Commission on capital flight from developing countries:

Tax havens and development

Summary of the preliminary report

Photo: Rodney Lobo/Norad

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Tax Havens and Development

Highlights of the report from the Commission of experts which analysed how tax havens harm developing countries and what Norway can do.

Commission with specific proposals
In June 2008, the government appointed an official Commission to learn more about tax havens and how they damage developing countries. The Commission also looked at Norway's role with regard to the use of tax havens, particularly through the activities of Norfund – the Norwegian Investment Fund for Developing Countries. The Commission reports to the Ministry of Foreign Affairs.

This work resulted in a number of specific proposals for measures to reduce the harmful effects of tax havens, including actions that the Norwegian authorities should take both at home and internationally. The Commission also provided new guidelines for Norfund's activities and recommended, among other things, that Norfund cease to make new investments through tax havens at the end of a transitional three-year period.

Summary
This presentation covers the main conclusions of the Commission's report, and focuses on the following points:

1) Description of tax havens
2) Scope – how much money is involved
3) The harmful effects tax havens have on developing countries
4) National measures
5) International measures
6) New course for Norfund

(The full report can be ordered from norad-post-info@norad.no)

1) Description of tax havens
"Either this is the largest building in the world or the largest tax scam," commented US president Barack Obama when he learnt that 18 000 companies have the same Cayman Islands address – a building named after a Norwegian family. A distinctive feature of tax havens is precisely that small countries may host an unusually large number of companies. No less than 830 000 companies, for instance, are registered in the British Virgin Islands which has a population of about 19 000 people.

Tax havens derive their income from registration and administrative fees paid by companies. The total amount paid is insignificant to the companies, but it represents an important source of revenue for the tax havens, which are often small countries. Accordingly, attracting as many foreign registrations as possible is important for tax havens. Foreigners often account for 95-98 per cent of the total number of registered companies in such jurisdictions.

No local operation
Most tax havens are geographically remote from the owners of the companies they register, and little or none of the real commercial activity of those companies occurs there. This is the intent, as legislation in tax havens specifies that the companies must not have local operations. They cannot normally own or lease real property, and their owners cannot reside locally or use the local currency in their business activities.

Tax favouritism and secrecy
A typical feature of tax havens is a tax and regulatory regime that distinguishes between local investment and investment made by foreigners, with the latter given favourable treatment (known as "ring-fencing"). This ring-fenced regime has legal structures which allow companies to conceal or veil the identities of those who own or control the business. In addition, they pay virtually zero tax, have no real accounting or auditing obligations or duty to preserve important corporate documents, and can easily move the company to a different jurisdiction. Enterprises which actually have operations in a tax haven often pay more tax and face requirements for accounting, official registration, auditing and so forth.

Certain tax havens have systematically facilitated ways to undermine the legislation of other countries. Some, for example, allow companies which register with them to adopt names which suggest they are domiciled in countries which are not tax havens. The Seychelles, for example, permits companies to register with Norwegian or Finnish suffixes – AS or OY – after their name.

2) Scope – how much money is involved
The size of money flows from developing countries to tax havens cannot be precisely estimated. But it is undoubtedly far higher than, for instance, financial assistance or direct investments flowing into these countries. Illegal capital flight corresponds to roughly ten times the financial assistance given to developing countries.

According to the best-qualified estimates, illegal money flows from developing countries totalled USD 641 to 979 billion in 2006 (Kar and Cartwright-Smith, 2008). In 2006 the total registered money flows into these countries (including

China and India) is estimated at USD 206 billion (IMF World Economic Outlook database) In addition, the total development assistance was USD 106 billion (OECD). In other words, even the lowest estimate indicates that money flowing *out* of these countries in an *illegal* manner is greater than the money flowing *into* them *legally*.

Not all the illegal money flows go to tax havens, but it has been well documented that placements in such countries are very large and that much of the capital placed there is undeclared for tax purposes. The Tax Justice Network estimates that USD 11 to 12 000 billion was placed in tax havens in 2004. Official statistics suggest that the scale of such placements increased sharply in subsequent years, but that the financial crisis led to a decline over the past year. Revelations in the US and the UK regarding the use of tax havens by their citizens suggest that only about five per cent of the funds invested in tax havens are declared for tax in the country of domicile.

The world currently has 30-70 tax havens, depending on the definition applied. This means that 15-30 per cent of the world's states are classified as tax havens in one way or another.

3) The harmful effects tax havens have on developing countries

Former president Suharto of Indonesia (who died in 2008) is suspected of misappropriating more money than anyone else in history – USD 15 to 35 billion according to Transparency International. Despite legal action, nobody has been found guilty of illicit transactions and no funds have been returned. Tax havens make this possible. What consequences do such conditions have for poor countries?

