

SHADY DEALS

HOW THE EU-MERCOSUR FREE TRADE AGREEMENT HELPS ILLICIT FINANCIAL FLOWS

Magdalena Rua, Martín Burgos and Verónica Grondona



GUE/NGL
European United Left • Nordic Green Left

www.guengl.eu

How the EU-Mercosur Free Trade Agreement helps illicit financial flows

Report for the European United Left/Nordic Green Left (GUE/NGL) in the European Parliament

Magdalena Rua is a Public Accountant (University of Buenos Aires, 2012), with Postgraduate studies on Political Economy (FLACSO, Latin American University of Social Science, 2016). Magdalena Rua is currently doing a Doctoral Degree in Economic Development. Magdalena also works as an Economic and Financial Crimes Investigator in the Judiciary Power of Argentina (Public Prosecutor's Ministry, General Direction of Economic and Financial Advice on Investigations) and is a Professor on 'Economic Power and Human Rights' at the University of Buenos Aires.

Martín Burgos is an Economist, Master in the School of Higher Studies in Social Sciences (EHESS-Paris, France), Coordinator of the Economics Department of the Cultural Center of Cooperation, Academic Coordinator of the Postgraduate Diploma on Finance for Development, National University of Quilmes.

Verónica Grondona is an Economist (University of Buenos Aires, 2000), with Postgraduate Studies in Finance (University Torcuato Di Tella, 2002). She is currently an advisor to GUE/NGL in the European Parliament on the Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3), and previously on the Inquiry Committee into Money Laundering, Tax Evasion and Tax Avoidance (PANA).



GUE/NGL
European United Left • Nordic Green Left

EUROPEAN PARLIAMENTARY GROUP
European Parliament,
B-1047 Brussels, Belgium
+32 (0)2 283 23 01

guengl-communications@europarl.europa.eu

Cover Image:
Buenos Aires Financial District - CC/Flickr - Deensel

December 2018

TABLE OF CONTENTS

Executive summary	5
1. Introduction	7
2. Legal framework of the EU-Mercosur FTA	8
3. Overview of provisions in fighting tax evasion, tax avoidance and money laundering in trade agreements	12
4. Financial secrecy jurisdictions in the Mercosur and in the EU	15
5. Estimations of IFF under the EU-Mercosur FTA	23
6. Policy recommendations and Conclusions	33
7. Reference	35

EXECUTIVE SUMMARY

The proposed free trade agreement between the Mercosur and the European Union (MEFTA) poses an extremely high risk of facilitating illicit financial flows, tax-dodging and money laundering for both the EU and the Mercosur.

An analysis of the agreement's draft chapters related to capital movements, services, financial services and digital trade reveals the lack of mechanisms to prevent tax evasion and avoidance practices, as well as the potential for it to be exploited for money laundering purposes.

The leaked draft agreement appears very porous in terms of fiscal, financial and exchange regulations. In many cases, the articles' negotiated objectives openly aim for the liberalisation and deregulation of controls whilst in others, their superficial nature and frequent omissions make tax-dodging and money-laundering possible.

In both regions, it is possible to identify countries with very flexible tax systems and liberalised financial and exchange regimes; several EU countries are listed as tax havens and financial secrecy jurisdictions.

This study presents its own estimations showing the importance of capital flows, accounting for the possible increase in capital flows, services and goods that would take place as a result of the EU-Mercosur FTA.

According to data by International Investment Position (IIP), Mercosur countries' estimated stock of offshore private wealth in 2017 was about 18.7% of their joint Gross Domestic Product (GDP). Meanwhile, the accumulated outflows from the Mercosur between 1978 and 2017 amounted to 19.8%, according to Balance of Payments (BOP) data.

The Mercosur's four developing countries' stock of offshore financial wealth in 2017 exceeded US\$ 853.7 billion, while during the last 10 years (2008-2017) the average annual outflows from these countries was around \$56.4 billion, says IIP data.

Over the last 10 years, the average annual outflows from Mercosur countries was around \$56.4 billion, according to the BOP data.

When considering transfer pricing manipulation, the amount of outflows is effectively higher. The UN Economic Commission on Latin America and the Caribbean (ECLAC) calculated an annual average of \$15.8 billion of financial outflows due to misinvoicing between 2004 and 2013, and Global Financial Integrity (GFI) duplicates these estimations, reaching \$32.5 billion over the same period.

The stock of offshore financial wealth from EU countries in 2017 was around \$65 trillion and represented over 350% of its GDP, estimated by IIP data. The annual average of outflows

from these 28 countries amounted to \$1.3 trillion between 2008-2017. This figure seems to reflect the high level of financial activity in EU countries, including outward financial flows.

When it comes to inflows, the European Commission's 2017 estimates also show the importance of FDI inward stocks of Cyprus, Luxembourg, Malta and the Netherlands.

According to European Commission (2012), the OFI sector (Other Financial Institutions, which are non-bank financial institutions) is larger than GDP in only four countries in the EU: the UK, the Netherlands, Ireland and Luxembourg. The same four countries also rank highly in the Financial Secrecy Index (Tax Justice Network, 2018): UK in 23rd position, the Netherlands 14th, Ireland at 26th and Luxembourg 6th. All of them are amongst the eight most secretive countries of the EU.

Some estimates from certain countries such as the United Kingdom, Luxembourg, Ireland, the Netherlands, Cyprus and Malta expose the striking level of financial flows and wealth when contrasting with GDP.

Luxembourg's stock of offshore wealth is \$12.6 trillion, which represents 20185% of GDP; the Netherlands's stock of offshore wealth is \$10.1 trillion, which represents 1228% of GDP; Ireland's stock of offshore wealth is \$4.8 trillion, 1442% of GDP; Cyprus's stock of offshore wealth is \$287 billion, 1350% of GDP - and Malta's stock of offshore wealth is \$277 billion, 2213% of GDP. It is important to highlight that the percentage of General Government Expenditure never exceeds 43% percent of the GDP of each country.

With regard to the financial outflows, the accumulated flows between 2008 and 2017 amounted to \$202 billion in Cyprus, which represents 948% of GDP; \$1.2 trillion in Ireland - 356% of GDP; \$6.4 trillion in Luxembourg - 10286% of GDP; \$2.7 trillion in the Netherlands - 322% of GDP; and \$231 billion in Malta, which represents 1841% of GDP.

The analyses of the IIP data shows that in some years there were negative flows which indicated inward financial flows instead of outflows. The main entries were registered in Austria, Belgium, Finland, France, Germany, Ireland, Luxembourg, Netherlands and the UK. In the case of UK, its accumulated flows were negative from 2008 to 2017, which indicates inflows.

Mercosur countries' estimated stock of offshore private wealth in 2017 was about 18.7% of their joint Gross Domestic Product

1. INTRODUCTION

Negotiations on a free trade agreement between the Mercosur and the EU (MEFTA) began in April 2000. But they have been speeded up in the past few years due to political changes in the Mercosur region which made the deal closer than ever. The MEFTA negotiations have been carried out in a very secretive manner, excluding civil society, trade unions and local and regional parliaments. However, a number of leaks have made several chapters available, including those relating to capital movements, services and digital trade.

More recently, differences between the Mercosur countries (Argentina, Brazil, Uruguay and Paraguay¹) and the EU regarding intellectual property, agricultural trade and government purchases were made public and are said to have delayed further negotiations until 2019. Nevertheless, despite the very serious imbalance in trade it is facing, Argentina - unlike the other Mercosur member states - has stated that it is in favour of signing the agreement and has asked its regional allies to reverse the prohibition for members to sign new trade agreements not signed by the Mercosur.

Very few studies have analysed the effects of free trade agreements (FTAs) on money-laundering, tax evasion and tax avoidance. Those that did have concluded that the liberalisation of capital controls and of trade in goods and services - with no accompanying mechanisms to prevent illicit financial flows, tax-dodging and money-laundering - all contribute to an increase in illicit financial flows but in particular, an increase in such flow from developing

countries to the EU. It is therefore necessary to investigate what could happen in the context of a MEFTA, given the continuous attempts by and eventual success of professional advisors (enablers and promoters) in arbitrating between the different legislations and finding loopholes in non-discrimination rules that can be used against anti-tax avoidance rules.

This study focuses on the risks the MEFTA carries for tax evasion, tax avoidance and money laundering for both the EU and Mercosur. It analyses the effects of provisions relevant to capital movements, services, financial services and digital trade in the MEFTA facilitating international tax evasion and avoidance practices, as well as its potential to be exploited for money laundering purposes. It also examines the different components of illicit financial flows and presents an estimation of the problem of the possible increased flows of capital, services and goods that would take place in MEFTA.

The second section of this study considers the main aspect of the legal framework of the FTA with the third section focussing on the provisions to fight tax evasion, tax avoidance and money laundering in MEFTA. The fourth section is an overview of financial secrecy jurisdictions in the Mercosur and the EU, with the fifth section taking a look at the stock of private offshore wealth of Mercosur and EU countries. The final section will conclude with policy recommendations.

1 The Bolivarian Republic of Venezuela has been suspended from the MERCOSUR agreement since August 2016. Bolivia has been in the process of accession since 2015.

2. LEGAL FRAMEWORK OF THE EU-MERCOSUR FTA

A- Overall considerations

Some information has been made available from both official and non-official sources on MEFTA even though the treaty has not yet been initiated. Official sources include communications by the Argentine embassy to the EU on the negotiating progress during the Argentinian presidency of Mercosur (December 14, 2016 to July 21, 2017)². Unofficial sources include the leaks compiled by bilaterals.org on various points of the agreement between both economic blocs³, where the most complete and most recent document (July 2018) is available at the time of compiling this study⁴. This document will therefore focus on the latter, which contains the consolidated text as it stands at the end of the 33rd round of negotiations (4th-8th June 2018).

As with any FTA, the core of MEFTA focuses on the trade in goods, limiting the various protection and regulatory mechanisms that countries - in this case, regional blocs - maintain. Trade in services has been added to all international trade negotiations in recent years. The content of this trade in services is very diverse and ranges from international consultancies, financial services to investments. The increasing importance of trade in services in FTAs requires their division into several chapters that we will summarise based on existing information.

Given that the leaked MEFTA documents are incomplete, we will take as an example the FTA signed by Colombia, Peru and Ecuador with the EU (EU-Andean Community FTA). The structure of this Agreement has initial and institutional provisions in its first titles; commodity trade in its third title; on trade in services, investments and e-commerce; movement of capital; public procurement;

and intellectual property (VII). The last chapters refer to competition, trade and sustainable development, transparency and administrative procedures, as well as solution to controversies.

The following sections present an analysis of the leaked chapters of the draft agreement related to goods, services, financial services, public contracts and movement of capital.

B- Goods

The bilaterals.org documents entitled 'Chapter on goods (consolidated text)', 'Rules of origin', 'Technical barriers to trade' and 'Sanitary and phytosanitary measures' are classified as referring to 'Goods'. The 'chapter on goods' is the general chapter that includes the schedule of tariff reductions to imported goods that have their origin in the other economic bloc. Far from being concluded, it contains several disagreements. Amongst the biggest include the rejection by the EU of the chapters on 'industrial development', or the discussion about agricultural trade and quotas, as well as the timetable for the elimination or reduction of taxes on exports. In every FTA, the EU tends to separate agricultural trade from the rest of the trade in goods - something that has been the main obstacle to this FTA because the Mercosur countries enjoy economic advantage in exporting products from this sector.

The various negotiations on technical barriers to trade and sanitary and phytosanitary measures usually revolve around setting limits in accordance with the agreements signed by the World Trade Organization (WTO), and

2 <http://eceur.cancilleria.gov.ar/es/content/negociaciones-mercosur-ue>

3 <https://www.bilaterals.org/?eu-mercosur-fta-10-draft-chapters&lang=en>

4 November 2018.

reinforcing provisions (except for products which already have a measure in the framework of the WTO). In this regard, negotiations seem to be aimed at the import licensing regime and export subsidies. Proposals have also been made to limit state trading companies impacting on prices, and to eliminate exports tariffs. Although the products with specific geographic locations are usually dealt with in the intellectual property chapter - as is the case in the EU-Andean Community FTA - they are mentioned in this Agreement's draft chapter on 'Goods'. The concessions made by the Mercosur as reported by the Argentine embassy in the EU in this regard were important, as this is part of the commercial defense strategy of the EU.

