tax justice network

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Tax Justice Network response to the questionnaire of the European Parliament Special Committee on Tax Crimes, Tax Evasion and Tax Avoidance ("TAX3"), in advance of the hearing on "The fight against harmful tax practices within the European Union and abroad", scheduled for 15 May 2018:

> *Why the TJN FSI lists 41 jurisdictions and the EU lists 9 jurisdictions at the moment? What differences in methodology do you notice? Could you explain the criteria used for the construction of the Financial Secrecy Index (FSI)? How could FSI be used for the implementation of anti-tax avoidance and even anti-money laundering rules in the EU and in the rest of the world?*

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The Tax Justice Network welcomes the opportunity to provide evidence to the European Parliament Special Committee on Tax Crimes, Tax Evasion and Tax Avoidance ("TAX3"), and the energy which is now dedicated to addressing the major issues of international tax abuse which have been revealed by the Panama Papers, Paradise Papers, LuxLeaks and in a range of other investigative work and by our own research.

For example, using a methodology developed by researchers at the International Monetary Fund, we estimate that global revenue losses to the profit shifting of multinational companies is in the order of $500 billion a year – and disproportionately felt by lower-income countries where those revenues are most badly needed. At the same time, EU member states are included among the biggest losers – and also among the most aggressive in seeking to disadvantage their neighbours. A similar pattern holds in respect of offshore tax evasion.

The EU has a potentially critical role in raising international standards of financial transparency and cooperative corporate tax behavior – not least, because the EU may be the only actor big enough to discipline the USA as it emerges as the biggest global threat in this area. But current EU engagement falls well short of the transparent, accountable approach needed to take a progressive leadership role. In this short note we outline some of the key issues, and identify some key opportunities for EU policymakers.

Identifying harmful tax jurisdictions: The Financial Secrecy Index

There are many ways in which the financial regulations, tax policies and practices of individual jurisdictions can have damaging impacts beyond their own borders. Typically, these depend on the provision of financial secrecy – allowing non-residents to hide abusive behaviour of various types from their home regulators and tax authorities, from tax evasion and tax avoidance to bribery, grand corruption, money laundering and other criminal behaviour. Much of the work of the Tax Justice Network, since our formal establishment in 2003, has centred on raising international standards, in order to limit the most damaging secrecy.

A key element in that work has been the design and publication of the Financial Secrecy Index (FSI), which every two years ranks more than one hundred jurisdictions according to the potential damage they cause. An important insight of the FSI is that it makes little sense to split jurisdictions into 'tax havens' and others – rather, there is a spectrum of secrecy on which all jurisdictions sit, and where all jurisdictions have room to improve substantially. Using objectively verifiable criteria, in contrast to the opaque 'tax haven' lists

that the IMF and OECD used to publish, the FSI ensures that jurisdictions are judged on a level playing field.

The FSI ranking depends on a combination of each jurisdiction's (i) Secrecy Score and (ii) Global Scale Weight. The Secrecy Score reflects a qualitative analysis of the legal transparency framework of each jurisdiction, and is compiled as an average of 20 secrecy indicators. The full list of indicators is available here, and covers a broad range of secrecy types. The underlying logic is that of the Tax Justice Network's ABC of tax transparency:

- **A**utomatic exchange of financial information (putting an end to mainstream bank secrecy);
- **B**eneficial ownership transparency (public registers of the ultimate owners of companies, trusts and foundations, to end the scourge of anonymous ownership); and
- **C**ountry-by-country reporting (public data from multinational companies, to reveal misalignments between the location of real economic activity, and where profits are shifted for tax purposes).

Often dismissed as utopian and unrealistic after we laid it out as our policy platform in 2003-05, the ABC had by 2013 become the basis for the global policy agenda pursued by the G20, G8 and OECD groups of countries.

