



# Tax Havens: Crucibles of financial turmoil and grand corruption

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Until recently tax havens, illicit financial flows and financial market secrecy have been neglected public policy issues. Fresh evidence from a variety of sources suggests that tax havens have had a profound impact on social and economic stability, poverty, development and financing public services in high, middle and low income countries (Schjelderup et al, 2009).

In April this year G-20 president Gordon Brown addressed the issue head-on when he commented to a Joint Session of the US Congress: “ ***...how much safer would everybody’s savings be if the whole world finally came together to outlaw shadow banking systems and offshore tax havens?***”

How much safer indeed. Across the world politicians and officials are struggling with the problem of how to fund public services in the face of fiscal termites which are steadily eroding their revenues and switching the tax charge from capital onto labour and consumers. Regulators, credit agencies, financial journalists and academic researchers struggle to understand highly complex structures spanning many different tax havens, involving special purpose vehicles and off-balance sheet vehicles which reveal little or no information about themselves or the purposes they serve.

Developed and developing countries face a massive dilemma: tax competition is undermining the taxation of corporate profits and other returns to capital and hundreds of billions of tax revenue are being lost annually to tax evasion and aggressive tax avoidance (Murphy et al, 2007). But many of the larger OECD economies, including the United States and the United Kingdom, both faced with huge deficits on their current accounts, have come to rely on huge inflows of capital from the South, much of which is illicit in origin (Baker, 2005). Major OECD countries also host or protect many of the world's largest tax havens and offshore financial centres, including London (the core of the British tax haven economy), the United States (notably through secrecy jurisdictions like Delaware or Nevada) Dublin, Luxembourg, Austria, Switzerland and the Netherlands, plus a variety of associated territories like Andorra, Guernsey, Jersey, Monaco and the Netherland Antilles, which act as catalysts for regulatory and tax competition and facilitate tax evasion on an industrial scale.

Thanks partly to civil society pressure, the hidden economy of tax havens is at last starting to be exposed to the light of day, and after decades of inaction we see some signs that political leaders might finally take some minimal action against these places. Faced with a devastating mix of financial market meltdown and fiscal crisis, G-20 leaders have committed to tackling banking secrecy and tax evasion. Tax havens that refuse to cooperate could face punitive sanctions, including scrapping of existing tax treaty arrangements and tougher disclosure requirements for companies and rich individuals who use tax havens.

Welcome as they are, the commitments made at the London G-20 summit in April will achieve little unless G-20 leaders move forward to implement several important measures. One would be a multilateral programme for automatic information exchange involving developing as well as developed countries. They also need to adopt a global standard for financial reporting by multinational companies, which will introduce country-by-country disclosure of a wide range of important accounting information. And ultimately the only way to effectively and equitably tax multinational companies lies with the adoption of a unitary form of taxation based on formulary apportionment of taxable profits to the various countries where the economic activities which create profits actually occur.

And, crucially, steps are required to roll back the endemic problem of tax havens not requiring disclosure of information relating not only to bank secrecy but also to ownership of companies, trusts, foundations and other legal persons.

Do the politicians truly have the appetite to take on these tasks, and will civil society provide support to counter the powerful lobbies protecting the tax havens and their corporate and individual clients? Failure to do so might mean losing the best opportunity in decades to tackle these faultlines in the global economy.

## **A phantom economy**

Abandonment of exchange controls in the 1970s, and de-regulation of the London and New York financial markets the following decade, unleashed unprecedented cross-border financial flows and massive accumulation of individual and corporate wealth in OFCs (Offshore Financial Centres). QUANTIFY These are financial centres located in tax haven jurisdictions which provide a mix of secretive banking and legal facilities, minimal or no regulation, and ultra-low or zero tax rates for non-resident companies, trusts, foundations and individuals (Murphy et al, 2007), as well as special exemptions such as legal indemnities for company directors guilty of fraud or negligence. This combination of factors attracts clusters of banks, legal and accounting firms and other financial intermediaries who use OFCs primarily to create tax avoidance structures and take advantage of lax regulation.

The secrecy space provided by tax havens also creates an enabling environment for rich people and companies engaged in hiding illicit financial flows, tax evading, insider trading, market rigging, money laundering, and exploiting loopholes in national tax laws to create aggressive tax avoidance structures (Baker et al, 2008).