The rules of origin of the products are also an important part of the Agreement since it defines whether a product was manufactured in the economic bloc, the tariff and the standards that govern its commercialisation. However, the negotiations appear unresolved. Finally, a chapter referring to small and medium enterprises (SMEs) was incorporated into the draft Agreement, in which SMEs are exempted from some standards and the trade between the blocs' SMEs is facilitated.

C- Services

Beyond the difficulties that were expressed by the Argentine embassy to the EU in July 2017 - such as agricultural special articles or export tax - the chapter on 'Services' seems to have been agreed, as the June 2018 leaks from bilaterals.org attest. The 'Services' chapter includes numerous aspects but it starts off by granting no less favorable treatment to any investor in both blocs with respect to their national investors.

Taking into account the format of the EU-Andean Community FTA, the MEFTA negotiations would be complemented by a list of sectors in which each country or bloc makes its 'reservations' or exceptions to the rule of market access. The importance of investment articles ('Establishment' in the language used for foreign direct investments) has been subject to numerous investigations because of the special significance they have in the framework of FTAs, as they can expose sensitive sectors to foreign competition - especially in relation to natural resources. It is interesting to note that these lists of reservations are not framed as a differentiated investment (as are the rest of the sectors framed in exceptional regimes) but are considered as one more sector in which possible investments can be made.

So every part must make explicit the reservations and regulations, and for the EU-Andean Community FTA, that they exclude sectors such as agriculture, fishing, forestry, mining or oil.

Besides the issues related to the regulation of professional consultancies and the regime of temporary employees of the residents of the signatory countries, the postal and messaging service regimes, telecommunications service, computer service and electronic commerce all have special articles in the service part of the Agreement, and they are considered the exceptions in MEFTA.

The particularity of the inclusion of electronic commerce is that it is considered as a service and that it must not pay customs duties (Article 44, section 4) when it seems clear that goods are exchanged in relation to such service. Even if electronic commerce - which is limited at present - were to grow in future, there is always the possibility that companies will take advantage of the differential in customs duties for their imports.

D- Financial services

Within the 'Services and Establishment' chapter, a significant sub-section is granted to financial services which is broadly defined as insurance services, banking services and other financial services in their multiple dimensions (deposits, loans, payment and transfer services, guarantees, commercial exchange, issuance of securities, administration of investment funds, financial advice, etc.). The leaked document published on bilaterals.org assures equal treatment to the financial services of the other parties for the payment and compensation system, as well as official means of financing granted by the authorities (Article 41), in line with the chapter on foreign investments.

Even though there are a number of precautions in this regard, amongst them prudential supervisory measures authorised and envisaged to protect the investor / depositor and guarantee the stability of the financial system, these measures are reduced to "that are not more burdensome than necessary and do not discriminate" between the investors of the parties to the agreement (Article 36).

It is stated that the parties must make all the necessary effort to guarantee the regulation and supervision of the sector and for fighting against money laundering, tax evasion

and tax avoidance in accordance with the international provisions in force (Article 37), being the international provisions those of the Financial Stability Board (FSB), the Financial Action Task Force (FATF)⁵ and the Organization for Economic Co-Operation and Development (OECD)⁶.

Although there are no details in the leaked MEFTA text of the sectors with investment reservations. However, in the EU-Andean Community FTA, investments in the financial system, accounting advice and all the structures related to the operation of illicit financial flows are the most regulated amongst the sectors with reservations in the annex of the investments chapter - more than the industrial and natural resources sectors, for example.

The chapter referring to new financial services - defined as a financial service that can be offered from the territory of another party - includes the provision that the party may determine the legal and institutional form through which the new service may be supplied, though it requires authorisation from the other party where it is intended to be supplied.

As with e-commerce, we are facing a situation in which the regulatory framework governing the new financial service can be distorted given that the service provider could choose the most appropriate regulation in a market segment with a growth trend. In fact, several international institutions, including the World Bank, have praised the financial innovations that new technologies can bring as well as the risk that growth in this sector can bring under the current regulatory and tax framework.

E- Public contracts

The draft of the section dedicated to public procurement is very similar to all the articles in the EU-Andean Community FTA. The 'general principles' describe the overall conception of the chapter: to give international suppliers the possibility of participating in public procurement. The major difference that still exists between both parties in the negotiations lies in the granting of compensation in the selection of suppliers.

Given the superior legal hierarchy of international treaties with respect to national laws, these negotiations force countries to change certain incentives to national production like the 'buy local/national' law in Argentina with respect to public procurement⁷. Participation in public procurement plays an important role in the development of SMEs and technological innovation.

In any case, neither the existing initiatives in Latin America nor the MEFTA considers any provisions to restrict the role and impact of multinational entities that currently operate in tax havens. Some EU municipalities⁸ are already implementing measures in this regard, and the December 2017 European Parliament Recommendation following the inquiry on money laundering, tax avoidance and tax evasion (PANA Committee) made specific calls⁹ in respect to prevent public administrations from working with companies that use tax havens and countries with strategic deficiencies in their AML/CFT regimes.

5 It should be noted that while FATF recommendations on anti-money laundering and counter terrorism financing (AML/CTF) are good but can be improved further (Knobel and Meizer, 2016); its blacklist is only a political exercise which does not serve the purpose of identifying the high risk countries for AML purposes.

6 As none of the Mercosur countries is a member of the OECD, and since Brazil has simplified and implemented more effective anti-tax avoidance provisions (e.g. its transfer pricing methods and its tax haven blacklist), this article could potentially pose a risk to non-OECD members by imposing regulations that they have not participated in setting, but that could also be less effective than their own.

7 The "Buy nacional" law in Argentina gives a preference to goods of national origin and a 5% to 7% premium to the national product versus the imported ones in public procurement.

8 Twenty five municipalities in Spain (Madrid, Barcelona, Sevilla, Valencia, Alicante, Zaragoza and Murcia are among them) have pledged to be tax haven free; and among Scandinavian countries, a number of local politicians are calling for tax-havens free cities and local governments.

9 See paragraphs 51 and 126 of the European Parliament Recommendation following PANA Committee adopted in 13 December 2017.

F- Movement of capital

The draft chapter about current payments and capital movements guaranteed free movement of capital relating to direct investments and liquidation or repatriation of these flows. In addition, it establishes that the parties shall allow in freely convertible currency any payments and transfers of the current account between these countries, in accordance with the Article VIII of the Articles of Agreement of the International Monetary Fund (IMF).

This implies that the exchange policy and capital control tools of the Mercosur countries involved should be relaxed in order to guarantee the free movement of capital and free entry and exit of foreign investments. Mercosur countries usually have volatile exchange rate policies, but restrictive policies on currency purchases or capital controls are repeatedly required to avoid balance of payments crises. This implies the need for a greater degree of freedom for local economic policy in reference to movement of capital.

On the contrary, it has been shown that liberalisation and deregulation cause instability and uncertainty to developing economies. Therefore, they need capital management techniques to discourage speculative investment and measures to prevent volatility, systemic risk and capital flight. Moreover, the chapter specifies that a party cannot apply any regulation, including those

related to anti-money laundering and counter-terrorism, in a discriminatory manner. This aspect could impact on the measures that a treaty partner is able to adopt against illicit financial flows, tax dodging and money laundering.

The leaked text indicates that the MEFTA will conclude in a similar way to the EU-Andean Community FTA. In this respect, the criticisms which Van Derstichele (2012) made of that agreement are also applicable to MEFTA.

Moreover, it is worth noting that the EU-Andean Community FTA does not have articles referring to the implementation of effective measures to combat money laundering and the financing of criminal activities; nor the tackling of tax evasion and tax avoidance, except for what has already been mentioned regarding Article 37 of the financial services chapter.

In addition, the EU-Andean Community FTA restricts much-needed controls on capital flows in countries that are characterised by being subjected to abrupt capital movements.

Provisions to deal with tax evasion or avoidance do not commit any of the signatory parties to take action or cooperate. As a result, tax evasion and money laundering can increase with the signing of the FTA (Vander Stichele, 2012).

It has been shown that liberalisation and deregulation cause instability and uncertainty to developing economies

3. OVERVIEW OF PROVISIONS IN FIGHTING TAX EVASION, TAX AVOIDANCE AND MONEY LAUNDERING IN TRADE AGREEMENTS

This document refers to illicit financial flows which, as will be revealed in the following chapters, are of great relevance to all governments but in particular developing countries. Illicit financial flows are flows of money which have either an illicit origin, or an illicit destination (i.e., those resulting from commercial flows between multinational companies and related to smuggling, tax evasion and tax avoidance; those related to public-private corruption acts; and those relating to specific crimes such as human trafficking, drug trafficking and terrorist financing).

Illicit financial flows can also take place through the over pricing or under pricing of imports and exports, through overpriced or fake services, loans and royalties; dividend payments; and various other financial transactions.

In this respect, a number of authors¹⁰ have studied the effects on money laundering, tax evasion and tax avoidance of free trade agreements; and have pointed out the following:

1. The power by authorities to apply controls on capital flows are being restricted when there are no particular instruments kept that could be used effectively to prevent illicit financial flows;
2. Free Trade Agreements (FTAs) do not fully exclude foreign investors from establishing themselves with the purpose of tax dodging practices, for example, in the 7-9 EU member states identified by the European Commission as having a high level of tax avoidance¹¹ (European Commission, 2017);
3. A wide range of speculative financial services have been liberalised by the FTA without any particular mechanisms to ensure strong regulation or joint supervision;
4. The far-reaching commitments made by the EU and developing countries on access to the markets for goods and services, including in the financial services sector, translate into such agreements by significantly increasing trade openness, and with that, the threat of money laundering facing developing countries.

Eskelinen and Ylönen (2017) have analysed the cases brought by Panama against Argentina and Colombia to the World Trade Organization (WTO), and how Panama has been able to invoke WTO rules to defend its tax regime. These cases could be seen as setting the precedent of what could happen under a free trade agreement (FTA), given the success of professional advisors (enablers) in arbitrating between the different legislations and finding in non-discrimination rules the loophole to be used against anti-tax avoidance rules, e.g. like in the case against Argentina, and anti-money laundering rules, e.g. in the case against Colombia.

It should therefore be noted that within the European Union it is already not possible for member states to impose any legislation that 'discriminates' against other EU member states. Even when some member states have been identified by the European Commission as providing opportunities for aggressive tax planning (European Commission, 2017), and by the Council of the European Union as having preferential tax regimes (Council of the EU, 2018, July 20), member

¹⁰ See Vander Stichele (2012) and Ioannides et al. (2016)

¹¹ Belgium, Malta, Ireland, Luxembourg, The Netherlands, Cyprus, Hungary; and also the United Kingdom and Estonia.

states cannot draft any legislation that imposes any sanctions or suggests any deterrent actions against such countries - even if the objective is to tackle tax avoidance, tax evasion or money laundering. This has been recently noted by representatives of the Latvian government during a European Parliament TAX3 Special Committee Mission, where it was pointed out that even though the country had drafted a new legislation banning shell companies, it could still not discriminate against shell companies resident in Malta, Cyprus or the United Kingdom from operating in Latvian banks (Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3), 2018).

In her reply to a Parliamentary Question on "Tax Avoidance through Trade Agreements" regarding the use of Investor-State Dispute Settlement (ISDS) to avoid taxation, EU Trade Commissioner Cecilia Malmström said¹² on behalf of the European Commission that 'mailbox companies' would apparently not benefit from the provisions in the Investment Chapter. That is because in order to be qualified as an investor, it is necessary to have real business operations in the territory of one of the parties to the agreement.¹³ Yet in reality, the opposite is happening as the EU allows shell companies to operate, create accounts and invest in EU member states with almost no restriction - as has been exposed in all recent leaks.

