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Tax Base Erosion Symptoms?

Overview on Offshore Capital Outflow

Summary: This article aims to give a broad overview on the knowledge available about the criteria of offshore jurisdictions, their historical development, the characteristics and degree of capital outflow, the involvement of Hungarian assets, its implications on sovereignty, the major features of national and EU legislation, and the potential directions of a supreme audit institution. It also endeavours to place the phenomenon of offshore economy in a global political economic context. This article relies largely on reviewing academic articles written in English that offer an international comparison. Giving an exhaustive definition of offshore jurisdiction and quantifying the capital affected is one of the major challenges of the topic. However, the calculations available are rather eloquent: semi-developed economies accumulating large foreign debts could have been subject to capital flight to offshore destinations in amounts exceeding their indebtedness. There are indications that offshore capital flight is merely a specific case of wealth leaving developing economies, notwithstanding that adverse effects emanate at economies of core countries, too. Hungary is subject to the negative impacts of the offshore phenomenon also on account of its relative position embedded in the world economy. Although regulation never managed to mitigate offshore, and only led to a restructuring among destination countries, auditing the efforts made by competent state authorities to explore taxable offshore assets is an option.

Keywords: offshore, taxation, political economy, capital flight, capital outflow
JEL code: F21, F32, F39, F42

The issue of income, assets flowing into offshore jurisdictions is thrust into the limelight every year in both developed and underdeveloped countries when relevant information is leaked out or scandals break out.

In 2013, the confiscation of bank deposits in Cyprus drew attention to Russian assets rescued to an EU member state (Kuznetsov, 2013), while in the same year, an e-mail was leaked out about 2 million offshore transactions on the British Virgin Islands. The selective disclosure of the documents known as "Panama Papers" was a similar case recently. The public discussion of the topic triggered political as well as regulatory responses. As far as we know, regulatory attempts following the offshore scandals did not eliminate the phenomenon, cash flows were only restructured between the individual offshore destinations. The periodically arising public interest does not lead to the availability of up-to-date and comprehensive statistics, systemic research or consistent public policy means. Rather, on the contrary.

The concept of offshore countries means states of different size and situation. Opinions

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vary even on whether this phenomenon is adverse or acceptable (capitalism coordinated through market), and there is no consensus on which countries are the actual losers and which ones benefit from this type of capital flight. These contradictions characterise the presentation of this topic in Hungary (as a drop in the ocean). While data on substantial capital flight are disclosed one after the other (albeit without the presentation of well-founded calculations), no real efforts are visible to summarise precise statistics and no substantial combative measures can be seen at the level of government and public administration in terms of official statistics, and no interest is shown in this topic by the academia.

WHAT IS OFFSHORE?

The Congress of Vienna that closed the Napoleonic wars acknowledged the neutrality of Switzerland in 1815. Thus, the first offshore jurisdiction was born and it became the destination of capital flight within Europe. Switzerland developed bank secrecy as known today in 1934 and it has served as a model for a long time (HELVEA, 2009). Monaco has not taxed incomes since 1868. The Britons and Canadians first established investment institutions at the Bahamas in 1936. The original meaning of the English word "offshore" is: away from the shores, open-water, outside the country. The term "offshore" came into use in the financial sense relatively late, in the 80's. The literature discussing this phenomenon is characterised by the lack of a standard definition (Cobham et al., 2015; Murphy, 2009). As to which state or jurisdiction is called "offshore" is not an issue of quality but of ranking – some state that even the United Kingdom can fall into this category since its financial sector is oversized (McClendon, 2010).

1 The term "Offshore Financial Center" (OFC)[1] replaced "tax haven" in the eighties. OFC means a state/national economy which

- has an oversized financial sector compared to its population (McClendon, 2010; Zoromé, 2007; Sinha-Srivastava, no year), or whose financial sector is governed by non-residents (Davis, 2008),
- is specialised on attracting the investment assets of foreigners (Cobham et al., 2015),

and to this end,

- has special bank and business secret regulations,
- or can consciously apply rules on immigration, citizenship, settlement through which it will attract investments (Van Fossen, 2015).

The first condition is well presented by an extreme case: the size of portfolio investments in the Cayman Islands is 424 times larger than the country's total annual GDP (Foad, 2012). According to the infamous example, nearly 12,000 companies are registered at a single address in the Cayman Islands (Pogátsa, 2016). However, the other elements of the definition include criteria requiring relative and additional deliberation: "disproportionately large", "special regulation", "conscious application".

2 The older term "tax haven" does not necessarily tally with OFC. Generally, in tax havens

- there are no taxes or they are very low,
- there is no substantial exchange of information with other states,
- the registered company performs reals economic activities elsewhere. (OECD, 1998)

In summary, while all OFCs are tax havens, not all tax havens are OFCs.

3 Secrecy jurisdiction means the legal system of states which creates rules for non-resident subjects in law which will protect foreign subjects in law from being identified by the bodies of other states.

4 The Financial Secrecy Index (FSI) developed by the *Tax Justice Network* represents a new attempt to create a definition. The FSI does not define "either/or" criteria but ranks the individual countries with the help of a secrecy score from 0 to 100 (where 0 = total transparency, 100 = no transparency) by reviewing 15 criteria and then weights this (GSW = Global Scale Weight – global share in the provision of financial services). The correlation is presented in *Equation 1*.

$$FSI_i = Secrecy\ Score^3_i \times \sqrt{GSW_i} \quad (1)$$

5 The Basel Anti-Money Laundering Index (AML or BAMLI) measures the extent of anonymity ensured by the individual offshore entities and the risk of money laundering and terrorist financing of countries based on 14 indicators which examine the given state's regulatory environment.

6 NCCT (Non Cooperative Countries and Territories) The Financial Action Task Force (FATF), an inter-governmental organisation created in 1989, defines the so-called "high-risk, non-cooperative" jurisdictions in a document disclosed three times a year, where such jurisdictions are deemed to take insufficient measures against money laundering/terrorist financing.[2] By now, the FATF list only includes nine, mainly politically isolated countries.

7 "EU list": The European Commission announced its action plan for fair and efficient corporate taxation on 17 June 2015. Within this framework, it disclosed a list composed of 30 countries which are included in the "blacklist" of at least ten states as non-cooperative jurisdictions. Naturally, the list of the Commission does not contain EU member states (Great Britain, Luxembourg), but Monaco and Andorra are added to it besides several countries from the Caribbean region. As the continuation of the member states' "least common multiple", the Commission plans to initiate the preparation of a list developed based on independently defined criteria.

8 In 2000, the OECD identified 47 harmful preferential tax regimes among the members of the OECD. Since then, 19 of them have been deleted, 14 have been changed and 13 have been later identified as non-harmful.

Table 1 provides an overview of the major criteria used by the OECD, the aspects mentioned in the working paper of IMF (2000) and the definition recommended by Zoromé (2012). Of course, these definitions include elements that are subject to deliberation such as a financial sector of a "disproportionate" size.

