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Resistance to taxation, shadow economies and corruption

The Hitchhiker's Guide to Nowhere: A journey into economic anarchy

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Ladies and Gentlemen

I feel honoured to join you at this meeting today. This discussion happens at a time of rising interest in tax evasion: recent revelations concerning Liechtenstein and the Swiss banking giant UBS have attracted political and media attention, but at the same time civil society is increasingly concerned about the impact of capital flight and tax evasion on development processes in poorer countries. It is recognised that efforts to help poorer countries mobilise their own resources for development and make them less reliant on aid and debt are undermined by tax evasion, illicit financial flows and corruption. These issues will feature as major themes at the Monterrey Consensus review summit in Doha at the end of this year (TJF, 2008).

Tax havens – or secrecy jurisdictions as I will call them – might appear as small and relatively insignificant places. They seldom feature in mainstream academic texts and most analysts and journalists either ignore them or treat them as externalities beyond the political economic mainstream.

I argue the opposite: secrecy jurisdictions are a central feature of the globalised financial markets. Far from being small and insignificant, secrecy jurisdictions include major financial centres like London, New York and Zurich, and many microstate jurisdictions such as the Bahamas, the Cayman Islands, the British Virgin Islands, the Channel Islands, Bermuda, Liechtenstein and others, act as satellites to these major financial centres.

For the past half century secrecy jurisdictions have been allowed to operate without effective scrutiny from the International Monetary Fund or central banks. As early as 1961, officials in the Caribbean were reporting concerns about 'financial wizards' operating from British colonies, arguing that their activities 'should be controlled in the public interest.' This did not happen: instead the British Foreign and Commonwealth Office advised many former colonies to become secrecy jurisdictions, and since the 1960s the number of secrecy jurisdictions has grown at an astonishing rate. We currently count 72 (TJN, 2005) and more join the ranks every year.

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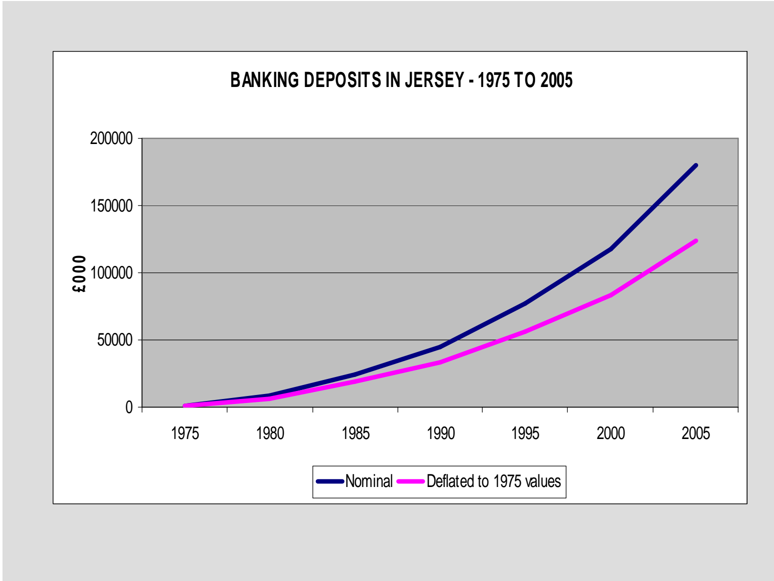
Statistical data on secrecy jurisdictions are scarce, but the following figures give some idea of their scale:

- over half of all international bank lending and approximately one-third of foreign direct investment is routed via secrecy jurisdictions;
- Over 50 percent of global trade is routed on paper via secrecy jurisdictions even though they only account for some 3 percent of world GDP;
- Personal wealth totalling US$11.5 trillion has been shifted offshore by the super-rich (known in banking circles as High-Net Worth Individuals, or Hen-Wees), evading taxes of over US$250 billion annually;
- Over two million international business corporations and hundreds of thousands, possibly millions, of secretive trusts and foundations have been created in secrecy jurisdictions;

- Tax evasion in Europe is estimated to have reached between 2 per cent to 2.25 per cent of European gross domestic product. Poor countries tend to be far more vulnerable.

