

# **ECONOMIC TRANSPARENCY CURTAILING THE SHADOW FINANCIAL SYSTEM**



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## EXECUTIVE SUMMARY

We may be at a rare moment when the interests of rich and poor countries are synonymous.

At the heart of the current worldwide economic crisis is a lack of transparency in the global financial system. This is the end product of a half century of creating and expanding a shadow financial structure comprising tax havens, secrecy jurisdictions, disguised corporations, anonymous trust accounts, and fake foundations. Also included in this system are trade mispricing mechanisms, money laundering techniques, and gaps left in western laws that facilitate the movement of corrupt, criminal, and commercially tax-evading money across borders. Some estimates suggest that as much as half of global trade and capital movements pass through this shadow financial system.

The consequences of this murky structure and the money it moves are now clear:

- In developed countries, credit has dried up in large part due to the difficulty of appraising the quality of assets held by financial institutions that operate partially or wholly within this opaque system. This includes almost all major U.S. and European banks.
- In developing countries, an estimated \$1 trillion a year of illicitly generated money is shifted abroad through this system, constituting the most damaging economic condition hurting the poor, undermining poverty alleviation and delaying sustainable growth.

The Task Force on Financial Integrity and Economic Development urges the G-20 to focus on substantially improving transparency in the global financial system. Thus far in discussions and commentaries, greater emphasis has been given to strengthening regulation within the existing structure. While some regulatory improvements are certainly needed, we believe this emphasis is misguided. Far greater benefit can arise by significantly curtailing the shadow financial system that is clearly at the root of the economic crisis all nations are facing.

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## CONCEPTUAL FRAMEWORK

The Task Force on Financial Integrity and Economic Development, a consortium of Governments and NGOs (see Appendix 1), focuses on achieving greater transparency in the global financial system for the benefit of developing countries.

Global Financial Integrity, a Washington, DC-based think tank and leader of the Task Force, estimates that the amount of money draining illicitly out of developing countries into western economies is approximately \$850 billion to \$1 trillion a year. These cross-border funds are generated as the proceeds of a) bribery and theft by government officials (about 3 percent of the global total), b) criminal activity such as drug trading and racketeering (comprising some 30 to 35 percent of the global total), and c) commercial tax evasion accomplished primarily through the mispricing of exports and imports (by far the largest component at about 60 to 65 percent of the global total).

Almost all of these shifts constitute permanent outward transfers. Only a fraction of them return to the countries of origin, and even then only as foreign direct investment. This massive transfer of wealth out of poorer nations is the most damaging economic condition undermining poverty alleviation and sustainable growth efforts in these countries, which are home to 80 percent of the world's population.

The enormous transfers of financial resources have been facilitated for decades by a shadow financial system that has expanded globally since the beginning of the 1960s (see Appendix 2). This system was created originally to move flight capital and tax evading money across borders and has since come to be used by criminals and terrorist financiers as well.

This same shadow financial system is now at the heart of the global financial crisis. It shields from view and from accurate appraisal the depths of the global problem with subprime mortgages and other collateralized debt obligations, credit default swaps, derivatives contracts, and more. Lending has nearly collapsed, since financial institutions are unable to discern the quality of assets of those needing funds.

Lack of transparency in the global financial system affects rich and poor countries alike. This may be a first in modern history, where the same economic phenomenon impacts the haves and have nots in similar proportions.

Solutions to the current crisis highlight the need for improved regulation and greater transparency. In commentary to date, much more emphasis has been given to strengthening financial regulation, while meaningful improvements in global transparency are seldom mentioned. We believe this is precisely the wrong balance. We believe that much more can be accomplished through transparency than through regulation. While regulation simply tries to provide a tighter set of rules governing financial transactions, transparency requires that the shadow financial system itself be largely dismantled.

The Task Force on Financial Integrity and Economic Development advocates five priorities in addressing the current global financial crisis, each one focusing on transparency and extending initiatives that have already begun to be put into place:

- 1) Curtailment of mispricing in trade imports and exports;
- 2) Country-by-country accounting of sales, profits, and taxes paid by multinational corporations;
- 3) Confirmation of beneficial ownership in all banking and securities accounts;
- 4) Automatic cross-border exchange of tax information on personal and business accounts;
- 5) Harmonization of predicate offenses under anti-money laundering laws across all Financial Action Task Force cooperating countries.