BLACK LISTS

Proscriptions by the individual international organisations provide another pragmatic definition of offshore jurisdictions. The most well-known OFCs are the Bermudas, the British Virgin Islands, the Cayman Islands, Jersey, Luxembourg, the Bahamas, Mauritius, Gibraltar.

The OECD launched its campaign against harmful tax competition in 1998, which determined the criteria of tax havens. In 2000, the OECD identified 47 jurisdictions that can be considered as offshore, while the IMF prepared a list including 26 countries (IMF, 2014). However, the rating is rigid, it reviews the taxation environment (OECD, 2000) or the cross-border nature of the financial services (IMF). In the past years, the scope of non-cooperative states included in the list grew significantly narrower. Between 2000 and 2002, the OECD accepted the formal commitment of 31 countries and removed them from the list. The next list

Table 1

THE MAJOR CRITERIA USED BY THE OECD, THE ASPECTS MENTIONED IN THE WORKING PAPER OF THE IMF, AND THE DEFINITION RECOMMENDED BY ZOROMÉ (2012)

OECD	IMF	Zoromé
No tax liability or only of a nominal value.	An especially high number of financial institutions providing services for foreigners.	An OFC is a country or jurisdiction that provides financial services for non-residents to an extent that is disproportionate compared to the size and financing need of its national economy.
Lack of efficient exchange of information	Foreign assets and liabilities are disproportionately large compared to the financial intermediary system of the national economy.	
Lack of transparency	Existence of one or all of the following conditions: • low or zero taxes, • moderate or light financial regulation, • bank secret, • anonymity.	
Lack of actual activity		

Source: OECD, IMF, Zoromé

(Foad, 2012) aggregates the 2009-2011 offshore list of the two organisations.

Countries included in both the OECD's and the IMF's lists: Andorra, Anguilla, Aruba, the Bahamas, Bahrain, Barbados, Belgium, Belize, the British Virgin Islands, Brunei, Cayman Islands, Cook Islands, Costa Rica, Curacao, Cyprus, Djibouti, Dominica, French Polynesia, Gibraltar, Grenada, Guernsey, Hong Kong, Ireland, Isle of Man, Jersey, Liberia, Lichtenstein, Luxemburg, Macao, Malta, Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, Dutch Antilles, New Zealand, Niue, Panama, Philippines, Pitcairn Islands, Samoa, San Marino, Seychelles Islands, Singapore, Sint Maarten, St. Kitts and Nevis, St. Lucia, St, Vincent, Switzerland, Turkey and Caicos, Uruguay, Vanuatu.

Countries included only in the IMF's list: Austria, Belgium, the Bermudas, Guatemala, Hungary, Kiribati, Latvia, the Maldives, US Virgin Islands.

The Tax Justice Network disclosed its FSI list in both 2013 and 2015. The survey indexed 82 and 92 jurisdictions with its score system ranging from 0 to 100. The FSI Index confirms the countries traditionally recognised as offshore along with the fact that there are offshore jurisdictions in the developed world, the centre states. The first countries on the blacklist are British Crown Dependencies, but the US is the sixth, while Germany is the eighth least transparent country.

Table 2 ranks the 10 most dominant countries with the 2013 and 2015 FSI, Secrecy Score and BAMLI indices (least transparent, providing offshore services with the largest weight). It is obvious that the FSI Index, supplemented with the global weight of financial services, indicates a completely different group of countries as being the most affected than the Basel Index which only focuses on regulatory solutions. The BAMLI list includes countries where the weight of financial services is not typical at all, the necessary infrastructure is not even in place.

As mentioned above, by now the FATF list contains only nine countries that are anyway

Table 2

THE 10 LEAST TRANSPARENT COUNTRIES PROVIDING OFFSHORE SERVICES WITH THE LARGEST WEIGHT

Rankings	Secrecy Score	FSI	FSI	BAMLI	BAMLI
	2013	2013	2015	2013	2015
1	Samoa	Switzerland	Switzerland	Somalia	Iran
2	Vanuatu	Luxembourg	Hong Kong	Afghanistan	Afghanistan
3	Seychelles Islands	Hong Kong	USA	Iran	Tajikistan
4	St. Lucia	Cayman Islands	Singapore	Cambodia	Bissau-Guinea
5	Brunei Darussalam	Singapore	Cayman Islands	Tajikistan	Mali
6	Liberia	United States of America	Luxembourg	Iraq	Cambodia
7	Marshall Islands	Lebanon	Lebanon	Bissau-Guinea	Mozambique
8	Barbados	Germany	Germany	Haiti	Uganda
9	Belize	Jersey	Bahrain	Eritrea	Swaziland
10	San Marino	Japan	United Arab Emirates (Dubai)	Myanmar	Myanmar

Source: Based on Cobham et al. (2015), and TJN and BAMLI 2015 data

politically isolated, including North Korea and Iran.

Since 1977, several studies and international organisations have tried to clearly identify offshore/tax haven type states and to prepare a "blacklist" of them. The usability and exhaustive nature of the lists are questioned by the fact that these criteria have never been uniform, blacklists differ despite certain overlaps. It is also clear that countries squeezed to the periphery in international cooperation or not in alliance with the West more frequently show up on these blacklists, while with the formal introduction of certain international standards some countries can easily be removed from the list.

As part of the briskened campaigns against offshore, blacklists did not result in anything apart from offshore scandals that time and again pilloried certain countries or tax evasion methods; i.e., instead of eliminating the phenomenon of offshore economy, they only rearranged capital flight among the individual offshore areas. It could only prove efficient in the competition of the individual offshore areas.

In the domestic use of blacklists it represents a risk that in the application of the Anti-Money Laundering Act, the National Tax and Customs Administration keeps records of the countries deemed to be non-cooperative based on the extremely narrow FATF list. The bill of LMP would have only incorporated the European list that operates based on the principle of the "least common multiple" into the legal system. For more details, see the part on "Certain rules related to offshore".

THE SIZE OF THE OFFSHORE ECONOMY

The problem of the quantifiable size of an offshore economy is derived from the uncertainty of the definition of offshore, while it is a source of additional uncertainty itself. The essence of offshore is the application of the asset-hiding practice, and its important element is secrecy, therefore, it is difficult to estimate its extent. The data referring to the extent of offshore are primarily the imbalances in the balance of global international trade starting from the eighties[3] as well as the abnormal cash usage of the areas that are close to the individual offshore states (Henry, 2012c).

One fifth of the US's missed annual tax revenues, nearly USD 100 billion, can be exempted from taxation through offshore schemes. The European Commission estimates that the tax evasion and non-payment of taxes affecting the EU as a whole is around EUR 1 thousand billion (Sikka – Willmott, 2013).

According to *Henry*'s estimate made based on a cumulative offshore asset model, by 2010, assets totalling USD 21 thousand billion were held in offshores, while in the case of the 139 reviewed country of origin, it represents a capital flight of USD 7.3–8.3 thousand billion (Henry, 2012a).

