NATIONAL BLACK MONEY CONVERSION TO EUROS: THE CASE OF THE CANARY ISLANDS

John F. Pfaff
University of Richmond

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Contact Information: Office of International Business Studies, Robins School of Business, University of Richmond, Richmond, VA, 23173 USA; Tel. 1-804-289-8251; Fax 1-804-289-8878; E-mail jpfaff@richmond.edu

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ABSTRACT

In 1997 the financial institution provisions of the Canary Islands' ZEC legislation where disallowed by the European Union Commission. This action in combination with the evolution of the European Monetary Union (EMU) and the new EMU currency, the euro, created an impetus for redirecting funds that had evaded taxation (black money) from the underground economy back into the official economy. Estimates are that between 25 to 50% of all currency in circulation is generated by the Ablack economy≅ or underground economic activity. In the Canary Islands, with its cash-based tourist industry and agricultural exports, the upper end of this range is a more than reasonable estimate.

It is documented that the method of converting black pesetas to white euros is by investing in tourist type residential property. The rapid expansion of the construction projects of this type and the decline in volume of mortgages indicate that the currency conversion is accelerating. There are possible negative effects on the Canary Islands' economy from over building in this sector.

As the black pesetas are converted into white currency the national and local tax authorities must develop better methods of preventing future tax evasion. If tax collection does not improve, the economy faces a tremendous down side risk in terms of a sudden loss of liquidity if the EMU was to collapse or expel Spain and the euros held in the Spanish underground economy had to be converted back into a national Spanish currency.

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INTRODUCTION

In order to stimulate economic activity and social development in the Canary Islands, legislation was passed in 1994 to create a tax haven as part of ALa Zona Especial Canaria≅ (ZEC). The legislative process that resulted in the ZEC law began in 1991. The basic provisions of the law provide incentives for investment by residents and non-residents to establish new businesses and expand existing businesses in the Canary Islands.

The justification for the special economic zone (ZEC) provisions was that they neutralized the negative effects of distance and insularity that are present in business operations on the Canary Islands due to their geographic separation from the major markets in Europe. In the early 1990s, the Canary Islands were not experiencing the same positive rate of economic growth and employment that peninsular Spain was achieving. The insular and geographic disadvantages were thought to be a major part of problem.

In 1994 the Canarian unemployment rate was averaging 26.5 percent compared to mainland Spain=s 23.9 percent. Canarian wages were 84 percent of the national Spanish average. The Canarian Gross Domestic Product (GDP) sector activity was about 80 percent service focused on the lower end tourist trade and nine percent in the industrial sector compared to mainland Spain=s 65 percent GDP in the service sector focused on financial services and telecommunications as well as diversified tourism and 22 percent in the industrial area. Most telling was that Spain as a whole had a GDP per capita of 79 percent of the European Union average while the Canary Islands GDP per capita was only 66 percent. The Canary Islands were and continue to be a prime regional candidate for development funds from the European Union.

This Special Economic Zone (ZEC) was heavily promoted by the governments of the Canary Islands during 1996 and early 1997. In November 1997 the financial institution provisions of the ZEC legislation were disallowed by the European Union Commission. This action in combination with the evolution of the European Monetary Union (EMU) and the new Euro currency created an impetus for redirecting funds that had evaded taxation (black money) from the underground economy back into the official economy. Estimates are that between 25 to 50% of all currency in circulation is generated by the Ablack economy≅ or underground economic activity. In the Canary Islands, with its cash based tourist industry and agricultural exports, the upper end of this range is a more than reasonable estimate.

ZEC LEGISLATION

The ZEC legislation was modeled on the industrial corporate incentives provide by the Irish government to foreign investors and the financial institution incentives found in the tax havens within the European Union: the British Channel Islands and Gibraltar, Portuguese Madeira, and the insurance industry in Luxembourg. The desired outcome of the legislation was not only expansion of the Canarian economy but diversification into financial and insurance services and light manufacturing industry. The growth in these sectors was to absorb the graduates of the Canarian university system and provide higher paying clerical jobs for the high school graduates.

