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Capital flight is a major problem in the international financial architecture. This problem must be confronted and solved.

The Cost of Capital Flight

In a Briefing Paper entitled The Price of Offshore published in March 2005, the Tax Justice Network estimated that the amount of flight capital is about 11.5 trillion U.S. dollars. The Tax Justice Network calculated that the annual income on that 11.5 trillion U.S. dollars at 7.5 percent per year would be about US\$860 billion. And if the applicable tax rate on such US\$860 billion of annual income were 30 percent, the amount of tax would be about US\$255 billion annually. That is, US\$255 billion of taxes is being evaded each year on the estimated US\$11.5 trillion of flight capital.

That US\$255 billion annually is enough to cover all of the financing needs of the UN's Millenium Development Goals.

Bank Secrecy and Capital Flight

The two basic causes of capital flight are first, bank secrecy and other confidentiality laws in major OECD and EU financial centers, and also in other onshore and offshore tax havens. Bank secrecy—whether de jure or de facto — prevents governments from exchanging information about cross border payments of income. And second, tax free treatment of interest on bank deposits and certain other interest bearing obligations. Therefore, a resident of one country can make a bank deposit or other

interest bearing investment in another country free of all tax, and protected from disclosure to the tax authorities of the residence country. This lack of an exchange of information facilitates and encourages capital flight and tax evasion.

Bank secrecy and other confidentiality laws also facilitate corruption and the violations of other laws, and the hiding of the proceeds of such violations of law.

The Position of the OECD and the European Union

The OECD and the European Union have taken action against capital flight from OECD countries to tax havens, and from one EU country to another EU country. But the OECD and the European Union have not taken action against capital flight from third countries into OECD and EU financial centers, and capital flight from third countries into tax havens. This obviously is very prejudicial to developing countries.

Capital Flight and Argentina

The Argentine situation is a good example of the distortions in the international financial system resulting from capital flight. The Argentine Government defaulted in 2001 on about US\$100 billion of sovereign debt, the largest sovereign debt default ever. It is rumored that Argentines have at least US\$100 billion (and most likely significantly more) of assets outside of Argentina, most of which is probably undeclared in Argentina, resulting in substantial tax evasion in Argentina and diversion of hard currency reserves.

The IMF and Argentina

Furthermore, the IMF, in the study by its Independent Evaluation Office of the Role of the IMF in Argentina, 1991-2001 (paragraph 169), and the Response of the IMF Staff (paragraph 5), admitted that the US\$9 billion that the IMF lent to Argentina in September 2001 “largely financed capital flight”.

Actions in the United Nations

In the United Nations, the issue of capital flight has been discussed:

(a) **The UN Zedillo Report:** The UN Report by the High-Level Panel on Financing for Development of June 2001 (also known as the Zedillo Report, after Chairman Ernesto Zedillo, former President of Mexico) stated:

“The Panel proposes that the international community should consider the potential benefits of an International Tax Organization.... Developing countries would stand to benefit especially from technical assistance in tax administration and tax information sharing that permits the taxation of flight capital....

(b) **The UN Monterrey Consensus:** Then, in March 2002, the UN International Conference on Financing for Development called on developing countries to mobilize resources for development, especially domestic resources. The Monterrey Consensus encouraged, among other things:

strengthening international tax cooperation... and greater coordination of the work between the multilateral bodies involved and relevant regional organizations, giving special attention to the

needs of developing countries and countries with economies in transition.

(c) **Report of the Technical Group on Innovative Financing Mechanisms**

In September 2004, the Report of the Technical Group on Innovative Financing Mechanisms (the Lula Group) was presented at the United Nations. The section on Tax Evasion and Tax Havens of that Report, stated (pages 53-54) in relevant part:

Tax evasion is a phenomenon of great magnitude that impairs fiscal revenue of governments and is especially detrimental to the domestic efforts to increase tax revenue in developing countries. Yet rebuilding these countries' tax bases is essential to their efforts to finance their fight against poverty, improve social expenditure, support economic development activities and increase productivity levels. ...Further joint and concerted international action is necessary to reduce the erosion of national tax bases. A strong and reliable tax base is the first source of finance for countries seeking to strengthen their national efforts to reduce hunger and poverty and, more generally, to improve equity. All efforts in this direction are likely to reduce the need to rely on external or special sources of finance. A crucial step in this regard is to intensify domestic efforts related to improving tax administration.