Weaken institutions

One of the most serious consequences of tax havens is that they undermine institutions and political systems in developing countries. Politicians and civil servants may have a personal interest in weakening existing institutions. The relationship is simple: weak enforcement bodies and little risk of being prosecuted make it easier to use tax havens to hide the proceeds of economic crime. These proceeds can derive from corruption, or revenues misappropriated by politicians from development assistance, or from natural resources and government budgets. Tax havens thereby provide the power elite with political incentives to demolish rather than build up institutions. When the likelihood that economic crime will be exposed is small, moreover, the threshold for engaging in this type of criminal activity is lowered and it becomes more profitable.

Create nothing new

Countries rich in natural resources have achieved lower growth on average than other countries over the past 40 years. Often called “the paradox of plenty”, one principal explanation for this phenomenon is that the elite who manage the resources do not use them to generate new income and productive activity. Instead, the resources are wasted on redistributing existing income in the elite’s own favour (known as “rent-seeking”). Society’s assets are thereby shifted away from productive, value-creating activities.

Tax havens contribute to this re-orientation. It is more profitable for individuals to evade tax than to create something and run it efficiently. The more people who pursue rent-seeking behaviour, the fewer who participate in productive activities to generate growth and development for the whole community. This is a bigger problem for developing countries than for rich nations, since the lack of expertise and the need for value creation and development are greatest in poor countries.

Reduce tax revenues

Tax havens offer secrecy, fictitious domiciles and zero-tax regimes to attract income and capital which should actually have been taxed in other countries. This has made it difficult for a number of countries to maintain high taxes on capital, which has in turn reduced taxes and government revenue. This is particularly serious for developing countries – both because they have a narrower tax base than wealthy nations, and because they obtain the greater part of their taxes from capital. Treaties which assign tax revenues between countries in order to avoid double taxation do not help to resolve the problem – rather the contrary, since they contribute to ensuring that tax havens secure the right to tax activities that are actually pursued in developing countries. These treaties also give the signatories the mutual right to acquire information from each other in order to assess tax liability, but the lack of public registries, accounts and so forth, make it difficult to identify ownership, and so the right to access tax-related information has little value in a tax haven.

Undermine international financial markets

The financial crisis has revealed that many financial institutions had off balance-sheet liabilities which were registered in tax havens and thereby protected from scrutiny. Secrecy in tax havens means that the various investors receive unequal information. This undermines the international financial market, contributes to higher risk and boosts borrowing costs for both rich and poor countries.

4) National measures
In some cases, taking on the tax havens can mean the return of large sums of money to poor countries. Sani Abacha was Nigeria's head of state from 1993 to 1998. After his death in 1998, it emerged that he had misappropriated at least USD 2 billion from the country's foreign currency reserves. The transfer of these funds to other countries occurred through the use of Nigerian and foreign companies. The money was invested in Switzerland, Luxembourg, Liechtenstein, the UK and Jersey. The Nigerian Abacha case is perhaps the most successful example of asset recovery by a poor country. Virtually the whole misappropriated amount may be returned to Nigeria. Normally, much smaller percentages of such funds are recovered.

So what can Norway do in the fight against tax havens?

a) An aggressive development policy
Norway should work to improve tax administration and sources of tax revenue in the developing countries. A specific example is assistance in the formulation of contracts between multinational companies and developing countries over the exploitation of natural resources.

In its dialogue with developing-country governments, Norway must require that civil society be given a place and that the press has the freedom to do its job. A stronger commitment should also be given to measures that improve the quality of the economic and financial press in select partner countries, especially in Africa. Norway must also demand that nations which receive government-to-government assistance make greater efforts to fight economic crime.

b) Front persons/facilitators must be registered
A special Norwegian register should be established for all Norwegian companies and individuals who facilitate or undertake the establishment of companies and accounts in tax havens. The register must include the name of the person or company with their personal identity/organisation number, and could be linked, for instance, to the Norwegian Register of Business Enterprise in Brønnøysund. The duty to report and register should run from 2004, and the register should be open to public inspection.

Creating such a register calls for legislation. A domestic law commission should therefore be appointed to establish the legal basis for such registration and the countries it should encompass.

c) More detailed annual accounts
Norwegian multinational companies should include the following information in their annual accounts:

- countries in which they have legal equity interests
- the size of this equity interest
- the number of employees in the company
- the gross income and taxable profit of each company in each country
- how much tax is paid by each company in each country as a percentage of the taxable profit.

Such information is important not only for investors but for the public generally, as most multinational companies have stated corporate social responsibility as an explicit goal.

d) Improved rules against transfer pricing
Companies price internal transactions inaccurately in order to transfer profits to low-tax countries. This practice is very problematic for both rich and poor countries. It can impose a substantial loss of tax revenue on developing countries, and weaken their ability to develop national commercial activities.

