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A European agenda to fight capital flight

Blackholes like offshore centres should no longer exist, and their disappearance should set in motion a rebirth of the international financial system.

-Prime Minister of France, François Fillon

The present financial crisis clearly shows the limits and dangers of an opaque, irresponsible and unregulated financial system. As the food products and raw materials prices shock has already shown, the effects of the global crisis on the real economy and social welfare is strongly amplified in developing countries. Under these circumstances, the already minimalist agenda of the Millennium Development Goals risks being definitely out of reach for most developing countries. Today the context shows the need for the establishment of a stable, transparent and well regulated financial system that works for development. Europe has a key role to play in developing a bold new approach on taxation. The privatisation of profits and socialisation of losses that we are witnessing these weeks show the need for new policies.

Tax havens divert resources, nourish instability

Every year developing countries lose at least €117 billion of tax revenues due to aggressive tax avoidance and tax evasion. Between €256 and €366 billion fly illicitly out of developing countries for commercial reasons related to tax avoidance and evasion, linked to the abuse of mechanisms such as transfer pricing or mispricing by transnational corporations. These flows are several times higher than official aid or foreign direct investment. They constitute an outrageous "reverse welfare", with money being transferred from the poorest countries to the richest and the tax havens. This is therefore a key issue in the development agenda that must be addressed by the European governments by:

- Tabling strong political messages at the international level to curb this phenomenon multilaterally, namely through the UN and the international financial institutions (IFIs);
- Including capital flight and tax evasion in the EU development policy agenda, as a matter of high concern alongside development aid; and
- Implementing concrete measures at the European level to regulate and curb capital flight and tax evasion.

The international community has started to recognise the impact of illicit financial flows on development, but

the attention so far has focused on corruption. While we acknowledge these efforts, corruption is estimated to be between 3-5 percent of the illicit flows. Another 30-35 percent is linked to criminal activities, such as arms or drugs traffics, while more than 60 percent of illicit financial flows are due to commercial reasons. Among the possible responses to curb this capital flight, there are two specific steps that can contribute: the end of bank secrecy and the country by country reporting standards for transnational companies.

Automatic exchange of information crucial

Curbing illicit flows from developing countries requires ending bank secrecy by obliging countries to automatically disclose information on flows transiting through financial institutions. For automatic disclosure to be fully effective in tackling capital flight it should be implemented at the global level. As a first step, the EU can lead the way by implementing this at the European level. This can be done by strengthening the existing European Savings Tax Directive (ESD), currently under review.

The ESD obliges EU member states to automatically exchange information¹ on the savings income of non resident individuals that are deposited in EU member states and other collaborating jurisdictions (Switzerland, Andorra, Monaco, Liechtenstein, San Marino and all overseas territories dependent on EU member states).²

By obliging countries to automatically exchange information, this directive permits the identification of individuals holding savings in other countries. But it only applies to individuals, leaving out all the assets held by legal entities such as trusts, foundations, shell companies, insurance companies, etc. which are much higher. This is why organisations are calling for the expansion of this directive to all sources of income and to all legal entities.

Improved accounting standards

The International Accounting Standards Board (IASB) is composed of major accounting and other transnational corporations, who in 2001 established a private entity that sets up the international accounting standards. The IASB now has a strong influence on the content of accounting standards worldwide. But several conflict of interests embodied in the IASB have not been addressed.

The IASB's mandate is: "To develop, in the public interest, high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial reporting to help participants in the world's capital markets and other users make economic decisions."

The EU is the largest jurisdiction implementing IASB standards³ and has recently expressed concerns about the legitimacy of this body and the need to strengthen its supervision. In the context of the present crisis, the EU stressed "the importance of a robust and legitimate independent international accounting standard-setting process, which is responsive to the public interest and consistent with the objective of ensuring financial stability."⁴

Global standards set by IASB permit companies to combine results from different countries into a single global (or regional) figure making it impossible to unpick these numbers for each country. All the trade between group companies⁵ disappears from view in the consolidated accounts that current IASB standards endorse.⁶

Country by country reporting would help curb illicit flows from developing countries by:

- Enhancing transparency;
- Opening the way to taxes on profits where these are produced;
- Curbing profit shifting and transfer mispricing and therefore minimising tax evasion and abusive tax avoidance; and
- contributing to financial stability on a longer term perspective.