According to Ioannides et al. (2016, p. 33), trade and investment agreements concluded by the EU since 2002 have included horizontal provisions on taxation which generally apply to the entire agreement, including the Investment Chapter¹⁴.

It also seems to be common practice in international investment treaty law to exclude taxation matters from the non-discrimination obligations (Article Chapter 28 Exceptions in CETA; XXXII.06 of CETA; Article 17.6 of the EU-Singapore FTA, Article 203 of the Central Asia FTA)¹⁵, which allows some exceptions for taxation in the service and investment sectors.¹⁶

Article 350 of the EU-Central America Association Agreement clarifies that nothing in the trade chapter should prevent the adoption of measures aimed at preventing the avoidance or evasion of taxes, in respect of any existing double taxation agreement (DTA). Nevertheless, this issue appears not to be treated uniformly in all FTAs.

Moreover, it should be noted that Double Tax Agreements (DTAs) allowed for in FTAs would not necessarily provide for anti-tax avoidance tools to be employed, as DTAs have been signed in order to eliminate double taxation (Ioannides, et al., 2016); and a recent study by Hearson (2018) on European member states' tax treaties with developing countries noted that such tax treaties leave on average only 40% of the taxing rights intact for developing countries when the signatory is an EU member state.

No articles in FTA refer to the problem of under-invoicing and over-invoicing in the trading of goods (Ioannides, et al., 2016) - something which is a problem for developing countries, as studied by Grondona and Burgos (2015), amongst others.

It is equally evident that if an FTA is agreed between economies that have different levels of shadow economies, this will inevitably generate some impact on the illicit financial flows moving between parties after the FTA is implemented. (Ioannides, et al., 2016)

Finally, one of the problems of the free movement of capitals within the European Union concerning FTAs is the lack of control over the financial flows. In members of the Mercosur, that task is still being carried out by a combination of institutions: tax administration, FIUs, prosecutors, and central banks. In the EU, however, a lot of measures have been implemented in order to facilitate the free movement of capital, eliminating controls that had been identified as potential restrictions to the development of the market, understanding such development as the growth of investment even if they were paper-only investments, as

12 Paradise Papers, Panama papers, LuxLeaks, Bahamas Leaks, etc.

13 See reply to MEP Anne-Marie Mineur (GUE/NGL) of 11 May 2016: http://www.europarl.europa.eu/doceo/document/E-8-2016-001362-ASW_EN.html

14 In the case of the MEFTA, as has been described in the previous section, such provisions would be included in Article 37 of the financial services chapter.

15 Also, Article 28.7 of the CETA refers to Exceptions on Taxation. See http://ec.europa.eu/trade/policy/in-focus/ceta/ceta-chapter-by-chapter/index_es.htm

16 No article similar to 28.7 of CETA has so far been included in the MEFTA according to the information leaked so far.

can be seen in the European Semester reports (European Commission, 2017).

Ioannides et al. (2016) present a series of recommendations to be included in other FTAs, particularly on cooperation and exchange of information as this has been treated disimilarly in different treaties¹⁷. Some of recommendations adapted to this case study include:

1. if one of the EU's trading partners fails to implement the international and European AML/CFT standards (e.g. EU-Andean Community FTA), then the EU should consider limiting the definition and/or scope of financial services to be liberalised where compelling reasons exist;
2. the EU should strive for a greater degree of specification of the AML/CFT and tax-related requirements in its FTAs;
3. ensure that all FTAs contain provisions on tax cooperation and that such provisions guarantee cooperation at the bilateral level in addition to any regional or international instruments or arrangements;
4. include provisions aimed at combating the mispricing of internationally traded goods and services;
5. include provisions on country-by-country reporting of corporate tax and the establishment of public registers of beneficial owners.
6. insist on the establishment of well-functioning channels of information exchange between domestic Financial Intelligence Units (FIUs), tax authorities, financial supervision authorities and prosecutors;
7. pursue a strategy of imposing a measure of conditionality during trade negotiations, where structural weaknesses in rule of law enforcement – mainly due to corruption, organised crime and shadow economy – undermine the EU's trade goals and the trading partner's legislative and administrative endeavours in combating money laundering and tax evasion;

So far, these considerations have not been made in into the MEFTA. It should also be noted that Mercosur members are not part of the OECD, and the governance of transparency based on OECD criteria imposes an affiliation to OECD on such countries.

It should also be noted that a number of jurisdictions have been identified both in the EU and the Mercosur for their opaqueness or their preferential tax and financial regimes. These will be addressed in the next section.

A number of jurisdictions have been identified both in the EU and the Mercosur for their opaqueness or their preferential tax and financial regimes

¹⁷ Proposed article 11 of the [CETA](#) states (however, this article has not been included in all FTAs):

Cooperation on taxation

With a view to strengthening and developing their economic cooperation, the Parties adhere to and apply the principles of good governance in the tax area, i.e., transparency, exchange of information and avoidance of harmful tax practices in the frameworks of the OECD Forum on harmful tax practices and the Union Code of Conduct on business taxation, as applicable. The Parties shall endeavour to work together to promote and improve the implementation of these principles internationally

4. FINANCIAL SECRECY JURISDICTIONS IN THE MERCOSUR AND IN THE EU

A- EU members' abusive tax planning and tax competition

In March 2018, the European Commission addressed the problem of aggressive tax planning (a euphemism for tax avoidance) opportunities using the analysis of a series of economic indicators (European Commission, 2017).

The broad picture emerging from European Commission's analysis is that several member states appear to be exposed to tax avoidance structures, such as **Ireland, Luxembourg, Cyprus, Malta or the Netherlands** where the country-level indicators suggest that tax avoidance structures play an important role.

In some other member states, there is a sizeable share of firms classified as conduit entities. This includes **Austria, Hungary, the Netherlands, Ireland and the United Kingdom**. In some cases, this might reflect profit shifting to zero/no tax countries outside the EU, since several of these countries are also characterised through a relatively large share of multinational entity (MNE) groups with links to such countries.

Some smaller member states, like **Cyprus, Malta and Luxembourg** seem to be able to raise more corporate tax revenues as a percentage of GDP (Gross Domestic Product) than others. **Ireland**, in contrast, has been able to attract a sizable amount of corporate tax base. For **Cyprus, Ireland, Luxembourg, Malta, the Netherlands and Hungary** there are Foreign Direct Investment (FDI) stocks that are unexplained by their economic fundamentals.

The high share of foreign controlled firms in Luxembourg and Estonia could reflect some tax driven behaviour.

The high share of surplus in foreign controlled firms in **Ireland, Hungary, Luxembourg and Romania** is also consistent with higher than average corporate tax bases, which in turn are possibly the result of tax avoidance activities.

Aggregate statistics of royalty flows are consistent with the hypothesis of substantial tax avoidance practices using intellectual property. **Ireland, Luxembourg, Malta and the Netherlands** appear to be affected by tax avoidance structures using royalty payments as reflected by their statistically large royalty inflows and outflows.

The Commission's study also pointed at the distorted bilateral import prices, as they have observed abnormally high import prices in high tax countries compared to transactions of the same good with other countries, a practice which points to the use of transfer pricing to shift profits out of these countries.

The United Kingdom, Luxembourg, Estonia and the Netherlands are absolutely central to many tax optimal repatriation - enabling tax efficient repatriation of dividends to and from countries outside the EU through treaty shopping.

Based on the European Commission's analysis (2017) and on its European Semester reports (European Commission, 2018), it could be understood that at least seven EU member states are behaving like tax havens¹⁸:

Belgium: its tax system remains complex, with tax bases eroded by numerous exemptions, deductions and reduced rates.¹⁹ Some features of the Belgian taxation system, in particular the lack of specific anti-abuse rules for the notional interest deduction regime to address the cascading of deductions and notably targeting transactions between related parties may facilitate tax avoidance by multinational groups that locate financial companies in Belgium.

Cyprus: Cyprus' Corporate Income Tax (CIT) rules are used by companies engaged in tax avoidance because of the absence of withholding taxes on dividend, interest and royalty payments by Cyprus-based companies. This, together with the corporate tax residency rules and notional interest deduction regimes, may lead to those payments escaping tax if they are also not subject to tax in the recipient jurisdiction.

Hungary: Hungary's tax rules may be used by multinationals in tax avoidance structures, as shown by the large capital flows entering and leaving the country as a share of GDP through special purpose entities (SPE)²⁰, combined with the absence of withholding taxes. The absence of withholding taxes on dividend, interest and royalty payments made by companies based in Hungary may lead to those payments escaping tax altogether, if they are also not subject to tax in the recipient jurisdiction.

Ireland: Ireland's high inward and outward FDI stock can partly be explained by real economic activities taking place in Ireland. The high level of dividend payments and charges for using intellectual property suggests the country's tax rules are used by companies that engage in tax avoidance. The absence of withholding taxes on dividend payments made by companies based in Ireland also indicate the country's corporate tax rules may still be used in tax

avoidance structures. The existence of some provisions in bilateral tax treaties between Ireland and other countries may also be used by companies to overrule when it comes to tax avoidance as well.

Luxembourg: its corporate tax reform sought to boost competitiveness by lowering tax rates. The absence of withholding taxes on outbound (i.e. from EU residents to third country residents) interest and royalty payments and the exemption from withholding taxes on dividend payments under certain circumstances may lead to those payments escaping tax altogether, if they are also not subject to tax in the recipient jurisdiction. Despite the size of its financial sector, the high level of dividend, interest and royalty payments as a percentage of GDP suggests that the country's tax rules are used by companies that engage in tax avoidance. The majority of FDI is held by SPEs.

Malta: Malta's high inward and outward FDI stock is only partly explained by real economic activities taking place in the country. The high level of dividend, interest and royalty payments as a percentage of GDP points to Malta's tax rules being used by companies to engage in tax avoidance. Companies might choose to invest in the country to benefit from these corporate tax regulations. The large majority of FDI is held by SPEs. The absence of withholding taxes on dividends, interest and royalty payments made by Malta-based companies may lead to those payments escaping tax altogether.²¹

The Netherlands: The high level of dividend, royalty and interest payments made via the Netherlands indicate that the country's tax rules are used by companies that engage in tax avoidance. A large proportion of the FDI stock is held by SPEs. The absence of withholding taxes on outbound (i.e. from EU residents to third country residents) royalties and interest payments may lead to those payments escaping tax altogether, if they are also not subject to tax in the recipient jurisdiction. The possibility for hybrid mismatches by using the limited partnership (CV) and the lack of anti-abuse rules also facilitate tax avoidance.

18 Based on the Country Reports of the European Commission's 2018 European Semester.

19 Moreover, it is not taxing capital gains - one reason why many of the wealthiest French businessmen are choosing this country for residence.

20 A SPE is a legal entity that has little or no employment, operations or physical presence in the jurisdiction where it is located, and is related to another corporation, often as its subsidiary, which is typically located in another jurisdiction.

21 Malta has introduced a Notional Interest Deduction (NID) regime (available from 2018), which will allow companies and foreign companies with permanent establishments in Malta to claim a deduction on their equity against their tax base. The Commission does not consider this a risk. However, it is probable that it ends up being used for tax avoidance in the same way as interest deduction is.

In addition to the European Commission's tax avoidance analysis in EU member states, other member states have been highlighted by other organisations (Eurodad, 2017) for the tax avoidance opportunities they provide to corporations:

Austrian holding companies, which have caused the country to be grey-listed by Brazil.

Denmark's limited liability companies continue to be an issue of concern, due to the fact that they can be used for international tax avoidance.

Italy has a patent box as well as relatively high number of unilateral advance pricing agreements with multinational corporations. Both these elements can introduce opportunities for multinational corporations to lower their tax payments.

