other activities. Leading multinationals such as Bofors, Siemens, BAE and Elf have been implicated.

- Hiding losses/inflating profits – This strategy, which involves the extensive use of offshore corporate and trust structures to hide losses, generate fictitious transactions and inflate profits were used extensively by Enron and Parmalat both of which overstretched themselves to end up bankrupt inflicting billions of dollars of losses on unsuspecting shareholders in the process.
- Excessive risk taking – A large chunk of the risky assets implicated in the current financial crisis were held off-balance sheet and offshore by Special Purpose Vehicles (SPVs) and Special Investment Vehicles (SIVs) registered in various tax havens and were subject to lower capital adequacy provisions and more lax regulation. There is little doubt that this lower regulatory burden combined with a lack of transparency has played a role in amplifying the crisis as confidence in the disclosure of liabilities and risk by financial institutions has plummeted.
- Germany has led the pack in calling for greater transparency by hedge funds and offshore vehicles and for a greater oversight role by regulators who are supposed to guard against systemic risk but seem to have been caught off-guard.

The consequences

The lack of financial transparency compounded and aided by the existence of tax havens and a lack of international co-operation public bad inflicting damage on the governance of the international system and undermining the rule of law. The damage done includes

- Undermining development
- Undermining the sustainability of the welfare state
- Undermining financial stability and the integrity of the financial system
- Undermining the rule of law and encouraging corruption and crime
- Undermining good corporate governance and confidence in the system

What needs to be done

That is why it is in the shared interest of leaders and citizens in both the developing and developed world to take urgent action to tackle this global public bad which poses a grave threat to the welfare and interests of most of the citizens in the world.

Germany is in a very strong position to take the lead on this and could act alone or preferably in partnership with like minded countries to launch an initiative aimed at increasing transparency across the financial system and corporations (no one can be against transparency).

The timing is right

Combining the possible benefits and putting them in a Financial Times editorial and enlisting co-operation between the finance and development ministries and even some other countries would be perfect. Or one could do it the other way round and write the editorial to draw attention and then build up an initiative.

I have suggestions on the editorial (which I am happy to make suggestions on or ghost write) as well as a draft Terms of Reference in case you are interested in exploring this avenue further.

Or

Idea 2 - A Permanent Secretariat to Tackle Developing Country Tax Flight

Proposal to the government of Germany (Sony.Kapoor@gmail.com)

with Norway, the Netherlands and South Africa as possible strategic partners

Background

Tax flight from developing countries, primarily through cross border tax evasion and tax avoidance adds up to somewhere between \$150 billion and \$500 billion annually.

This not only undermines the effectiveness of almost \$100 billion of annual overseas development aid (ODA) flows but also reduces the development impact of increased trade and investment flows to developing countries.

Moreover this phenomenon undermines the development of a vibrant system of accountability that accompanies an effective tax system. The tax flight undermines the development of a sustainable domestic revenue base which is a prerequisite for sustainable development and a freedom from aid dependence.

With the ongoing financing for development process having rightfully refocused the development community's attention on domestic resource mobilization, it is impossible to ignore the centrality of developing country domestic tax revenues which are by far the largest source of development finance, being much bigger than, overseas development aid, for example.

However, globalization and accompanying increases in cross border trade, investments and financial flows mean that developing country domestic tax revenues are increasingly dependent on the existence of an enabling international environment. The current international environment, characterized by the lack of transparency of financial flows, the secrecy of many jurisdictions, the aggressiveness of businesses and individuals seeking to minimize tax liabilities and the readiness of financial intermediaries to help them do so, means that raising domestic tax revenues in a fair, effective and efficient way is becoming ever more challenging.

This challenge can be tackled through increasing transparency in financial flows significantly enhancing international co-operation on tax and the capacity of developing countries to use these tools.

The current landscape

While there are a plethora of inter-governmental initiatives and institutions that deal with

- Taxation
- Tax systems in developing countries
- International co-operation on taxes

There is almost no work being done on tackling tax flight from developing countries. This is unfortunate and needs to change.

