Illuminating the dark corners of the financial system

Marina Ponti
Federica Biondi

Financial mechanisms, as they stand today, are not able to counteract illegal transactions. Greater transparency and stricter rules should be prioritised by richer countries, not only as a means of fostering social justice and redistribution of wealth, but also as an instrument to fight criminal operations and terrorism. Along these lines, a currency transaction tax would be a relevant step forward and provide a concrete mechanism for monitoring cross-border financial transactions.

> *"The fundamental problem is to find a social system which is efficient economically and morally."*
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> *J.M. Keynes, 1925*

Donor countries lament lack of resources as the reason for neglecting their commitment to give at least 0.7% of GNP for Official Development Assistance. But these same countries allow the many dark corners of their financial markets to cause large and increasing losses of fiscal revenues every year. Financial markets are not transparent; this implies an enormous loss of revenue and creates a breeding ground for illicit transactions. The current international financial system disperses those precious resources, which could otherwise be used for the implementation of successful development policies. Unfortunately, the Monterrey Conference on Financing for Development neglects this issue, despite its relevance for development.

Transparency of financial markets means correct management of all information related to capital flows. The benefits of transparency are many, but most importantly, full tax revenue. Greater public resources would be available for the pursuit of public policies, amongst these, development and a greater redistribution of wealth. Developing countries have often been reprimanded for their insufficient and malfunctioning financial and tax systems. But when loss of potential tax revenue decreases their ability to guarantee social services and defend human rights, they are not the only guilty parties in the game. Northern countries hold a great responsibility for this general loss of revenue by allowing vicious national and international mechanisms to contaminate financial markets.

In Europe, there are many examples of tax systems that allow funds deriving from commercial activities in a country to flow through a special *agent company* before being transferred to a company registered in a tax haven. Various countries in Europe allow agent companies to operate in their territory. This system works as follows: The *agent company* (A), situated in one of these particular European countries, is both the mother company of the *active company* (C) (situated in a different country) and the daughter of a company (H) situated in a tax haven. Given that the A acts on behalf of H, providing only financial services (*ie*, the collection and distribution of the proceeds of the commercial company C), said A is only allowed to retain a small percentage of the profits created by C and destined to H. This mechanism thus allows all the proceeds of C to flow through A to H. H then "pays" A for its services and this amount is then taxed in the country where A is situated. But the amount paid to A by H for its services is a very small percentage of the total sum of funds that it channels.

The implications are various: the commercial company C evades taxation in its country, thus drastically reducing the tax revenue for said country; the intermediate country (*ie*, that of company A) receives a tax revenue it would otherwise not receive, given that company A's sole purpose is to "provide services" for H (*ie*, channeling funds); the large majority of revenue produced by C ends up in a tax haven where no (or a minimal) taxation is applied. These operations not only distort the fiscal framework, but also lead to negative fiscal effects in the country of origin, which, seeing its tax revenue reduced, seeks other ways of increasing it, *eg*, by increasing tax pressures. This causes general discontent amongst the tax-paying population, thus further increasing the risk of illegal flight of funds to avoid high taxation. A vicious circle sets in.

Another example of the lack of transparency in cross-border financial transactions is the agencies that transfer money worldwide using money orders. These agencies have widespread networks of offices all over the world. They are used mainly by people who have moved from a "developing country" to a "developed" one to find work and who wish to send part of their earnings to their families without the complications of opening a bank account. Considering the number of people in this situation, it is easy to deduce that the figures involved are huge. These transactions are not monitored and not even the traditional banking system has a clear idea of the size. It follows that fiscal authorities are also in the dark.

A third point: bank secrecy towards governmental authorities, including tax authorities, may enable taxpayers to hide illegal activities and to escape taxation. The effective administration and enforcement of many laws and regulations, including those on taxation, require access to, and analysis of, records of financial transactions. Technological advances, particularly in the area of e-commerce and banking, have made international banking readily accessible to a wide range of taxpayers, not just to large multinationals and wealthy individuals. The elimination of exchange controls by OECD countries and many non-member countries, has facilitated the rapid expansion of cross-border financial transactions. This new era of "banking without borders" has raised new challenges for tax administrations around the globe. Experience has shown over the last 50 years that inadequate access to bank information has been an impediment to tax administration and law enforcement. The scope of non-compliance with the tax laws, which is facilitated by lack of access to bank information, is difficult to measure precisely because there is insufficient access to the necessary information.