The basic provisions of the REF legislation that included ZEC were:
For resident businesses -

Subsidized transport, energy and water resources

Allowance of an Investment Reserve with up to a 90% reduction of taxes on profits reinvested in the Islands

A 50% reduction on taxes on profits derived from exports of goods produced within the Islands

A six year tax holiday on newly established business

Exemption of taxes related to the establishment, transfer, modernization or enlargement of business registered in the Islands

For non-resident business with a share capital of one million pesetas or more (a little more than U.S. $8,000 at the time)-

Guaranteed free movement of capital and foreign exchange

Exemption of capital gains tax within the ZEC

A one percent corporate profit tax

Issuance of bearer bonds and shares

A requirement that only one director be a resident of the Canary Islands

For ships registry-

Reduction of corporate tax by 35 percent

Reduction of social security payments by 50%

Exemption for ship=s crews from income tax

These provisions of ZEC legislation provide a tax haven competitive with those within the European Union and the major tax havens outside of the European union such as the Cayman

Islands, Panama, Dutch Antilles, Hong Kong and Uruguay.

In 1995 enabling legislation was enacted that permitted competitive insurance and reinsurance activities in the Canary Islands for offshore insurance companies for non-Spanish nationals and private insurance plans for Spanish nationals. In addition, late in 1995 the administrative details of annual tax reporting and tax collection for ZEC corporations were published. The terms were very liberal with a tax rate of 1% and the timing of tax payments and tax reporting was over a year after the end of firm=s business year.

In 1996 the ZEC regulations and operating procedures were established by the governing bodies of the Provinces of Tenerife and Gran Canaria and approved by the AGobierno de Canarias≅ and the national administration in Madrid. The Canarian governments began a multimillion-dollar promotion of the ZEC with the opening of ZEC offices in the financial capitals of Europe.

EU Modification

In 1997 the European Union Commission required a modification of the ZEC legislation as constituted in Spanish law that limited the provisions permitting tax haven financial institutions and the secrecy associated with bearer instruments. The other provisions of REF regarding importation and manufacturing industry remained unchanged and the beneficial provisions for non-residents where extended to Spanish residents. The Arejected≅ provisions for a Acentro offshore≅ for financial institutions will not be reconsidered by the EU Commission until after December 31, 2000.

The result of the Amodification≅ of the provisions for financial institutions incorporated in the Canary Islands of the Aaspectos fiscales del Regimen Economico Fiscal de Canarias≅(REF) was that the major tax haven aspects as applied to financial activities were far less competitive and secretive than other tax havens within or without the European Union. The possibilities of attracting manufacturing and non-financial service sector industries from the mainland of Spain seemed to have been enhanced.

This modification of the REF, the anticipation during 1997 and early 1998 of Spain=s participation in the European Monetary Union (EMU), and the country=s formal inclusion in the EMU in May of 1998 created pressure on black money holders to inject their cash into the official economy before the switch to the new EMU currency occurs. On the date of conversion from peseta denominated currency to the official European Monetary Union currency, the euro, black monies held in cash would have to be converted through the Spanish banking system. This action would leave a visible and traceable trail for the tax authorities.

BLACK PESETA CONVERSION

If black pesetas are not converted through the Spanish banking system, they will need to be converted to a non EMU currency through the commercial money exchange system within Spain operating outside of official bank system, smuggled out of Spain and converted into a non-EMU currency, or invested in the official economy in a way that is not traceable but provides a fixed asset that will preserve the value of the black money and provide for a legitimate vehicle for the funds to become euros.

Despite the large tourist industry, the Canary Islands have a limited and transparent foreign exchange system outside of the official banking system. Most tourists are from the EMU countries and do not have non-EMU currencies. This method offers few possibilities for conversion of large amounts of black money.

Being insular, the Canarian region has limited exit points from its airports and harbors where smuggling can occur. Smuggling is a high-risk activity. The vast majority of Canarian holders of black money are legitimate business operators who do not engage in criminal activities beyond tax evasion. Therefore, smuggling is not an acceptable activity and not a viable option.