The amount that annually escapes from countries' tax bases exceeds by far the resources needed to finance the Millennium Development Goals....

Tax evasion frequently involves offshore financial centers, as concealment seeks the protection of systems combining zero or low taxation with banking secrecy. Fighting tax evasion and elusion via action on tax havens reduces significant distortions in the allocation of resources. It also contributes to diminish the extent of money laundering and financing for terrorism.... These characteristics are not exclusive to offshore financial centers. In particular, banking secrecy is a standard practice in tax matters in many countries, to varying degrees..... Reducing tax evasion and bringing more transparency to financial operations are international public goods..... Given its global nature, the issue of tax evasion must be dealt with in the context of strengthening international cooperation in tax matters. Indeed, there is an international consensus to fight tax evasion and the lack of transparency in financial activities.

The Tax Justice Network hopes that the Lula Group, the GT-5 countries, will focus their efforts on mechanisms to confront bank secrecy and capital flight.

The Solution: Automatic Exchange of Information

The solution to the problem of capital flight and tax evasion in the international context is the automatic exchange of tax information between governments. If governments automatically exchange information about cross border income payments, without the impediment of bank secrecy and confidentiality, it would be difficult for the recipient of the income to evade tax in his/her/its country of residence. The OECD has been working on the essential mechanics of such automatic exchange of information: transmission of information from one government to another about cross border income payments, and the coordination by computers of information about cross-border payments, based on (a) Tax Identification Numbers (TIN) in the jurisdiction where the income has its source, and (b) the Tax Identification Numbers in the jurisdiction where the recipient of the income resides. The OECD's technical efforts in this regard merit great commendation (although the OECD Proposals against Harmful Tax Practices only require the exchange of information upon request).

Other UN Efforts

The UN Convention against Corruption (December 2003) calls upon countries to override bank secrecy in the case of domestic criminal investigations of offences

established in accordance with that Convention (Article 40). The Tax Justice Network hopes that the UN will consider and adopt a similar position to override bank secrecy, and to implement automatic exchange of information, in international tax matters.

The Eleventh Meeting of the UN Ad Hoc Group of Experts on International Cooperation in Tax Matters in December 2003 in Geneva considered the issue of bank secrecy, capital flight, and exchange of tax information. That Ad Hoc Group of Experts has been converted into the stronger UN Committee of Experts on International Cooperation in Tax Matters. The Tax Justice Network hopes that the UN Committee of Experts on International Cooperation in Tax Matters will include on its agenda for its December 2005 meeting in Geneva, the issues of bank secrecy, capital flight and automatic exchange of tax information. The Tax Justice Network will be monitoring the work of this new Committee and will participate at its forthcoming meeting in December 2005.

The Joint Proposal of the IMF, World Bank and OECD

In the March 2002 report Developing the International Dialogue on Taxation: A Joint Proposal by the Staffs of the IMF, OECD and World Bank, the IMF, OECD and World Bank committed to assist developing countries in improving the effectiveness of their tax administrations, thereby increasing governmental revenues of those countries. The Tax Justice Network hopes that the IMF, World Bank and OECD will advise developing countries on how to improve their tax administrations to try to prevent capital

flight to OECD and non-OECD financial centers, and the Tax Justice Network hopes that the IMF, World Bank and OECD will work with those OECD and non-OECD financial centers to implement automatic exchange of information in tax matters.

Redesigning the International Financial Architecture

Each financial crisis inevitably leads to questions about the architecture of the international financial system, and how it can be redesigned to help avoid future crises. It seems clear that an international financial system that in effect encourages capital flight, resulting in trillions of dollars of flight capital, with the active participation of banks and other financial institutions, and the consequent tax evasion and diversion of hard foreign currency reserves of developing countries, must be redesigned. The Tax Justice Network hopes that the Argentine debt crisis will shake the international financial community enough so that both the public sector and the private sector focus more attention on the impact of capital flight, and the mechanisms to attack it.