The links between tax evasion and corruption: how the G20 should tackle illicit financial flows

A briefing paper by Global Witness, Tax Justice Network, Christian Aid, and Global Financial Integrity

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Introduction

The past year has seen increased attention on different aspects of the same problem: illicit financial flows out of developing countries and their role in perpetuating poverty. There is growing consensus on the importance of this phenomenon and the damage it causes, and that development is not just about providing aid, but enabling developing countries to mobilise their own resources.

These illicit financial flows include illegal tax evasion, abusive transfer mispricing, and the transfer of corruptly-acquired funds into bank accounts abroad, which should be prevented by anti-money laundering regulations.

All of these illicit financial flows are facilitated by global financial opacity, both in tax havens and major financial centres.

As a result of the financial crisis, which was largely created by global financial opacity, governments are now starting to tackle these issues, particularly through the G20 process.

Political will and institutional capacity to address these issues are of course required at the country level. However, as NGOs have been arguing for some time, there are potentially huge development benefits from this progress in international regulation. **But the links between these problems and their solutions need to be made clear, and that is the purpose of this briefing.**

The wording of the G20 communiqué and the G20 Working Group 2 report in April suggested that tax issues be dealt with by the OECD tax havens process, and corrupt flows into the financial system be dealt with by the Financial Action Task Force. While these are the bodies mandated to deal with these two issues, there are multiple linkages across the problems of tax and capital flight that, if recognised, will allow more effective holistic solutions to be implemented.

Types of illicit financial flows that harm developing countries

1. Transfer pricing: tax avoidance by multinationals

Foreign direct investment and international trade do not automatically translate into tax revenues for the recipient country. Approximately 60% of global trade is conducted within multinational corporations (MNCs), between subsidiaries of a parent company. Such intra-group transactions are not subject to the same market forces as those taking place in the external market, so there is huge potential for profit shifting via under- or over pricing of these intra-group transactions, in order to avoid tax liabilities. Profits are shifted from the country where they were earned – eg a developing country whose natural resources are being exploited – to a tax haven where the corporate tax rate is zero. Such mispricing can also occur by agreement between unrelated companies, with prices artificially manipulated to avoid tax. The resulting profit, which is the difference between the artificial price and the real price when the goods are sold on to the world market, is often shared between the two companies through apparently unrelated trades, often through tax havens.

This technique is not just used to avoid tax obligations. If goods from industrialised economies are sold to a developing country at an artificially inflated price, the buyer can shift capital abroad. If that buyer is a company, it reduces recorded profits and reduces tax liability; if the buyer is a corrupt official, he is able to shift illicitly-acquired money out of the country without detection. If goods are sold from a developing country to an industrialized country at an artificially low price, capital is likewise shifted abroad.

Whatever the method used, the end result is that developing countries lose out on tax revenues from the foreign direct investment into their country. Christian Aid estimates that from transfer mispricing and false invoicing, the loss of corporate taxes to the developing world was US$160 billion a year, more than one and a half times the total global aid budget to developing countries.

Tax avoidance on such a large scale is facilitated by a lack of transparency in the way MNCs report and publish their accounts. Under recently revised rules MNCs are no longer required to publish almost any geographic data on their trading performance, and there is no requirement at all to do so on a country by country basis. This makes it difficult to establish an overview of what is happening within a group of companies for tax purposes or how it impacts on a particular jurisdiction.

2. Capital flight: tax evasion by individuals on money held offshore

Tax is a more effective development tool than aid, and helps build democracy by making governments accountable to their own populations. Tax evasion by individuals in developing countries therefore denies revenues that could be put towards development.

A Boston Consulting Group report in 2003 found that 50% of the assets of high net worth individuals in Latin America were being held offshore, where they would be untaxed. It did not have a figure for Africa. Unfortunately the data appears not to have been published again since 2003.

3. Capital flight: money looted by corrupt officials from the state

This issue is not just about money being held offshore to illegitimately avoid tax, or the abuse of otherwise legitimate trades to secure offshore tax advantage. It is also about money stolen wholesale from government funds. The millions, or perhaps billions of dollars of national funds stolen by Mobutu from Zaire, Abacha from Nigeria and Marcos from the Philippines are well known, but examples continue to emerge of corrupt rulers or their family members with their hands in the till. Corruption on this scale could not occur without the facilitation of the financial sector; these amounts are too large to be kept at home in cash. Recent research by Global Witness shows that banks, despite a raft of anti-money laundering laws, have been continuing to do business with corrupt regimes including those in Congo-Brazzaville, Equatorial Guinea, Gabon, Angola, Turkmenistan, and Charles Taylor's Liberia.