Latvia recently passed a tax reform that even though it increases the rate for corporate taxation from 15% to 20%, it creates a potential loophole for tax avoidance as it offers companies a corporate tax rate of zero for all retained and reinvested profits.

Spain's holding companies (ETVEs) and patent box regime can be and has been used by MNEs to avoid taxes.

The **United Kingdom** is continuously lowering its corporate tax rate, and offers harmful tax incentives such as patent boxes. The country also plays a key role as a conduit country, which can be used by multinational corporations as a route to channel profits into tax havens.

B- EU member states' financial secrecy

The main characteristics of a tax haven are not only the existence of a beneficial tax system, low or zero taxation for certain income and/or subjects, but also flexible commercial legislation (with few accounting requirements, and flexible rules as to incorporation and operation); lack of regulation of financial instruments and legal structures; and confidential information, bank and tax secrecy, which conceal the beneficial owners of companies, accounts and financial investments (Rua, 2014). Many of them were established in small, sparsely populated territories - islands that are far away from industrialised countries. However, in most cases, they are jurisdictions that depend on or have direct links with industrialised nations. Also, certain industrialised nations are tax havens too, in view of the incentives and tax secrecy they offer for certain income and subjects, and others are highly-specialised service hubs that grant tax advantages and secrecy (Bertazza, 2013).

The offshore industry combined tax avoidance with financial and fiscal secrecy. Table 1 (overleaf), compiled with data from Tax Justice Network, shows that most of the EU member states and some of their dependencies rank amongst the top secretive jurisdictions of the world.

According to Nicholas Shaxson (2014), tax havens can be divided in groups. One of them is European havens created after World War I, such as Switzerland, Luxemburg, the Netherlands, Austria, Belgium, Liechtenstein and Monaco.

The offshore industry combined tax avoidance with financial and fiscal secrecy

Table 1. Top 30 Countries of Financial Secrecy Index (by Tax Justice Network)

Rank	Jurisdiction	FSI Value(3)	FSI Share	Secrecy Score(4)	Global Scale Weight
1	Switzerland	1589,57	8,13%	76,45	4,50%
2	USA	1298,47	6,64%	59,83	22,30%
3	Cayman Islands(2)	1267,68	6,48%	72,28	3,79%
4	Hong Kong	1243,68	6,36%	71,05	4,17%
5	Singapore	1081,98	5,53%	67,13	4,58%
6	Luxembourg(1)	975,92	4,99%	58,20	12,13%
7	Germany(1)	768,95	3,93%	59,10	5,17%
8	Taiwan	743,38	3,80%	75,75	0,50%
9	United Arab Emirates (Dubai)	661,15	3,38%	83,85	0,14%
10	Guernsey(2)	658,92	3,37%	72,45	0,52%
11	Lebanon	644,41	3,29%	72,03	0,51%
12	Panama	625,84	3,20%	76,63	0,27%
13	Japan	623,92	3,19%	60,50	2,24%
14	Netherlands(1)	598,81	3,06%	66,03	0,90%
15	Thailand	550,60	2,82%	79,88	0,13%
16	British Virgin Islands(2)	502,76	2,57%	68,65	0,38%
17	Bahrain	490,71	2,51%	77,80	0,11%
18	Jersey(2)	438,22	2,24%	65,45	0,38%
19	Bahamas(2)	429,00	2,19%	84,50	0,04%
20	Malta(1)	426,31	2,18%	60,53	0,71%
21	Canada	425,84	2,18%	54,75	1,75%
22	Macao	424,92	2,17%	68,25	0,24%
23	United Kingdom(1)	423,76	2,17%	42,35	17,37%
24	Cyprus(1)	404,44	2,07%	61,25	0,55%
25	France(1)	404,18	2,07%	51,65	2,52%
26	Ireland(1)	387,94	1,98%	50,65	2,66%
27	Kenya	378,35	1,93%	80,05	0,04%
28	China	372,58	1,91%	60,08	0,51%
29	Russia	361,16	1,85%	63,98	0,26%
30	Turkey	353,89	1,81%	67,98	0,14%

Source: own, based on Tax Justice Network, 2018, available at: www.financialsecrecyindex.com.

Notes:

(1) Jurisdictions in bold are EU member states.

(2) The highlighted territories are Overseas Territories (OTs) and Crown Dependencies (CDs) where Queen Elizabeth II is head of state; and British Commonwealth territories which are not OTs or CDs but whose final court of appeal is the Judicial Committee of the Privy Council in London.

(3) FSI Value indicates the Financial Secrecy Index Value of each country, where a bigger value means more financial secretive activity. It is important to highlight that the scale is inverted in relation with the Rank value.

(4) Secrecy Score indicates the secrecy level of each country, where 0 means completely transparent and 100 means exceptionally secretive. It is important to highlight that the scale is inverted in relation to the Rank value.

- *Luxembourg is one of the most important offshore financial hubs characterised by their high secrecy and bank confidentiality, which have a large number of professionals.*

Luxembourg was involved in one of the biggest global scandals of international tax evasion. “Lux leaks”, revealed in November 2014 by Luxembourg-based whistleblowers, showed that the Big Four accounting, auditing and consulting firms assisted MNEs from around the world (IKEA, AIG, Deutsche Bank, Walt Disney Co., Pepsi and many others) in reducing their global tax bills using Luxembourg-based structures. The scheme cut their effective tax rates to less than one percent of the profits that they had shuffled into Luxembourg. The case was publicised by the International Consortium of Investigative Journalists (ICIJ) and led to the creation of a Special Committee into tax rulings and other measures in the European Parliament in 2015. Subsequently, the Panama Papers investigation exposed 411 intermediaries linked to Luxembourg.

According to Tax Justice Network (2018), Luxembourg recently launched a high-security ‘Freeport’ warehouse to store assets such as paintings, gold bars or bearer bonds, with ample opportunity for financial mischief. It has also just established a new, unregulated investment fund for ‘well-informed’ investors (Reserved Alternative Investment Fund, or RAIF) which can be used to hold ‘tangible’ assets such as art or to run hedge funds that are not subject to regulatory approval.

Table 2 shows the major role of EU member states in the administration of the offshore industry (the UK, Luxembourg, and Ireland) and the UK’s related jurisdictions (Jersey, Guernsey and the Caribbean). These estimations were published by the Boston Consulting Group and they are confirmed by a report from the Swiss Bankers Association (2018) which shows the same distribution of the global private banking market.

- *Another important group is composed by the UK and territories under its political or economic influence.*

The Channel Islands (Jersey and Guernsey) are Crown Dependencies of the UK, and they maintain tax confidentiality and opacity. Jersey provides a very aggressive system through rules that do not impose taxes on corporate profits nor capital profits, and that it keep the identity of the beneficial owner confidential through sophisticated wealth management structures. The Cayman Islands, Bermuda and the British Virgin Islands are British overseas territories subject to the UK’s jurisdiction and sovereignty. Others, such as the Bahamas and Mauritius, are sovereign states that belong to the British Commonwealth of Nations, which has Queen Elizabeth II as its constitutional monarch. All of these are traditional tax havens, sparsely populated and developing countries. Additionally, Hong Kong, Singapore, Dubai and Ireland are sovereign states that are completely independent of UK, but maintain close ties with the City of London.

Table 2. Share of offshore wealth under management and Financial Secrecy Index.

FSI 2018 (TJN)	Countries or groups of countries	Share of Offshore Wealth 2016	Offshore Wealth (trillion) 2016
1	Switzerland	23.3%	2.4
-	The Caribbean & Panama	12.6%	1.3
23	United Kingdom	12.6%	1.3
5	Singapore	11.7%	1.2
18	Jersey		
10	Guernsey	10.7%	1.1
26	Ireland (Dublin)		
2	United States	8.7%	0.9
4	Hong Kong	7.8%	0.8
6	Luxembourg	3.9%	0.4
	Others	8.7%	0.9
	Total		10.3

Source: own, based on The Boston Consulting Group (2017) and Financial Secrecy Index 2018 (Tax Justice Network).

The four aforementioned UK-linked groups of tax havens comprise the extraterritorial network of the UK, whose base is around the City of London and where most international funds that end up in these jurisdictions are transferred (to Shaxson, 2014). Thus, the UK is one of the most important global financial hubs. Individually, it serves almost 12.6% of the private banking market, and added to the jurisdictions with which it maintains close links, spread all over the world, its share is much more relevant. Private banking in the UK (in the City of London) has highly skilled personnel, specialising in complex structures, such as multi-jurisdictional trusts and investment funds.

Amongst Latin American countries, Uruguay is characterised by its advanced industry of enablers - that is, the financial, accountancy and legal industries that assist Argentina's richest families

C- MEFTA's Secrecy Jurisdictions

The EU and Mercosur member states have been ranked in the as follows in TJN's 2018 Financial Secrecy Index²²:

Table 3. EU and Mercosur Member states, Financial Secrecy Index (TJN)²³

Rank	Jurisdiction
6	Luxembourg
7	Germany
14	Netherlands
20	Malta
23	United Kingdom
24	Cyprus
25	France
26	Ireland
35	Austria
41	Italy
47	Romania
51	Poland
52	Spain
53	Belgium
54	Sweden
55	Latvia
61	Denmark
62	Paraguay
64	Portugal (Madeira)
67	Uruguay
70	Czech Republic
71	Finland
73	Brazil
74	Hungary
76	Slovakia
79	Croatia
80	Greece
89	Bulgaria
93	Estonia
97	Lithuania
104	Slovenia

Source: own, based on Financial Secrecy Index 2018 (Tax Justice Netowrk).

²² See <https://www.financialsecrecyindex.com/introduction/fsi-2018-results>

²³ TJN has not analysed the case of Argentina, and nor have the European Commission and the Council of the European Union for the listing of EU's non-cooperative jurisdictions for tax purposes. However, the chair of the Code of Conduct Group on Business Taxation has stated in an exchange of views held with the TAX3 Special Committee on October 10, 2018 that the situation of Argentina will soon be evaluated.

According to European Commission (2012) the UK, Luxembourg, Netherlands and Ireland accounted for 71% of the shadow banking market in the EU in 2010, and these transactions are closely linked to offshore wealth. In effect, the level of assets held by the shadow banking sector, measured by the assets of the OFI sector (Other financial institutions, which are non-bank financial institutions) is larger than the GDP in these four countries only.

Table 4. Size of the OFI sector across the EU26, December 2010, €bn²⁴

EU member states	OFI sector (2010, €bn)
Malta	1
Cyprus	2
Latvia	3
Lithuania	3
Estonia	4
Slovenia	8
Bulgaria	9
Slovakia	10
Romania	12
Greece	20
Hungary	22
Poland	58
Finland	77
Portugal	131
Denmark	229
Austria	245
Sweden	248
Belgium	312
Italy	816
Spain	852
France	1,552
Germany	1,558
Ireland	1,605
Netherlands	3,125
Luxembourg	4,042
United Kingdom	6,116
Total	21,060

Source: own, based on European Commission (2012).

D- Mercosur countries' deregulation process

For almost three years, Argentina has been adopting an aggressive policy of financial liberalisation and deregulation of exchange and capital controls, with the aim of ensuring free movement of capital and increasing the level of international financial integration. This programme was combined with short-term government debt instruments which provided an attractive interest rate that encouraged external financial flows. However, such deregulation brought with it serious consequences. In the face of changing international economic conditions, foreign investors rapidly withdrew their funds. This situation caused a climate of uncertainty and volatility, which ended up with the recent currency crisis. These measures resulted in a record total of \$59 billion in outflows of foreign currency owned by local residents, according to the Exchange Balance sheet published by the Central Bank of Argentina Republic (the formation of the private sector's external assets) and an increase in the public external debt of around \$79 billion. These took place within the period of two-and-a-half years, according to INDEC data (Statistics Institute of Argentina, latest available in June 2018).