Traditional Method

The traditional method of black money re-entering the official economy has come into play. This method is purchasing fixed assets that will keep their value and possibly appreciate. Preferred assets are those that allow the black cash to re-enter the official economy in numerous small streams by disbursing the black cash in the working economic structure rather than being hoarded by individuals. Buying an asset from a seller who uses the cash to make payments to a large number of suppliers and laborers is least traceable.

The shift from black cash to fixed assets causes the official price of the asset to be below the actual price. The difference being the black money cash. Once the conversion to the official EMU currency has occurred, the official price or reported price and the actual price converge. If the asset is then sold, black money is now converted to euros. Or the asset may be generating a stream of cash that can be hidden becoming ΑBLACK EUROs≅.

With land being a limited and valuable resource on the Canary Islands, the stage is set for a chain of events to occur that legitimatizes a great deal of black money. A typical scenario goes as follows. The original landowner has an Αofficially≅ recognized increase in cash from the sale of property plus, possibly, partial ownership in the tourist residential or hotel construction project. The investors have ownership in the fixed asset and the future stream of earnings and cashflow. The developer has access to cash at below bank rates that can be disbursed to meet legitimate expenses. If the developers retain a percentage of the asset, a later sale can also convert their black money profits into official EMU currency.

In the Canary Islands the main economic activity is low-end tourism. This industry has grown in terms of tourists visiting the islands at an annual rate of 11 percent for the last 5 years. The current occupancy rate is over 80 percent for tourist facilities in the Canary Islands. This is a normal occupancy rate for low-end tourist areas if there is to be even a marginal return on investment.

These fixed assets (tourist facilities) are a viable means of injecting black money into the official economy and converting it into the official EMU currency. The holders of small to medium amounts of black money are buying condominiums in new and old complexes. Large holders of black money are investing in the new condominium complexes and hotels.

RESULTS OF BLACK MONEY CONVERSION

Official data on property sales indicates that the two leading areas in Spain for price increases in already-built housing are the Canary Islands and Balearic Islands. The average rise in the price for built housing in the whole of Spain was four percent for the first half of 1998 whereas the price rise was eleven percent in the Canaries. Even with the high prices, there has been an increase of 50.1 percent in the number of properties sold in 1998 over the same period in 1997. Most of the property sold is in the resort/tourist areas of the islands.

The foreign consulates in the Canaries are reporting a decrease in the number of their nationals buying housing. Obviously, it is Spaniards purchasing the Canarian property and, most likely, Canarians seeking Aofficial≅ investments. Those selling the property are converting black money investments into official pesetas. The price increases are a signal that the currency conversion has already begun.

This increased real estate activity is occurring despite a new Canarian regulation limiting the rental options of resort property in complexes and associated communities. Something is driving the market other than classical investment rates of return and foreigners buying the sunshine and mild year round weather of the Canary Islands.

The construction of commercial residential property has increased by 45 percent in 1998 to 1,078 projects. The number of plans (4,849) approved for new commercial residential projects has increased by 108 percent during the first six months of 1998. The constant growth of tourism at an average rate of eleven percent over the past five years and the current economic upswing on the continent does not provide an explanation for this amount of new construction activity since the past hotel and tourist rental residential complex construction rate had maintained equilibrium between tourist lodging and tourists visiting the Canary Islands. Increased construction of tourist facilities has kept pace with tourist demand for accommodations. There is no unmet demand for additional tourist hotel or condominium complexes.

At the time that this paper was written, a continuing debate was ensuing in the Canarian parliamentarian government calling for the number of hotels and commercial tourist oriented residential properties to be built in the islands to be slashed. The ACoalicion Canaria≅, the largest political party, made the plea. This political openness flies in the face of many of their supporters and property developers who are profiting from the economics of currency conversion.

Some of the increased sales of built housing and new construction might be attributed to the historically low interest rates of less than five percent available on mortgages. But the banks are reporting a decrease of 25.3 percent in the number of mortgages for the first half of 1998 with the total peseta volume of these loans down three percent. One sees the size of the projects is increasing but these loan trends do not coincide with the increase of 45 percent in tourist residential project construction during the same period.