The Global Scale Weight is a quantitative component, reflecting how large the offshore financial services market of each jurisdiction is. It indicates the US dollar value of the financial services each jurisdiction offers to non-residents, expressed as a percentage of the total financial services offered by all jurisdictions in the world. The full methodology is available here.

Overall, the FSI shows which are the worst offenders in effective terms, globally speaking (because it measures which are the most secretive jurisdictions, and how much they are used in practice). The resulting picture differs sharply from those old lists of typically small jurisdictions – as of 2018, the top two jurisdictions on the FSI are not palm-fringed islands, but Switzerland and the United States of America. These are not the most secretive jurisdictions in absolute terms; but given the scale of their cross-border financial services activity, they are responsible for the greatest threat globally.

The EU 'blacklist'

An alternative approach is the EU 'blacklist' of non-cooperative jurisdictions. This follows the FSI approach in using at least some objectively verifiable criteria, but also contains more opaque and subjective elements. In addition, the EU list is aimed at providing the basis for targeted sanctions, so emphasises a binary division into good/bad jurisdictions, rather than reflecting the underlying secrecy spectrum. (A final difference is that the EU blacklist gives greater importance to corporate tax behaviour than does the FSI- on which, see the later section.)

The EU list relies on three criteria: tax transparency, fair taxation and anti-BEPS measures. Criterion 1 is subdivided into three sub-criteria. The first is about commitment to the OECD Common Reporting Standard (the new, multilateral instrument for automatic exchange of information). The second sub-criterion entails that a jurisdiction should possess at least a 'largely compliant' rating by the Global Forum with respect to the OECD Exchange of information on Request standard. The third sub criterion demands that jurisdictions either participate in the Multilateral convention on Mutual Administrative Assistance in Tax Matters – which is a multilateral convention on information exchange on request – or have a network of exchange agreements that is sufficiently broad to cover all EU member states. In the

future, a fourth criterion regarding beneficial ownership will be included (Council of the European Union, 2016).

While Criterion 1 captures the A and (prospectively) the B of tax transparency, Criterion 3 includes partially the C. Overall, it measure implementation of OECD minimum standards on Base Erosion and Profit Shifting (the BEPS process, which ran from 2013-15). Simply pledging to implement the four BEPS minimum standards – on harmful tax practices, country-by-country reporting (privately to tax authorities, rather than publicly), treaty shopping, and dispute resolution – is enough in the short term, since the peer review process is still in development. This criterion will be updated in the future to require a sufficient compliance rating by the BEPS inclusive Framework; but for now, signing up to the framework allows jurisdictions to pass.

Finally, Criterion 2 on fair taxation contains two sub-criteria. The first is that countries should have no preferential tax measures that could be regarded as harmful. This is specified as: third country jurisdictions should not have preferential tax measures that go against the EU Code of Conduct on Business Taxation (1997). The second sub-criterion is that the jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction (Council of the European Union, 2016).

We have argued (Lips and Cobham, 2017) that Criterion 1 and 3 have important limitations. In particular, we have shown that because they rely on OECD compliance, rather than specific assessment of the underlying phenomena, the resulting assessments are systematically more likely to list jurisdictions which are economically smaller in absolute terms.

Criterion 2, however, is the most problematic since it relies on private, subjective assessment by the Code of Conduct Group. To the surprise of nobody who is familiar with earlier 'tax haven' lists, this results in an even more pronounced bias against the listing of larger and more powerful jurisdictions. It also defeats the original intention of publishing the criteria in advance to allow scrutiny and independent progress by jurisdictions.

Using the published criteria to the extent possible, and relying for Criterion 2 on peer-reviewed measures of the actual role of jurisdictions in networks of global corporate ownership, we published our own assessment of what the EU blacklist should have included. In total, we identified 60 non-EU jurisdictions which fail to meet the criteria, of which we think 41 should be listed, plus an additional six EU member states: Cyprus, Ireland, Luxembourg, Malta, Netherlands and the United Kingdom.

