Waking up to the true story of tax

In November and December 2008 heads of state and of government from around the world will attend a United Nations-sponsored conference in Doha, Qatar, to discuss financing for development. Tax is the big new issue. Powerful financial interests, notably from Britain and the United States, are lobbying against reforms in international taxation. Non-governmental organizations and individuals concerned with poverty around the world must engage fast, and decisively, to help ensure success.

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Historical background

Near the end of the Second World War the economists John Maynard Keynes from Britain and Harry Dexter White from the United States sketched how the world's financial architecture would emerge from the ashes of conflict. Their work led to the Bretton Woods agreements in July 1944, and the creation of the World Bank and the International Monetary Fund (IMF).

Keynes and White were especially worried about capital flight out of Europe: if wealth was drained out of these countries, it would further destabilize the shattered European nations and possibly turn them towards the Soviet bloc. They knew well how difficult it would be to control capital flows across national borders, and they addressed this with a further proposal: transparency. They wanted the governments of countries receiving flight capital (such as the United States) to share information automatically with those European (and other) governments suffering the capital flight, so that the sending countries could 'see' the wealth their citizens had sent abroad. This would not only allow weak countries to tax their citizens' income appropriately, but it would also remove one of the great incentives for capital flight. Secrecy lets wealthy citizens and corporations shift their wealth outside the reach of taxation and escape their responsibilities to the democratic societies from which their wealth is derived.

The US financial community lobbied hard against transparency, and in the final IMF Articles of Agreement, Keynes' and White's proposals were watered down. International co-operation between countries was now no longer 'required', but merely 'permitted'. The impact of this successful lobbying went far beyond Europe, and it has since had nothing less than catastrophic consequences for ordinary people around the world, both in rich and poor countries.

Today very few countries benefit from information exchange treaties, and the limited number that do exchange information do it only 'on request'. As John Christensen and David Spencer of the Tax Justice Network argued recently in the *Financial Times*: "In other words, you must know what you are looking for before you request it. This is shockingly inadequate. We need the *automatic* exchange of tax information between jurisdictions, and all developing countries must be included."

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The scale of what has been unleashed is becoming clear. The World Bank reports that USD 1-1.6 *trillion* of illicit money crosses borders each year, about *half* (USD 500-800 billion) from developing and transitional economies. That compares to just USD 100 billion in foreign aid provided annually by all the Organization for Economic Co-operation and Development (OECD) countries to the world's poorest nations. Secrecy and low (or zero) taxes are the central incentives prompting illicit capital flows. International transparency in cross-border financial flows is clearly one of the most important global issues of our time. It is remarkable that the international development community has paid so little attention to these issues for so long.

If secrecy were removed, and capital taxed properly, it would transform the economies and public finances of developing (and rich) nations, and go a long way towards preventing elites from enriching themselves at the expense of ordinary citizens.

The road to Doha

There are currently no global, multilateral agreements or bodies that let developing countries know what income their residents' overseas assets earn in places like the United States, United Kingdom, Switzerland, Luxembourg, Singapore or anywhere else, and that help them recover the taxes owed on that income.

The Doha conference from 29 November to 2 December 2008 (not to be confused with the Doha negotiations for a global trade deal under the auspices of the World Trade Organization) has the potential to lay the groundwork for putting right what Keynes and White were prevented from achieving – notably automatic exchange of tax and other information between countries, on a global, multilateral basis.

This is certainly not impossible: such a scheme already exists on a regional level within Europe: countries within the EU scheme automatically exchange information between each other regarding the incomes of each others' residents, allowing proper taxes to be paid.

However, the EU scheme contains loopholes. Although some are being fixed, one big gap is that Europeans wishing to hide their money from taxation still can simply deposit their money elsewhere – in Singapore, for instance. The solution requires this scheme to be applied on a global basis – and especially including developing nations.

Furthermore, more transparency is needed in other important aspects. About 60% of world trade consists of internal transfers within multinational companies, and the prices at which the internal transfers are recorded are manipulated by these companies to minimize their tax liabilities.

