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Discussing Tax Havens: The Case of Luxembourg Questions from a development perspective

Functioning taxation systems are of primary importance for development policy. This applies as much to the tax levy within developing countries as well as their capacity to prevent tax and capital flight. Taxation is the most important instrument for mobilising internal financial resources for the development process. Gradually aid in the establishment of an efficient taxation system is gaining significance as part of bilateral development cooperation. By **Rainer Falk***)

International tax policy cooperation has also become more important recently as a complementary element. However, the effectiveness of tax policy cooperation is inversely proportional to its importance. At the 2nd UN Conference on Financing for Development in Doha at the end of 2008 or the UN Conference on the Global Economic and Financial Crisis and its Impact on Developing Countries in New York in June 2009 there were vocal demands for strengthening the institutional preconditions for international tax cooperation under the umbrella of the United Nations. Yet concrete initiatives have been limited to those from the organisations dominated by the North such as the OECD resp. regional bodies like the EU or bilateral taxation agreements, above all the many so-called double taxation agreements.

* Billions of losses year by year

Among other things developing countries lose billions each year because rich individuals prefer to move their assets abroad or because transnational corporations are able to evade taxes by means of transfer pricing practices that shift taxable income to more favourable tax jurisdictions. The estimates of losses incurred by developing countries due to tax flight and tax avoidance practices are varied. These estimates fluctuate between \$64–124m

and nearly \$1,000bn, generally depending on whether only private assets are considered or corporate capital transfers or “illegal transfers” are included.

Luxemburg is an integral part of the increasingly globalised financial system in which tax flight and tax avoidance are at the top of the agenda. As a financial services venue, Luxemburg is essentially linked to the international financial system through its strong position in private banking and wealth management (15% market share for assets managed offshore), as international investment fund location (Europe’s market leader) and by virtue of its excellent position as base and transit country for foreign direct investment (FDI).

The new study (see reference) shows among other things that alone through the private wealth managed in Luxemburg, tax authorities in developing countries lose—conservatively estimated—up to \$2.5bn annually—many times more than the development aid rendered by Luxemburg (according to OECD figures \$409million in 2008). Moreover, Luxemburg is an ideal base for tax avoidance strategies by transnational enterprises due to its strong position as target and transit country for FDI.

The official argument, shared more or less by

all relevant local political forces, whereby Luxemburg is supposedly not a tax haven, is very weak. It can be rebutted quite easily using the OECD standards. Even the most recent acceptance of the OECD standards in the double taxation agreement, currently subject to negotiation (which also means that Luxemburg has been stricken from the OECD “grey list”) does not alter the fact that the financial market venue bears significant attributes of a tax haven. For instance, bank secrecy will only be relaxed in the case of specific cases of suspicion and upon specific, individual requests by other countries. Hence the current official policy is also not suited to solving the problem of the financial venue’s international reputation problems by creating more transparency and more tax justice.

The tax haven is there

The principal factors making Luxemburg significant in the context of the tax haven debate are the bank secrecy regarding capital earnings of non-residents and the exceptional tax regime for corporate offices of foreign companies by means of financial engineering. In its present form bank secrecy favours and promotes tax evasion and also makes the place attractive for investment of illicit earnings, even if this is difficult to verify empirically due to the opacity of the relevant capital flows. This exceptional tax regime for foreign enterprises is still one of the main factors attracting foreign capital to Luxemburg.

Even if this is defended as legitimate by pointing to the international tax competition, it has to be said that the line separating stimulation of tax evasion and tax competition is often very thin. Moreover, the question arises whether this does not constitute a “race to the bottom” scarcely justifiable ethically and from the standpoint of development policy. In addition, it must be said that excessive international tax competition is undesirable in terms of just distribution policy.

In addition to these fundamental problems there are many special rules, which currently privilege Luxemburg that are of limited dura-

tion. This pertains particularly to the exceptional provisions of the EU savings income directive, which allow Luxemburg (like Austria and Belgium) to levy a withholding tax rather than participate in automatic information exchange. The recent orientation toward adoption of the OECD standard—which had been opposed for years—as regulatory framework for the EU interest taxation ignores the progressive character of the principles governing the EU interest income tax regime and the extent to which the international debate has changed. It is simply fantasy to hope that the majority of EU member-states will allow steps backward from the current status of the interest income tax directive.