The FSI offers a much more granular, and broader assessment of financial secrecy, and – crucially – is based on objectively verifiable criteria. As such, we view the FSI as clearly superior to the EU blacklist approach. On its own terms, the EU blacklist approach is seriously weakened by the inclusion of unambitious assessment of OECD process, and by the inclusion of opaque, subjective determinations by the Code of Conduct Group – all of which introduce systematic distortions against smaller, poorer jurisdictions.

As a result, *the EU blacklist cannot be considered to offer a legitimate basis for counter-measures.* This not only means that the EU risks adding to the global tax injustices faced by lower-income countries; it also undermines the EU's legitimacy to take decisive action against the un-neighbourly behavior of larger actors such as Switzerland and the USA.

Opportunities for EU policymakers

The Financial Secrecy Index is now widely used in assessments of risk, and increasingly in peer-reviewed academic research. For example, the Basel Anti Money Laundering Index uses the FSI score to assess Money Laundering/Terrorist Financing Risk and Corruption risk (two out of its five categories). The Italian central bank has used the FSI for its research on the determinants of financial flows to 'tax havens'. Following an approach pioneered in the High Level Panel report of the African Union/UN Economic Commission for Africa, the FSI can be used to assess the range of risks facing individual jurisdictions or regional blocs such as the EU, in terms of their exposure to secrecy elsewhere through trade, investment and banking relationships. Instead of blacklisting small and often unimportant jurisdictions, this approach would allow EU policymakers to identify and target for counter-measures those jurisdictions whose secrecy actually poses the greatest risks of tax abuse, corruption etc to EU member states.

At a more granular level, the FSI Secrecy Score allows policymakers to target individual aspects of secrecy – so that it is not necessary to share the Tax Justice Network view, but instead a bespoke measure of secrecy can be compiled. The EU could, for example, decide to look only at legal and beneficial ownership registration of companies (but not of trusts and foundations), or at implementation of automatic exchange of information (but not of the 'upon request' standard), and so on. In other words, the EU could decide which of the 20 FSI indicators it wishes to use for its blacklist.

The above would mostly be relevant for risks related to money laundering, corruption and tax evasion. For risks related to tax avoidance, the forthcoming Corporate Tax Haven Index should also be applied. While secrecy may also be a part of a tax avoidance scheme (e.g. Luxembourg's secret tax agreements with multinational entities), secrecy is usually related to tax evasion, corruption or money laundering (where the main strategy is to remain hidden). Instead, many tax avoidance practices are not based on secrecy (e.g. the famous "double-Irish Dutch sandwich", etc.) – even if their users or the accounting firms promoting them would prefer to avoid direct scrutiny.

For this reason, the Tax Justice Network is currently developing the Corporate Tax Haven Index (CTHI) to focus precisely on jurisdictions offering tax rules and provisions that facilitate tax avoidance by multinational entities, even if these are not based on secrecy. The CTHI will, like the FSI, be based on objectively verifiable criteria and will offer a clear way to rank jurisdictions according to their attempts to obtain inward profit shifting at the expense of those jurisdictions where multinationals' real economic activity takes place. A concept note is available upon request, and we welcome inputs and discussion.

Finally, EU policymakers should give serious consideration to moving beyond 'defensive' measures at the level of their own economic bloc, and to engage in global discussions on the appropriate framework for tax policy discussions. This requires critical assessment of the OECD's appropriateness, as a rich countries' club, to set the rules of the game for lower-income countries and smaller jurisdictions – or if the United Nations would not be the right venue. In addition, policymakers should consider engaging in a process to create an international convention on financial transparency that would legitimise the basis for counter-measures, on the basis of inclusive, international discussions.

The EU has an important opportunity to drive international progress, by setting clear and objectively verifiable standards for financial transparency and for responsible corporate tax behaviour. The tools, including those designed by the Tax Justice Network, are available – if EU policymakers are ready to embrace the opportunities, and to confront the challenges.