Amongst Latin American countries, Uruguay is characterised by its advanced industry of enablers - that is, the financial, accountancy and legal industries that assist Argentina's richest families and receives large amounts of financial flows from this country. Uruguay played a key role in the capital flight that occurred in Argentina mainly because of the close proximity of the two countries. It maintains regulatory flexibility in terms of capital transfers and foreign currency exchange, and has established an important free economic zone. Uruguay has long been considered as a 'tax haven' (Gaggero, et. al., 2013). In the past, Uruguayan corporate structures were widely used to conceal the beneficial ownership of non-registered wealth and, despite the advances made in recent years, Uruguay continues to maintain gaps in its commercial legislation that allows tax dodging and money laundering. Uruguay has a secrecy score of 61 (Tax Justice Network, 2018), where 0 means completely transparent and 100 means exceptionally secretive.

²⁴ Czech Republic is not included as Eurostat do not provided information on the total assets held by other financial institutions for 2010 (European Commission, 2012). Croatia is not included as it was not an EU member state in 2012.

Uruguay is also in the EU's grey list of non-cooperative jurisdictions for tax purpose. It is not in the blacklist because it had replied to the European Commission in November 8th, 2017 noting that it had modified its patent boxes to frame incentives in the context of the nexus approach; that it is having parliamentary discussions on its free economic zones; and that it is working on modifying its Shared Service Centers system.

Paraguay has the peculiarity of preserving the highest levels of informality of the economy in Latin America (70 percent, according to Gasparini and Tornarolli, 2009) and is a recipient country of large cross-border financial flows. In the last decades, this country has applied a liberalisation policy that combined heavy inflows of capital and the deregulation of the financial sector, accompanied by permissive banking supervision. According to Tax Justice Network (2018), Paraguay is even more secretive than Uruguay, with a secrecy score of 84. For instance, it remains one of the economies that has not yet committed

to implement the Automatic Information Exchange for tax purposes.²⁵

Brazil has long been considered as a financially integrated country. Over the last decade, the volumes of financial inflows and outflows have strongly multiplied in Brazil ever since it expanded its financial market. Brazil has a moderate secrecy score of 49 (Tax Justice Network, 2018). Biancareli (2011) points out that the Brazilian economy was one of the most important destinations of capital inflows in recent decades, and that the main motivation of the currency inflow was the great differential in interest rate when compared with the international rate. Currently, Brazil is the major recipient of financial inflows of the region but is also the Latin American country with the largest financial outflows. Authors like Da Costa Val Munhoz y Libánio (2013) explain that these flows are dominated by mostly financial speculative movements, causing volatility and external vulnerability.

Brazil is the major recipient of financial inflows and outflows of the region [...] These flows are dominated by mostly financial speculative movements, causing volatility and external vulnerability

25 Please see: <https://www.oecd.org/tax/transparency/AEOI-commitments.pdf>

5. ESTIMATIONS OF IFF UNDER THE EU-MERCOSUR FTA

A- Methodology

In this work, 'capital flight' refers to financial outflows (or foreign exchange flows within the country, albeit outside of the formal economy) that integrate the offshore assets stock owned by local residents, including licit and illicit flows. The definition of 'illicit financial flows' (IFFs) is the unregistered portion of such outflows owned by residents in contravention of applicable laws; in other words, it contains funds that have been illegally obtained, transferred and/or used (GFI; Henry, 2012; Gaggero, et al., 2013).

In this sense, illicit financial flows involve funds originated by licit activities (commercial activities) associated with local or international tax evasion or tax avoidance, the transgression of exchange or financial norms, in addition to flows originated by illicit activities (criminal activities, such as trafficking in persons, drugs or arms smuggling, etc.).

This study estimates Mercosur and the EU's IFFs, taking into account the World Bank Residual Method, which calculates offshore financial assets with the data of the balance of payments. In this work, the authors opted for an alternative measure obtained by the financial account data of the balance of payments, calculated by adding the resident's direct investment to portfolio investment, financial derivatives and other investment. The main difference between this method and the residual model is that the own estimation excludes 'errors and omissions', which is usually considered as the illegal portion of capital abroad. The reason for choosing this option was to reduce all possible mistakes of the residual method since 'errors and omissions' may include real errors and omissions. The data source used is the IMF's Balance of Payments Statistics (BOPS) which provides data on every country and the values of residents' assets abroad. This is a very conservative estimation because it does not calculate the profit of the investment abroad that increases the stock wealth, or the outflows that occurred before 1978; and it is only based on registered outflows (direct, portfolio and other investments plus financial derivatives).

Also, both methodologies have a disadvantage: under-invoicing or over-invoicing of exports and imports, and transfer price manipulation are recorded as capital outflows 'legitimised' by the balance of payments current account and not as capital flight. Both methods therefore underestimate the figure.

For this reason, the study presents estimations of the MNEs' predicted profit-shifting in the context of the FTA and for such purpose, it reviews the recent indicators used by European Commission (2017).

The other estimation available is the official calculation of the stock of offshore assets based on the International Investment Position (IIP) data provided by IMF which is calculated by the Statistics Institutes of each country. Although this data is essential when analysing offshore wealth stocks, the methodology may involve an underestimation, as it is a direct method that uses local and foreign sources to determine the changes in investments abroad (Gaggero, Rúa y Gaggero, 2013). Based on IIP data, the stock of offshore wealth can be determined by adding the value of 'Other Sectors' (private non-financial sector) external assets to 'Deposit-taking corporations, except the central bank' (financial institutions) external assets. This method estimates portions of licit and illicit offshore capital owned by local residents.

This study uses both methodologies (BOP and IIP) to estimate capital flight from Mercosur and EU member states. For Mercosur countries, both BOP and IIP methodologies are used to estimate outflows and stocks. For EU Member states, only IIP was used, due to the complexity involved in preparing both estimations for 28 countries. The IIP data makes possible to estimate outflows and stock for each country.

The main difference between BOP and IIP is that the first registers the operations of each country with the rest of the world, including residents' investments abroad, and the second is an estimation of the residents' assets abroad and the foreign residents' assets within the country. As an estimation, the second one could include assets that are not registered.

The study also uses estimates relative to other measures of economic activity, such as the GDP of the countries and their government expenditure.

To summarise, this work makes estimations of licit and illicit financial outflows from EU and Mercosur countries from own and other sources, with the purpose of presenting a measure of the enormous financial flows that these countries generate and are not able to retain. Considering the rise in the free trade of services and goods that would take place in the context of the MEFTA, the amount of flows would likely increase.

B- Mercosur's offshore wealth

As we have seen, the behaviour of the financial flows in developing countries is quite heterogeneous, although all these peripheral countries have, in common, volatility and dependency on international financial flows. Table 5 below provides own estimations of private offshore wealth originated in the four developing countries and Mercosur members which are the subject of the study, calculated with flows of residents' direct investment, portfolio investment, financial derivatives and other investment between 1978 and 2017.

Tables 5 & 6 show that the four developing countries' stock of offshore financial wealth in 2017 sums are around \$853.7 billion in the first estimation and \$806.3 billion in the second one. This indicates that the second estimation could be miscalculated, since the first one is a very conservative figure including flows since only 1978.

Table 5. Mercosur Countries' Stock of Offshore Assets estimated by the Balance of Payments data, compared with GDP (2017), GDP-PPP²⁶ (2017) and General Government total expenditure in percentage of GDP (2017). (\$ in millions)

Countries	Stock of Investments (BOP)	GDP	GDP-PPP	Stock / GDP	Stock / GDP-PPP	Expend. / GDP
Argentina	213,239	637,717	920,249	33.4%	23.2%	40.5%
Brazil	618,905	2,054,969	3,240,319	30.1%	19.1%	37.9%
Paraguay	-366	29,619	68,326	-	-	26.8%
Uruguay	21,901	58,415	78,148	37.5%	28.0%	33.1%
Total	853,680	2,780,720	4,307,042	30.7%	19.8%	

Source: own, based on IMF data.

Table 6. Mercosur Countries' Stock of Offshore Assets estimated by the International Investment Position (IIP) data, compared with GDP (2017), GDP-PPP (2017) and General Government total expenditure in percentage of GDP (2017). (\$ in millions)

Countries	Stock of Offshore wealth (IIP)	GDP	GDP-PPP	Stock / GDP	Stock / GDP-PPP	Expend. / GDP
Argentina	274,205	637,717	920,249	43.0%	29.8%	40.5%
Brazil	486,004	2,054,969	3,240,319	23.7%	15.0%	37.9%
Paraguay	5,630	29,619	68,326	19.0%	8.2%	26.8%
Uruguay	40,457	58,415	78,148	69.3%	51.8%	33.1%
Total	806,296	2,780,720	4,307,042	29.0%	18.7%	

Source: own, based on IMF data.

²⁶ GDP - PPP refers to Gross Domestic Product, Purchasing Power Parity, which implies that the value of the currency is expressed in terms of the amount of goods or services that one unit of money can buy. In other words, it considers inflation impacts.

In 2017, Mercosur countries' stock of offshore private wealth was about 18.7% of their joint GDP, estimated by the IIP data, while the accumulated outflows from Mercosur between 1978 and 2017 amounted to 19.8%, according to the Balance of Payments data.

For Argentina, the stock of offshore wealth estimated by the IPP is higher than the estimate using BOPs data - \$274.2 billion versus \$213.2 billion - essentially because the first estimation excludes the outflows before 1978 and its profits, and it only contains registered outflows (direct, portfolio and other investments plus financial derivatives). It is important to highlight that capital flight in Argentina is a structural problem which remains to be solved. The stock of offshore wealth owned by Argentinians amounts to 43 percent of total income produced in this country, and it represents more than the total amount of General Government expenditure.

In the case of Brazil, the stock of offshore wealth estimated by the BOPs is higher than the estimate using IIP data, \$618.8 billion versus \$486 billion. Considering the biggest estimation, the stock of offshore wealth owned by local

residents in relative terms is less harmful than in other countries, although it is still a significant number. It amounts to 30.1 percent of total income produced by this country and it represents 80 percent of the general government's overall total expenditure.

At first glance, capital flight seems not to be a problem for Paraguay or Uruguay, but its stocks of offshore wealth have more weight in comparison with their relatively smaller GDPs. For Paraguay, offshore wealth equals 19 percent of total income and it represents 71 percent of government expenditure. Uruguay's offshore wealth amounted to 69.3 percent of total product and represents more than double the public expenditure in spite of its oscillating behaviour. Unlike the others three developing countries, Uruguay experimented inflows in both estimations (IIP and BOP) during 2011, 2016 and 2017.

Tables 7 & 8 reveal the average annual outflows from the four developing countries measured by our two methods. During the last 10 years, the average annual outflows from Mercosur countries was around \$56.4 billion, according to the IIP data.

Table 7. Mercosur countries' financial flows estimated by the Balance of Payments (BOP) data, 2008-2017. (\$ in millions)

Country	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Cumulative	Average
Argentina	15,787	7,536	9,095	20,110	11,042	5,279	3,317	9,782	4,741	19,092	105,782	10,578
Brazil	29,186	21,305	71,597	34,880	36,176	61,731	71,914	33,261	31,846	55,310	447,205	44,721
Paraguay	167	-375	117	-366	157	132	-185	937	302	238	1,124	112
Uruguay	37	2,262	831	-1,872	5,010	15	2,994	4,295	-1,352	-2,265	9,955	995
Total	45,176	30,728	81,640	52,752	52,385	67,157	78,041	48,274	35,536	72,375	564,065	56,407

Source: own, based on IMF data.

Table 8. Mercosur countries' financial flows estimated by the International Investment Position (IIP) data, 2008-2017. (\$ in millions)

Country	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Cumulative	Average
Argentina	2,315	11,715	11,478	21,273	12,365	10,207	5,401	10,544	6,446	28,704	120,449	12,045
Brazil	14,082	10,660	53,380	7,729	67,174	35,327	58,629	-7,752	13,775	22,902	275,907	27,591
Paraguay	215	1,089	956	-526	162	132	-183	937	302	238	3,323	332
Uruguay	423	2,800	2,205	-2,077	19,467	109	3,069	3,425	-1,652	-2,337	25,432	2,543
Total	17,036	26,265	68,019	26,399	99,168	45,775	66,917	7,154	18,872	49,507	425,110	42,511

Source: own, based on IMF data.