Some of the relevant institutions and initiatives are

- The OECD – committee on fiscal affairs and the forum on tax administration
- The EU/EC – the EU savings tax directive and the EC tax directorate
- The IMF – Fiscal affairs department
- The World Bank and Regional development banks
- The UN Committee of Tax Experts
- Ad hoc initiatives such as the International Tax Dialogue, the Joint International Tax Shelter Information Centre, the Leeds Castle Group and the Seven country working group on tax havens
- The Norwegian led Task Force on Illicit Financial Flows

Of these the OECD/EU/EC and the Ad hoc initiatives are all technically very competent but pay no (or very little) attention to the problems of developing countries. The ITD and Leeds Castle groups have some (but not enough) developing country focus and are not very effective in highlighting the problems highlighted above.

The development banks have very little capacity on tax matters especially on tackling tax flight. The IMF has technical expertise but does not have the development mandate or the willingness to seriously promote work on tackling tax flight from developing countries.

The UN Committee of Tax Experts, while more focussed on developing country issues does not have sufficient political weight and has had very limited success thus far. Even if the upgrade to an inter-governmental level takes place after the Doha meeting, it is likely to lack sufficient capacity, political weight and nimbleness to tackle tax flight effectively in the near future.

The Illicit finance task force has been effective at bringing together some of the relevant constituencies, raising the profile of the issue and doing some good scoping work but its mandate expires at the end of the third meeting and it has always suffered from its rather ad hoc and transient nature. Besides Norway has been a relatively lonely voice in the political landscape.

What needs to be done?

There is a strong need for a body that is able to

- Increase the visibility of the issue of tax flight from developing countries
- Make existing relevant bodies (listed above) divert some of their resources towards tackling tax flight from developing countries
- Co-ordinate and provide coherence to the various streams of related work that is going on in various fora – both as a guidance tool and for information sharing
- Provide the political clout of a big donor, G8 member and an influential international voice which can help translate technical work into action
- Provide a permanent structure to help increase effectiveness, clout and institutional memory
- Assist in developing relevant technical assistance tools for implementation

Launching a small permanent secretariat with a high level political mandate to work with all relevant inter-governmental institutions as well as other stakeholders would be the perfect tool to effectively tackle tax flight from developing countries hence promoting domestic resource mobilization and taking the work of the Monterrey consensus forward.

The resources needed for such a secretariat would be significantly smaller than those needed for the EITI secretariat.

What would come out of such work?

The work of the secretariat would result in

- A higher profile for the issue
- Increased domestic resource mobilization, retention and recovery for developing countries
- Lower aid dependence and subsidiary benefits for Germany and other developed countries as both the public discussion and the tools developed would help these states address their own fiscal erosion
- More transparency in international finance with the added benefits of higher financial stability, lower corruption and reduced crime

I have written a draft Terms of Reference for the group which I am happy to send to you in case you think this is interesting

Appendix V – FfD hearing statements on Domestic Resource Mobilization and FDI

Sony Kapoor spoken statement at the FfD Hearings on Domestic Resource Mobilization

Respected chair, I would like to highlight that domestic resource mobilization exists not in isolation but in a changing international economic and political context.

Evidence is - that this context is making it harder to mobilize domestic resources, which primarily come from direct and indirect taxes as well as royalties.

The liberalization of trade and investments has resulted in a tremendous increase in the scope of capital leakages and tax loss especially in the absence of effective international co-operation on tax.

- This happens through the mis-pricing of trade transactions in goods and especially in services.
- The mis-pricing of Intra corporate transactions between subsidiaries of MNCs, also called transfer mis-pricing is an even more serious problem.
- The manipulation of cross border financial transactions such as loans, royalty payments is also a very serious problem as is mis-represented bank transfers of the kind which resulted in almost \$70 billion going missing from the Russian central bank in the 1990s

The failure of governments to exchange information on cross-border transactions especially as it relates to taxation allows, in fact encourages both domestic and international actors to engage in hundreds of billions of dollars of capital flight and cross-border tax evasion and tax avoidance.

While this is a serious problem for both developing and developed countries, lower administrative capacity means that these leakages are more serious for developing countries – where their effect of depressing tax revenues – and hence financing for development – makes a difference between life and death.