According to *Foad*, portfolio investments of a value of USD 6.1 billion were made in 2008 in the OFCs identified by the OECD. This amount equals the total investments made in Germany, Japan, France and Italy together (Foad, 2012).

According to *Zucman*, nearly 8 percent of the world's financial savings i.e. USD 7 and a half thousand billion is held currently at offshore financial centres (Zucman, 2013; 2015).

According to the data of Helvea, in 2008, the amount held by foreigners on Swiss accounts may total CHF 2.2 thousand billion, while 80 percent of the nearly CHF 1 thousand billion derived from the EU and managed on Swiss accounts can be unreported income. According to *Gaggero*'s estimate, 85 percent of the assets held by Argentinian citizens abroad may be untaxed. (Meinzer, 2012)

Pogátsa discloses that 43 percent of the working capital flowing into India was from Mauritius in 2007, while the largest source countries of working capital flowing into China were Hong Kong and the British Virgin Islands (Pogátsa, 2016).

THE OFFSHORE CONTEXT

According to the arguments condemning offshore practices, offshore distorts financial processes, undermines the integrity of tax regimes, corrupts tax morale, transforms the ratios of the sharing of public dues towards non-mobile sources (work, consumption, property). (OECD, 1998, p. 16) When applying transfer pricing, since the GDP is the sum of the values added by the individual companies, the officially measured gross national product may also deviate from the real value. According to Pogátsa, if the aggregate added value (GDP) in reality is higher than the one shown by the official statistics after transfer pricing, productivity and salaries should also be higher. (Pogátsa, 2016) According to those arguing for the acceptability of offshores, offshores increase public good because they optimise investments and capital allocation and facilitate international capital flows. Offshore is a legitimate player in the world's financial regime since the FSC system and foreign aid policy of the US[4] supports the presence of offshore in the UK's Caribbean sphere of influence. The proximity of offshore areas increases banking competition and competitiveness (Rose, 2006) and it may make a positive impact on interest rates. There is an explanation that uses the competitive edge of offshore as an argument for further decreasing tax levels (Kudrle, 2013). Others say that after the regulatory initiatives in the decade after 2000 there will be less opportunities to launder money through offshores (McClendon, 2010).

It is worth reviewing the arguments related to the judgement of offshore in order to determine the conditions which enable offshore-type capital flights and to see whether we can identify systemic effects that go beyond the individual (illegal) capital flight methods.

The driving force behind offshore capital flight is generally explained/verified along the lines of a microeconomic rationale: Such reasons may include capital flight in general, fear of expropriation by the state, evasion of the rules of lawful inheritance, evasion of the rules for share issuance, erosion of lender coverage, tax base erosion, manipulation of financial results, exemption from liability for damages, taking advantage of registries (shipping/aviation companies). (McClendon, 2012; Foad, 2012)

However, in the context of global political economy it is clear that the strengthening of offshore capital flight of developing (periphery/semi-periphery) states happens at the same time as the upswing of their debt trajectory (Henry, 2012a), the expansion of neoliberal public policies in centre states and financialisation that goes hand in hand with this.

The oil price boom of the seventies resulted in the growth of the dollar savings of the OPEC countries, and the appearance of oil dollars facilitated the expansion of European and global financial markets. Simultaneously, high oil prices resulted in the fall of global demand which had adverse effects on the possibilities of the Western exports of semi-periphery/periphery economies (including Eastern Europe). Decreasing exports, imports becoming expensive because of the oil price and cheap funds due to the oil dollars contributed to the indebtedness of these economies to a great extent. From the seventies and eighties, therefore, periphery states in South America and Eastern Europe pursuing a convergence policy become indebted. After the Volcker shock (Varoufakis, 2011), the American monetary adjustment, which followed the oil crisis, their debts increased with hardly manageable interest rates.

Perverse flow of capital?

One of the characteristics of a (semi)periphery situation is the scarcity of capital. In the meantime, in the individual world economy cycles, capital is flowing from countries with high capital concentration to the peripheries because of falling profit rates, relatively high labour costs and public dues in various forms (like loans and FDI), in search of more profitable recovery. Consequently, economic growth and investments may appear as well as financial bubbles. Regardless of the dependency theories, these periods are often identified as convergence: less developed economic areas are believed to have converged to the developed centre.[5]

These phases may be characterised by the fact that in the meantime the world economy is re-specialised, and the forms of production appearing on the peripheries will not dominate the economy of the centre any more. However, the period of capital inflow is generally not lasting forever, after a while, repatriated profits and interest rates exceeds the extent of capital inflows. If we accept that parallel to the inflow of loans and working capital, capital owners save some of this in offshore jurisdictions on the semi-periphery, then a new form of capital flight can be identified on the periphery besides back-flowing profits and interest rates. So from the perspective of global political economy, within the framework of offshore capital flight, capital is flowing from capital-scarce and indebted national economies to rich financial institutions/economic regions which are in a lending position (Henry, 2012b). All this is an important supplementation of the traditional hypothesis of economics which states that countries with high capital concentration export capital to the poor, and over time this may lead to the moderation of inequalities. We can call any reverse process as a "perverse flow of capital" (Prasad et al., 2007). It will not result in the moderation of inequalities but rather in the accumulation, regeneration[6] of advantages and under-development. While from the nineties, Eastern European countries have dismantled their welfare systems and privatised their production capacities under the weight of indebtedness, a significant portion of former state properties and income was concentrated in the hands of private individuals. The new owners hid these incomes, partly in the offshores tied to the centre states, taking them away from the tax administration of the given national economy. *Palan* modulated the image of the losers and winners of this phenomenon. He emphasises that as opposed to the traditional expectations of dependency theories, the capital flowing out of undeveloped countries will not create a more advantageous situation for the developed world, either, since offshore investment instruments are outside its range. Offshore has an adverse effect on developed countries also due to the narrowing of tax bases and increasing inequalities. All this, among others, also contributes to the break-up of the European democratic consensus since high-income groups do not have to make allowances for their own governments, and an easy access to OFC has an adverse effect on the development of the local financial market (Palan, 2012).

According to Henry, from the seventies, parallel to capital flowing in in the form of loans to the peripheries, a huge capital flight was observed from these countries towards the offshore centres that are dependent on developed countries. Having studied 139 semi-developed, (semi-)periphery "indebted" countries, the study established that from these flows, nearly USD 7.3–9.3 thousand billion was accumulated in the offshore financial centres by 2010. The same 139 countries accumulated foreign debts of nearly USD 4.08 thousand billion (Henry, 2012b). Therefore, if the estimate is correct, these countries are not in a net debtor position, they might even have a surplus. *Zucman* partially contradicts this, stating that having performed the calculations for the euro area, the net debtor euro area (taking into account the assets that flew to offshore from there) is probably a net lender (Zucman, 2015).