In addition to the aforementioned estimation, we need to add the outflows that are linked to transfer pricing manipulation and over and under-invoicing. ECLAC (UN Economic Commission for Latin American and the Caribbean) has the estimated volumes of these outflows in table 9 below between 2004 and 2013. According to the data²⁷, over this 10-year period, the estimates amounted to \$29.2 billion in Argentina, \$122.6 billion in Brazil, \$3.8 billion in Paraguay and \$2.3 billion in Uruguay.

Table 9. ECLAC data for Latin America and the Caribbean: financial outflows estimated by the manipulation of prices of international trade in goods – 2004-2013. (\$ in millions)

Country	Over-invoicing	Under-invoicing	Total	Total Annual Average	Percentage of total region
Argentina	6,319.20	22,918.80	29,238.00	2,923.80	3.80%
Brazil	46,192.40	76,457.40	122,649.80	12,264.98	16%
Paraguay	822.3	3,011.90	3,834.20	383.42	0.50%
Uruguay	186.3	2,106.90	2,293.20	229.32	0.30%
Total	53,520.20	104,495.00	158,015.20	15,801.52	20.60%

Source: own, based on ECLAC data (Podestá, A., Hanni, M., and Martner, R., 2017).

On the other hand, Global Financial Integrity (GFI) has calculated IFFs due to trade mis-invoicing from developing countries²⁸. The average outflows between 2004-2013 from Argentina amounted to \$6.3 billion; \$21.9 billion from Brazil; \$3.6 billion from Paraguay; and \$0.8 billion from Uruguay.

Table 10. GFI estimate for Latin America and the Caribbean: estimation of illicit financial outflows due to trade mis-invoicing, GFI, 2004-2013. (\$ in millions)

Country	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Cumulative	Average
Argentina	6,116	4,992	3,747	5,391	9,586	4,179	4,656	5,266	7,458	11,171	62,561	6,256
Brazil	14,305	17,171	10,599	14,021	21,926	22,061	28,315	31,057	31,138	28,185	218,778	21,878
Paraguay	3,588	3,955	4,514	1,956	4,523	2,879	2,653	3,828	4,274	4,116	36,286	3,629
Uruguay	466	497	129	489	396	715	1,395	908	1,039	1,515	7,549	755
Total	24,475	26,615	18,989	21,857	36,431	29,834	37,019	41,059	43,909	44,987	325,174	32,518

Source: own, based on GFI data (Kar, D, y J, Spanjer, 2015).

²⁷ The methodology used could be subject to under or over estimations as it is based on comparing the exports of a country with the imports of its trade partner (Grondona and Burgos, 2015).

²⁸ GFI uses a similar methodology to that of ECLAC. The main difference is that the second one does not consider services trade estimations because of the lack of data.

ECLAC calculated an annual average of \$15.8 billion of financial outflows due to mis-invoicing between 2004 and 2013, while GFI doubled the previous estimations, reaching \$32.5 billion over the same period.

It is important to highlight that the primary destinations of Latin American financial flows are the United States, Switzerland and the territories located in the Caribbean that are politically dependent on EU countries. According to BCG (2015), 29% went to the US, 29% to the Caribbean and 27% went to Switzerland.

On the other hand, it is important to analyse the sources of the FDI in the two major economies of Latin America. With Argentina in 2016, the main investor countries are the United States (\$16,993 million, 23 percent), Spain (\$13,169 million), the Netherlands (\$9,140 million), Brazil (\$4,536 million) and Chile (\$3,863 million), according to the Central Bank of Argentina (BCRA, 2016). In the case of Brazil, the main investors were the following in 2016:

Table 11. FDI inflows to Brazil - 2016

Country	FDI
United States	12,2%
Netherlands	19,6%
Luxembourg	13,8%
Switzerland	1,8%
Spain	6,5%
France	5,2%
Chile	1,6%
United Kingdom	6,7%
Canada	1,0%
Japan	2,6%
Singapour	0,4%
Italy	5,3%
Norway	4,1%
Korea	1,0%
British Virgin Islands	3,1%
Germany	3,4%
Belgium	1,1%
Cayman Islands	0,7%
Uruguay	0,5%
Portugal	0,5%
Sweedeen	0,7%
Ireland	1,1%
Mexico	1,5%
China	1,6%
Bermuda	0,5%
Cyprus	0,4%
Others	3,1%

Source: Central Bank of Brazil (www.bcb.gov.br).

It is important to highlight that the primary destinations of Latin American financial flows are the United States, Switzerland and the territories located in the Caribbean that are politically dependent on EU countries.

C- EU member states' offshore wealth

According to the European Commission (2017) several EU member states stand out with particularly high values of both inward and outward FDI stocks. This seem to be a clear indication of the attractiveness of Cyprus, Luxembourg, Malta and the Netherlands for holding companies, which themselves are foreign-owned and also indicates tax avoidance activities that take place due to FDI through SPEs. In 2015, in Luxembourg both inward (5766%)

and outward (6749%) FDI stocks are multiple times the GDP; and in Malta, inward FDI amounts to more than 17 times the GDP and the FDI outward stocks are nearly 7 times larger than the GDP. In Cyprus, inward and outward FDI stocks are roughly 900 percent of GDP, in the Netherlands both are more than 500 percent of GDP, and in Ireland both are more than 3 times the GDP.

Table 12. EU member states FDI Positions by European Commission (2017)

	Foreign direct investment positions (2015)					
	Inward FDI stock		Outward FDI stock		Gravity FDI stock	
	% GDP	M. Dollars	% GDP	M. Dollars	M. Dollars	%
Austria	70.6	240,056	83.8	284,737	235,613	89.8
Belgium	102.2	418,266	100.1	409,880	538,002	129.9
Bulgaria	86.0	37,958	4.0	1,762	23,497	118.3
Croatia	54.0	23,721	11.5	5,035	30,010	208.7
Cyprus	904.7	159,557	906.5	159,879	7,239	4.5
Czech Republic	61.5	102,756	10.1	16,897	122,468	204.7
Denmark	39.2	104,234	63.0	167,672	180,815	133.0
Estonia	86.2	17,462	27.9	5,657	11,831	102.4
Finland	35.5	74,154	40.8	85,352	104,891	131.5
France	27.8	606,370	50.5	1,101,103	1,832,664	214.7
Germany	23.8	722,826	41.7	1,264,059	2,471,133	248.7
Greece	12.1	21,348	14.6	25,666	80,372	341.9
Hungary	160.6	176,125	124.1	136,093	70,387	45.1
Ireland	311.0	795,644	318.7	815,202	140,908	17.5
Italy	18.9	309,620	26.1	429,228	842,831	228.1
Latvia	55.6	13,545	4.9	1,196	13,572	184.1
Lithuania	36.2	13,497	6.4	2,397	20,784	261.5
Luxembourg	5766.8	3,005,207	6749.3	3,517,234	63,527	1.9
Malta	1732.0	152,216	700.4	61,553	3,414	3.2
Netherlands	534.9	3,618,685	633.4	4,285,080	823,059	20.8
Poland	39.3	167,917	5.2	22,354	248,081	260.8
Portugal	58.7	105,475	30.5	54,699	82,590	103.1
Romania	40.2	64,440	0.5	745	82,087	251.9
Slovakia	51.0	40,129	2.8	2,177	62,379	294.9
Slovenia	30.0	11,565	14.2	5,461	27,438	322.3
Spain	46.7	502,663	41.9	450,361	514,290	107.9
Sweden	62.2	277,877	76.9	343,786	239,675	77.1
United Kingdom	50.2	1,294,795	55.6	1,433,450	1,960,756	143.7
EU 28	63.1	13,078,106	72.9	15,088,714	10,834,312	76.9
Average	374.9		362.3			151.9
Std. Deviation	1115.7		1272.9			101.3

The next table shows the evolution of the EU member states' stock of wealth booked offshore during the past decade. The stock of offshore financial wealth from EU countries is around \$65 trillion.

Table 13. EU member states' offshore wealth stock evolution, estimated by the International Investment Position (IIP) data, 2008-2017. (\$ in millions)

Country	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Austria	1,020,915	1,072,718	985,438	978,225	1,012,072	1,054,011	963,976	853,157	802,372	914,479
Belgium	2,503,430	2,558,128	2,471,445	2,497,748	2,499,586	2,435,345	2,261,194	2,094,068	2,073,462	2,451,376
Bulgaria	12,348	14,518	15,736	17,088	19,374	23,007	23,429	20,188	23,318	28,778
Croatia	18,795	20,228	17,451	16,064	16,315	16,172	18,716	18,775	17,649	18,394
Cyprus	303,041	331,247	318,475	288,313	328,046	304,658	262,584	267,991	262,513	287,583
Czech Republic	96,802	100,503	107,041	107,362	120,821	130,184	125,917	118,169	119,669	147,612
Denmark	663,703	692,343	741,161	740,448	815,203	894,169	941,135	870,480	917,723	1,082,233
Estonia	18,214	18,532	19,800	20,998	23,041	25,863	24,290	21,959	22,182	26,276
Finland	495,330	545,946	617,531	699,055	692,268	673,807	655,099	367,614	444,540	455,480
France	6,975,378	7,417,886	7,227,172	7,243,753	7,435,086	7,463,377	7,353,236	6,548,616	6,496,514	7,233,997
Germany	6,750,408	7,036,474	7,760,418	7,669,437	8,064,305	8,208,812	8,136,165	7,418,245	7,290,051	8,241,491
Greece	403,567	351,475	288,858	282,020	299,517	264,142	222,053	219,041	176,352	142,895
Hungary	291,581	287,123	258,931	254,519	273,928	272,316	249,259	251,937	314,200	315,454
Ireland	3,345,897	3,676,671	3,676,500	3,840,669	3,415,374	3,458,134	3,974,956	4,277,366	4,150,258	4,817,204
Italy	2,299,090	2,457,013	2,358,563	2,334,541	2,432,804	2,510,289	2,434,192	2,288,923	2,312,193	2,793,564
Latvia	19,913	21,300	21,441	21,945	23,459	25,411	24,766	22,715	20,274	22,351
Lithuania	12,161	14,561	14,233	13,625	14,078	15,899	13,867	13,801	15,897	18,540
Luxembourg	5,352,301	6,000,891	6,292,885	6,788,960	8,407,397	9,651,229	10,658,017	11,178,195	11,239,170	12,593,738
Malta	204,886	219,762	229,030	245,711	265,827	282,817	265,379	239,141	233,930	277,615
Netherlands	6,991,346	7,381,133	7,365,933	7,682,229	8,313,763	9,008,359	8,861,096	8,576,154	8,740,675	10,138,606
Poland	83,750	87,401	110,664	113,557	125,836	127,780	128,688	132,949	129,182	156,340
Portugal	231,937	272,250	252,043	204,379	216,948	229,210	303,094	266,852	244,186	274,300
Romania	13,710	17,234	18,408	18,565	19,491	20,706	21,929	18,448	21,059	25,812
Slovak Republic	24,192	31,612	33,607	34,065	36,480	44,293	43,239	40,252	44,445	59,103
Slovenia	35,480	37,936	34,291	32,507	31,938	33,889	32,792	32,382	31,537	37,278
Spain	1,599,422	1,671,586	1,560,795	1,529,091	1,666,888	1,600,071	1,537,944	1,501,654	1,511,370	1,807,347
Sweden	1,043,245	1,168,094	1,277,017	1,300,104	1,356,893	1,467,443	1,376,722	1,293,811	1,252,341	1,478,963
United Kingdom	11,108,372	9,033,009	10,522,453	11,406,104	11,135,784	10,917,503	11,105,757	9,755,305	9,099,291	9,540,616
Total	51,919,214	52,537,571	54,597,320	56,381,081	59,062,525	61,158,896	62,019,490	58,708,188	58,006,355	65,387,427

Source: own, based on IMF data.