Thus, transparency means public records, multiple oversight mechanisms to review financial structures, a genuine curtailment of tax-evading activities, and trade conducted without disadvantaging weaker nations. Through transparency the shadow financial system, currently moving upwards of one trillion dollars a year of illicit money out of developing countries, will be contained. This will result in 80 percent of the world's 6.5 billion people being able to participate in a free-market system that is not biased against them. Transparency means that economic prosperity has a chance of becoming a reality for all.

However, we are deeply concerned that what appears to be a focus on "stabilizing" the financial system could in fact mean maintaining the status quo, merely accompanied by improvements around the regulatory edges. In resolving the current financial crisis, the interests of developed and developing countries should be identical—elimination of the realities that caused the global meltdown. This requires, not adjustments, but sharp curtailment of the shadow financial system at the heart of the crisis. Resolving this issue must be the key concern in rebuilding the global free-market system.

What follows are the five primary priorities of the Task Force and a brief description of each.

## TRADE MISPRICING

**Action Item:** 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 and that the transaction is priced using the OECD arms-length principle.

**Background:** In the continuing debate over how to best integrate developing nations into the global economy the issue of foreign direct investment is inevitably mentioned. For a time conventional wisdom stated that by increasing foreign investment a country could significantly improve its living standards. A growing understanding of the resource curse, however, has somewhat dampened the optimism of the role foreign investment plays in development. Ultimately, foreign investment alone will not be a sufficient catalyst for a struggling economy. Tax revenue the host government obtains from the investors is a critical component of the revenues needed to have an impact on development.

A 2004 paper issued by the OECD entitled "Institutional Approaches to Policy Coherence for Development" noted that "Attracting FDI and international trade into developing countries is not the end of the game. There is no guarantee that FDI and international trade will translate into tax revenues for the countries attracting them."

Approximately 60% of global trade is conducted by multi-national corporations and half that amount is between subsidiaries of a parent company. The OECD paper notes that since "intra-group transactions are not subject to the same market forces as transactions between unrelated parties operating on the free market, there is a huge potential for profit shifting via under or over pricing of intra-group transactions." In other words, unless sufficient attention is given to transfer pricing issues, it is possible that in practice a developing country will derive little or no revenues from the FDI attracted to its territory.

A similar signature process has already been implemented to verify the legitimacy of the diamond trade. The Kimberley Process Certification Scheme requires signatures to guarantee that shipments of diamonds are not used to fund conflict.

**G-20 Jurisdiction:** Working Group 1 (Enhancing sound regulation and strengthening transparency) and Working Group 2 (Reinforcing international cooperation and promoting integrity in financial markets).

**Executing Authority:** Organization for Economic Co-Operation and Development; World Trade Organization.

**Benefit:** Instituting procedures that curtail the practice of trade mispricing will enable governments in poor countries to collect a fair amount of tax revenue from multinational corporations operating in their territories. That revenue can then be utilized to develop the local economy.

## COUNTRY-BY-COUNTRY REPORTING

**Action Item:** Require that all multi-national corporations report sales, profits, and taxes paid in all jurisdictions in their audited annual reports and tax returns.

**Background:** Tax avoidance is a global problem. It involves the abusive exploitation of gaps and loopholes in domestic and international tax law that allows multinational companies (MNCs) to shift profits from country to country, often to or via tax havens, with the intention of reducing the tax they pay on some or all of their profits. Tax avoidance on such a large scale is facilitated by a lack of transparency in the way MNCs report and publish their accounts. Making MNC accounts more transparent would help tackle tax avoidance at very low cost.

At present most MNCs publish segmented information that breaks their trade down along product or division lines. However, MNCs are not required to publish geographic data, and there is no requirement to do so on a country-by-country basis. Despite publishing their accounts as if they are unified entities, MNCs are not taxed in this way. Each member company of the group is taxed individually. This makes it difficult to establish an overview of what is happening within a group of companies for tax purposes.