According to the calculation that primarily relies on the practice of transfer pricing, capital flowing out of developing countries against the rules totalled USD 7.8 thousand billion at real value in the period between 2004 and 2013, which represented an annual growth of 6.5 percent. It only fell back somewhat in the years following the financial crisis (Kar-Spanjers, 2015). In correlation with international aids, it has been shown that the poorest countries receive aid from the G20 countries in an amount of USD 120 billion, while they may suffer a loss of nearly USD 1 thousand billion due to the unlawful capital flight (Sikka – Wilmott, 2013).

In summary of the overview of *Meinzer* and Palan, in relation to the global South (countries with low or medium income) and the global North (countries with high income), offshore regenerates the inequalities shown in *Figure 1*.

Financialisation

As we have seen, the indebtedness of the (semi)peripheries and the following FDI dependency trajectory may be connected to the widening of the offshore phenomenon. However, opinions on the connection of financialisation and the build-up of the offshore world vary. It is a general opinion that according to the interests of the financial intermediary system, the easing of the rules on

Figure 1

OFFSHORE IN RELATION TO THE GLOBAL SOUTH (COUNTRIES WITH LOW OR MEDIUM INCOME) AND THE GLOBAL NORTH (COUNTRIES WITH HIGH INCOME)

Source: Meinzer (2012), Palan (2013)

the system of financial institutions aimed at the conscious swelling of the sector, which in turn lead to the strengthening of the offshore institutions. However, according to others, the widening of tax bases, the increase of tax burdens, the tightening of the rules for financial services and the convertibility of most of the national currencies aimed at mitigating the increasing deficits already as from the sixties in developed countries collectively contribute to the widening of the offshore phenomenon, and not the looser financial requirements accompanying financialisation.

Sovereignty

The political economical correlation appears in the dimension of intergovernmental relationships where OFC is arranging the "sovereignty business" and in exchange for the incoming investment instruments, it provides the state guarantee of secrecy and anonymity. Often, this is embodied in the conflict where small states providing services in the "sovereignty business" are presented as the ones causing the offshore phenomenon and which have to forced to cooperate by the large states with stricter rules. The G20, FATF, OECD regulatory initiatives essentially follow this perception, while they fit into the trend seen prior to 2008 which addressed problems with international standardisation and legal unification. This endeavour refers to investments flowing into OFCs not according to their political economic importance, but for the sake of sanctioning, it applies phrases (money laundering) which shifts the phenomenon towards the zone of criminality. From the perspective of OFCs and small states entering tax competition this appears as if countries with greater influence threatened their sovereignty (Van Fossen, 2015, p. 158).

Additionally, only a small portion of the infrastructure ensured by OFCs can be tied to the given offshore state's sovereignty rights. A significant portion of infrastructure represents private banking services providers, legal offices, bookkeepers, tax consulting institutions working in the services sector of the "offshore industry" (Sikka – Wilmott, 2013). The ownership background of these entities is often tied to the countries of origin of the offshore assets. So examining only intergovernmental relations, the fact that the beneficiaries of the existence of OFCs are not the individual states but the small or large countries themselves, hardly receives attention. It is much more a layer of transnational owners that, in the context of offshore, uses the infrastructure offered by both large and small states to optimise its income and, as we presented above, the losers of the offshore capital flight are the less developed economic regions from where the capital is fleeing.

OFCs themselves are not necessarily the winners in this mechanism. The OFC becomes greatly dependent on a single sector i.e. the financial sector. According to many, it has effects similar to the resource curse (Dutch disease) of national economies built on the export of one type of raw material (raw material exporting African countries, oil exporters of the Gulf region, Russia). The whole economy and population of the given OFC does not profit from the success of the financial sector because the one-sector economy pushes out the rest of the industries, weakens the entrepreneurial sphere, leads to higher inequalities, volatile economic performance, despotic political systems and access to corrupted and criminalising public services.

The functions that the offshore financial centres fulfil in the world economy were not necessarily the results of conscious planning, up until the recent past. Capital flight utilised historical and legal precedents such as the neutrality of Switzerland or the network that continues to exist as a remnant of the British Empire (Palan, 2013, 2015). However, it is clear that a significant portion of global high-wealth is interested in the further operation of the practice of offshore asset hiding.

HUNGARY AND OFFSHORE

Based on the data of Henry (2012b), the loss incurred by Hungary was quantified at USD 242 billion. The following list shows this in comparison with other countries. *(See Table 3)*

In proportion to population numbers, the total outflow of USD 242 billion means that Hungary may be the 3rd biggest loser of offshore capital movements. Based on this calculation, rescued assets of USD 24 thousand may be allocated to each Hungarian citizen (approx. HUF 7 million). For details see *Table 4*.

It makes the country one of the biggest losers in terms of offshore, to an extent that is much bigger than our weight in terms of population and world economy. It was not by accident that the relevant data reached the majority of the Hungarian public.

Figure 2 shows the global breakdown of assets rescued to offshores, in respect of the countries affected the most.

According to the estimate examining the extent of average, unlawful capital flight net of cyclic effects over a four-year period (Kar – Cartwright-Smith, 2008), Hungary is the tenth biggest loser of such capital outflow (USD 13.5 billion) which equals the withdrawal of equity afflicting Poland, whose population is the quadruple of that of Hungary, and hardly less than half of the equity withdrawal smiting Russia. Data are shown in *Figure 3*.

Table 3

EXTENT OF CAPITAL OUTFLOW FROM HUNGARY (ESTIMATE)

The most important offshore centres	Greatest losers in Europe	USD billion
Switzerland	Russian Federation	798
Luxembourg	**Hungary**	**242**
Territories under British Rule (Virgin Islands, Guernsey, Jersey, Cayman Islands, Bermudas, Granada etc.)	Ukraine	167
Netherlands	Poland	165
Ireland		
Cyprus		
Hong Kong		
Singapore		

Source: Pogátsa (2016), Guardian, Tax Justice Network (2007)