Moreover, capital flight and cross-border tax evasion are more pernicious than domestic tax evasion because the money and resources mostly leave the country permanently and hence do not even generate a positive multiplier effect in the economy.

The seriousness of these problems which are encouraged by the lack of international tax co-operation especially from developed country financial centres – results in an annual loss of at least \$500 billion from developing countries in the form of capital flight and at least \$100 billion of tax losses.

The race to the bottom on tax rates and on offering tax holidays and similar incentives to try attract investments is hampering developing countries accruing a fair share of their natural resource wealth. It is also generating a deadweight loss in potential domestic resource mobilization as sometimes effective tax rates being offered have turned negative – more subsidies are being offered to companies than the investments will generate in tax revenue.

All of these disturbing phenomenon which are severely hampering developing country efforts to mobilize resources domestically flourish due to

- the absence of transparency in cross-border financial flows
- the lack of effective exchange of information especially from developed countries
- the lack of a discussion and even awareness of the magnitude of these negative flows
- the absence of a discussion on how to stem the race to the bottom in tax rates

The lack of transparency and in many cases - active secrecy associated with financial flows not only undermines domestic resource mobilization but also facilitates capital flight, cross- border corruption, and money flows linked to criminal and terrorist financing. As highlighted by recurring problems

Estimates show that developing countries have cumulatively lost as much as 4-5 trillion dollars through these channels and that much of this money is still illicitly stashed in financial centres. The 5-10% of GDP of annual capital flight from countries such as South Africa and Cote d'Ivoire must be stopped and tax leaks be plugged to create an international environment which allows developing countries to mobilize resources domestically. Domestic Resource Mobilization can only happen in the context of Domestic Resource Retention

Additionally, the trillions of dollars which have already leaked out rightfully belong to developing countries and their peoples and must be brought back to help finance their development plans. While token efforts have now been made at recovering stolen assets under the UNCAC, these are far too narrow and we need a much more ambitious program of the identification and repatriation of these assets to the developing country of origin. These trillions of dollars are rightfully domestic resources so must be returned.

Effective Domestic resource mobilization, domestic resource retention and domestic resource recovery all go hand in hand and are the only way to achieve sustainable development. Developing countries need to act together – strongly supported by developed countries – to highlight the seriousness and magnitude of the problem, to highlight how capital flight undermines domestic resources, encourages corruption and worsens governance. The ongoing FFD process needs to urgently recommend efforts to increase financial flow transparency, increased co-operation on tax matters to plug the leaks, and an ambitious program aimed at the repatriation of fled capital to effectively finance development.

Sony Kapoor spoken statement at FFD hearings on Private Investment Flows

Respected Chair,

The Monterrey consensus highlighted that FDI and other private capital flows could make a positive contribution to financing for development. Under the right circumstances, this is indeed true.

Unfortunately, this has often been interpreted to mean that FDI and portfolio flows ARE financing for development. This belief, actively promoted by several major international actors, has been partly responsible for the race to the bottom we see in

- tax concessions,
- labour,
- environmental
- and social standards

that has often been observed as countries scramble to attract investments.

It is far from obvious that all FDI and private capital flows contribute to financing for development or indeed development. Private capital flows are for profit transfers not gratuitous flows. This means that for the most part for every \$100 million invested - \$150 million (or more) would be taken out, perhaps over a period of a few years.

So over the medium term, the channel of private investment will turn from positive (when new investment comes in) to negative (when profits are taken out) and will not generate net positive financial flows. This has been observed over recent decades where the profits on existing investment in Sub Saharan Africa, for example, have in most years exceeded new investments coming in.

Portfolio investments, which are short term in nature, can generate additional problems of financial instability of the kind seen in recent emerging market crisis when this 'hot money investments' reversed sharply over a period not of months but days.

Even when money comes in and stays in, tax competition plus an ever growing use of trade, transfer and financial mis-pricing for tax evasion/avoidance by MNCs means that less and less of the money adds to domestic resources (tax revenues) which are critical for investments in health, education and development sectors.