Raymond Baker, a world authority on illicit financial flows and author of the ground-breaking book *Capitalism's Achilles Heel*, estimates that mispricing and abusive transfer pricing alone (as these practices are known) are worth USD 500-750 billion annually. Tackling this is a complex task, and requires international co-operation; one of the simplest approaches would involve *country-by-country reporting*.

Country-by-country reporting is necessary since international regulations and accounting standards currently do not require multinationals to break down and publish their payments, profits and taxes for each jurisdiction they operate. Instead, they are allowed to scoop up data from several countries and put them into one number reflecting, say, a region ('Africa', for example). This makes it impossible for outsiders – be it individuals wishing to hold their rulers accountable for secretive payments from multinationals, or national tax authorities wanting to know if they are being cheated – to unpick the data for each country. We need rules that make multinationals publish this data automatically.

The preparations for Doha

No single measure can eliminate the problems associated with the fault lines in international taxation, and no country can achieve meaningful change alone. International co-operation between nations is the key.

The OECD, in the late 1990s, seriously attempted to build a coalition of developed countries to act together to require transparency in international banking. After some initial successes, however, the efforts foundered, partly because the United States defected following the 2000 election, when George W. Bush became president.

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What is more, an indelible problem for the OECD is being a regional institution – a so-called rich-man's club – that lacks the legitimacy to establish international norms applicable to all countries. There is one organization, however, with legitimacy to speak for the global community: the United Nations (UN). The Doha meeting it will host this year is a perfect chance for it to step up to the plate.

The UN has already laid solid foundations for addressing tax at Doha with the 2001 Report by the High-Level Panel on Financing for Development (also known as the Zedillo Report, after Chairman Ernesto Zedillo, former President of Mexico). That report called for tax information to be shared on a multilateral basis, and for countries to be given technical assistance in tax administration and tax information sharing so as to allow flight capital to be taxed.

As financial interests again lobbied against change, it stalled; then, in 2002, the UN convened a meeting of heads of state at Monterrey, Mexico, to discuss plans for financing development in the developing world. The resulting Monterrey Consensus pushed the issue forward, and today it acts as a foundation document on many matters, including tax policy for development.

At the subsequent 2005 World Summit the UN resolved "to support efforts to reduce capital flight and [to support] measures to curb the illicit transfer of funds." Then, in December 2007, the UN General Assembly resolved to hold the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus – the official title for the Doha meeting this year.

Tax is the next big thing

Tax, under the theme "Mobilizing domestic financial resources for development", is one of six Doha conference chapters. But tax, and the closely related subject of international financial transparency, is so important that it must be at the centre of the Doha debates and outcomes.

People are beginning to wake up to the sheer scale of the financial resources drained out of some of the world's poorest countries. Astonishing new research from the University of Massachusets, Amherst, analyzing capital flight from 40 African countries, estimates:

> Real capital flight over the 35-year period amounted to about USD 420 billion (in 2004 dollars) for the 40 countries as a whole. Including imputed interest earnings, the accumulated stock of capital flight was about USD 607 billion as of end-2004.

Nearly all the money that flows out of Africa as capital flight stays out. Compare this figure to these countries' total external debt in 2004, which amounted to USD 227 billion. Indebted African countries have been forced to undertake painful economic adjustments and devote their scarce foreign exchange to debt-service payments while, at the same time, they have experienced massive outflows of private capital towards Western financial centres. These private assets surpass the continent's foreign liabilities, ironically making sub-Saharan Africa a 'net creditor' to the rest of the world.

> We are now seeing signs that world opinion is fast turning in support of action against the world's tax cheats and those who help them. As Mike McIntyre puts it: "A code of conduct can help create a climate of opinion where tax cheats cannot successfully pose as refugees from oppressive government but instead are seen for what they are – selfish, self-absorbed people who undermine good government and help keep two-thirds of the world locked in poverty."

There is one absolutely crucial difference between the assets and the liabilities: the private external assets belong to narrow and wealthy elites, while public external debts are borne by the people through their governments. Even worse, this capital flight flows, almost exclusively, into the world's secrecy jurisdictions. This not only encourages tax evasion, draining African nations of investment capital and billions of dollars of lost state tax revenues that must be replaced with aid, but encourages and fosters all sorts of nefarious activities – such as corruption. For those worried about the African debts and governance issues, this is the hidden side of the coin. Research like this should be a wake-up call.