Table 4

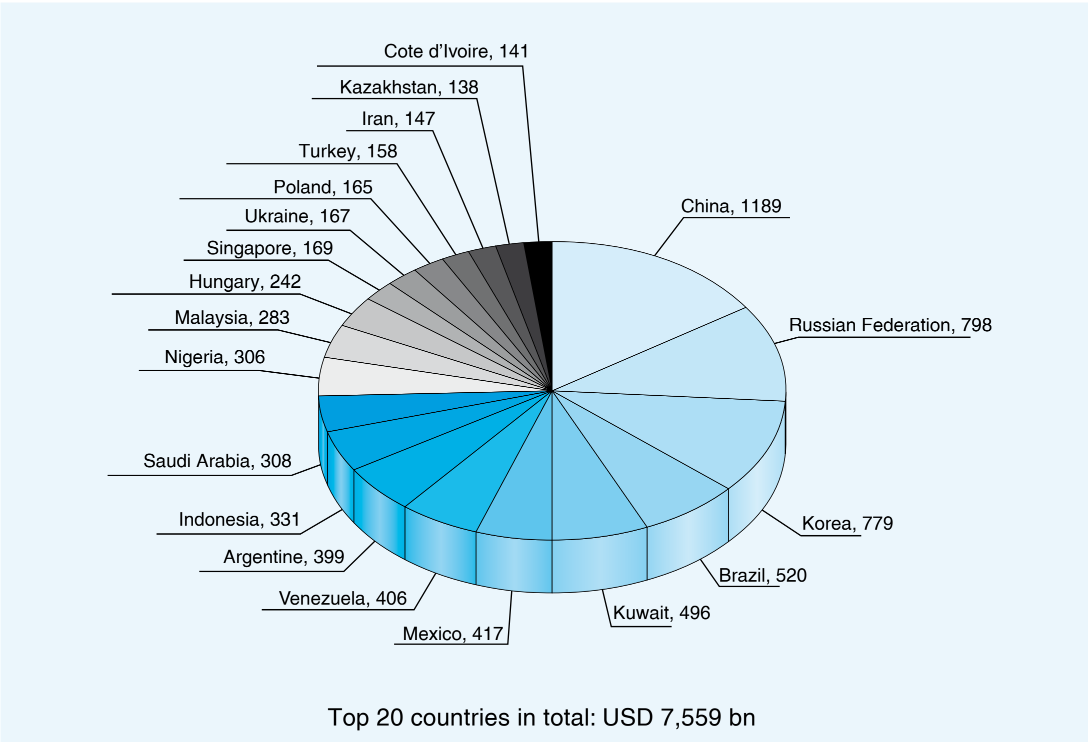
LOSERS OF OFFSHORE CAPITAL MOVEMENTS

Rankings	Country	Offshore assets per person (USD)
1.	Kuwait	190,989.60
2.	Singapore	37,077.67
3.	**Hungary**	**24,243.64**
4.	South Korea	15,822.72
5.	Venezuela	14,558.23
6.	Saudi Arabia	10,937.11
7.	Malaysia	10,308.90
8.	Argentine	10,039.00
9.	Kazakhstan	8,996.09
10.	Cote d'Ivoire	7,674.30
11.	Russian Federation	5,619.36
12.	Poland	4,328.89
13.	Mexico	3,792.46
14.	Ukraine	3,607.92
15.	Brazil	2,726.34

Source: Privátbankár, http://privatbankar.hu/ado/dobogos-helyen-magyarorszag-az-egy-fore-juto-offshore-penzek-listajan-249199

Figure 2

GLOBAL OUTFLOW OF ASSETS (IN 2010, USD BILLION)



Source: Tax Justice Network

However, it is problematic that the precise calculations behind the data relevant for Hungary, the methodologies, the original sources and several relevant studies of Henry and the Tax Justice Network have been studied, discussed or compared to data from other sources by neither journalists, nor academics. We do not know which data and data sources Henry's study was using when defining the figure for Hungary.

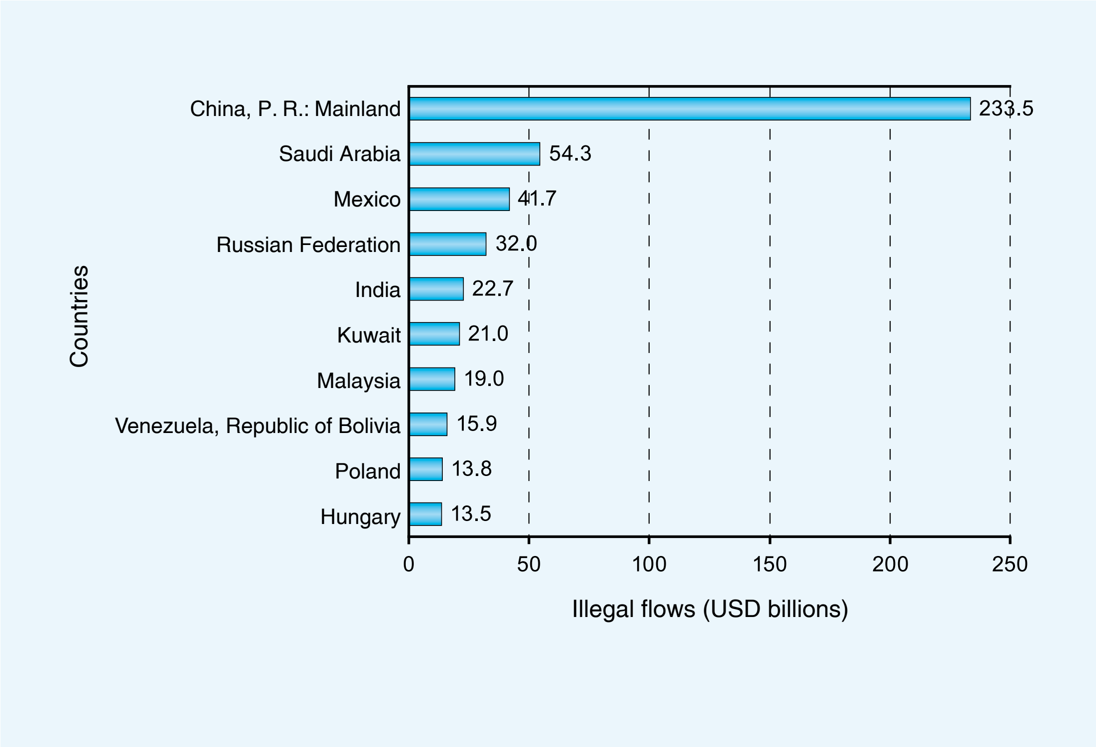
Disputing the methodology of the survey, some state that such an amount could only leave the country if the post-Soviet financial assets flowing through Hungary in the nineties also formed part of the statistics (D. Kovács, 2012). At the same time, it is also important to see that several studies that were prepared independently and in different views also present Hungary among the top losers.

Apart from the lack of precise calculations and based on the aforementioned estimates only, in the absolute term and in proportion to its population and GDP, Hungary may be one of the biggest losers of offshore capital flight. If the estimates of Henry are correct, the amount that flowed out of Hungary from the eighties may make up two and a half times the amount of Hungarian public debt.

Since Hungary participates in the Central European tax competition, thus theoretically, of course, Hungary may be affected not only as a loser, since certain tax types and low tax rates, the level of corporate income tax and local business tax may have played a role in

Figure 3

THE 10 COUNTRIES WITH THE HIGHEST AVERAGE NORMALISED ILLEGAL CASH FLOWS, 2002–2006



Source: Kar – Cartwright-Smith, 2008

the establishment of certain corporate management centres in our country. According to *Cekia*, a Czech economic consultant and Hospodárské Noviny, a Slovakian newspaper, Slovakian and Czech companies established branches in Pest county from 2012 because they found Hungarian corporate, dividend and royalty taxes to be low. At certain Hungarian settlements such as Csomád and Újlengyel, no local business tax had to be paid, transnational companies with high sales revenues could operate their subsidiaries at these places (Bódis, 2012; Deák, 2012). According to some, the technique of "carousel" type VAT fraud may be behind the establishment of companies in Hungary.

