

Free Movement of Capital and Tax Havens

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The era of deregulation – connecting the dots

The financial crisis is becoming a watershed moment between the collapse of unregulated global capitalism, and the prospect of a new global economic order. It seems only fit to look back and consider the manner in which deregulation has been instituted and then considering the prospects for effective re-regulation. Free movements of capital in a global economy placed regulation beyond the bounds of nation-states into offshore financial centres that claimed regulatory, fiscal, legal and juridical sovereignty while being under the aegis of the major powers for ensuring both monetary stability and military protection.

To unpack the terminology of free capital movements, it's useful to first look back to the era of deregulation, which started in the 1970s and may now be coming to an end with the current financial crisis. Deregulation actually meant that previously existing regulations on the level of nation-states were largely abandoned or lifted, and capital owners shifted much of the essential day-to-day workings of the global economy such as currency trading, patents and royalties, leasing agreements and other so-called "intangible assets" to offshore locations.

For example, Ireland is a tax haven in the sense that it doesn't tax patent income, a loophole that has attracted many technology and pharmaceutical companies to register their patents on the republic. The most notorious example is Microsoft who booked 9 billion USD worth of patent revenue in Ireland in a subsidiary that was only established and controlled by a single Dublin law firm. Estimated losses to foreign revenue authorities were as high as 500 million USD - Apple and Dell use similar schemes. What enabled this system was a clever use of double-taxation treaties to find loopholes in the ways in which you could subsequently repatriate profits from foreign operations without paying taxes at the source.

The global banana trade also passes through the Irish law offices before reaching our supermarket shelves. When *The Guardian* revealed (06/11/2007) how the global banana trade makes up the majority of the profits offshore for the utilisation of the brand (Ireland), management services (Jersey), use of the distribution network (Bermuda) etc. While the banana reefer actually travels from Ecuador, Cameroon or Costa Rica straight to the ripening houses in large European ports, on paper the bananas criss-cross the Atlantic six times [Table 1].

Nobody thought that global trade would be dominated by such letter-box entities, back of the law firm operations, brass-plate companies and scrupulous offshore registrars. As tariffs were reduced to a minimum with successive trade rounds leading to the creation of the World Trade Organisation, international tax co-operation was completely missing in the picture. While the Bretton Woods discussions in 1944 talked about the exchange of tax information between authorities, no advances were then possible as tax was still strongly connected to the war effort and the US still continues to tax global profits of its enterprises.

Today, an estimated 60 % of world trade takes place within the subsidiaries of Transnational Corporations (TNCs). This astonishing amount of world trade isn't regulated at all, as the trade and investment liberalisation regime only tackled the rights of the merchants and investors. Instead a private-sector body called the International Accounting Standards Board (IASB) based in the US secrecy jurisdiction

of Delaware, and operated from London, has been setting international accounting standards since 2005. Its guidelines are incomprehensible for establishing the source of revenues, beneficial ownership of subsidiaries and other information that investors and tax collectors need.

Developing countries have been actively encouraged to permit corporate tax holidays, special labour regimes and other tax and regulatory incentives in Export Processing Zones, oil and mining projects, and hydroelectric dams. It is estimated that illicit capital flows in the global economy account for 1 – 1,6 trillion USD annually, half of which originates from developing or transitional economies. Criminal activities (drug trafficking, bribery, illegal arms trading, etc.) account for a third of this sum, while the vast majority is of commercial nature. Commercial corruption is composed of fake transactions, abusive uses of transfer pricing between subsidiaries of the same parent company, and mispricing goods between unrelated companies. The intent of all of these operations is to minimise taxes, shift capital out of developing countries, and hide the large-scale operations that are required to conduct it. [Table 2]

Regulating global capitalism

In terms of a *global financial architecture*, the aforementioned gaps regarding automatic and effective exchange of tax information between jurisdictions should be a cornerstone of a new financial architecture in a future International Tax Organisation, as an upgrade of current UN tax committee should be called. To facilitate its work the IASB should become a publicly accountable body instead of being a private members club, and mandate country-by-country financial reporting listing all beneficial ownership ties, including trusts and other obscure ownership vehicles such as International Business Companies.

Market transparency is crucial for both ensuring the rule of law in the global economy, as well as avoiding TNCs from distorting the market by opaque and secretive ownership structures. Country-by-country reporting, should lead to the public knowing how much a TNC makes profits in their territory, enabling the public to hold TNCs accountable. The way tax revenues are divided should follow international agreements, rather than bilateral tax treaties that leave too much room for loopholes and special interests. Boards of directors of TNCs should prepare and sign off bi-annual risk assessments involving financial, political, environmental, labour market risks caused by their global operations.

Markets have been distorted by the extent of *financial wizardry*, which by hiding risks behind ever more complicated and multi-jurisdictional investment products, has evaporated trust in markets by investors and the public alike. A bench mark for the approval of any investment product (whether offshore or onshore) needs to follow one simple rule, it must be regulatable. This means that the authorities must be able to establish the ownership structures, and risk associated to the product in order to grade it and deem it fit for trading. In the case of offshore funds, clearing houses and banks would be mandated to provide similar assessments of offshore investors before allowing any transactions to take place with offshore funds by strengthening the money-laundering legislations. Turning a blind eye, and accepting reassurances from large investment banks is not the way to approve products.

The result of the current system of global financial markets have been an unlevel playing field where TNCs have dominated not only through their technological and managerial advances, but also through offshore operations that are used to evade taxes, establish monopolistic cartels, and enhance corruption. It is ironic that the “free market” touted so loud in rhetoric, created the most opaque ownership structures when it was allowed to operate freely.

The offshore interface is like a cancer in our global society, and the quicker we tackle the illicit financial flows, mandate tax havens to exchange tax information on an automatic basis, and bring all financial centres to a single global regulatory framework the best we can salvage the patient which is the current ailing global society, with has suffered the triple heart attacks of the food crisis, financial crisis and climatic change. Enhancing public finances will play a key role, as it is through public investment and tough regulation, not tax breaks and other incentives that we will face the combined challenge of these crises.

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Tables:

Table 1: How one Euro's worth of bananas purchased in Europe is traded on paper for profit-shifting purposes		
Invoice 1	Producer country	Bananas exported at 13 cents. Labour and other production inputs account for 12 cents. Approximately 1 cent of taxable profits booked in producer country
Invoice 2	Cayman Islands	8 cents fee charge for use of purchasing network
Invoice 3	Luxembourg	8 cents charged for use of company financial services
Invoice 4	Ireland	4 cents charged for use of brand
Invoice 5	Isle of Man	4 cents charged for use of insurance services
Invoice 6	Jersey	6 cents charged for management services
Invoice 7	Bermuda	17 cents charged for use of distribution network
Invoice 8	Consumer country	Bananas imported at 60 cents and invoiced to retailers at minimal margin or even at a <i>loss</i> . The retailer adds a margin of 39–40 cents. Approximately 1 cent of taxable profits booked in consumer country.

Source: Christensen, J. (2009)

Table 2: Sources of commercial dirty money flows		
Transaction	High estimate (billions of dollars)	Low estimate (billions of dollars)
Mispricing	150	100
Fake transactions	200	150
Abusive transfer pricing	150	100
Total	500	350

Source: Baker, R. W. (2005)