Secrecy jurisdictions have also played a major role in the credit crisis that emerged in 2007: a fact which very few analysts and financial journalists have recognised. The lax regulation they offer, combined with the opacity and complexity of structured investment vehicles and collateralised debt obligations, significantly undermines the efficiency of the capital markets (Murphy, 2008).

Hosting a financial centre targeted at tax evading non-resident clients is very profitable: measured in terms of GDP per capita, eight out of the world's top ten economies are secrecy jurisdictions.



Source: States of Jersey Statistical Review, 2007

The use of secrecy jurisdictions has grown spectacularly since financial market de-regulation started in the 1970s: This chart shows the growth in the volume of banking deposits held – in electronic form only – in Jersey over the past 30 years. Similar growth rates apply to most secrecy jurisdictions.

The outcome is that measured in terms of GDP per capita, eight out of the world's top ten economies are secrecy jurisdictions. Imagine if all countries adopted the same development strategy and became secrecy jurisdictions!

Innovators, or parasites?

They attract huge electronic cash deposits, and have a major role as booking centres for trade and investment flows. But there is a big question: how do secrecy jurisdictions add value to the global economy?

When I have put this question to bankers and officials in the secrecy jurisdictions, they talk vaguely about 'oiling the wheels of the international markets' or providing 'regulatory certainty', or promoting tax competition, by which countries keep offering tax incentives to attract mobile capital from other countries. I will deal with each of these in turn.

First: they say they provide "regulatory certainty." But it is just not clear what they mean by this - other than the certainty that awkward questions will not be asked, ever.

Second, the 'oiling the wheels' metaphor means little in a world of largely de-regulated cross border capital flows. There is no need for secrecy, or low or zero tax rates, to achieve this. It is a bit like an old, now discredited, argument from the 1970s that corruption 'greases the wheels of commerce.' Even on the tax side most cross border trade is covered by double taxation agreements between exporting and importing countries.

The tax competition argument is more complex. In 2007 I challenged *The Economist* magazine to find a professional economist who could explain in simple terms how tax competition spurs productivity and innovation. They failed. Instead, in an article of astonishing intellectual dishonesty, they quoted a Swiss banker saying: *"Tax competition in the only agent of productivity for governments – it is the only competition they have."* (*The Economist*, 2007) Presumably this banker discounts democratic elections as the proper basis for competition between ideas and governments. He did, however, concede that tax competition can go too far. The only argument that is put forward is that tax competition between countries forces tax rates lower. But tax rates for whom? It drives down tax rates for mobile capital meaning that the tax rates on other factors such as labour must rise to compensate. In the process inequality – which is one of the great economic challenges of our age - increases sharply. Nobody has been able to explain

how secrecy jurisdictions, which are used primarily to shift profits artificially out of the countries where they are created, do anything other than engage in a process of 'beggar-my-neighbour'. Tax competition is profoundly anti-democratic: it prevents governments from providing the tax systems their electorates vote for.

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Competition theory belongs to the world of microeconomic theory in which consumers make informed choices between suppliers of goods and services, and companies that fail to adapt go bankrupt and are replaced by more efficient ones. Proponents of tax competition casually assert that market competition is like tax competition, but this is false. In liberal democracies, it is electors - not consumers – who control choices between one government and another. A failed company is one thing. A failed state is another thing entirely. Market competition cannot be compared to tax competition.

Similar arguments also apply to regulatory competition: secrecy jurisdictions provide 'light-touch' regulation, which, it is argued, encourages risk-taking. But the current banking crisis reveals how secrecy has allowed risk to be disguised within high-risk instruments – particularly collateralised debt obligations – that have been sold throughout the world with little or no knowledge of inherent risk. This is a lethal combination: when markets are booming there is no pressure on regulatory authorities to correct asymmetric information between sellers and buyers. The nature and scale of risks only materialise when the downturn comes.

