The Economist

Automatic response

February 16th 2013

NOT ONE TO mince words, Daniel Mitchell of the right-wing Cato Institute denounces the OECD's push to co-ordinate global tax enforcement as "the devil's spawn" and possibly even a step towards the fiscal equivalent of—shudder!—the World Trade Organisation. Tax havens "should not have to enforce the burdensome tax laws of other countries", he thunders. "Having grown rich with the tax policies of their choosing, the OECD countries are pulling up the ladder and saying, 'you can't do the same to attract investment'. It's fiscal imperialism."

To tax-freedom advocates like Mr Mitchell, one of the most infuriating aspects of this perceived imperialism is the complete overhaul of cross-border information exchange. It is technical stuff, but the changes are extremely important. They promise to shine a light on some of the darkest corners of banking and investing, not only making tax evasion much harder but also casting a net over a host of other financial sins—and, along the way, testing financial firms' compliance departments to the limit.

The new era began in 2009 with something of a false start. The G20 decreed that in order to be considered clean, tax havens had to sign bilateral tax-information exchange agreements (TIEAs) with at least 12 other jurisdictions. This led to a surge in TIEAs and tax-treaty amendments (see chart 4 below) and the fairly prompt removal of tax havens from the OECD blacklist. The accords call for exchange "on request". A country has to share information only if the other signatory asks for it and the request is based on well-founded suspicions.

Ask, and it shall be given?

The OECD touted this as a step towards transparency that would also respect individuals' right to confidentiality as much as possible. But tax investigators complain that the process for getting information is cumbersome and the bar has been set too high. "You already have to have pretty much all the information you're after to get the last piece. It's a catch-22," says one. That may explain why the number of requests made has been small.

Offshore officials have complaints of their own. Françoise Hendy, Barbados's chief tax negotiator, thinks that the real motive for promoting TIEAs was to draw the tax havens' competitive sting, because TIEAs do not offer the same benefits as the full-blown double-taxation treaties that OFCs such as Barbados generally prefer. And small jurisdictions felt obliged to comply even though they knew that the main target was Switzerland.

Moreover, the TIEAs did not appear to reduce financial flows to tax havens. An academic study of the crackdown by Niels Johannesen of the University of Copenhagen and Gabriel Zucman of the Paris School of Economics looked at data on cross-border bank deposits in 2009-11 and found that, despite modest outflows from less compliant jurisdictions, the overall level of funds in OFCs barely changed.

Tax NGOs say the "on request" model is a dud and that tax transparency can be achieved only through the regular, automatic exchange of information. America gave the world a big push in this direction in 2010 when it passed the Foreign Account Tax Compliance Act (FATCA). This requires foreign financial firms to identify account-holders and investors who might be American. If the clients do not reply to inquiries, they will have a 30% tax withheld from their income arising in America. The rules will be phased in over four years, starting in 2014.

FATCA's intrusiveness has caused concern among banks and fund managers. It raises big questions about data privacy. Compliance costs, mostly borne overseas, are likely to be at least double the revenue that the law will generate for America. The necessary overhauls of systems and procedures and the extra digging around to identify American clients could add $100m or more to a large bank's administrative costs. No wonder bankers have dubbed FATCA the Fear And Total Confusion Act.

An OECD tax official describes the law as "awful, in a way, like a nuclear bomb" but also sees it as "a remarkable leap forward for transparency". And though it began as a brazenly unilateral move, it has since become more inclusive. America has signed or is negotiating bilateral agreements with 50 countries, each of which would accept some version of FATCA. In return America would offer information on its holdings of their citizens' money. The resulting patchwork of intergovernmental agreements, each one slightly different, will add further to the compliance burden for international banks and fund managers.

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Inspired by America's chutzpah, other countries are drawing up similar legislation of their own. Britain is planning to impose a so-called "Son of FATCA" on its dependencies. The Isle of Man has already agreed to this; its chief minister accepts that automatic exchange "is becoming the global standard". Jersey and others are holding out for now, but will come under increasing pressure to sign up. “It’s the last days of the Roman Empire,” mutters a senior Cayman lawyer.

The automatic-exchange model also enjoys support from some big emerging economies, such as India. And the practice has already been adopted within the European Union (apart from a few holdouts) for cross-border bank deposits, through the EU’s savings directive (EUSD). But the EU’s experience has been mixed, not least because the original directive was riddled with loopholes. Some have been closed through amendments, more of which are proposed, but gaps will remain.

Another problem with automatic exchange is the huge quantities of data it produces. Europe’s tax authorities have struggled to stay on top of the information swapped under the directive. An official from a British dependency taking part in the EUSD reportedly complained that some countries which receive encrypted DVDs with client information do not even get round to asking for the decryption key. And information is not necessarily helpful if the recipient still has to penetrate the web of shell companies, trusts and foundations between the account and the beneficial owner.

A further concern is the risk of misuse of information by corrupt administrations, or rogue government employees, such as the sale of personal financial data to would-be kidnappers. Global automatic exchange is “a developed-world solution for a global economy unsuited to it”, argues Geoff Cook of Jersey Finance. Some developing countries lack the administration to deal with it, says Gurbachan Singh, a tax lawyer in Singapore. In places like Indonesia “you may have a tax officer but not a proper tax office.”

Tax campaigners argue that appropriate checks and balances can be put in place in most countries. Governments in the developing world already have access to lots of sensitive information about their citizens. And the biggest benefit of automatic exchange is that it deters rather than detects, says John Christensen of the Tax Justice Network (TJN).

Even ultra-secretive Switzerland has made some concessions, such as entertaining other countries’ “group requests” for information on, say, a batch of unidentified clients of a particular bank. But the Swiss remain firmly opposed to automatic exchange and continue to push their own model, dubbed the “rubik” because of its complexity, which involves handing over money but no names. It has signed deals with Britain and Austria under which it will collect and pass on penalties imposed on clients for past evasion, as well as withholding tax on their future investment income. But Germany’s upper house, the Bundesrat, has rejected the Swiss accord with Germany, seriously undermining the rubik project.

Like the EUSD, the rubiks have been criticised for being leaky. The TJN's analysts believe that the deal with Britain will raise only a small fraction of the £5 billion that the British government hopes to collect. Whatever the type of agreement, implementation is just as important as design. Some of the Caribbean tax havens that received a pat on the back for signing lots of TIEAs have dragged their feet when asked for assistance.

Universal information exchange is still a long way off, if it happens at all. But not so long ago the norm for countries, whether onshore or offshore, was to refuse any co-operation on cross-border tax enforcement, so a lot has been achieved. That cannot—yet—be said of reform efforts in the corporate sphere.