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Alternative Architectures of the Financial System

THE ENGINES OF CHAOS

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At the roots of this crisis lies the delusion that growth can be sustained on the basis of rising consumer debt rather than rising real household incomes. Contrary to what we hear from many commentators, the warning signals had been noticed by some analysts years before the sub-mortgage markets collapsed in the US: rising household debt. These signals included:

- clear indications of asset price bubbles – not just in the commercial and residential property markets, but across most classes of equity and corporate bonds;
- banks taking on debt : equity ratios exceeding 30 to one, with excess liquidity fuelling speculation across a variety of derivatives markets, including energy and food;
- Savings ratios close to or near zero;
- massive and sustained trade and capital account deficits treated as sustainable, rather than the structural problems that they are.

In other words, some of the apparently richest nations of the world, including the United States, Spain, the United Kingdom, and Ireland, based their economies on unsustainable levels of debt, and thought the music would never stop.

Alarmingly, none of these warning lights were flashing on the balance sheets of the engines of capitalism, the banks. And very few mainstream economists were raising alarm bells. As recently as 2007, the British prime minister, responsible for the largest offshore financial markets in the world, was repeating his mantra of "no more boom and bust."

So where did it all go wrong? I have three points of departure:

Firstly, this is not a single failure of the residential mortgage market but a series of systemic failures implicating most if not all of the people and organisations who should have acted as gate-keepers to protect the integrity of markets, but singularly failed for a variety of unsatisfactory reasons:

- bankers who failed to manage risks and encouraged reckless indebtedness;
- regulators who failed to join the dots and recognise how, where and why risks were mutating through the financial markets;
- credit rating agencies with conflicts of interest;
- auditors who signed off on accounts for companies just weeks before their total failure;
- financial journalists who became delivery agents for corporate public relations and newspapers which have become hostage to corporate advertising;

- economists whose models were totally removed from reality, and therefore lost sight of how markets function at ground level;
- academics who have accepted corporate sponsorship and lost the degree of independence required to formulate new ideas and to take a leadership role in presenting those ideas to a broader public; and
- politicians who rely over-heavily of party funding from corporate sources and, faced with the biggest banking failure since the late nineteenth century, surrounded themselves with advisers and review bodies recruited from exactly the same cadre of bankers and business leaders who created the mess in the first place.

At the international level, agencies have demonstrated their inability to monitor or control systemic risk: the Financial Stability Forum distinguished itself by failing to recognise the crisis before the banks hit the rocks; the Basle Committee saw the problem but failed to prevent it; the IMF has belatedly recognised that tax policies have cross-border macroeconomic consequences but its tax consensus has drastically harmed public finances – leaving many developing countries especially vulnerable to the crisis due to lack of scope to enact counter-cyclical fiscal programmes.

Second, a massive disconnect has emerged between market theory and practice. The theory is that markets only operate efficiently in public interest when information is shared symmetrically between buyers and sellers. In practice, the opposite pertains. Too much material information is withheld from key players, including investors. Assets and liabilities are held off-balance sheet. Intra-group activities are wrapped up into

consolidated accounts. Information about ownership is disguised through offshore companies and trusts with nominee directors and shareholders. Secrecy jurisdictions across the world allow incorporated companies to trade outside their jurisdiction without any financial reporting requirement. Banks create complex shadow banking structures which operate outside the spheres of regulatory controls.

Far from being transparent and efficient, markets have becoming increasingly opaque and complex, with hidden risks and an inevitable loss of trust between the players. In other words, the prevailing orthodoxy preaches the language of economic transparency but has no clear idea of what that means and how it can be operationalised. Worse still, their actions demonstrate a widespread preference for secrecy and covertness, much of which is rooted in the aggressive tax avoidance structures that most companies now operate.

Third, over the past fifty years a shadow economy has been created that works in parallel to the mainstream economy. The majority of cross border trade and investment is transacted on paper through this economy.

A huge proportion of personal wealth – estimated at between \$5tn to \$11.5tn has been accumulated in this shadow economy. Unknown numbers of trillions of dollars of corporate wealth are held there. The vast majority of the world's hedge funds operate from this economy. 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.

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.