The secrecy jurisdictions include not only the traditional tax havens of lore like the Cayman Islands, Jersey and Switzerland, but also the world's largest financial centres – especially New York and London. In May 2008 Reuters reported that former Liberian president Charles Taylor, whose forces routinely used mutilation and rape as weapons of war, stashed large quantities of money in a US bank – which apparently took his money happily and did not ask questions. This happens routinely.

However not everyone in America likes this. In May 2008, US Senators Barack Obama, Carl Levin and Norm Coleman in May introduced a bill trying to restrict financial secrecy in the United States. As Levin said:

> Each year, the States allow persons to form nearly two million corporations and limited liability companies (LLCs) in this country without knowing – or even asking – who the beneficial owners are behind those corporations. Right now, a person forming a US corporation or LLC provides less information to the State than is required to open a bank account or obtain a driver's license. Criminals are exploiting this weakness in our State incorporation practices. They are forming new US corporations and LLCs, and using these entities to commit crimes ranging from terrorism to drug trafficking, money laundering, tax evasion, financial fraud, and corruption (…) our law enforcement officials have too often had to stand silent when asked by their counterparts in other countries for information about who owns a US corporation committing crimes in their jurisdictions.
>
> The reality is that the United States is as bad as any offshore jurisdiction when it comes to responding to those requests.

Much of the money flowing into the United States comes, of course, from developing countries.

Britain has a similar effect, though it uses slightly different mechanisms. It is adept at using its offshore Crown Dependencies (like Jersey or Guernsey) and its Overseas Territories (like Cayman or Bermuda) as tentacles of the main London financial markets, using these to scoop up money from around the world. Both the United States and the United Kingdom run large fiscal and trade deficits; and by shrouding financial inflows in secrecy, and failing to tax them (and share the proceeds with the victim countries), they help attract inflows that finance these deficits. Britain's and America's efforts to look generous as aid contributors, while taking much larger volumes of dirty money under the table, look somewhat cynical.

Not just how much money is raised, but how money is raised

The scale of financial flows out of developing countries helps explain why tax is so crucial to them. Yet there is another dimension, which may be equally important. Tax, and especially direct taxation (as opposed to indirect taxes like VAT or import tariffs), is a powerful force for improving governance.

This is another emerging discipline in the field of international development. A new book, *Taxation and State-Building in Developing Countries: Capacity and Consent*, edited by Deborah Bräutigam, Odd-Helge Fjeldstad and Mick Moore, explains how tax

> (…) is the new frontier for those concerned with state-building in developing countries. The political importance of taxation extends beyond the raising of revenue (…) taxation may play the 'central' role in building and sustaining the power of states, and shaping their ties to society. The state-building role of taxation can be seen in two principal areas: the rise of a social contract based on bargaining around tax, and the institution-building stimulus provided by the revenue imperative. Progress in the first area may foster representative democracy. Progress in the second area strengthens state capacity. Both have the potential to bolster the legitimacy of the state and enhance accountability between the state and its citizens.

We can no longer focus so strongly on aid, without bringing tax into the core of the debate. Aid provides benefits, but perhaps its biggest drawback is that it makes governments and other recipients accountable to (and dependent on) donors, not citizens. Tax is different: tax is the most accountable, and sustainable, source of financing for development: it makes states accountable to its citizens, not donors. It mitigates aid dependency. As the Kenya Revenue Authority puts it, "Pay your taxes, and set your country free." Students of European and American history, familiar with the famous term "no taxation without

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representation" have long known this. For some reason, its relevance is only now starting to filter into the field of development. As Deborah Bräutigam explained in a recent paper:[1]

> Discussions on taxation's potential contributions to state-building are largely absent from the practical concerns of the aid community, which tends to focus on increasing aid (or cutting expenditures) rather than on raising revenues. The state-building role of taxation should be a far more central issue for those concerned with the problem of collapsed states, weak governments, and the lack of democracy across the developing world (…) high levels of aid can create incentives for donors and governments that make it more difficult to build a more capable and responsive state.