The issue of how Hungary can be affected by the offshore world's cash flows through the investments coming into Hungary is illustrated by a phenomenon that arose as a statistical problem. Since 2006, when preparing the balance of payments, the National Bank of Hungary has prepared the indices of foreign debts and the debt ratios with two approaches. There are several companies operating in Hungary with foreign ownership and a registered office in Hungary about which it can be assumed that they do not use their financial assets for the financing of their tangible activities in the real economy, but rather, they finance other parts of the corporation and fulfil a financial intermediary function between those parts. Again, there is no international consensus on the characteristics of these Special Purpose Vehicles (SPV), the MNB itself took the recommendations of the OECD as a basis in order to identify these companies. The MNB had 768 such companies on its records in 2006 (VG, 2006), while their number fell below 500 by 2011. In light of the SPVs, the invested working capital would be the third highest value in Hungary in proportion to the GDP, after Luxembourg and Hong Kong, although we have to add that the data calculated without the SPVs is also the 10th highest (Koroknai et. al., 2011). All this also raises the issue of the reliability of the data calculated without the SPVs. The domestic operation of these companies is similar to the functions seen at offshores. For example, they may have appeared here because of the provision, which has been cancelled since, which allowed them to decrease their corporate tax base by half of their net interest revenues. At the same time, while examining the whole of the global investment cycle, it is possible that they use the tax advantage achieved in Hungary and the amounts that flew through the system for financing actual investment activities in other countries. The amounts flowing through the domestic SPVs may have an auxiliary impact, just like other forms of capital flow to offshore targets, where they maintain the financial and legal infrastructure which is indispensable for their existence. However, we do not have a comprehensive view of the local consultancy and legal activities specialised in this area or the income that lands here. Thus, the indirect negative effect of SPVs is that debts appear in the gross statistical data in a distorted manner and this may have an adverse effect on our rating at the credit rating agencies that take it as a basis. As the MNB writes: *"The actual target of their investments is not local direct investment: the net investment that appears in the various financial instruments is nearly zero on the long run. At the same time, large amounts are moved through them, thus the accounting for their transactions increases particularly the gross data of the financial account, distorting the statistics that describe the financial processes of the national economy* " (MNB, 2014).

INDIVIDUAL METHODS IN OFFSHORE CAPITAL FLIGHT

Offshore areas play a great role in the hiding of the income derived from illegal activities (money laundering). At the same time, reducing the impact of offshore to money laundering would be an over-simplification. Below we review the more well-known withdrawal of equity and income hiding techniques and the National Tax and Customs Administration's relevant knowledge of this topic.

Transfer pricing is a tax base erosion practice of high significance. The survey of Ernst and Young performed among affiliated companies in 2008 found that according to 70–80 percent of company managers, transfer pricing is "very important issue of vital importance" (Silbertzein, 2010). Transfer pricing is a conscious tax policy on behalf of a group which has subsidiaries/sites in several countries, and which may itself determine the commercial prices to be applied between them. Through intentional wrong pricing, profit is rearranged to countries where taxes are lower. This practice lowers the tax base in the country of origin and the official gross domestic product may deviate from the real value (Pogátsa, 2016). The "double Irish" arrangement also reduces the corporate tax base. With this technique the Irish subsidiary of a multinational (e.g. US) company has the royalty related to the manufactured products. But the office where the company registered in Ireland is governed is actually located in the territory of an offshore jurisdiction. According to the US tax rules, the company counts as an Irish corporation, but from the perspective of the Irish rules, it qualifies as one with a registered office in an offshore jurisdiction (e.g. Cayman Islands). In view of the Irish regulations, the company has a minimal tax liability in the US. Thus, the sales revenues of the taxpaying company are derived from a third market, regardless of the fact that it has an American origin, while according to the Irish tax rules, it has to pay taxes after the minimum tax base valid at the offshore jurisdiction. The essence of the "Dutch sandwich" solution is that a person hiding its assets actually borrows his own funds from himself. The person participating in the transaction either establishes a bank in any of the tax havens and finances himself, or applies for a loan at a commercial bank while placing an amount kept on an offshore company's bank account as a security deposit.

The 2015 report of the NTCA's Financial Intelligence Unit (NAV, 2015) recorded two dominant forms of money laundering: The first form is the application of a transit payment account. Here, transfers typically arrive from payment accounts managed by credit institutions with a registered office abroad, then the amounts are further transferred to credit institutions with a registered office in a country other than the dispatching country, possibly in offshore centres. Transfers usually take place in the same amount, within a short while. Transfers between own accounts are generally performed between the payment accounts of offshore institutions. Often, the offshore company's payment account is used as a dormant account. The credited amount is available on a payment account for years, then its transfer or withdrawal is initiated in the same amount. The NTCA assumes that the basic crime of money laundering is committed in these cases abroad, while the payment account managed in Hungary may serve to hide, cover up the origin of the liquid assets derived from the crime. In the other case of committing the crime, the payment accounts of the offshore companies that can be linked to the activity of the domestic taxpayer are opened for the offshore company at credit institutions with a registered office abroad. According to the report of the National Tax and Customs Administration, the typical banking transactions between an offshore company and the economic associations with a registered office in Hungary and their business partners are lending, provision of owner's loans, payment of share capital, fixing deposits, transfer of dividends or dividend advances, purchase or sales of business shares, purchase of receivables, realisation or re-investment of earned interest (interest revenues).

OTHER RULES RELATED TO OFFSHORE

The phenomenon of offshore economy was supposed to be confined by the individual national rights and several international agreements. These regulatory initiatives are so numerous that their exhaustive review and evaluation would require an independent study. Below we describe EU and domestic regulations directly related to the topic along with the domestic institutions and initiatives. We cannot evaluate the efficiency or specific deficiencies of the regulatory initiatives as part of this study, but we need to premise that all of these regulators altogether failed to eliminate offshore capital flight.