An analysis based on Norwegian enterprise data indicates that, even in a nation like Norway with relatively strong tax controls, multinational companies transfer a substantial proportion of their profits to countries with lower taxes. This makes it necessary to consider utilizing a broader range of regulations than those available today (the OECD's model tax treaty and Norwegian domestic law). The US tax authorities have made considerable progress in applying rules to identify inaccurately priced transactions. One example is the comparable profits method, which compares earnings between companies in the same industry. If a subsidiary of a multinational company has far smaller profits over time than the average for its sector, this may be evidence of transfer pricing.

e) New centre of expertise – more knowledge
Little research is being done into tax evasion. Developing countries, in particular, suffer from the fact that expertise on tax evasion and transfer pricing exists primarily in the private sector, where the willingness to pay for such knowledge is high. A centre of expertise should be established in Norway to pursue research on these issues.

Such a facility would secure leading-edge expertise for Norway on issues of international tax, transfer pricing, tax havens and capital flight. The facility should collaborate with researchers and research teams in developing countries and contribute to the education of personnel from those countries.

5) International measures

a) Networks for applying greater international pressure

The Ministry of Foreign Affairs should appoint a cross-ministry working-group to develop networks with other countries that might cooperate with Norway in the fight against tax havens. This body should also seek to put tax havens on the agenda in international finance and development institutions such as the World Bank and the African Development Bank.

b) Inappropriate tax treaties

Tax treaties regulate which countries have the right to tax international income, and also provide some right of access to tax-related information. These treaties can meet some of the requirements of industrial nations for access to tax-related data. Where developing countries are concerned, however, the strong focus on tax treaties represents a diversion from the economic forces which make tax havens harmful to them.

Many conditions in tax havens are not affected by the tax treaties. Paradoxically, these agreements can have the effect of making such jurisdictions more favourable than would otherwise have been the case. Moreover, developing countries are in a weak position when they negotiate with tax havens. Poor countries desire the capital which tax havens can provide, and in exchange for this capital are willing to reduce their tax rates and thereby forego tax revenues.

Norway should take the initiative to revise tax treaties so that the location a company's real operations determines where it should be regarded as domiciled for tax purposes. Furthermore, tax treaties should give developing countries greater rights to tax profits transferred to foreign owners.

c) Establish a convention

Norway should join forces with like-minded countries to initiate the preparation of an international convention that combats harmful structures in tax havens. It is proposed that a working party in the Ministry of Foreign Affairs should pursue this. The convention should be general, apply to all countries, and be directed at specific damaging structures but not against particular states or systems of government. A number of countries can be expected to refuse to sign such a convention. Nonetheless, experience shows that even conventions which many countries have refused to sign can have a positive impact. Examples include those banning anti-personnel mines and cluster weapons, which have had a constructive effect on non-signatory nations.

d) Support the OECD
The Norwegian authorities should increase their financial support for the taxation outreach programme for non-OECD economies run by the OECD. The programme functions as a meeting point for tax authorities in various countries, and is important to the development of new international standards for good tax practice. The programme's strength lies in its focus on practical tax policy and current challenges.

6) New course for Norfund

Norfund – the Norwegian Investment Fund for Developing Countries – had an investment portfolio of NOK 4.8 billion at 31 December 2008. About 80 per cent of this amount was invested directly or indirectly through tax havens.

a) No new investment through tax havens
It would serve no purpose to require Norfund to withdraw from *existing* investment funds currently registered in tax havens, but the institution must gradually reduce its new investments in such jurisdictions to zero over the next three years. This will increase Norfund's direct investment in developing countries without necessarily affecting its profitability or development effect.

b) Improved reporting
A good deal of information about Norfund's investments is already available on the institution's website and in its annual report on operations. But this type of information should be concentrated in one place and given a more central position. Moreover, Norfund should establish ethical guidelines for its choice of investment locations, and work to ensure that the funds in which it invests provide publicly accessible accounts.

Norfund's investments fall into two categories:
1) fund investments, where the institution joins with other investors to establish a fund which purchases shares in or makes loans to companies
2) direct investments, where the institution invests directly in companies in developing countries in the form of loans or share purchases.

Norfund should report:

- the proportion invested in funds and direct investments respectively, and how this breaks down between loans and shares
- the return on these two categories as well as on the sub-categories of loans and shares before and after tax
- where the funds are registered
- which countries receive fund investments
- co-owners of the funds
- for fund investments, Norfund should present its share of tax paid as a proportion of its share of the capital in the fund.

c) Good country analyses

Norfund should conduct country analyses of the locations in which it invests. The analysis should contain a detailed assessment of relevant legislation, including laws or regulations on tax, company and enterprise registration, bank and finance, money laundering and anti-corruption. Norfund must assess whether African countries, for example, can be identified which do not permit the harmful structures typical of tax havens and which can function as alternative investment locations.

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