Participants and observers to the Doha conference risk spending too much time focusing on *how much* money is raised by taxation, and not enough on *how* that revenue is raised. Much more research must be done, including on the impact of international tax issues, tax havens and loopholes on developing countries' tax systems and the way they raise revenue.

The UN Tax Committee

Britain and the United States, in league with some of the world's other tax havens, have led the fight against improved transparency. The UN – and specifically the UN Tax Committee[2] – is one of the little-known forums where this struggle is being played out. This committee is a key player feeding input into the Doha conference, and it contains a mix of representatives from developed and developing nations. But unfortunately too many of the 'developing nations' representatives, as well as those from wealthy countries, are in fact tax havens, including Barbados, the Bahamas, Switzerland, the United Kingdom, and Ireland. While developing-nation tax havens like Barbados or Cayman are eager to preserve their revenues, comparing their populations (45,000 in the case of Caymans, for example) with that of other populations afflicted by tax havens (over 600 million, in Africa's case) must be the basis for judging where our priorities lie on tax havens.

Civil society urgently needs to take notice of this committee and its activities, and the broader context in which it is embedded, and to work hard to make sure that its voice is heard. Before now, civil society has been all but absent, allowing powerful vested interests to drive and distort the agenda.

Urgent: a code of conduct is needed

There are several crucial areas in which the UN, and the Doha meeting in particular, can help foster progress, with the potential to do at least as much good as all foreign aid combined. All of these areas need strong support from global civil society.

One area that will be profoundly important is the idea of a UN Code of Conduct on tax. In November 2006, the UN Tax Committee took a first step by voting to approve the principle that a Code of Conduct should be drawn up for co-operation on controlling capital flight and international tax evasion (which is, by definition, illegal) and tax avoidance (which is technically legal but, by definition, goes against the wishes of elected parliaments). It has asked the US tax expert Michael McIntyre to work on this. Nothing like this has ever been done before.

To have maximum impact, a Code of Conduct should be adopted by the UN General Assembly. But a series of steps are needed first – technical steps within the UN system, where powerful tax haven interests will attempt to twist the outcomes towards their own ends. Civil society needs to be vigilant in monitoring progress, and must complain loudly when things go wrong. The Doha meeting will play an important role in this. Things are already moving fast – and the time to act and engage is now.

Even adoption by the General Assembly will not be enough. It must also be promoted vigorously, once adopted, by signatory governments and also by private actors and members of civil society.

Codes of conduct are sometimes referred to as 'soft law' because they do not provide for explicit methods of enforcement. They are aspirational, not operational. They seek to mobilize public opinion (or at least the opinion of relevant actors); and they work through persuasion, not legal force.

For years, countries have treated international tax evasion and abusive tax avoidance with benign neglect. We are now seeing signs that world opinion is fast turning in support of action against the world's tax cheats and those who help them. As Mike McIntyre puts it: "A code of conduct can help create a climate of opinion where tax cheats cannot successfully pose as refugees from oppressive government but instead are seen for what they are – selfish, self-absorbed people who undermine good government and help keep two-thirds of the world locked in poverty."

Other crucial areas to address

In September 2007, the Tax Justice Network presented 18 recommendations to the UN Tax Committee, including the following:

- Ask the IMF to include in its Reports on the Observance of Standards and Codes whether a jurisdiction that is a financial centre provides adequate information to foreign partners and looks at issues such as bank secrecy in tax matters and effective exchange of information.
- Consider if capital flight (and the resulting tax evasion) should constitute acts of corruption under the UN Convention Against Corruption – and all parties to it, including tax evaders, intermediaries who facilitate tax evasion, and the financial centres that handle and receive tax-evading funds.
- Consider capital flight and tax evasion as money laundering under the relevant conventions and institutions – such as the IMF's Financial Action Task Force.

> "…the accumulated stock of capital flight [out of Africa] was about USD 607 billion as of end-2004." Compare this figure to these countries' total external debt in 2004, which amounted to USD 227 billion. Indebted African countries have experienced massive outflows of private capital towards Western financial centres that surpass the continent's foreign liabilities, ironically making sub-Saharan Africa a 'net creditor' to the rest of the world.