This shadow economy, is widely referred to as the world of tax havens, but it is more helpful to think of these places as secrecy jurisdictions, since this is their key function: to allow the creation of opaque and complex structures to avoid taxation and escape regulation.

Tax havens have been a major contributory factor to the current crisis. 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.

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.

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 evasion.

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. It is vital that these tax distortions are removed, and that international frameworks are negotiated to prevent countries, for example the United Kingdom and its tax haven satellites in the British Channel Islands and Cayman, from seeking competitive advantage through beggar-my-neighbour tax and regulatory concessions.

This raises a major problem: until now tax policy has largely been treated as an issue of national sovereignty. What little international cooperation has happened in the past, has largely focussed on preventing double taxation of corporate income. Corporate lobbyists pushed hard for that, but have pushed equally hard to ensure that little or no cooperation happens to prevent double non-taxation of income. The result is that the current financial architecture is a tax avoider's paradise. And there is no effective institutional framework for moving ahead with programmes for enhanced international cooperation: the OECD wants to take the lead but does not promote the interests of developing countries, and the UN Tax Committee lacks political authority and resourcing. A new institution is needed, perhaps an International Tax Organisation, which will overcome this problem.

Writing in the *Wall Street Journal* immediately after last year's elections, Rahm Emmanuel, a key adviser on the Obama administration, said *"you never want a serious crisis to go to waste."*

The current crisis is serious. Very serious indeed. But judging by the tone of politicians, bankers, businesspeople and journalists in recent weeks, many seem to think that stock market growth signals recovery in the real economy. In reality unemployment is rising at rates faster than happened in the 1930s. The delusion of recovery is cause for real anxiety, since there is an appalling prospect that the opportunities for change will in fact be wasted.

We cannot allow this to happen. Fundamental reforms are needed at many different levels: institutions that have failed the test of the market place must have root and branch reform to ensure that the culture of greed and short-termism is replaced by one of placing public interest first.

After years of relying on the financial markets to set their own rules, and then to self-regulate within a framework of rules which favour the interest of elites over public interest, we now require a financial architecture that emphasises international cooperation, democratic accountability and operational transparency.

As a starting point we must restore the ability of elected governments to tax capital and to tax on a progressive basis. To do this, we need enhanced international cooperation to combat tax evasion and the abusive activities of tax havens. The G-20 has called for measures to tackle tax havens, and has asked the Organisation for Economic Cooperation & Development to take steps in that direction. But the OECD's proposals are far too weak and do little to protect the interests of developing countries. Instead of complex, time-consuming and ineffective bilateral

treaties for tax information by request, the Tax Justice Network proposes a multilateral treaty process based on automatic information exchange on the model currently being used within the European Union.

In addition, we call for General Anti-Avoidance Provisions, enshrined in national laws, which will de-legitimise the harmful but highly profitable activities of the global tax dodging industry.

And we go further. The current framework of international financial reporting standards, promulgated by a private company based in London, but registered in the secrecy jurisdiction of Delaware in the United States, has patently failed to protect public interest. Too much of what happens within and between subsidiaries of multinational companies is not disclosed in the published accounts, creating opportunities for profits shifting to tax havens and massive tax avoidance. We propose a new reporting standard for country-by-country reporting, which would require publication of accounts for all subsidiaries in the countries where they operate. This information is material to a wide range of stakeholders, not least tax authorities. Having this information would be a major stepping stone towards tackling trade mispricing and tax fraud.

And whilst we're about it, the International Accounting Standards Board, which has demonstrated a lack of willingness to promote public interest, should be replaced by a democratically accountable body constituted of a far wider stakeholder community, including civil society.

Audit processes also need radical overhaul. Auditors should be fully independent of all other areas of consulting activity, especially in the areas of tax and regulation. Given the complexities and volatility of derivative instruments it seems

imperative that audits of financial institutions become continuous processes, operating in real-time, with regular operational and financial risk statements signed-off by board directors to clarify what risks have built up within the organisation.

The need to tackle the tax havens is urgent. They lie at the root of massive wealth inequalities in most countries. They promote the process of shifting the tax charge from capital to labour and consumers. This shift causes huge macroeconomic distortions, lowering job creation, encouraging speculation, and facilitating corrupt practices.

Thank you.