This is the first problem

The main potential benefits of private investment lie then not in the money it brings in but in its indirect spill-overs. FDI has the potential to generate development benefits by bringing in

- new technologies
- managerial know how which can help upgrade local skills
- better social, environmental, gender equality and labour standards
- and by creating decent work, well paid jobs
- and through inter-linkages with the local economy

For the most part, this has not happened

Pressure applied on developing countries through the WTO, IFI conditionality, investments treaties and regimes has meant that most performance requirements, where host governments had the ability to make policy so as to maximise the development impact of FDI, are no longer allowed. The stringent intellectual rights regime, for example, has seriously harmed the ability of developing countries to use technology effectively.

Developing Countries are losing the regulatory power to require private investors to

- transfer technology
- hire and train local managers
- operate through joint ventures
- meet social, environmental, labour and gender standards
- use local content
- or meet export quotas etc

It was exactly by using policies such as these that countries all the way from the United States to Japan and Korea were able to harness private capital and private know-how to maximise development. These successful policies are now not available to developing countries – another symptom of their shrinking overall policy space.

This is the second problem

Much FDI, especially in the extractive sector for example, does not generate many jobs, has little integration with the local economy, limited technology spill-overs and a serious negative impact on the environment in particular.

While there exist many international frameworks, standards and principles pertaining to good labour, environmental, social and gender related practice, few are followed. The rapid expansion in private flows, combined with the power of the corporate lobby and the lack of binding regulatory frameworks means that even when good words exist – they do not translate into good deeds.

Private sector accountability for meeting international standards on

- Labour rights

- Gender equality
- Environmental and social protection

Is a prerequisite to achieving sustainable development.

The absence of an effective regulatory framework which tracks, monitors, evaluates and enforces these standards has resulted in a deterioration in a significant number of cases.

This is the third problem

The liberalization of investment in services – especially basic services such as health and the provision of water etc has proven to be especially controversial where the profit motive has clashed with the public service motive. This has especially been true in loosely regulated environments which have resulted from pressure on developing countries to liberalize. The likelihood of a negative development impact in such cases, is very high.

This is the fourth problem

Shorter term capital flows in the form of portfolio investments have often triggered financial instability both when they come in and when they leave so need to be carefully regulated as had been done effectively in the past by Chile and then Malaysia after the SE Asian crisis. The pressure to liberalize finance being put on developing countries risks limiting the development potential which well-regulated financial flows can have and risks increasing it's the potential negative impact.

This is the fifth problem

It is essential to address these problems if we are to capitalize on the financing for development potential of private capital flows.

Towards this – we have the following recommendations for this ongoing process

- 1) there is an urgent need for this process, as emphasised by the second panellist today, to look at the cost-benefit analysis of private capital flows in their entirety and recognize that the FDI and private capital flows have a positive development impact only under very special circumstances. Policy towards FDI should thus be strategic and selective.
- 2) this forum needs to urgently reverse the constant shrinkage of policy space for developing countries – in the area of the regulation of investments in particular. It is unacceptable that developing countries are being pushed into a corner where they are no longer allowed to exploit the very policies used by countries that are now developed to become prosperous partly through appropriate regulation of FDI
- 3) Voluntary standards and codes are important but have proved ineffectual in making FDI accountable to stakeholders. It is now time for this process to initiate the development of an international regulatory framework to ensure that cross border investment flows subscribe to high standards on taxation, labour (ILO core standards) social and environmental impact, anti-corruption and gender equality. – And it is time to end the race to the bottom - The WB doing business report, for example, penalizes countries that are trying to promote a decent work agenda – minimum wages and core labour standards. This is counterproductive and unacceptable.
- 4) The agenda for the liberalization of investment in services needs to be rethought – especially in the light of recent less than positive experiences especially in the area of basic services
- 5) Recurring financial crisis, especially the current sub-prime crisis, point to the need for an international regulatory framework which allows countries, especially developing countries to regulate (using speed bumps, prudential norms and capital controls) portfolio flows. This process also needs to make urgent progress towards developing such a framework. This should also provide for much greater transparency in the working of institutions such as hedge funds, private equity and sovereign wealth funds.

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