An important step was made in 2007, when the European Parliament called on the European Commission to support country by country reporting on extractive industries.⁷

Europe's responsibility

Europe has a key responsibility on illicit flows since it hosts many tax havens⁸, both directly and indirectly, through many of its overseas countries and territories. In this regard, European leaders must be coherent in their willingness to lead on development finance and to regulate the financial system and apply these concerns in their own territories. The 21 overseas countries and territories include a number of prominent tax havens, for example the Cayman Islands and the British Virgin Islands.⁹ The Savings Tax Directive should be expanded to all these territories, and any introduction of country by country reporting and other improved accounting standards should also be binding on these jurisdictions. Tax competition is particularly acute in the EU. Upward fiscal harmonisation is needed in order to increase public income and enhance stability. By doing this, the EU would not only dramatically improve distribution of wealth but would also set a good example for other regions - including developing countries - to follow.

Recommendations

Tax havens and offshore finance centres should

be closed down due to their undermining role in allowing illicit practices, in providing opacity and by channelling tax evasion and capital flight. Other specific recommendations are:

- Automatic exchange of information through the expansion of the ESD to all EU countries and EU-related overseas countries and territories as well as other associated territories;
- Expansion of the ESD's automatic disclosure of information to all sources of income and to all legal entities;
- Require country by country reporting standards from all economic sectors in all EU member states and their overseas countries and territories; and
- Upward fiscal harmonisation among all EU MS including its overseas countries and territories to ensure a fair redistribution of wealth, enhance transparency and strengthen good governance.

- By Andrea Baranes, CRBM & Marta Ruiz, Eurodad

Endnotes

1. The directive has provided some exemptions on a temporary basis: Austria, Luxembourg and Belgium do not automatically exchange the information and, in exchange, they withhold tax on savings: 15 percent until 2007, 20 percent between 2008-2010 and 35 percent after 2010.
2. Guernsey, Isle of man, Jersey, British Virgin Islands, Aruba, Anguilla, Cayman Islands, Montserrat, Turks and Caicos islands. See: http://consilium.europa.eu/uedocs/cmsUpload/green_light.pdf The EU has also asked to start a negotiation process with Hong Kong, Singapore, Macao, Japan, Canada, Bahrain, Dubai and the Bahamas.
3. The US has been applying its own standards but is currently considering applying IASB ones.
4. See: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/101732.pdf
5. The OECD estimates that 60 percent of global trade is made on this basis.
6. See: <http://taxjustice.blogspot.com/2008/06/press-release-country-by-country.html>
7. See: www.europarl.europa.eu/sides/getDoc.do?Type=MOTION&Reference=B6-2007-0437&language=EN
8. According to the Tax Justice Network, the main features of a tax haven, are: low or zero taxes; high levels of secrecy to hide the beneficiaries of companies, trusts, and bank accounts; no requirement of economic substance to the transactions booked in the jurisdiction and a ring-fence between their domestic tax regimes and the regime offered to non-residents to encourage profit and income shifting from other countries.
9. The full list of EU overseas countries and territories includes: Greenland, New Caledonia and Dependencies, French Polynesia, French Southern and Antarctic Territories, Wallis and Futuna Islands, Mayotte, Saint-Pierre and Miquelon, Aruba, Netherlands Antilles (i.e. Bonaire, Curaçao, Saba, Sint eustacius, Sint Maarten), Anguilla, Cayman Islands, Falkland Islands, South Georgia and the South Sandwich Islands, Montserrat, Pitcairn, Saint Helena and dependencies, British Antarctic Territory, British Indian Territory, British Indian Ocean Territory, Turks and Caicos Islands, British Virgin Islands and Bermuda. However, the arrangements for association have never been applied to Bermuda in accordance with the wishes of the Government of Bermuda.

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Created with support from the Ford Foundation