The same problem exists in attempting to measure the extent of money laundering. Nevertheless, the Financial Action Task Force on Money Laundering annual report 1995-96 estimates that the size of that problem amounts to hundreds of billions of dollars annually.

The elimination of tax evasion has never been high on the political agenda of governments, but the fight against criminal organisations and illegal trade has. Nevertheless, after September 11 attempts to use international financial mechanisms to freeze the financial assets of suspected terrorists was not completely successful because of the current structure of the financial system. Despite the political primacy of the case, it was not possible to obtain all the required information from banks and other actors involved. Financial mechanisms, as they stand today, are not able to counteract illegal transactions. Greater transparency and stricter rules should be prioritised by richer countries, not only as a means of fostering social justice and redistribution of wealth, but also as an instrument to fight criminal operations and terrorism.

Tax co-operation is crucial in addressing both social and criminal issues, but the political will to put tax co-operation in place is not yet there. The current international framework shows the exact opposite, with the proliferation of tax havens (40 countries at present). They represent the total absence of financial transparency and impede any form of fiscal co-operation. Tax havens offer many services with very high added value, with the cost being paid by those who do not use the services. Financial mechanisms that involve tax havens can be used for the discrete management of huge family fortunes and show-business or sports revenues; for speculation and fiscal fraud; for fiscal evasion and the transfer of multinational profits to their off-shore shell companies; to finance political parties and individual candidates; and to pay for all kinds of illicit operations. Tax havens offer a wide range of relatively low-cost financial services: bank secrecy protected from any juridical request; absence of exchange controls; the right to stipulate any kind of contracts, to carry out any transaction and set up any company, even if fictitious; guarantee of anonymity; absence of fiscal pressure; free access in real time to all the worldwide markets; guaranteed connection with the largest bank circuits, usually represented on location; and weak or non-existent mechanisms for the repression of financial criminality. The mere existence of these tax havens encourages people to use them.

The first draft of the preparatory document in view of the Monterrey Conference, prepared by the former President of Mexico Ernesto Zedillo, contained a very important proposal regarding the establishment of a tax organisation. This organisation would have been charged with addressing tax matters, tax-harmonisation, the fight against tax havens and, more broadly, tax competition.

Such an organisation could have been the right forum for discussing the implementation of global taxes devoted to financing the development targets contained in the Millennium Declaration, as agreed upon by heads of states and government in September 2000. Along these lines, a *currency transaction tax* would be a relevant step forward and provide a concrete mechanism for monitoring cross-border financial transactions. Moreover, the setting up of such a tax system would necessarily require the transparency of financial flows.

Currently, most financial transactions are carried out through the SWIFT banking system. Therefore, such a tax could be implemented and enforced through the SWIFT itself. In addition, as an increasing number of civil society organisations argue, a currency transaction tax would:

- reduce short-term speculative currency and capital flows;
- enhance national policy autonomy;
- restore taxation capacity of individual countries eroded by the globalisation of markets;
- distribute tax pressures more equitably among different sectors of the economy;
- trace movements of capital to fight tax evasion and money laundering.

Transparency will be achieved when there is sufficient political will to put it in place. Civil society will continue to fight for its achievement, despite the current lack of political will. Transparency means democracy, and democracy is a vital component of human development. ■

> *"There is nothing more difficult to execute, nor more dubious of success, nor more dangerous to administer, than to introduce a new order of things; for he who introduces it has all those who profit from the old order as his enemies, and he has only lukewarm allies in all those who might profit from the new. This lukewarmness partly stems from fear of their adversaries…and partly from the skepticism of men, who do not truly believe in new things unless they have actually had personal experience of them."*
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> *Macchiavelli, The Prince, 1532.*

Mani Tese
<ponti@manitese.it>