Table 14 reveals the flows from EU member states between 2008 and 2017, reaching \$13 trillion during this 10 year period. The annual average of outflows from these 28 countries amounted to \$1.3 trillion.

Although EU member states show huge outflows through the IIP estimates, they are also destination countries for investment flows. As this study reveals, EU member states show both very high level of financial inflows and outflows. They therefore represent a different behaviour from Mercosur countries, with the latter being exporters of

financial flows. EU member states are also capital exporters, but additionally present highly relevant investments both inward and outward flows, due to financial and corporate activity there.

Note that during some years there are negative flows, which indicate inward financial flows instead of outflows. The major entry points were registered in Austria, Belgium, Finland, France, Germany, Ireland, Luxembourg, Netherlands and the UK.

Table 14. EU member states' financial outflows evolution, as estimated by the International Investment Position (IIP) data, 2008-2017. (\$ in millions)

Country	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Cumulative	Average
Austria	-43,046	51,803	-87,281	-7,213	33,847	41,939	-90,035	-110,819	-50,784	112,107	-149,482	-14,948
Belgium	92,604	54,698	-86,683	26,303	1,838	-64,241	-174,150	-167,127	-20,605	377,914	40,551	4,055
Bulgaria	730	2,170	1,218	1,352	2,286	3,633	422	-3,241	3,130	5,460	17,159	1,716
Croatia	885	1,432	-2,776	-1,387	251	-143	2,544	60	-1,127	745	484	48
Cyprus	217,396	28,207	-12,772	-30,163	39,733	-23,389	-42,074	5,407	-5,478	25,070	201,938	20,194
Czech Republic	3,648	3,701	6,538	322	13,459	9,363	-4,268	-7,747	1,500	27,942	54,458	5,446
Denmark	-37,513	28,640	48,818	-714	74,756	78,966	46,965	-70,654	47,243	164,510	381,017	38,102
Estonia	-1,657	318	1,268	1,198	2,044	2,821	-1,573	-2,331	223	4,094	6,405	641
Finland	55,485	50,616	71,586	81,524	-6,786	-18,461	-18,708	-287,485	76,927	10,939	15,634	1,563
France	-24,530	442,507	-190,714	16,581	191,333	28,291	-110,141	-804,620	-52,102	737,482	234,088	23,409
Germany	-633,560	286,066	723,944	-90,981	394,868	144,506	-72,647	-717,920	-128,194	951,440	857,524	85,752
Greece	135,556	-52,092	-62,618	-6,838	17,497	-35,375	-42,088	-3,013	-42,688	-33,457	-125,116	-12,512
Hungary	37,322	-4,458	-28,191	-4,413	19,410	-1,612	-23,057	2,678	62,263	1,255	61,195	6,120
Ireland	-283,592	330,773	-170	164,169	-425,295	42,760	516,822	302,409	-127,107	666,946	1,187,715	118,772
Italy	-183,344	157,923	-98,449	-24,022	98,263	77,485	-76,097	-145,269	23,269	481,372	311,130	31,113
Latvia	3,055	1,387	141	504	1,515	1,951	-645	-2,051	-2,442	2,078	5,493	549
Lithuania	-413	2,400	-328	-607	453	1,821	-2,032	-66	2,096	2,643	5,967	597
Luxembourg	-823,472	648,589	291,994	496,076	1,618,437	1,243,832	1,006,787	520,178	60,976	1,354,568	6,417,965	641,796
Malta	158,213	14,876	9,269	16,681	20,115	16,990	-17,438	-26,237	-5,212	43,685	230,942	23,094
Netherlands	-484,517	389,787	-15,200	316,296	631,535	694,596	-147,264	-284,942	164,521	1,397,931	2,662,744	266,274
Poland	-17,279	3,651	23,263	2,893	12,279	1,944	908	4,261	-3,767	27,158	55,311	5,531
Portugal	-23,190	40,312	-20,206	-47,664	12,569	12,262	73,884	-36,242	-22,665	30,114	19,173	1,917
Romania	913	3,523	1,174	157	926	1,215	1,223	-3,481	2,611	4,752	13,015	1,301
Slovak Republic	10,945	7,420	1,995	458	2,415	7,813	-1,054	-2,987	4,193	14,658	45,856	4,586
Slovenia	-7,631	2,456	-3,645	-1,784	-569	1,951	-1,097	-410	-845	5,741	-5,833	-583
Spain	540,129	72,163	-110,791	-31,704	137,797	-66,817	-62,127	-36,290	9,716	295,978	748,054	74,805
Sweden	-134,586	124,849	108,923	23,088	56,789	110,550	-90,721	-82,911	-41,470	226,621	301,132	30,113
United Kingdom	1,234,955	-2,075,362	1,489,443	883,652	-270,320	-218,281	188,254	-1,350,452	-656,014	441,325	-332,801	-33,280
Total	-206,494	618,357	2,059,749	1,783,762	2,681,443	2,096,372	860,594	-3,311,302	-701,832	7,381,071	13,261,719	1,326,172

Source: own, based on IMF data.

Tables 15 & 16 illustrate the stock of offshore wealth in 2017 and the outflows during the period 2008-2017 against the GDP. Certain estimations of some countries, such as Luxembourg, Ireland, the Netherlands, Malta and Cyprus, indicate excessive levels of financial activity, showing a heightened amount of offshore financial flows. These flows contrast with the total government expenditure in percentage of GDP.

Luxembourg's stock of offshore wealth is \$12.6 trillion, which represents 20185% of GDP; Netherlands's stock of offshore wealth is \$10.1 trillion, which represents 1228% of GDP; Ireland's stock of offshore wealth is \$4.8 trillion, which represents 1442% of GDP; Cyprus's stock of offshore wealth is \$287 billion, which represents 1350% of GDP; and Malta's stock of offshore wealth is \$277 billion, which represents 2213% of GDP.

Table 15. EU member states' Stock of Offshore wealth in 2017, estimated by the International Investment Position (IIP) data, compared with GDP (2017), GDP-PPP (2017) and General Government total expenditure in percentage of GDP (2017). (\$ in millions)

Country	Offshore wealth stock	GDP	%	GDP-PPP	%	Total expenditure in % of GDP
Austria	914,479	416,845	219%	439,575	208%	50%
Belgium	2,451,376	494,733	495%	528,458	464%	52%
Bulgaria	28,778	56,943	51%	153,138	19%	33%
Croatia	18,394	54,516	34%	101,344	18%	46%
Cyprus	287,583	21,310	1350%	31,588	910%	38%
Czech Republic	147,612	213,189	69%	375,679	39%	39%
Denmark	1,082,233	324,484	334%	286,766	377%	52%
Estonia	26,276	25,973	101%	41,564	63%	40%
Finland	455,480	253,244	180%	243,975	187%	54%
France	7,233,997	2,583,560	280%	2,835,746	255%	56%
Germany	8,241,491	3,684,816	224%	4,170,790	198%	44%
Greece	142,895	200,690	71%	1,606	8898%	49%
Hungary	315,454	152,284	207%	288,990	109%	50%
Ireland	4,817,204	333,994	1442%	357,163	1349%	26%
Italy	2,793,564	1,937,894	144%	2,310,902	121%	49%
Latvia	22,351	30,319	74%	53,909	41%	37%
Lithuania	18,540	47,263	39%	91,244	20%	33%
Luxembourg	12,593,738	62,393	20185%	62,730	20076%	42%
Malta	277,615	12,543	2213%	19,307	1438%	38%
Netherlands	10,138,606	825,745	1228%	916,078	1107%	43%
Poland	156,340	524,886	30%	1,121,009	14%	42%
Portugal	274,300	218,064	126%	313,437	88%	44%
Romania	25,812	211,315	12%	481,453	5%	31%
Slovak Republic	59,103	95,938	62%	179,365	33%	41%
Slovenia	37,278	48,868	76%	71,081	52%	40%
Spain	1,807,347	1,313,951	138%	1,773,906	102%	41%
Sweden	1,478,963	538,575	275%	520,937	284%	48%
United Kingdom	9,540,616	2,624,529	364%	2,914,042	327%	39%
Total	65,387,427	17,308,864	378%	20,685,782	316%	

Source: own, based on IMF data.

With regard to the financial outflows, the accumulated flows among 2008 and 2017 amounted to \$202 billion in Cyprus, which represents 948% of GDP; \$1.2 trillion in Ireland, which represents 356% of GDP; \$6.4 trillion in Luxembourg, which represents 10286% of GDP; \$2.7

trillion in the Netherlands, which represents 322% of GDP; \$231 billion in Malta, which represents 1841% of GDP. In the case of UK, its accumulated flows were negative among 2008 and 2017, which indicate inflows.

Table 16. EU member states' outflows between 2008-2017, estimated by the International Investment Position (IIP) data, compared with GDP (2017), GDP-PPP (2017) and General Government total expenditure in percentage of GDP (2017). (\$ in millions)

Country	Outflows 2008-2017	GDP	%	GDP-PPP	%	Total expenditure in % of GDP
Austria	-149,482	416,845	-36%	439,575	-34%	50%
Belgium	40,551	494,733	8%	528,458	8%	52%
Bulgaria	17,159	56,943	30%	153,138	11%	33%
Croatia	484	54,516	1%	101,344	0%	46%
Cyprus	201,938	21,310	948%	31,588	639%	38%
Czech Republic	54,458	213,189	26%	375,679	14%	39%
Denmark	381,017	324,484	117%	286,766	133%	52%
Estonia	6,405	25,973	25%	41,564	15%	40%
Finland	15,634	253,244	6%	243,975	6%	54%
France	234,088	2,583,560	9%	2,835,746	8%	56%
Germany	857,524	3,684,816	23%	4,170,790	21%	44%
Greece	-125,116	200,690	-62%	1,606	-7791%	49%
Hungary	61,195	152,284	40%	288,990	21%	50%
Ireland	1,187,715	333,994	356%	357,163	333%	26%
Italy	311,130	1,937,894	16%	2,310,902	13%	49%
Latvia	5,493	30,319	18%	53,909	10%	37%
Lithuania	5,967	47,263	13%	91,244	7%	33%
Luxembourg	6,417,965	62,393	10286%	62,730	10231%	42%
Malta	230,942	12,543	1841%	19,307	1196%	38%
Netherlands	2,662,744	825,745	322%	916,078	291%	43%
Poland	55,311	524,886	11%	1,121,009	5%	42%
Portugal	19,173	218,064	9%	313,437	6%	44%
Romania	13,015	211,315	6%	481,453	3%	31%
Slovak Republic	45,856	95,938	48%	179,365	26%	41%
Slovenia	-5,833	48,868	-12%	71,081	-8%	40%
Spain	748,054	1,313,951	57%	1,773,906	42%	41%
Sweden	301,132	538,575	56%	520,937	58%	48%
United Kingdom	-332,801	2,624,529	-13%	2,914,042	-11%	39%
Total	13,261,719	17,308,864	77%	20,685,782	64%	

Source: own, based on IMF data.

6. POLICY RECOMMENDATIONS AND CONCLUSIONS

As this investigation has shown, an FTA between EU and Mercosur countries under the current conditions would be highly destructive. Capital controls would be restricted and speculative financial services would be liberalised, whilst it would exclude requirements to identify the states with high levels of tax avoidance opportunities and financial secrecy, as well as other measures to prevent IFFs, tax evasion and money laundering.

In 2017, Mercosur countries' stock of offshore private wealth was about 18.7% of their joint GDP, estimated by using the International Investment Position (IIP) data, and the cumulated outflows from Mercosur between 1978 and 2017 amounted to 19.8% when using the Balance of Payments (BOP) data.

