At issue: The IMF and capital flight: Redesigning the international financial architecture

The international financial system facilitates trillions of dollars of capital flight from developing and developed countries to onshore and offshore financial centres, with the active participation of banks and other financial institutions. The consequences are massive tax evasion, a resultant erosion of state budgets, and rising disrespect for the law.

The international financial architecture must be redesigned. The UN general assembly at the 2005 world summit resolved to "support efforts to reduce capital flight and measures to curb the illicit transfer of funds". The relevant international organisations that, working together, can achieve such a redesign are the IMF, the Organisation for Economic Cooperation and Development (OECD), and the UN.

$255 billion in lost tax revenues

Research by the Tax Justice Network has revealed that the amount of funds held by individuals in offshore and onshore tax havens, and undeclared in the country of residence, is about $11.5 trillion. This estimates capital flight from all countries, and not only from developing countries. Annual worldwide income on such undeclared assets is estimated to be about $860 billion, and the annual worldwide tax revenue lost is approximately $255 billion. That figure is equal to the annual funds needed to reach the UN's Millennium Development Goals.

Onshore tax havens include financial centres which are important members of the IMF, such as Luxembourg, Switzerland, the United Kingdom and the United States. Offshore tax havens include jurisdictions monitored by the IMF in its Offshore Financial Sector Assessment Program. Capital flight exacerbates the problem of emerging market countries being net capital exporters. The IMF itself has expressed concern over this issue "in light of the conventional wisdom suggesting that capital normally flows from capital rich to capital-scarce emerging markets".

> "... conflicting objectives among the tax authorities in various countries, especially tax-haven countries, ensure that in many cases [information on income earned abroad will not be exchanged between countries]. That leads to losses in total revenues and to changes in the incidence of the tax burden. It also leads to changes in the statutory tax systems when policymakers attempt to compensate for such losses by increasing the rates for other taxes. Obviously the existence of tax-haven countries facilitates tax evasion. The other countries suffer losses of revenue and decreased control over their tax systems."
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> Vito Tanzi, former director, fiscal affairs department of the IMF

UN calls for reform

The United Nations has emphasised the need for developing countries to mobilise domestic resources for development, and has spoken out against capital flight. The 2001 UN report by the high-level panel on financing for development 2001 (also known as the Zedillo report) stated "... globalisation has progressively undermined the territoriality principle on which traditional tax codes are based. Developing countries would stand to benefit especially from technical assistance in tax administration, [and] tax information sharing that permits the taxation of flight capital."

In March 2002, the UN international conference on financing for development in Monterrey called on developing countries to mobilise resources for development, especially domestic resources and the UN's Millennium Development Goals have also focused attention on the resources available to developing countries. About capital flight, the UN general assembly stated in the 2005 World Summit Outcome: "We therefore resolve ... to support efforts to reduce capital flight and measures to curb the illicit transfer of funds".

Previously, many countries relied on exchange controls to try to prevent capital flight and resulting tax evasion. The increasing liberalisation of economies and the resulting relaxation or dismantling of exchange controls have raised the question of how countries can combat capital flight. The liberalisation of economic activity, resulting in the exponential increase in cross-border commercial and financial transactions, has converted the private sector into a world without borders. This has created a major problem for national tax authorities since it has not been accompanied by similar changes in their enforcement powers. The answer is to override bank secrecy in onshore and offshore financial centres, improve tax administration in developing countries, and further implement international exchange of tax information.

In a joint IMF-OECD-World Bank paper in March 2002 , the three organisations indicated that they would assist developing countries in improving the effectiveness of their tax administrations, with the goal of increasing government revenues: "Developing countries must be able to raise the revenues required to finance the services demanded by their citizens and the infrastructure that will enable them to move out of poverty. Perhaps the greatest challenge facing these countries is to improve the effectiveness of their tax administration. In this context, the increasing globalisation of the economy is relevant both for developed and developing countries. The constraints that it places on countries' ability to set and enforce their own taxes are felt increasingly keenly."

The OECD project on harmful tax practices has tried to limit capital flight from OECD countries into offshore and onshore tax havens. At the same time, the project requires member countries to abolish certain specified "harmful preferential tax regimes". However, the OECD did not apply to itself the requirements for information exchange and overriding bank secrecy rules that it has imposed on designated tax havens. Similarly, the EU directive on the taxation of savings does not apply to interest paid from EU countries to residents of non-EU countries, and therefore does not limit capital flight from these non-EU countries into EU financial centres. Within the OECD and the EU, the opposition of Austria, Belgium, Luxembourg and Switzerland (all OECD

members) to exchange of information in both the OECD proposals and the EU directive on the taxation of savings, has framed the debate on this issue.