In Nigeria, the Economic and Financial Crimes Commission estimated in 2005 that about $400 billion had been stolen or misused by past rulers. As with all criminal estimates, there is no agreement on the total quantity of money looted globally by corrupt officials from their states' funds. What is clear is that those examples of corruption for which we do have figures have a devastating effect on development in the affected countries. The designer shopping sprees paid for out of Congo's oil money by Denis Christel Sassou Nguesso, the son of the president of Republic of Congo's, came to tens of thousands of dollars each month. His credit card bill for just one month, July 2005, was $32,000. This would have paid for 80,000 Congolese babies to be vaccinated against measles.

NB: A range of estimates exist for the total scale of the illicit financial outflows that developing countries suffer, and a World Bank conference to be held shortly before the September G20 meeting will discuss the research agenda in this area. Global Financial Integrity has produced a major analysis of illicit financial flows out of developing countries, using the World Bank Residual Method and IMF Direction of Trade Statistics. This study estimates such flows at $800 billion to more than $1 trillion a year. Even this estimate is considered conservative, since it does not including smuggling, mispricing of trade in services, and mispricing that occurs within the same invoice between cooperating trade partners. Such massive flows merit the most serious attention by G20 nations.

Six key policy solutions

1. Country by country reporting:

Recommendation: All multi-national corporations should be required publicly to report sales, profits, and taxes paid in all the jurisdictions where they operate in their audited annual reports and tax returns.

Which problems will this help to solve?
Country by country reporting would be a risk management tool to identify transfer mispricing. It would show if a company was declaring unexpectedly high or low profits in different jurisdictions, including recognised tax havens, and would thus reveal transfer mispricing. This would enable developing-country tax authorities to prioritise which financial flows need further investigation, in order to collect a fair and legal level of tax revenue from multinational corporations operating in their territories. The prospect of such transparency would also deter multinational corporations from engaging in such mispricing practices.

Country by country reporting would also provide information to a wide range of stakeholder groups which would strengthen efforts to monitor corrupt practices, transparency of natural resource revenues, corporate governance and responsibility, tax payments, and world trade flows. It would benefit investors by revealing which corporations operate in politically unstable regimes, tax havens, war zones, and other sensitive areas.

What is happening so far?
The Anglo-French summit in July 2009 declared: ‘We also call on the OECD to look at country by country reporting and the benefits of this for tax transparency and reducing tax avoidance.’

Dave Harnett, permanent secretary at the UK’s Revenue and Customers, has said this is "an idea that is gathering momentum… There is a growing recognition that country by country reporting brings additional transparency, particularly in relation to how multinationals are operating in emerging and developing countries."

The UK's Department for International Development published its White Paper on international development which committed to “discussing with its international partners whether other initiatives, including country by country reporting of tax payments, could offer an effective and suitable means of advancing the tax transparency agenda."

Ernst and Young reported in July 2009 that at an OECD meeting in Berlin during which country by country reporting was discussed, ministers from Sweden, Norway, Belgium and Korea expressed interest.

What should the G20 do now?
The G20 should express its support for country by country reporting. There are a number of additional options available to the G20. It could back the call for more research into country by country reporting, a process that would be assisted by the offer of funding. It could directly name those it wanted to do such research: for example it could demand that the International Accounting Standards Board and OECD cooperate on this issue. It could also specify the goals it seeks to achieve, the importance to developing countries and set a time scale for reporting.

2. Identify ways of reducing transfer pricing abuse and the misallocation of corporate profits for taxation purposes

Recommendation: Require that the parties conducting a sale of goods or services in a cross-border transaction sign a statement in the commercial invoice certifying that no trade mispricing in an attempt to avoid duties or taxes has taken place.

What problems will this help to solve?
The G20 countries have a twofold need: to stabilize the economies of the developed world in the face of significant recession and ensure that the economies of developing countries receive the support they need. In both cases governments need tax revenues to achieve their goals. There is ample evidence that the abuse of current transfer pricing rules – and the absence of such rules in many developing countries – provides opportunities for corporate tax abuse. The manipulation of prices in exports and imports of goods and services moves more tax evading money across borders than any other mechanisms, hurting poverty alleviation and economic development in poor countries

What is happening so far?
Most discussion of this issue has centred around strengthening the arms-length principle in international trade. However, the arms-length principle does not in itself provide sufficient protections from abusive transfer pricing. Furthermore, databases of pricing information for all traded merchandise items are becoming available and should be utilized by nations wishing to protect against abuses.