*** Defensive-obstructive defence of national peculiarities**

There is an attitude in Luxemburg policy evident in the debate about the OECD standard and the EU savings income directive that can be characterised as defensive-obstructive defence of national peculiarities in a changed international environment. One could also say: The attitude in the international arena is aimed primarily at winning time. This attitude is typified in the recent statement by the director of the banking association ABBL, Jean-Jacques Rommes: “If one would have had to concede relaxation of bank secrecy at the time of the Feira Treaty (EU savings directive; RF), that would have been a catastrophe. At this time however it is no longer a serious problem.” (Interview in the *Letzebuurger Journal*, 20.5.2009, Finanzplatz supplement)

However the question has to be asked whether a stronger, more pro-actively oriented international financial policy would not better serve the country’s long-term interests. This is even more critical given the financial venue’s current reputation problems, growing international pressure and the new significance of tax issues in long-term development policy could also draw in the international political environment in which Luxemburg had been able to profile itself in extremely positive fashion over the past few years. The latter applies above all to the country’s decision to raise

official development assistance to more than 0.7% of gross national product, helping give the country a role in the development policy vanguard. Taken from the viewpoint of North–South issues, a sustainable financial venue ought to follow the principle “not only to give more, but to take less”.

* **Recommendations**

A pro-active policy that will secure the future viability of the financial market can also rely on certain strengths in the local financial sector. These include innovative product policy, the ability to use first-mover advantages and above all the accumulated potential from professional experience, competence and expertise. These are factors that make the location attractive as a supplier of financial services even “beyond” special tax rules.

Clearly pro-active policy should not be exhausted in the promotion of cleverer product innovations (even if these include more „ethical investment“ or promotion of micro-credit in future) any more than in verbal commitments to cooperate internationally in plugging tax loopholes. An earnest readiness to permit even critical questions about the development compatibility of certain functions of its own financial centre, e.g. the role of bank secrecy or the exceptional tax regime, would be decisive. Supplying more information would also be important: hence not only direct investment should be published but also the source of the inflow of funds and the destination of their outflow; also the regional and country-specific origin of assets managed in Luxembourg ought to be published.

Such questions, among others, could be examined by an independent national commission. The credibility of such a commission depends however on whether critics of the current system are also represented in it. However, the recently founded Luxembourg Institute for Global Financial Integrity (LIGFI) does not satisfy this criterion.

Other elements in a stronger, more pro-active international financial policy could include:

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* The recent proposal by Edmond Israel, pursuing essentially the right direction (see *d’Letzebuenger Land*, 15.5.2009), that Luxembourg ought to grasp the initiative for a new international taxation conference, in order to arrive at a perspective for a multilateral approach to creating an international tax organisation with global competence for issues regarding a just and transparent tax system. This would have the advantage, amongst other things, that it would not exclude the developing countries like those bodies (OECD, EU) where cross-border tax issues are currently negotiated.

* Luxembourg ought to review joining the Initiative for an International Tax Compact, introduced in Doha and supported by the Stiglitz Commission.

* In order that tax can be appropriately levied on income not only from private investment but also corporate earnings, transnational enterprises should itemise their balance sheets by country (so-called country-by-country reporting). This would make it more difficult to conceal portions of their profits by means of internal transfer pricing, respectively to have profits incurred where the taxes are lowest, including tax havens. Country-by-country reporting could be introduced either through an international convention or immediately through the International Accounting Standards Board (IASB). The IASB develops reporting standards for transnational enterprises, which are then adopted in national law. Luxembourg could also take the lead here through an international initiative.

* However, there is probably a long way to go before a multilateral approach can be implemented. Therefore Luxembourg should search for transitional strategies. The centrepiece of such strategies could be a “most favoured nation status” for the South: If Luxembourg makes concessions to information exchange within the context of the OECD or even during the current review of the EU interest income directive (and without such concessions the survival of the financial venue will be scarcely guaranteed) then Luxembourg should

offer the developing countries the same information to support their battle against tax flight. Luxemburg also ought to transfer the interest tax income levied against assets from developing countries to the countries of origin (which already happens within the EU).

* Luxemburg should review its bilateral development cooperation as to whether funds could not be employed to strengthen an efficient tax collection system in the partner countries. Measures which need to be promoted more vigorously—especially since trade liberalisation has eliminated much customs income—are the introduction of progressive direct taxes, better remuneration and training of tax officials and in general the establishment and reinforcement of tax authorities in the sense of institutional *capacity building*.

Reference:

* This article is based on the summary and recommendations of a study by the author, *Zur Debatte um Steueroasen: Der Fall Luxemburg. Fragen aus entwicklungspolitischer Sicht (Discussing Tax Havens: The case of Luxembourg. Questions from a development perspective)*, 26 pp, Cercle de coopération des ONG: Luxembourg, July 2009.

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