IMF in Argentina: financing capital flight

The June 2004 report of the Independent Evaluation Office (IEO) on the Fund's role in Argentina only mentions capital flight from Argentina in passing - but what it mentions is significant. At a meeting in late August 2001 to consider increasing Fund exposure to Argentina, senior IMF staff concluded that: "The additional few billion dollars would not buy enough time to make a difference, but would be more likely to disappear in capital flight, leaving Argentina more indebted to the IMF".

In their response to the IEO evaluation, Fund staff concluded "that the Fund would have avoided increasing its exposure to Argentina by about $9 billion, which in the event largely financed capital flight."

The report also refers to the technical assistance provided by the IMF's fiscal department to Argentina's tax authorities, without any detailed reference to the problems of tax evasion. Rumours are that Argentine residents held assets offshore exceeding the total amount of the sovereign debt defaulted by their government.

Overriding bank secrecy

Bank secrecy has two basic forms: de jure and de facto. With de jure bank secrecy, financial institutions are prohibited by law from disclosing the identity of depositors/investors except in cases of money laundering or other criminal activity. De facto bank secrecy results when these institutions are not required to provide their governments with information through automatic reporting about foreign depositors or investors.

In cases of either de jure or de facto bank secrecy, the government of the country where the financial institution is located does not receive the relevant information about the foreign depositor or investor. Therefore, that government cannot effectively exchange information about the foreign investor with the country of residence of the investor. This lack of exchange of information facilitates capital flight and tax evasion.

The solution to the capital flight problem is to override bank secrecy in tax matters and require automatic exchange of tax-relevant information. For example, if the investment by an Argentine were not protected by bank secrecy in an OECD or other tax haven financial centre, and if that financial centre would automatically provide the Argentine government with tax information about that person's investment, it would substantially diminish capital flight and the resulting tax evasion. Exchange of information between governments about capital flight was urged by the architects of the IMF, when the Bretton Woods agreement was being drafted in 1944. But this proposal was allegedly opposed by the US financial community which had benefited from capital flight.

The OECD has made significant steps toward addressing these issues, by emphasising the benefits of automatic reporting by financial institutions of tax-relevant information to their governments, and the benefits of automatic exchange of such information between governments. The OECD has worked on the mechanics of automatic exchange of information. Other OECD efforts to limit bank secrecy in tax matters include amendments to the OECD model income tax treaty, requiring an 'override' of bank secrecy in international tax matters when income tax treaties apply. Further, and extremely important, in a paper to the UN committee of experts in international cooperation in tax matters, the OECD favours similar changes to the UN model taxation convention between developed and developing countries. Thus, the OECD has emphatically stated that bank secrecy should be overridden in tax treaties between OECD countries, and also in tax treaties between developed and developing countries. The override of bank secrecy in tax matters should be an international standard.

The most effective type of exchange of information is automatic exchange of information: the government where the investment is made automatically transmits the relevant information to the government where the investor resides. However, the OECD and UN model income tax treaties only require exchange of information upon request. Only the EU savings directive requires automatic exchange of information, and only in limited cases.

The key role of the IMF

To confront the problem of capital flight and to help developing countries mobilise domestic resources and meet the UN's Millennium Development Goals, the IMF should work with developed and developing countries, in accordance with the March 2002 joint IMF-OECD-World Bank proposal. Firstly, the Fund should - following OECD recommendations - encourage international financial centres, both onshore and offshore, to override bank secrecy (both de jure and de facto) in international tax matters, and to require automatic reporting of income, in order to facilitate automatic exchange of tax information.

Secondly, the Fund should adapt its Reports on the Observance of Standards and Codes (ROSCs) to deter capital flight. Currently, the IMF considers twelve factors in its ROSCs, in three broad areas of financial sector regulation: (1) transparent government operations and policy making (data dissemination, fiscal transparency, monetary and financial policy transparency); (2) financial sector standards (banking supervision, payments systems, securities regulation, insurance supervision, and efforts to combat money laundering and the financing of terrorism); and (3) market integrity standards for the corporate sector (corporate governance, accounting, auditing, insolvency and creditor rights). This list of standards and codes does not include whether a country overrides bank secrecy in tax matters, requires the automatic reporting of information, or engages in automatic exchange of information in tax matters. The IMF should include these factors as a fundamental part of worldwide transparency policy.

Finally, the IMF should work with the Tax Justice Network and other interested parties, to further implement exchange of tax information to combat capital flight, and report at least annually, including to the UN's Economic and Social Council (ECOSOC), on the progress made by the IMF to combat capital flight and the resulting tax evasion.

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