- The IMF, the World Bank and the OECD should work together with financial centres to help developing countries tackle capital flight and lost taxes.

All these measures need to be tackled not just before and during the Doha process, but far into the future. International financial reform takes many years.

The mood is changing

Change has been blocked until now: the vested interests have been too strong, and civil society has been all but asleep on international taxation. Nevertheless, the global mood is turning. One reason is that there now exist civil society groups – notably the Tax Justice Network and Global Financial Integrity – that can provide high-level analysis and advice to help others to engage.

Also, in contrast to most issues on the 'development' agenda, the harm provoked by tax havens and abusive international taxation is felt not only in the developing world, but also in the wealthiest nations. For this reason, political action unites a diverse group of people with shared interests.

Events in financial markets are also now prompting change. A financial deregulation process that began in the 1970s provided the oxygen allowing secrecy jurisdictions and the abusive tax practices they facilitate to flourish and metastasize through the global financial architecture. The credit crisis that began in 2007 has shattered confidence in the self-regulating powers of markets, and thrown deregulation into reverse, ushering in a period where international co-operation is now actively being pushed at a high level. As Lawrence Summers, a former US Treasury Secretary, said in May 2008:

> There has been a race to the bottom in the taxation of corporate income as nations lower their rates to entice business to issue more debt and invest in their jurisdictions. Closely related is the problem of tax havens that seek to lure wealthy citizens with promises that they can avoid paying taxes altogether on large parts of their fortunes. It might be inevitable that globalization leads to some increases in inequality; it is not necessary that it also compromise the possibility of progressive taxation. The US should take the lead in promoting global co-operation in the international tax arena.

1 "Taxation and Governance in Africa", available at: <www.aei.org/publications/pubID.27798/pub_detail.asp>.

2 Its full title is the Committee of Experts on International Cooperation in Tax Matters.

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The Stop Tax Haven Abuse Act introduced recently by US presidential candidate Barack Obama, in partnership with a Democrat and a Republican Senator, amid a flurry of newspaper investigations into the tax-dodging activities of private defence contractors, is sharply changing the political mood in the United States.

Europe, notwithstanding spoilers in its midst like Austria, Belgium, Britain, Luxembourg and Switzerland, will be a somewhat willing partner. Revelations from a paid whistleblower about secret accounts held by many wealthy Europeans in Liechtenstein have helped spur a new political will to tackle the problem of tax havens and tax abuse.

In Britain and the Netherlands, newspaper articles are now prompting parliamentary debates about whether democratic societies should accept aggressive tax avoidance by retail giants or by banana companies and others, or whether Britain's 'domicile' rule allowing the wealthiest members of British society to escape much of their tax bills, can be tolerated. Trade Unions in Britain are now aggressively starting to push tax justice onto the agenda. A Norwegian-led task force, supported by civil society, is starting to target capital flight and tax evasion. The Tax Justice Network and the Washington-based Global Financial Integrity Program are now undertaking a new multi-year research project, funded by the Ford Foundation, which will for the first time properly expose and describe the full extent of global infrastructure of secrecy jurisdictions.

Many of the world's tax havens, particularly the British-linked ones, emerged or spread their wings as part of the process of decolonization, as Britain's overseas empire crumbled after the Second World War and Britain looked for ways to fill the gaps. The time has come now to start clearing up these relics.

An awakening in civil society, particularly in Europe, about the pernicious and very powerful role of tax havens in development, is now starting to get underway at last. The Doha process needs to be instrumental in broadening this awakening. ■

Further reading

Tax Justice Network: <www.taxjustice.net>.

Tax Justice blog: <taxjustice.blogspot.com/>.

Tax Justice Focus, First quarter 2008, The Doha Edition: <www.taxjustice.net/cms/upload/pdf/TJF_4-1_Doha.pdf>.

UN Financing for Development web site: <www.un.org/esa/ffd/>.

For general tax analysis: <www.taxresearch.org.uk/Blog/>.

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