When interpreting the meaning of the increased construction activity and the decrease in mortgages, keep in mind that the objective of the individuals holding black money cash is not to inject the cash into the official economy but to Aofficially≅ convert the black money pesetas into the new EMU currency and begin generating EMU black money. The injection of funds into the official economy is a temporary byproduct of the need to convert from one currency to another. It is a one-time activity that given the volume of black money in circulation will be done over the next few years and not at the last moment.

The insular nature of the Canary Islands= opportunities for black currency conversion has accelerated real estate investment trend in fixed assets (Canarian tourist facilities) to a far greater degree than on mainland Spain. The number of new projects approved is far outracing even the most optimistic estimates by regional economists, the tourist board and local governments. Even the local government is alarmed by the possible over building.

CONCLUSION

The elimination of the financial activity tax haven provisions of the REF legislation for the ZEC by the European Union Commission in conjunction with the inclusion of Spain in the European Monetary Union has created a situation whereby black peseta cash needs to be converted into official pesetas. This has resulted in an injection of black money back into the official economy of the Canary Islands. Whether this was an intended effect of the EU Commission=s decision is beyond the scope of this paper.

No matter what the intention of the EU Commission, the fact remains that economic activity in the Canary Islands has been greatly stimulated by black money conversion type of Ainvestment≅. Unfortunately, the nature of this investment and its associated cashflows is likely neither to remain permanently within the official economy nor to diversify the Canarian economy into new financial or industrial sectors. The continued, traditional type of investment in relatively inexpensive tourist facilities will keep the Canarian economy tied to the low margin, low end tourist trade where economic setbacks on the continent have disastrous consequences for the social and economic development of the Islands. The real estate investment boom may even lead to an over-supply of tourist lodging facilities that if too great could result in a downward economic spiral caused by predatory price wars. If the construction boom is held in check, it will at least provide tourist facility renewal.

Evidence of the dependence of the Canary Islands on EU funding is found in the 1994-99 fiscal plan of the Canary Islands Government, which includes 1,051,790,000 euros (about $930,787,610 US) to be received from the European Union. In order to wean the Canary Islands from the economic handouts of the EU, greater diversification of the Islands= economies is needed. Whether tax haven regulations and laws will provide this diversification is open to question. But the insular disadvantages of the Canary Islands need to be compensated for in a way that attracts investors to economic sectors other than low-end tourism. The Irish success is one example the Canaries would like to duplicate.

If the tax haven legislation is approved by the EU commission, the timing should not be such that it simply provides another means of converting black pesetas into the new euros. But some measures are needed to establish a financial services industry and upgrade the level of visitors to the Islands in order to provide a more solid underpinning for the Canarian economy. The impact that a flourishing, successful financial services economic sector can have on upgrading tourism and fostering island development can be clearly seen in the cases of the Cayman Islands and many other tax havens with geographically disadvantaged locations.

Another concern related to black money is that any economy with a large underground or black economic sector will be open to greater risk under the European Union Monetary system. Once black currency is converted into official EMU currency and starts to regenerate black euros, a sudden collapse of the EMU system and a quick conversion back to national currencies will have a far greater negative economic effect on national economies than projections based solely on official economic figures would predict. In the case of Spain, removal of a significant amount of liquid capital from the economy by not converting black money into new pesetas caused an economic slowdown in the early years of the socialist government. The alternative to a severe economic decline is to face another conversion scheme where the government allows black monies to be exchanged for low interest government bonds held by the banks as it did during the transition from the Franco era. The latter alternative may damp the shock, but there still exists a severe increased risk under the EMU system of membership criteria, control of price stability by the EUROPEAN CENTRAL BANK, and the unknown degree of the stability of the euro currency in the world financial markets.

As the conversion to white euros occurs, there is an opportunity for national fiscal growth that should be used to the nation=s social and economic advantage. It is critical that the Canarian Regional Government, the Spanish National Government, and the European Union develop efficient controls to assure that taxes are collected and that the black money or underground economic activity that once operated in the official economic sector does not return to business as usual. The increased tax collection will reduce the risk to the national economy of an EMU collapse or Spanish withdrawal from the EMU.

Given the amount of underground economic activity in several of the other EMU countries, a further study of the national economic risk associated with black money conversion in the case of a failure of the European Monetary Union would be appropriate.

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