Tax avoidance is facilitated by tax haven structures created to shroud business activity in secrecy. It is often impossible for tax authorities to obtain information or assistance from the government of a tax haven, and companies are not usually under any obligation to disclose what they are doing outside the country that is making the enquiry. Given this opacity, even proving the existence of a tax avoidance scheme can be difficult.

The European Parliament has already urged the International Accounting Standards Board to move beyond voluntary guidelines and support the development of an appropriate accounting standard requiring country-by-country reporting by extractive companies. While this measure is a sound first step, it is not far-reaching enough.

**G-20 Jurisdiction:** Working Group 1 (Enhancing sound regulation and strengthening transparency) and Working Group 2 (Reinforcing international cooperation and promoting integrity in financial markets).

**Executing Authority:** International Accounting Standards Board.

**Benefit:** Country-by-country reporting (CCR) would provide information to a wide range of stakeholder groups which will strengthen efforts to monitor corrupt practices, corporate governance and responsibility, tax payments, and world trade flows. CCR would benefit investors by revealing which corporations operate in politically unstable regimes, tax havens, war zones, and other sensitive areas. CCR would also enable citizens of developing nations to determine who owns the companies that are trading in their countries, what tax is being paid and whether that appears reasonable in relation to the tax rates in the country in question.

## **BENEFICIAL OWNERSHIP**

**Action Item:** Require that the beneficial ownership, control and accounts of companies, trusts and foundations be readily available on public record to facilitate effective due diligence.

**Background:** The flow of illicit money, tax evasion, terrorist financing and a host of other global ills can be traced to the lack of information about the beneficial owners of corporations, trusts and foundations. Often located in some 70 secrecy jurisdictions around the world these entities can absorb, hide and transfer wealth outside the reach of any law enforcement agency. The activities of these entities are largely unknown (and can be moved to other jurisdictions at a moment's notice), they often do not benefit the local population, and they frequently have no legitimate business purpose. Furthermore, beneficiaries of these activities often remain secret. In effect these entities operate in a world very much separate from the legitimate global economy.

As the collapse of Enron showed, multinational corporations can have thousands of subsidiaries hidden throughout the world. Corporate entities can use these structures to transfer profits abroad in order to reduce tax liability or to circumvent local regulation in developing countries. Multinationals can use additional tools of transfer mispricing (manipulating prices of inter-subsidiary transactions to shift profits) to divert profit to no- or low tax jurisdictions and which are very hard to detect. Convoluted structures of this kind are used commonly as a way of siphoning off and handling illicit funds. These structures make uncovering the true nature of transactions and tracing beneficial ownership and the origin of funds difficult for investigators. The modus operandi of illicit financial flows are not aberrations but a part of a broad structural problem.

In order to address these ills jurisdictions must ensure that they maintain a current list of the beneficial owners of corporations, limited liability companies, and other legal persons organized under their laws. The FATF requirements for establishing beneficial ownership as part of the customer due diligence process must be implemented globally. A beneficial owner must be defined as a natural person or listed corporation, not a nominee corporation or disguised trust.

**G-20 Jurisdiction:** Working Group 1 (Enhancing sound regulation and strengthening transparency) and Working Group 2 (Reinforcing international cooperation and promoting integrity in financial markets).

**Executing Authority:** Financial Action Task Force.

**Benefit:** Providing beneficial ownership information will enable national authorities to better estimate tax revenue (and plan for its utilization) and track and address illegal activity. 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 determine the credit worthiness of potential customers. Thus, a fully transparent corporate structure will foster a better functioning global financial system.



## AUTOMATIC EXCHANGE OF TAX INFORMATION

**Action Item:** Require governments to collect from financial institutions data on income, gains, and property paid to non-resident individuals, corporations, and trusts. Mandate that data collected automatically be provided to the governments where the non-resident entity is located.

**Background:** Globalization and the liberalization of economic activity has converted the private sector into a world without borders. This creates a major problem for national tax authorities because similar changes in their enforcement powers have not kept pace with industry. National tax authorities continue to be constrained by national borders and collecting tax revenue has been difficult.

Additionally, bank secrecy and other confidentiality laws in many jurisdictions (such as tax havens and international financial centers) prevent disclosure of relevant information by financial institutions to government authorities. Further, lax response by tax authorities in those jurisdictions to information requests from foreign governments often delays or prevents cases against tax cheats.