During and after the period of the G-20 summit, political leaders focussed heavily on tax evasion but not on tax avoidance, and tax professionals seldom miss an opportunity to distinguish between the legality of the latter compared to the illegality of the former. But avoidance is at least as big a problem as evasion, whatever the legality, and there is a huge grey area between the two. The economic distortions caused by the opportunities for tax avoidance created by tax havens are an issue of fundamental concern. Wide divergences of tax rates, bases and practices between tax havens and other economies create substantial incentives for multinational companies, including and especially banks, to engage in international tax arbitrage, introducing additional complexity and opacity into the financial markets (IMF, 2009). As the IMF and others have noted, the combination of tax biases and excessive liquidity available from banks operating in tax havens, has encouraged companies to favour debt finance over equity finance, increasing their vulnerability to economic shocks during periods of market stress.

Despite an astonishing deficit of robust statistical data relating to tax havens, research in Europe and America suggests that tax havens operate on a massive scale. Over half of international bank lending and approximately one-third of foreign direct investment is routed through tax havens. Speaking to members of the Paris Club ten years ago, Dominique Strauss-Kahn suggested that around 50 percent of global trade is invoiced through tax havens (Hampton & Christensen, 1999). Personal wealth totalling US\$11.5 trillion has been shifted to tax havens by the super-rich (known in banking circles as High-Net Worth Individuals, or Hen-Wees), avoiding taxes of over US\$250 billion annually (TJN, 2005). Over two million international business corporations and

millions of secretive trusts and foundations have been established in tax havens. Tax avoidance in Europe is estimated to have reached between 2 per cent to 2.25 per cent of European gross domestic product (SNUI, 2008).

Tax havens are particularly harmful to developing countries, which suffer illicit financial outflows currently estimated at around €750 billion a year (Baker, 2005), and are more vulnerable to tax evasion and avoidance. Recent research suggests that developing countries are losing US\$160 billion a year to deliberate mispricing of trade between subsidiaries of multinational corporations (a process known as transfer mispricing) and false invoicing (Christian Aid, 2008). This sum, let alone the full scale of illicit outflows, represents considerably more than they receive in international aid. Independent research has found that Sub-Saharan Africa is in fact a net creditor to the world:<sup>1</sup> with the continent's private external assets belonging to a narrow, wealthy stratum of the population, while public external debts are borne by ordinary people through their governments.

Tax evasion and illicit outflows devastate the prospects of developing countries, which are forced to depend on foreign investment to replace illicit capital outflows and also lose out on desperately needed tax revenues that would flow from the investment of this capital (Oxfam, 2000). Faced with diminishing domestic resource mobilisation and widespread tax evasion, many developing countries have had to rely heavily on external debt and aid, both carrying unwelcome conditions which undermine democracy and the links between citizen and state that foster accountability and the 'social contract'. (Bräutigam et al, 2008)

## **The secretive core of financial capitalism**

Despite popular images of sunny islands and alpine microstates, tax havens are neither geographically remote nor disconnected from the mainstream economy. Modern communications link them to major financial centres across the world, and politically and economically most tax havens are linked to major OECD states, including the USA, United Kingdom, Switzerland and Luxembourg (Hampton, 1996).

In the case of the City of London, identified by the IMF (International Monetary Fund) as an offshore financial centre, the bulk of offshore transactions are managed from the City, but often through subsidiary offices located on UK Overseas Territories and British Crown Dependencies. These small island tax havens offer permissive regulatory regimes, and zero or minimal tax rates combined with secretive arrangements which prevent disclosure of beneficial ownership of companies and trusts. Tailor-made, in other words, for tax evasion and other corrupt practices, including payment of bribes

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<sup>1</sup> <http://taxjustice.blogspot.com/2008/04/six-hundred-billion-drained-from-africa.html>

and contract kickbacks, and illicit political donations (Baker et al 2008). London, therefore, sits at the centre of a global network of secretive jurisdictions, which since colonial times have acted as conduits for capital originating from other countries:

*Almost half the tax havens in the world are Commonwealth Dependencies, which remain under the jurisdiction of HMG. Jersey, Bermuda and the rest are just filling a niche knowingly created by politicians and bankers in London. It may be helpful to think of the financial networks that converge on London as a recharged version of the British Empire, held together by modems rather than gunboats and overseen by the mother of all anachronisms, the British political system. As with the original empire, there's a good chance that the colonials will now be left to clean up the mess. (Finn, 2009)*

Major banks and other multinational corporations use tax havens to devise complex financial structures spanning the world. Research has shown that around three quarters of the top American businesses use tax havens, and almost 100 per cent of the top European businesses do the same (GAO, 2009; TJN, 2009). In every national survey so far, banks top the lists of tax havens users – by far. Acting with stealth they have created a shadow banking system of inter-related structures spanning different tax havens, often using SIVs (Structured Investment Vehicles) and SPVs (Special Purpose Vehicles) to hold assets and liabilities off their balance sheets. The trend for financiers to structure complex financial instruments through tax havens is partly a response to tax considerations relating to favourable treatment of capital gains and profits-shifting to low tax areas. Similarly, favourable tax treatment has encouraged the use of debt securitisation and other devices (e.g. by reducing the cost of sub-prime financing), and the combination of opacity and complexity inherent to CDOs (Collateralised Debt Obligations) has significantly contributed to the failure to identify hidden risks (IMF, 2009)