The four Mercosur countries' stock of offshore financial wealth in 2017 exceeded \$853.7 billion, while between 2008-2017, the average annual outflows from these countries was around \$56.4 billion, according to the IIP data.

For the last 10 years, the average annual outflows from Mercosur's countries was around \$56.4 billion, says BOP data.

In terms of transfer pricing manipulation, the amount of outflows is effectively higher. The Economic Commission for Latin America and the Caribbean (ECLAC) has calculated an annual average of \$15.8 billion of financial outflows due to misinvoicing between 2004 and 2013, and Global Financial Integrity (GFI) duplicates these estimations, reaching \$32.5 billion during the same period.

The stock of offshore financial wealth from European Union's countries in 2017 was around \$65 trillion and represented over 350% of its GDP, estimated by the IIP data. The annual average of outflows from these 28 countries amounted to \$1.3 trillion between 2008-2017. This figure seems to reflect the high level of financial activity in EU countries, including outward financial flows.

These estimations underscore the importance of capital flows - and with it in mind, the possible increase of capital flows, services and goods that would take place in an EU-Mercosur FTA. Therefore, a crucial recommendation is that the MEFTA must include provisions aimed at combating international tax dodging, illicit financial flows and money laundering.

Ioannides et. al. (2016) also suggested a series of recommendations on strengthening the ability of EU FTAs to combat these issues. Amongst them, they said that if one of the EU's trading partners fails to implement the international and EU AML/CFT (anti-money laundering and combating the financing of terrorism) standards, then the EU should consider limiting the definition and/or scope of financial services to be liberalised where compelling reasons exist. This could be recommended in both directions; and it should not be based in FATF's blacklist, which is highly political and inaccurate in its identification of the high risk countries for AML purposes.

Also, the EU should strive for a greater degree of specification of the AML/CFT and tax-related requirements in its FTAs and must ensure that all FTAs contain provisions on tax cooperation and that such provisions guarantee cooperation at the bilateral level in addition to any regional or international instruments or arrangements. It is also essential to establish functional channels of information exchange between domestic AML/CFT, tax authorities, and financial supervision authorities.

However, there are some loopholes that should be resolved before the implementation of bilateral or multilateral tax agreements. For instance, the effectiveness of automatic exchange of tax and financial information depends on the creation of public registers of ultimate beneficial ownership, which must include the disclosure of companies and other shelter instruments' control chains. Corporate structures such as trusts, foundations and shell companies are widely used to conceal the identity of the beneficial owners, which affect the credibility of the financial information that is the

subject of exchange. This is a prior objective which has to be concluded before the implementation of provisions on tax and financial information exchange between countries, and public country-by-country reporting.

On the other hand, the FTA must incorporate provisions against transfer pricing manipulation of internationally traded goods and services. In addition, it is necessary to discuss the limitations of the 'arm's length' principle, which considers related entities as independent companies, simulating a fictitious price fixation by establishing the value of intra-group operations of MNEs. Instead, the provisions to fight transfer mispricing must incorporate the criterion of 'economic reality', adopting a perspective that considers MNEs as an 'economic group' (Corti, 2012) or as a 'unique corporation' (Picciotto, 2014).

Another very important recommendation is to establish legislations that protect those who blow the whistle on financial crimes and to preserve the identity of the complainant, safeguard the security of the individual and his/her family, provide legal support and relocation expenses. A reward system should also be offered (Rua, 2017). Most of large-scale tax evasion cases, such as HSBC leaks, Lux leaks, the 'Panama Papers', were made public by internal complainants. The information and knowledge that these people have are extremely valuable for public interest, and yet, they are intimidated, prosecuted and often sent to prison.

The EU-Mercosur FTA must incorporate provisions against transfer pricing manipulation of internationally traded goods and services.

7. REFERENCE

Alstadsaeter, A., Johannesen, N., & Zucman, G. (2017), Tax Evasion and Inequality, Working Paper.

BCG, The Boston Consulting Group (2015), *Global wealth 2015, Winning the growth game*, Recuperado de: mg-stg.bcg.com/BCG-Global-Wealth-2015_tcm9-76658.pdf

BCG, The Boston Consulting Group (2017), *Global wealth 2017, Transforming the Client Experience*, Recuperado de: http://image-src.bcg.com/Images/BCG-Transforming-the-Client-Experience-June-2017_2_tcm9-161685.pdf

BCRA (2016) Las inversiones directas en empresas residentes. Banco Central de la República Argentina. Diciembre de 2016.

Bertazza, H., J. (2013) *Evasión fiscal y Administración Tributaria*. 1ra Edición. Buenos Aires: Consejo Profesional de Ciencias Económicas de la Ciudad Autónoma de Buenos Aires. Abril de 2013.

Biancareli, A., M. (2011) Brazil, developing economies and private international capital flows: the (new) challenges in the post-crisis scenario. 15th conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM). Berlin, Octubre de 2011.

Cobham, A., & Janský, P. (2017a), Global distribution of revenue loss from tax avoidance, Re-estimation and country results, Working Paper 2017/55, United Nations University (UNU-WIDER), in partnership with ICTD, March 2017

Cobham, A., & Janský, P. (2017b), Measurement of Illicit Financial Flows.

Corti, A., H., M. (2012) Algunas reflexiones sobre los mecanismos de exacción de la renta impositiva nacional. A propósito de las ficciones de contratos al interior de los conjuntos económicos. Instituto Argentino para el Desarrollo Económico (IADE).

Council of the EU. (2018, July 20). Overview of the preferential tax regimes examined by the Code of Conduct Group (Business Taxation) since its creation in March 1998. Code of Conduct Group (Business Taxation).

Council of the EU. (2018, June 8). Report to the Council/ Endorsement. 9637/18. Code of Conduct Group (Business Taxation).

Christensen, J. (2007), The corruption interface, Tax havens, bankers and dirty money flows, Tax Justice Network, Accountancy Business and the Public Interest, Vol, 6, No, 1, 215-227.

Da Costa Val Munhoz, V. y Libánio, G. (2013) Volatilidad de los flujos financieros y fuga de capitales: la vulnerabilidad externa de Brasil, 1995-2010. *Investigación Económica*, Vol. 72, No. 286 (OCTUBRE-DICIEMBRE DE 2013), pp. 65-100.

Eskelinen, T., & Ylönen, M. (2017). Panama and the WTO: new constitutionalism of trade policy and global tax governance. *Review of International Political Economy*. doi:10.1080/09692290.2017.1321569

Eurodad. (2017). Tax Games: the Race to the Bottom, Europe's role in supporting an unjust global tax system.

European Commission. (2017). Aggressive tax planning indicators. Taxation Papers, working paper No 71-2017, Brussels. Retrieved from https://ec.europa.eu/taxation_customs/sites/taxation/files/taxation_papers_71_atp.pdf

European Commission (2012), Non-bank financial institutions: Assessment of their impact on the stability of the financial system. *European Economy; Directorate - General for Economic and Financial Affairs*. Economic Papers 472. November 2012, Brussels.

Gaggero, J.; Rua, M.; Gaggero, A. (2013), Fuga de Capitales III, Argentina (2002-2012), Magnitudes, evolución, políticas públicas y cuestiones fiscales relevantes, CEFID-AR, Working document N° 52, Buenos Aires, December 2013.

Gasparini, L. and Tornarolli, L. (2009) Informality in Latin America and the Caribbean: Patterns and Trends from Household Survey Microdata. *DESARROLLO Y SOCIEDAD PRIMER SEMESTRE DE 2009*, PP. 13-80. ISSN 0120-3584.

Grondona, V., and Burgos, M. (2015). Fuga de Capitales VI. Argentina 2015. Estimación de los precios de transferencia. El caso del complejo sojero. Centro de Economía y Finanzas para el Desarrollo de la Argentina (CEFID-AR). Buenos Aires: CEFID-AR.

Grondona, V. (2014), Fuga de capitales IV, Argentina, 2014, La manipulación de los "precios de transferencia", Con la supervisión de Jorge Gaggero, Documento de Trabajo N° 58, Buenos Aires: CEFID-AR,

Hearson, M. (2018). The European Union's tax treaties with developing countries. Leading by example? European United Left/Nordic Green Left (GUE/NGL) in the European Parliament. Retrieved from <http://www.guengl.eu/uploads/publications-documents/LeadingByExample.pdf>

Hebous, Shafik and Johannesen, Niels (2015) "At Your Service! The Role of Tax Havens in International Trade with Services", CESifo Working Paper no, 5414, Centre for Economic Studies and Ifo Institute (CESifo), Frankfurt and Copenhagen, June 2015.

Henry, J., S. (2012), The Price of Offshore Revisited, Tax Justice Network, Julio de 2012, https://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_Revisited_120722.pdf

Ioannides, I., Douma, W. T., Güven, O., Jancic, D., Pantaleo, L., van der Velde, S., de Vries, F. (2016). The inclusion of financial services in EU free trade and association agreements: Effects on money laundering, tax evasion and avoidance; Ex-Post impact assessment. European Parliamentary Research Service (EPRS), Ex-Post impact assessment Unit. European Parliament. doi:10.2861/868389.

- Kar, D, and J, Spanjers (2015), "Illicit Financial Flows from Developing Countries: 2004-2013", Global Financial Integrity, Washington D,C., December.
- Knobel, A. and Meizer, M. (2016) Drilling down to the real owners – Part 1; TJN; May 18th, 2016
- Lines, T. (2017) "THE 'GLOBAL AGREEMENT' THAT PROFITS THE FEW; Free Trade Agreements as Instruments for Corporate Tax Avoidance and Illicit Financial Flows: the "Modernisation" of the EU-Mexico FTA"; the Green/EFA group in the European Parliament; June 2017,
- Palan, R., Murphy, R. Y Chavagneux, C. (2010) Tax Havens. How Globalization Really Works. A volume in the series: Cornell Studies in Money. Nueva York, 2010.
- Picciotto, S. (2014) "Informe sobre Erosión de la base tributaria y deslocalización de beneficios (BEPS), Implicancias para los países en vía de desarrollo," Tax Justice Network, Enero de 2014, Recuperado de: <https://www.taxjustice.net/wp-content/uploads/2013/04/TJN-1402-Briefing-BEPS-espanol-v1.pdf>
- Piketty, T. (2014), Capital in the Twenty-First Century, Cambridge, MA: Harvard University Press.
- Podestá, A., Hanni, M., and Martner, R. (2017). Flujos financieros ilícitos en América Latina y el Caribe. Comisión Económica para América Latina y el Caribe (CEPAL, ECLAC). Macroeconomía del desarrollo. ISSN 1680-8843
- Scherrer, A. (2017). Fighting Tax Crimes-Cooperation between Financial Intelligence Units. European Parliament, Ex-Post Impact Assessment Unit. Brussels: European Parliamentary Research Service (EPRS). Retrieved from https://polcms.secure.europarl.europa.eu/cmsdata/upload/1763b1ce-f177-456c-b596-766dec2b4ced/2017_EPRS_STU_FIUs_FINAL.pdf
- Seabrooke, L. (2014) 'Epistemic arbitrage: Transnational professional knowledge in action', Journal of Professions and Organization 2014(1): 49–64,
- Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3). (2018). Delegation to Riga (Latvia) 30-31 August 2018 - Mission Report. European Parliament.
- Vander Stichele, M. (2012). Free Trade Agreement EU- Colombia & Peru: Deregulation, illicit financial flows and money laundering. GUE/NGL Group in the European Parliament and SOMO. Retrieved from http://www.guengl.eu/uploads/_old cms_files/FINAL_CETA illicit financial flows for KLUTE 5 12 -3.pdf
- Zucman, G. (2015), La riqueza escondida de las naciones: cómo funcionan los paraísos fiscales y qué hacer con ellos, Buenos Aires: Siglo Veintiuno Editores.

**ANOTHER EUROPE
IS POSSIBLE!**



GUE/NGL
European United Left • Nordic Green Left

www.guengl.eu