Tax, not aid, is the most sustainable source of finance for development, and tax havens undermine developing countries' efforts to pay their way. The United Nations' 2002 Monterrey Consensus and the 2005 UN World Summit require developing countries to mobilize domestic resources for development. This means tackling illicit capital flight and tax evasion. Moreover, the Commentary to the OECD Model Income Tax Treaty and the Commentary to the UN Model Income Tax Treaty both refer to automatic exchange of information.

Some steps have already been taken on this issue. The EU Savings Tax Directive was adopted to ensure the proper operation of the internal market and tackle the problem of tax evasion. It was approved in 2003 and came into effect on July 1st, 2005. The automatic exchange of data on interest paid has been agreed upon by all member states except Austria, Belgium and Luxembourg. More needs to be done to ensure that all nations, developing and developed, collect a fair amount of tax from both individuals and corporations.

**G-20 Jurisdiction:** Working Group 1 (Enhancing sound regulation and strengthening transparency) and Working Group 2 (Reinforcing international cooperation and promoting integrity in financial markets).

**Executing Authority:** European Union; UN Committee of Experts on International Cooperation in Tax Matters.

**Benefit:** It is estimated that individuals have about \$12 trillion of assets in jurisdictions other than their countries of residence and not declared in their countries of residence; the lost tax revenue annually from such undeclared assets is estimated at \$255 billion. Tax evasion by corporations and other entities is also a major problem.

## ANTI-MONEY LAUNDERING

**Action Item:** Require that predicate offenses for a money laundering charge are harmonized at the most restrictive level and codified.

**Background:** Under current U.S. law it is legal for American banks to accept the proceeds resulting from handling stolen property, customs crimes, counterfeiting, and trafficking in stolen property when those crimes occur outside US borders. American banks are also permitted to accept deposits that are derived from sex and arms trafficking, racketeering and dozens of other crimes that, if they were committed in the U.S., would be predicate crimes for a money laundering offense. Indeed, the United States was found partially non-compliant with international anti money laundering standards in the most recent Financial Action Task Force peer review.

While predicate crimes for a money laundering charge — when the crime is committed outside a nation's borders — are more restrictive in European nations they are by no means universal. Corrupt officials, criminals, tax evaders and terrorist organizations can easily transmit the proceeds of illegal activity to the safety of the western banking system by simply conducting legal arbitrage.

It is estimated that some \$900 billion in illicit funds are funneled out of developing countries each year. This depletion of capital undermines the ability of poor countries to build their economies and become productive and vibrant participants in the world economy. Porous anti-money laundering regimes in countries where illicit funds are most likely laundered contribute to illicit flows.

Taking this step will be an important contribution to the growing debate on the degree to which money obtained from crime is permitted to cross international borders and enter the banking systems of OECD countries.

**G-20 Jurisdiction:** Working Group 1 (Enhancing sound regulation and strengthening transparency) and Working Group 2 (Reinforcing international cooperation and promoting integrity in financial markets).

**Executing Authority:** Financial Action Task Force.

**Benefit:** Requiring that predicate offenses for a money laundering charge are harmonized and codified within the OECD will create a bolstered defense against money laundering. The ultimate goal is to see that best practices are embraced by nations that have relatively weak anti-money laundering regimes and that a universal set of standards is adopted by all OECD countries to curb the flow of illicit capital.

# APPENDCIES

## Appendix 1: Task Force on Financial Integrity and Economic Development

### Coordinating Committee

Global Financial Integrity – [www.gfip.org](http://www.gfip.org)

Christian Aid - [www.christianaid.org.uk](http://www.christianaid.org.uk)

Global Witness – [www.globalwitness.org](http://www.globalwitness.org)

Tax Justice Network – [www.taxjustice.net](http://www.taxjustice.net)

Transparency International – [www.transparency.org](http://www.transparency.org)

Secretariat of the Leading Group on Innovative Financing for Development representing the following governments:

Algeria	Germany	Nicaragua
Bangladesh	Great Britain	Niger
Belgium	Guatemala	Nigeria
Benin	Guinea	Poland
Brazil	Haiti	Romania
Burkina Faso	India	Sao Tome and Principe
Cambodia	Italy	Saudi Arabia
Cameroon	Japan	Senegal
Cape Verde	Jordan	Sierra Leone
Central African Republic	Lebanon	South Africa
Chile	Liberia	South Korea
Congo	Luxembourg	Spain
Cote d'Ivoire	Madagascar	Togo
Cyprus	Mali	Uruguay
Djibouti	Mauritania	
Ethiopia	Mauritius	<i>Observer Countries:</i>
European Commission	Mexico	Austria
Finland	Morocco	China
France	Mozambique	Egypt
Gabon	Namibia	

### Partnership Panel

Government of Norway

Government of Germany

Government of France

Government of Spain

Government of Chile

Government of Denmark

Ministry of Foreign Affairs of the Netherlands

Ford Foundation

## Appendix 2: The Shadow Financial System

Since the 1960s western nations have built a global financial structure that facilitates the movement of illicit money across borders, primarily out of poorer countries into richer countries. There were minor elements of this structure available before the 1960s, for example, four or five tax havens and the use of trade mispricing techniques. But by far the greater part of the structure was built from the 1960s forward, for two reasons. First, the 1960s was the decade of independence. Between the late 1950s and the end of the 1960s, 48 countries gained their independence, and many of the economic and political elites in these countries wanted to take money abroad by whatever means possible. Western financial institutions serviced this desire. Second, the 1960s marked the decade when multinational corporations began an aggressive expansion across the globe. Certainly there were international businesses before the 1960s, but typically an international oil or trading company would have operations in only perhaps 12 or 15 foreign locales. Beginning in the 1960s, corporations started the process of planting their flags all over the globe, a process that continues today. Many multinationals utilize tax-evading techniques to remove profits from developing countries, again an activity that is well serviced by the shadow financial system.

This global shadow financial system has now grown to encompass the following:

**Tax havens** – These are places where an entity can be established and then sales can be made on paper to that entity and that entity can sell to other entities and the pricing can be handled in such a way that all or much of the profits are earned in the tax haven entity and little or no taxes are payable on such profits. From just four or five in past years, there are now 91 tax havens around the world.

**Secrecy jurisdictions** – Many tax havens provide secrecy capabilities through lawyers, accountants, and bankers, so that entities can be established behind nominees and trustees such that no one can determine who are the real owners and managers of the business.

**Disguised corporations** – Such disguised entities, mostly corporations, number in the millions around the world.

**Flee clauses** – Many such disguised entities are equipped with “flee” clauses, whereby the nominees and trustees fronting for the real owners and managers can have the entity flee from one secrecy jurisdiction to another in the event that anyone tries to determine who are the real people behind the entity. It can flee from one secrecy jurisdiction to another, always staying ahead of government authorities or private investigators.

**Anonymous trust accounts** – Able to operate like businesses, such trust accounts can also be established behind nominees and trustees fronting for the settlers and beneficiaries of the trusts.

**Fake foundations** – Foundations fronting as charities can be established behind nominees and trustees, giving tax-free benefits to owners.

**False documentation** – Widely used in trade and capital transactions to shield the real purposes behind financial movements.

**Falsified pricing in imports and exports** – Usually referred to as abusive transfer pricing in related-party transactions and mispricing in unrelated party transactions, such falsified pricing in imports and exports moves more illicit and tax-evading money across borders than any other mechanism.

**Holes left in anti-money laundering laws** – Many western nations leave gaps in AML legislation which serve to allow ill-gotten gains from abroad to enter into national financial systems. For example, the United States remains legally open to deposits of money generated abroad from handling stolen property, counterfeiting, contraband, slave trading, alien smuggling, trafficking in women, environmental crimes, all forms of tax-evading money, and more. Most European countries have tighter AML regimes on their books. Having said this, no western nation does a particularly good job of putting up a barrier between its financial institutions and incoming illicit money generated abroad.

Use of this shadow financial system has now become normalized across borders. It has been estimated that perhaps half of global trade and capital movements pass through this system somewhere between initiation and completion. And it is this shadow financial system that lies very much at the heart of the current global financial crisis affecting both rich and poor countries.