Examining the regulatory regimes in most secrecy jurisdictions, from the minor players like Monaco and Andorra through to major financial centres like London and Zurich, we find that behind the shop window of anti-money laundering (AML) regulations imposed by the Financial Action Task Force lies a reality of lax regulation and a culture of non-enforcement, particularly in respect of tax evasion (Murphy, 2008). Most offshore tax evasion schemes employ multi-jurisdictional structures carefully designed to avoid regulation, by ensuring that transactions occur on paper outside the scope of the regulatory authorities of the jurisdictions in question. In

political geography terms, the transactions occur nowhere, and no-one is responsible for their regulation.

The McKinsey Global Institute estimates the volume of cross-border financial flows at around US$8.2 trillion per year (McKinsey, 2008). Illicit financial flows, involving money that has been obtained, transferred or used in an illicit fashion, constitute about one-fifth of this amount. Despite a cumbersome and highly intrusive anti-money laundering (AML) regime, the failure rate for detecting illicit financial flows is spectacularly poor: less than one per cent is detected (Baker, 2005).

This is partly because AML regimes focus too narrowly on drugs and terror, which account for a relatively small proportion of illicit flows. But a generally lax attitude towards commercial trade mispricing and fraudulent invoicing is also a factor. Most capital flight and tax evasion involves trade mispricing (Baker, 2005), but existing rules, for example the OECD guidelines on transfer pricing, are inadequate and not enough effort has been made to tackle this problem. Even worse, international accounting rules make it far harder to detect mispricing.

Welcome to a world without rules

Working in Jersey for 14 years helped me understand how secrecy jurisdictions facilitate capital flight and tax evasion. Most of my work involved creating elaborate structures for shifting profits out of producer countries and consumer countries into offshore structures. Tax evasion, typically dressed up as tax avoidance, was the principal motive.

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This banana industry case study illustrates the point. International trade in bananas exceeds US$50 billion a year. The three companies that dominate the trade use secrecy jurisdictions to shift profits by means of packaged intellectual property rights, thus minimising tax payments and maximising profits. Almost half of the final retail price of a banana produced in Latin America and purchased in Europe is accounted for by ‘costs’ inserted into the value chain by subsidiaries in secrecy jurisdictions. Tax payments at both ends are minimised to less

than one per cent of the entire value chain, despite these companies' super-high profits.

What I realised in Jersey was that the techniques used for tax dodging involve exactly the same mechanisms and financial subterfuges as other forms of money laundering: offshore companies with nominee directors and shareholders; offshore trusts and foundations; bearer shares; dummy wire transfers; secret bank accounts. Legal institutions granted special privileges by societies are subverted to illicit purposes. I was trained to create tax dodging schemes spanning three, sometimes four or even five different jurisdictions, each scheme carefully designed to prevent investigation by external authorities.

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My trainers justified this by arguing that tax avoidance is legitimate and that company directors have a duty to minimise tax payments so as to maximise shareholder value. This argument needs careful unbundling. Firstly, tax is not a business cost but a distribution to the societies which provide the infrastructure and markets within which profits are created. Treating tax as a production cost enables economic free-riding, and undermines both corporate responsibility and good governance. Second, company directors who maintain a more ethical position on tax avoidance will suffer a competitive disadvantage compared to their less scrupulous rivals, and this creates market distortions. Third, no country requires company directors to minimise tax under company law, especially when this involves seeking to defeat parliamentary democracy and keeping tax planning structures hidden from shareholders, investors and national authorities.

But tax avoidance is only a part of what I uncovered in Jersey. I am not a classic whistleblower in the sense that I have never revealed client-specific information, but reading through the files of clients from all over the world revealed indisputable cases of insider trading, market rigging, non-disclosure of conflicts on interest, fraud, bribe paying, international sanctions busting, and, of course, tax evasion on a epic scale. These crimes are seldom exposed because they occur in a milieu of legal secrecy and judicial non-cooperation. When investigators persist, their efforts are likely to be thwarted by flee clauses and

redomiciliation instructions built into trust and company arrangements.

So we now need a complete reassessment of anti-corruption efforts to bring the supply side agents into focus (Christensen, 2008). Transparency International played an important role in kick-starting the anti-corruption drive in the 1990s, but their approach was fundamentally flawed by too narrow a focus on what constitutes corruption. Worse, TI failed to show good leadership by tackling the full extent of the supply side from the very start.