The purpose of Council Directive 2003/48/EC is to enable the taxation of capital income generated in the form of interest in one of the member states but payable for a private person who is resident in another member state and is entitled to the payment of interest, according to the legal regulation of the country where the person is resident. The enforcement of the directive is ensured in Hungarian law by the Act on the Order of Taxation and the Act on Personal Income Tax. In the case of a private person resident in an EU member state other than the paying agent's country and entitled to capital income, the directive requires a minimum content for the information to be provided by the paying agent mandatorily for the competent authority of the EU member state of establishment. The information provided by the paying agent should contain the interests separated, according to the interest types defined in the directive. However, the individual member states may limit the mandatory minimum contents of the information, for example, to the total amount of the interest or the income. The directive provides for an automatic exchange of information; it requires the competent authority of the paying agent's EU member state to annually inform the authority of the EU member state where the person entitled to the interest is resident. Directive 2003/48/EC does not cover, for example, financial assets equivalent of interest-bearing securities and certain methods used to possess interest-bearing securities indirectly. Directive 2014/48/EU was accepted in light of this, and the EU member states have to incorporate this into their national law in order to remedy the situation by 1 January 2016. The European Banking Association was against the directive, while Austria, Belgium and Luxembourg requested temporary exemption from certain provisions of the directive. Instead of participating in the automatic exchange of information, from 2011, these countries levy a 35 percent withholding tax on the interests payable not to their own citizens. It is considered to be a major deficiency of the directive that only natural persons count as potential parties entitled to interest payment. It simplifies the circumvention of the regulation that the income hidden behind non-natural persons or various legal grounds will be removed from the scope of the directive.

Transparency

According to Article 39 (1) of the Fundamental Law, aid can only be provided or contractually paid from the central budget for organisations whose organisational structure and activity that is subject to the aid are transparent. Act CXCVI of 2011 on National Assets and Act CXXXVI of 2007 on the Prevention and Combating of Money Laundering and Terrorist Financing define the notion of a transparent organisation. The state of Hungary, the municipalities and a foreign state are transparent organisations. Domestic or foreign legal entities or economic organisations without a legal personality are also transparent if

- their ownership structure and the actual owner defined by the Act on the Prevention and Combating of Money Laundering and Terrorist Financing can be known,
- and it has a tax residency in an EU member state or a state with which Hungary has a double taxation convention,
- and it does not qualify as a controlled foreign company under the Act on Corporate Income Tax and Dividend Tax,
- and, if the aforementioned conditions prevail in respect of a legal entity or economic organisation without a legal personality, who, directly or indirectly, has a share, influence or voting right in the economic organisation in excess of 25 percent.

A civil organisation whose executive officers can be known and whose registered office is in an EU member state or a state with which Hungary has a double taxation convention.

The definition is also included in other legal regulations: according to the Act on National Assets, the state and the municipality cannot establish an economic organisation and cannot acquire a share in an economic association which, or whose member, is not transparent. The act stipulates that the ownership right of the national assets can be transferred to a natural person or a transparent organisation. According to the Act on General Government, a budgetary subsidy can be provided if the applicant qualifies as a transparent organisation. Under Act XV of 2016 on the National Home Making Communities, only a transparent organisation can be an "organiser". The Act on Public Procurement provides that the party that is not transparent according to Act CXXXXVI of 2007 or is not registered in a state with which Hungary has a double taxation convention cannot be a bidder.

The phenomenon of transfer pricing is regulated within the framework of corporate income tax. According to Section 18 of the Act on Corporate Income Tax and Dividend Tax, when in their transactions between each other, affiliated companies apply prices that deviate from the arm's length price, the corporate income tax base has to be modified accordingly. Act CXXXVI of 2007 on the Prevention and Combating of Money Laundering and Terrorist Financing incorporated into the Hungarian law the dimensions of the phenomenon of offshore economy related to money laundering i.e. Directive 2005/60/EC of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing. The law requires in specific cases that the service provides subject to this obligation have to establish the person and identity of the so-called beneficial-owner in the case of non-natural persons. A beneficial-owner is primarily the natural person who

- holds, directly or indirectly, at least twenty five percent of the voting rights or ownership shares in a legal entity or an organisation without legal personality,
- if the legal entity or the organisation without legal personality is a company not registered on a regulated market to which disclosure requirements that are in line with Community laws or the equivalent international requirements apply.

The Anti-Money Laundering Office operating within the organisation of the National Tax and Customs Administration performs the tasks of the financial information unit. According to the international requirements, the states designate a central authority that receives and evaluates the reports of suspected money laundering, and forwards the results of the evaluation for law enforcement purposes. This central unit is called the *Financial Intelligence Unit* (FIU).

Initiatives

The LMP submitted a bill under No. T/5803, which intends to achieve the following by modifying the Act on General Government, the Act on the Legal Status of Civil Servants, the Civil Code and the Act on Public Procurement:

- to prevent state and government officers from holding offshore assets,
- to reveal who the company's beneficial-owner is during the company registration process, and
- to extend the prohibition on granting benefits to non-transparent organisations from the state budget and economic associations owned by local governments.

Based on all this, the bill may only mean a moderate step forward in light of the fact that it extends the use of the term of "transparent organisation" which already exists in Hungarian law and implements the use of the offshore list compiled in the EU based on the lowest common multiple principle.

The Hungarian government already reacted occasionally to the news about offshores several times: In 2013, Minister János Lázár initiated to contact Switzerland, Austria and Cyprus in order to detect Hungarian deposits held there and to tax them with a one-off 35 percent withholding tax, and also suggested that the NTCA, the Ministry of the Interior and the Ministry of Foreign Affairs and Trade should review the local legal framework. We have no information on the outcomes of the measure. After the meeting of the National Security Cabinet held on 11 April 2016, the NTCA and the Police created investigative teams to detect offshores. Lately, the Prime Minister requested the Minister of the Interior, the secret services and the Minister overseeing the tax authority to investigate at least the Hungarian offshore threads one by one. According to Secretary of State *Pál Völner*, offshore activities were strongly limited, and in the case of state assets, practically banned, after 2010, but it cannot be prohibited in itself.

ABOUT THE POSSIBILITY OF SAO AUDITS

Since offshore asset rescue makes a significant impact on the national economy, this in itself may justify that the related tasks to be performed by the state should be audited by an independent controlling body. The issue may arise whether a SAO audit is justified in an area where one of the major features is that it is difficult to describe the state's tasks in relation to it in terms of regulation (since a portion of the offshore capital flight is legal), while the quantifiable mapping of the phenomenon itself is in its infancy and a significant portion of the factors that enable this is derived from its situation in the international economic system of relations. The rough review of the following working papers and reports suggests that primarily those activities of the tax authorities can be checked which aim at limiting the offshore asset rescue. Such types of activities can be detected in the case of the Hungarian tax authority, as well. Although the two reports mentioned here do not cover this, but it is worth considering that the actual application of the international exchange of information that is already valid should be in the focus of a potential audit. It means an opportunity even if otherwise we know that these information exchange agreements did not limit the phenomenon of offshore economy globally. Such an audit could still give account of the resources that the responsible area is operating with, and whether they are sufficient. The decision-maker would have an insight into the implementation and result of the treaties as well as the monitoring possibilities.