Opportunities to use tax havens for tax evasion and avoidance have played a major part in shaping the globalised financial markets. Anxious to protect the interests of financiers in London and New York, and to attract much needed capital to balance their chronic current account deficits, both the UK and USA have provided tax concessions which have caused distortions in the global capital markets (Picciotto, 2009).

The growth of hedge funds is a prime example of these distortions. Tax authorities have treated hedge funds with enormous lenience, allowing them to operate in London and New York, but treating them for tax purposes as though they were resident in the Channel Islands and Cayman and therefore not taxable on profits or capital gains. Furthermore, their distributions to investors are not subject to withholding tax and their location in secretive tax havens has provided investors a tailor-made opportunity for tax avoidance.

This favourable tax treatment has encouraged investors to accumulate their capital in tax havens, fuelling excess liquidity which has been channelled into hedge funds, other derivative markets and private equity funds, all of which are largely engaged in speculative financial transactions rather than genuine business activity.

Tax havens have hosted many of the activities that lie at the root of the current crisis. Major players like London, Delaware, Luxembourg, Dublin, the Cayman Islands and the British Channel Islands provide specialist services including:

- Creating the complex packages of securitised risk known as CDOs (collateralised debt obligations) that have been marketed indiscriminately around the world;
- registering 'off-balance sheet' entities used to withhold materially sensitive information from investors, regulators, rating agencies, journalists and others;
- promoting a race-to-the-bottom in regulatory practices and disclosure of information;
- hosting hedge funds and other derivative instruments;
- creating complex and opaque structures criss-crossing multiples of jurisdictions in order to frustrate investigation and fragment regulatory effort;
- evading and avoiding tax on an industrial scale.

Tax havens are engines of chaos in the financial markets, serving the dual purposes of helping financiers to 'get-out-of taxation-free' and 'get-out-of regulation-free.'

Worse still, the role of tax havens in facilitating corrupt practices is rapidly coming to the fore. The global anti-corruption crusader Transparency International has acknowledged the role of tax havens in creating a criminogenic environment, and is collaborating with the Tax Justice Network in collating a new index – the Financial Transparency Index – which will rank tax havens according to how they create opacity in the global financial markets.

This new index, which will be published for the first time in the fourth quarter of this year will play a part in drawing attention to the role of the supply side of corrupt practices. Our hope is that this shift of attention to corruption's supply side will raise public awareness of important factors such as:

- how tax havens supply the secrecy space through illicit money flows;
- how private sector agents, including and especially professional intermediaries such as bankers, lawyers, accountants, company formation agencies and trust

companies, facilitate (or overlook) corrupt financial practices (U.S. Senate, 2006);

- how company directors are responsible for illicit transactions that contribute to capital flight, tax evasion and tax avoidance.

A radical change is also needed in the public understanding of what constitutes corruption, away from a narrow focus on bribery, which is only a very small part of the corruption equation. The focus needs to shift away from merely focussing on bribe-takers and bribe-givers towards the entire supply side of corruption, which includes those jurisdictions and individuals that assist in shifting the money. So we need to focus less on individuals in a context of bribery, and more on the systems and processes that encourage and enable corrupt activities. Corruption always involves narrow interests, both in the public and private spheres, who abuse the common good. It always includes insiders using guarded information who can operate with a high level of impunity. And it always corrodes public confidence in institutions, laws, rules and systems that are intended to promote the public interest. Thus, it might be more useful to define corruption as *'the abuse of public interest and the undermining of public confidence in the integrity of the rules, systems and institutions that promote the public interest'* (Baker et al, 2008).

Broadening the definition of corruption in this way creates room for a wider range of actors and their facilitating activities. It widens the focus to encompass activities such as insider-trading, tax evasion and avoidance, market-rigging, non-disclosure of pecuniary involvement, embezzlement, and trade mis-pricing, all of which occur in the private sector and are disguised through opaque and complex legal structures.<sup>2</sup> It is not just the public sector where corruption exists: economic crimes in the private sphere can be highly corrupting to market economies and institutions, and pressure is mounting for tax evasion to be identified as a corrupt practice within the scope of the United Nations Convention Against Corruption (Ban Ki-moon, 2008).