What should the G20 do now?
The G20 should call for a more robust debate on curtailment of abusive transfer pricing, involving the World Bank, IMF, OECD, corporate interests, and civil society organisations, and should support innovate measures that limit the risk of abuse occurring. Abusive transfer pricing can be substantially curtailed with declarations on commercial invoices, fortified by checking of prices against available databases and significant liability attached to mis-statement.

3. Transparency of beneficial ownership information

Recommendation: The beneficial ownership, control and accounts of companies, trusts and foundations should be available on public record in each jurisdiction. A beneficial owner must be defined as a natural person or publicly-listed corporation, not a nominee or trust.

Which problems will this help to solve?

Companies, trusts and foundations, while having legitimate uses, provide cover for those companies or individuals who wish to disguise their identity for the purposes of capital flight or tax avoidance. These structures make uncovering the true nature of transactions and tracing beneficial ownership and the origin of funds difficult for investigators. Providing beneficial ownership information will enable national authorities to identify foreign subsidiaries of multinationals and thus to track and address tax avoidance. It will also enable national authorities to identify, for tax purposes, assets owned by their individual citizens. The deterrent effect of such transparency will help to prevent tax avoidance and evasion. Current and potential investors will have an enhanced understanding of the workings of the corporation in which they invest. Banks will be in a better position to conduct customer due diligence, which is a vital tool in preventing flows of corrupt funds out of developing countries. Developing countries that are trying to trace the corruptly acquired assets of current or former government officials will be able to follow the trail more easily.

What is happening so far?

The G20 has tasked the Financial Action Task Force (the intergovernmental body that sets the international standard for anti-money laundering laws and measures countries' compliance with them) to 'revise and reinvigorate the review process for assessing compliance by jurisdictions with AML/CFT standards'. FATF has interpreted this as an opportunity to address the measures that should be taken if a state's anti-money laundering laws are not up to standard.

In addition, FATF is preparing for its fourth round of 'mutual evaluations'; according to the Netherlands, its current president, it agreed in February 2009 that the question of transparency of beneficial ownership and control, embodied in FATF Recommendations 33 and 34, was a key priority for reassessment. These recommendations require states to prevent the misuse of corporate vehicles (33) and trusts (34). Currently it is possible to be in compliance with them by reaching the low standard of ensuring that beneficial ownership information is accessible to law enforcement officials; but the FATF Methodology for Assessing Compliance does suggest a possible higher standard of public registers. This higher standard should become the mandatory one.

Trusts are hugely significant in the management of illicit financial flows, including tax evasion, and there is an additional option for enforcing transparency. If it was mandated that no trust would be enforceable against the trustee unless it was registered on public record with the settlor, trust deed, letters of instruction and accounts all publicly available, then almost instant compliance with this requirement would occur.

What should the G20 do now?

Sixteen members of the G20 are also members of FATF. The other four, India, Indonesia, Saudi Arabia and South Korea are all members of FATF-style Regional Bodies. They should ensure that FATF strengthens the standard to achieve compliance with Recommendations 33 and 34 to require public registries of beneficial ownership and control of companies and trusts.

4. Automatic exchange of tax information

Recommendation: Governments should collect data from financial institutions on the financial assets within their domain (whether in a person's own name, or in the name of legal entities and constructs they beneficially own or direct) under the control of a person resident outside their own domain. With regard to those assets they should collect information on the nature of the person or entity that owns it and its income, gains, and other distributions paid to non-resident individuals, corporations, and trusts, and automatically provide this data to the governments where the non-resident individual or entity beneficially controlling the structure is located.

Which problems will this help to solve?

This information would provide the 'smoking gun' to authorities to identify where tax evasion is taking place. This would mean that the information required to make enquiries under the OECD's standard Tax Information Exchange Agreements would be automatically available to all governments who had such agreements in place, so increasing the number of enquiries made and the chance of a successful outcome for all authorities involved at a considerably lower cost than at present, and would thus provide a massive deterrent effect to tax evaders.

This data would also, if made available to those authorities responsible for enforcing anti-money laundering laws, provide them with the information needed to trace stolen assets, so reducing the likely benefits of international money laundering crime.

What is happening so far?