Year after year the corruption perceptions index reinforces a popular view that Africa is irredeemably corrupt while secrecy jurisdictions in the North are squeaky clean. The bribe payers index, which is supposed to tackle supply side issues, is no better: Switzerland ranks number one in terms of good practice. This speaks volumes about the politics of corruption. The supply side is not just about the bribe-giver: it is about all the facilitators of corruption – and that means bringing the world of financial secrecy into the equation. Who can blame people in the South who accuse anti-corruption campaigners of acting in bad faith?

We must reconsider what constitutes corruption. It is right to be concerned by bribery and embezzlement of public assets, but tax evasion is generally overlooked even though it represents theft of public assets and, in terms of orders of magnitude, has far greater impact on public revenues than bribery and embezzlement (Baker, Christensen and Shaxson, 2008).

Tax evasion involves abusive behaviour at the intersection between private activity and the public interest. It involves minorities bypassing accepted social norms, and provides one set of rules for the rich and well-connected, and another set of rules for the poor and weak. More insidiously, it involves privileged elites, who use secrecy jurisdictions to undermine the will of elected parliaments. It is time that secrecy jurisdictions are recognised for what they really are: a full-on assault on the sovereignty of nation states, a direct attack on democracy, and a cancer running through the veins of contemporary capitalism.

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Conclusions

The Greek historian Thucydides described a world of conflict in which the strong do whatever they want, and the weak are obliged to survive on whatever terms are offered to them. The political system at the heart of this world is based on plutocracy and domination. That is the system emerging around us today, and secrecy jurisdictions serve the interests of the plutocrats.

The proponents of secrecy jurisdictions suggest that they represent the free market at its most innovative (*The Economist*, 2007). But they have failed to show how they add value to productive processes, and their arguments ignore the fact that the secrecy provided by these jurisdictions is totally inimical to market efficiency.

Secrecy acts systemically, creating a criminogenic environment within which criminality and corruption can thrive, immune from investigation. It promotes harmful market distortions by shifting investment away from where it is most productive towards where it can attract the biggest tax subsidy; it facilitates capital flight, it shifts the tax charge from capital to labour, and distorts processes of capital accumulation.

The outcome is a world of extremes of wealth and income inequality; of persistent poverty; of increased alienation, corruption, and disregard for the rule of law.

We face clear choices about the future of the globalisation project. We can allow secrecy jurisdictions to continue with business as usual: the outcome will be an anarchic world order of disorder and insecurity. The alternative is a system that respects the taxation rights of sovereign states; which requires transparency of market relevant information; which supports cooperation on information sharing, on taxing capital, and on disclosure of ownership; which recognises that tax dodging is both economically harmful and anti-democratic, and which asserts the widely-accepted principle that progressive taxation serves the public interest.

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Thank you for your attention.

Some proposals for discussion:

Europe both can and should take the international lead in tackling secrecy jurisdictions. The Tax Justice Network suggests the following actions:

- Strengthening and broadening the Savings Tax Directive and entering into information exchange agreements based upon the principle of automatic exchange with countries outside the Union;

- Adopting an international accounting standard for country-by-country reporting by multinational companies;

- Supporting proposals to strengthen the UN Tax Committee to help this Committee become the principal forum within which norms for multilateral tax cooperation can be agreed;

- Promoting the UN Code of Conduct on International Cooperation in Combating Tax Evasion, to create a benchmark for testing the actions of secrecy jurisdictions and the financial professionals who promote tax evasion services;

- Pushing for tax evasion to be treated as a predicate crime under the UN Convention Against Corruption, and under the AML regimes of all countries providing financial services to non-resident clients, and requiring the International Monetary Fund to extend the process of its Reports on the Observance of Standards and Codes to include matters relating to banking secrecy, disclosure of ownership, and ability to comply with requests for information exchange;

- Requiring all European secrecy jurisdictions and their dependent territories to:

    (i) provide full public disclosure of the beneficial ownership of all legal entities registered under their jurisdiction;

    (ii) to abolish banking secrecy arrangements;

    (iii) to demonstrate their capability to engage in effective information exchange; and

    (iv) to require all professionals covered by AML regulations to automatically submit suspicious activity reports for each and every client who they suspect of tax evasion.

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