## **Decades of inaction**

The tax haven economy did not emerge suddenly in the 1970s. Its roots lie in the growth of transnationalism in the nineteenth century, and the failure of successive initiatives to achieve a framework of global cooperation to protect national tax regimes from abusive tax practices (Christensen, 2008). Even today, despite clear evidence of the harm caused by tax havens and by underlying tax distortions which have contributed significantly to the current crisis (IMF, 2009), resistance to international cooperation persists on the wholly spurious grounds that cooperation undermines

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<sup>2</sup> <http://www.the-american-interest.com/article-bd.cfm?piece=466>



national sovereignty in respect to tax and that “competition” between countries on tax and regulation is a good thing. The exact opposite is the case: the absence of cooperation has created opportunities for tax evaders to operate with impunity, and for tax avoiders to make maximum use of tax havens for tax arbitrage, transfer mis-pricing and for structuring trade and investment patterns in ways which are economically inefficient but nonetheless maximise post-tax profitability. What is more, the spurious arguments rest on a false understanding on the word “competition” – as the Financial Times writer Martin Wolf memorably put it: “the notion of the competitiveness of countries, on the model of the competitiveness of companies, is nonsense.” Competition between *companies* in well-regulated free markets is generally beneficial; competition between *countries* on tax rates and exemptions, on secrecy and on regulation, involves a race to the bottom: it is always harmful. Always question what the word “competition” means when wielded in this context.

Early attempts by the League of Nations to introduce a cooperative framework to resist tax avoidance were frustrated by intensive lobbying from self-interested business interests. Lobbying also hampered negotiations on the issue of capital flight at the 1944 Bretton Woods conference. More recent efforts by the OECD (Organisation for Economic Development & Cooperation) to tackle tax evasion and transfer mispricing have been timid (Christensen & Spencer, 2008) and have faced fierce counter-attack by special interest groups. The OECD guidelines for transfer pricing within MNCs using the ‘arms-length’ pricing technique, which assumes a world market price for bespoke products, services and intellectual property rights “traded” between subsidiaries of the same company, have introduced complexity without significantly diminishing transfer mispricing. The OECD has also led the international project to tackle harmful tax competition, launched in 1998, which amongst its goals included a radical transformation of tax havens through increased transparency and improved information exchange between national authorities (OECD, 1998). This project was effectively killed off by the Bush administration in 2001, underlining legitimacy problems facing an organisation like the OECD, whose membership includes half a dozen of the most powerful tax haven economies on the planet.

At least part of the blame for the failure to tackle the tax haven issue must lie with civil society, which has shied away from tackling matters seen as complex and unappealing to the public. The Tax Justice Network and its partners such as Global Financial Integrity in Washington represent the first serious attempt by civil society to engage on the issue of tax havens, and we have led the process of putting tax havens onto the G-20 agenda earlier this year. Now that leaders of the G-20 countries have indicated that they want to tackle the problem of tax havens, we need to recognise that they will face fierce resistance at every step from powerful lobbies who fund political parties, sponsor academic posts and high-profile think-tanks and can muster influential support from national and international media.



To counter this lobbying, civil society must form an effective and vocal counter-lobby to back up those politicians who want to remedy decades of inaction. In January 2009 the newly formed Coordinating Committee of the inter-governmental Task Force on Financial Integrity and Economic Development agreed its priority recommendations for tackling illicit financial flows and tax havens. Not surprisingly, its recommendations focus heavily on increasing market transparency:

- Systems to curtail the practice of mispricing trade;
- Country-by-country reporting of sales, profits, and tax paid by multinational corporations be required in audited annual reports and tax returns;
- The beneficial ownership, control and accounts of companies, trusts and foundations be readily available on public record to facilitate effective due diligence;
- Multilateral and automatic cross-border exchange of information between national authorities on income, gains and property received by non-resident individuals, corporations, and trusts, be made mandatory;
- Predicate offenses for a money laundering charge be harmonized and codified.

Taken as a package, these measures will severely restrict the use and abuse of tax havens. Many can be expected to suffer economic decline and might need transitional support to restructure. But at the global level the benefits of tackling tax havens will vastly outweigh the costs to the small number of microstates which might require transitional support. Perhaps the most important benefit will be the removal of the financial and legal secrecy infrastructure which encourages and facilitates grand corruption.

The Walton family, of Wal-Mart fame, is wealthier than the bottom third of the US population put together – about 100m people. But the United States is far more equal in terms of income and wealth distribution than most, if not all, developing countries. Tax is central to this. Our proposals will restore the ability of democratically elected governments to tax on a progressive basis, to apply the regulations and rules that their electorates vote for. And they will start the process of re-balancing a system that has created wild inequality of wealth and income distribution, especially amongst the developing nations.

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