Automatic exchange already happens within the EU, in the form of the EU Savings Tax Directive, but this only covers accounts belonging to named individuals. The G20 should support its planned extension to accounts in corporate names and call for its geographic spread to be extended to other key financial centres.

Furthermore, automatic exchange of tax information exists between the United States and Canada and has been a valuable tool against tax evasion for these two countries for years.

The G20 has proposed transparency standards based on the OECD's tax information exchange agreements which enshrine the on-request model of information exchange. This method on its own has been proven to be ineffective in a number of cases including the treaty between Jersey and the US which provided only four successful requests in a year, and the UK's treaties with the Channel Islands providing only two successful transfers of information in a year.

What should the G20 do now?

The G20 should adopt automatic exchange of tax information as a goal, advancing beyond the current provision of exchange of information only upon request with a proven need. A date for adoption of automatic exchange should be determined. The G20 should also consider the technical assistance required for developed and developing countries to comply with and effectively use the information exchanged.

Only through the enhanced transparency that automatic information exchange can bring can governments get the true benefit of the Tax Information Exchange Agreements now being put into place, and the G20 has the power to lead the way towards this enhanced state of international tax cooperation.

5. Stronger due diligence requirements on banks

Banks should be required not only to identify their customer and his source of funds, as at present, but if their customer is a politically exposed person (PEP: a high level official, family member or associate), the bank must also have strong evidence that the source of funds is not corrupt or otherwise illegally derived. If they cannot do this, they should not accept the customer or the transaction. Regulators should actively monitor banks to ensure that they do this. Banks should not be allowed to open accounts for a PEP from a country that has a law preventing its PEPs from opening bank accounts abroad.

Which problems will this help to solve?

Currently anti-money laundering regulations in many countries require banks to do due diligence to identify their customer, back to the ultimate beneficial owner, and his source of funds. They must also file a 'suspicious activity report' to the authorities if they suspect the funds are criminal. But the rules are insufficiently explicit about the steps that banks must take to avoid corrupt or otherwise illegally derived funds. This provision would put the onus on banks to have found strong evidence that the funds are clean before being able to accept the funds, rather than waiting for regulators or investigators to come along and discover that they are not.

What is happening so far?

The G20 has tasked the Financial Action Task Force (the intergovernmental body that sets the international standard for anti-money laundering laws and measures countries' compliance with them) to 'revise and reinvigorate the review process for assessing compliance by jurisdictions with AML/CFT standards'. FATF has interpreted this as an opportunity to address the measures that should be taken if a country's anti-money laundering laws are not up to standard. In addition, FATF is preparing for its fourth round of 'mutual evaluations'; it agreed in February 2009 that the question of customer due diligence, embodied in FATF Recommendation 5, is a key priority for strengthening.

What should the G20 do now?

The sixteen members of the G20 that are also members of FATF should ensure that FATF strengthens Recommendation 5 so that countries must require the banks they regulate not to take business unless they have identified a beneficial owner, and for PEP customers, have strong evidence that the funds are not the proceeds of corruption or other illegal activity.

6. Harmonising predicate offences for money laundering and including tax evasion

Recommendation: The Financial Action Task Force should require that predicate offenses for a money laundering charge include tax evasion, as well as all crimes committed both at home and abroad.

Which problems will this help solve?

Current FATF standards permit countries to have substantially different lists or ranges of predicate offences. Most countries do not include tax evasion as such an offence. Harmonising predicate offences and including tax evasion among them will curtail regulatory arbitrage across jurisdictions, which is a necessary step in curtailing all forms of illicit money, including the proceeds of tax evasion, corruption, other crime or terrorist financing. In addition, it would ensure that those countries which currently fail to recognise most crimes committed abroad as a predicate offence for money laundering (such as the US) do not operate an 'easy way in' to the global financial system for criminals wishing to deposit their funds.

What is happening so far?

According to the Netherlands, its current president, FATF agreed in February 2009 that the question of tax crimes as a predicate offence for money laundering was a key priority to be addressed in the preparations for the forthcoming fourth round of mutual evaluations.

What should the G20 do now?

Sixteen members of the G20 are also members of FATF. The other four, India, Indonesia, Saudi Arabia and South Korea are all members of FATF-style Regional Bodies. In order to coordinate with the action they are taking against tax evasion in other arenas such as the OECD standards, they should use their influence in FATF to ensure that its standards are upgraded explicitly to recognise tax evasion as a predicate offence. Individual G20 members which have not yet taken an 'all-crime' approach to the recognition of predicate offences should immediately do so.