A working paper of the INTOSAI Working Group of Extractive Industries (Schneider – Pilskog, 2015) draws attention to the importance and potential directions of a SAO audit of the losses incurred by the state in respect of transfer pricing. Where the supreme audit institution does not have an insight into transfer pricing through the control of a partially state-owned company, it has an opportunity to audit the area partially through the audit of the tax authority. It is common in the rules for transfer pricing that companies will have an information transfer and documentation obligation for the judgement of the market price. The GAO, the supreme audit institution of the US audited four tax authority programs (GAO, 2013) that aimed at the repatriation of the capital rescued in offshores, by mitigating criminal consequences and tax penalties, in exchange for the voluntary disclosure of taxable capital. The GAO reviewed data that were available for the federal tax authority from other sources and established that it could have detected offshore capital flight based on these. The GAO phrased a recommendation for the tax authority that it should better inform taxpayers about their obligations regarding offshores, explore the possibilities for developing a more well-founded methodology about offshore asset rescue that can be established from other sources and analyse those who report offshore accounts for the first time.

One of the reports of the audit institution of the United Kingdom (NAO, 2003) was about the auditing of the anti-fraud activities of the tax authority in respect of taxes and tax credits. The report pays special attention to the tax authority's activity related to taxable income held on offshore financial accounts and at offshore institutions. The report establishes the ratio of offshore schemes applied in tax evasion and the fact that the tax authority does not have any estimates regarding the taxable assets and income held on offshore accounts.

The audit applied the following methods regarding the activity related to offshore: interviews, evaluation of the office's risk analysis, based on a "good practice" questionnaire prepared by an external consultant, comparison with the activities of foreign supreme audit institutions and government players qualifying as "good practice". The report states that the offshore tax base erosion has become more extensive and complex since 1990, the individual cases detected by the tax authority imply extensive systemic tax base erosion. The treaties and national legal regulations offer a wider opportunity for exploration. In respect of taxable income held in offshores, the report recommends that the tax authority has to closely cooperate with the players of the bank and credit card industry in order to utilise the opportunities of the exchange of information treaty and it has to be clearly communicated that the control of offshore assets by the tax authority is increasingly likely.

In its report disclosed in 2007, the NAO (NAO, 2007) evaluated the risk management of the Foreign and Commonwealth Office in relation to the British Crown Estates. In respect of the Crown Estates qualifying as offshores, they established that there was a progress regarding the regulation of the OFCs but the 4 largest OFCs perform better compared to the offshore areas which have smaller regulatory capabilities. The funds of Caicos, Anguilla and Montserrat are not enough to satisfy a complex international regulation, the government of the United Kingdom has to strengthen the audit capacity and regulatory level of these areas.

The State Audit Office of Hungary made a statement regarding offshores after being contacted by the National Assembly. On 30 May 2016, the Parliament conducted the political debate titled *"On the measures required in the step-up against offshores"*, to which the State Audit Office of Hungary sent the technical document titled "INFORMATION on the SAO audit of the enforcement of the requirements relevant for transparent organisations". For the preparation of the information, the SAO's risk analysis reviewed in the 2015 SAO reports the SAO's findings related to the legal criteria of a "transparent organisation".

SUMMARY AND CONCLUSIONS

The two essential elements of offshore jurisdictions are that, on the one hand, they ensure secrecy for the origin, owner of the capital that is fleeing there, and, on the other hand, they offer favourable rules on the sharing of public dues and tax exemption. The two conditions appear in the case of specific offshore countries to a variable extent. In the aggregate, it enables the capital and income of both welfare states with a more developed taxation culture and developing countries to come back into business circulation at a certain point, exempt from the public dues of the source country, in an anonymous way.

It is evident from all this that intergovernmental tax competition and the elements of business and bank secrets used in civilised countries are the factors based on which offshore can be outlined. So which state or jurisdiction is considered as an offshore and which ones are not – it is not an issue of differentiation in terms of quality but rather in terms of degrees.

Discommended offshore states are not characterised by a clear legal limit only but by the emphases of the regulation and the resulting financial dynamics: The capital flow, whose target is the offshore jurisdiction, and the financial services sector, which is oversized compared to the population of the destination country.

The offshore jurisdiction/country hides behind the state's sovereignty in a legal sense (Van Fossen, 2003, 2015). However, certain offshore areas are clearly dependent on the United Kingdom and the Kingdom of the Netherlands. The financial institutions, banks, legal offices of the developed world offer their services in the offshore countries. While the offshore creates a deficit of billions of dollars even in the budget of developed countries, these very countries, while some of them are EU member states, are at the top of the offshore lists: Switzerland, Luxembourg, the state of Delaware of the United States or the Crown Colonies of the United Kingdom.[7]

In the seventies and eighties, parallel to capital flowing into indebted, capital-scarce, periphery states in the form of loans, a great capital outflow could be observed from these countries towards the offshore centres that can be tied to developed countries. It was also significant in the period when privatisation assets were generated and working capital flew into the country as the Soviet empire and its satellites were subordinated to the Western world.

From the nineties, these countries (including Hungary) built back their welfare systems and privatised their production capacities under the weight of indebtedness. However, some of the income and incoming funds were focused in the hands of private individuals who could withdraw it from the tax administration of the given national economy, streaming it to offshores.

According to one of the presented studies, having studied 139 semi-developed countries, it can be established that from these flows, a capital of nearly USD 7.3-9.3 thousand billion was accumulated at the offshore financial centres by 2010. The same countries accumulated foreign debts in the tune of USD 4.08 thousand billion. Therefore, if the estimates are correct, these countries are not in a net debtor position, they might even have a surplus.

Although experiences show that the practice of offshore asset hiding continues to exist despite the regulatory efforts, it is not impossible to limit it. Within this circle, it is possible to have it audited by the supreme audit institution whether the competent bodies of the state do their best to enforce the available rules, intergovernmental agreements in order to find taxpayers with offshore assets.

This paper is only one of those first little steps that might direct the attention to the fact that the relationship of Hungary and the offshore world needs to be further mapped.

Notes

[1] Within the framework of this study the Hungarian translation is "Offshore Pénzügyi Központ" (OPK).

[2] The lack of financial transparency, which is typical of offshore jurisdictions, becomes visible when international anti-money laundering rules are enforced deficiently in a given country.

[3] In the case of appropriate statistics, the sum of the current balance of payments between all the states has to be zero. The insufficiency of statistical monitoring is indicated by the very fact that it is not true (see Economist, 2011) and there can be several additional reasons in the background, for example, free trade policies will decrease the insight of customs management into international trade turnover.

[4] This tax regulation of the United States enabled some tax allowances in the federal tax regime in respect of the public dues payable after export revenues.

[5] Here we do not touch the issue that in the case of certain countries, the appearance of convergence may go hand in hand with the descending of "competitors" which are nearly of the same level of development. So it is not at all about the implementation of a convergence strategy that can be implemented by everybody simultaneously.

[6] As Thomas Piketty shows this trend, see the description of Cseh (2015) for all this.

[7] The Channel Islands did not become part of the EU at the request of the Britons, Hong Kong, Macao, the Chinese and the Caribbean Crown Estates are the offshore destinations of American capital. The City of London is the centre of this British offshore network. See also Palan (2015) and Pogátsa (2016).

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