TAX HAVENS – CORPORATE PARADISES AND COMMUNITY HELL

SKATTEREVIORENES FORENING

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Welcome to a world without rules

tax evasion, secrecy and the suppliers of corruption

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Ladies and Gentlemen

I am very honoured to have this opportunity to address you today, all the more since the Norwegian government has been a strong ally in our efforts to tackle illicit financial flows.

Events in the past few weeks have pushed the global economy to the very edge of meltdown. Senior economic commentators in the international media, not least the *Financial Times*, have openly discussed how the banking rescues in Europe, North America and elsewhere represent the end of the neo-liberal economic experiments launched by Prime Minister Margaret Thatcher in the late 1970s and picked up shortly afterwards by President Ronald Reagan in the early

1980s. I agree with that view. But until now virtually no-one has made the link between the chaos on the global financial markets and tax havens. But it is important that we recognise that these links exist, and that tax havens - or secrecy jurisdictions as they are often called nowadays – are not just used for tax evasion, but have also played a key role in creating the turmoil on the globalised financial markets. So my focus today will be on how secrecy jurisdictions have impacted on the global economy, on democracy and more generally on the institutions, laws and systems that form the basis of human societies.

The core of my argument is that secrecy jurisdictions are corrupting agents operating in a clandestine fashion at the core of the global financial markets. They have played a wholly destructive role in allowing economic players to circumvent onshore regulation and evade financial oversight. By providing what academics call "secrecy space" they multiply market risks by facilitating the creation of complex and opaque corporate structures, for example Special Investment Vehicles used to hold assets off-balance sheet.

The majority of the securitised credit swaps involved in the sub-prime mortgage market crisis were created in places like Jersey and the Cayman Islands, neither of which have the capacity or inclination to effectively regulate their financial services sector.

From personal experience I have seen how companies festoon their financial affairs all around the world, slicing and dicing complex structures between multiples of jurisdictions, in response to offshore incentives. A company incorporated in the Isle of Man, might be owned by a trust established in Jersey, with trustees in Bermuda and a bank account in Luxembourg. Even if each tax haven's claim that it is well regulated were true, the regulation falls between the stools: such

transnational entities are regulated, in effect, nowhere, since each jurisdiction only accepts responsibility for what happens in its domain and none for the entity as a whole. This is deliberate.

Secrecy jurisdictions 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. This lack of attention is all the more surprising when you recognise that major financial centres like London, Luxembourg and Zurich are all based in secrecy jurisdictions, and many of the 'islands in the sun' such as the Bahamas, the Cayman Islands, the British Virgin Islands, the Channel Islands, Bermuda, Gibraltar 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.

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. But poor countries tend to be far more vulnerable to tax evasion and avoidance and the UK based NGO Christian Aid reckons that poor countries lose approximately US$160 billion a year to just transfer mispricing and false invoicing, which is considerably more than they receive in international aid. The full cost of tax evasion and capital flight to poorer countries is probably at least double this sum, making tax evasion the biggest cause of economic failure, inequality and persistent poverty.**

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. Clearly this

is very profitable activity, and not surprisingly most of the world's largest banks and accounting firms choose to operate from these places.

The hitch-hikers guide to Nowhere

So 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 speak 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. 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).

In practice secrecy jurisdictions only regulate transactions occurring within their territorial boundaries, and since almost by definition the majority of transactions booked within their jurisdiction occur elsewhere, the regulators feel under no obligation to regulate

them. The outcome of this officially sanctioned game of smoke and mirrors is that a huge proportion of offshore transactions occur in a regulatory void which we can only describe as 'Nowhere'.

To give some examples of the creeping culture of regulatory laxity, visiting the Irish offshore financial centre earlier this year I learned that the Irish Financial Services Commission, in its efforts to attract hedge funds to its shores, boasts that if the relevant documents are submitted to the regulator by 3 p.m. in the afternoon, the fund will be authorised by start of trading the next day. Not to be outdone in this regulatory race-to-the-bottom, Luxembourg has introduced a new law allowing what they call "pre-authorisation approval", which merely requires the find manager to notify the regulators within one calendar month of the launch of the fund. Jersey, my native island, has gone all the way and now permits totally unregulated hedge funds.

The second issue I mentioned earlier relates to the 'oiling the wheels of global finance' metaphor. The language attempts to suggest that some kind of productive activity might be occurring, but in reality this term means very 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 <u>democratic</u> 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.**

Competition theory belongs to the world of microeconomics 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.

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 <u>one per cent</u> 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.

The undercover economist

I first started to pay attention to the parallel universe of secrecy jurisdictions in the early 1980s. Financial market liberalisation was being pushed by the new conservative governments in the UK and US. The International Monetary Fund was pushing developing countries to liberalise their own financial markets, and countries in Far-east Asia,

where I was working at that time, were experiencing huge problems with capital flight, currency instability and tax evasion. Most of these illicit financial flows out of the poorer countries disappeared into elaborate offshore structures, but scarcely anyone understood how this happened, and what role the secrecy jurisdictions played in the process. When I started to research the issue I found no books or academic papers, and the IMF and World Bank officials I met knew nothing about the subject. So in 1985 I quit my job overseas and returned to my home in Jersey and found work in the offshore banking sector.

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.

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. There is no economic substance to any of the activities booked in these tax havens, but the outcome of these complex and secretive structures is that 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.

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 re-domiciliation 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. I understand that the 2008 index results, due out this week, elevate Singapore to number 4 in the world: most experts in money-laundering and tax evasion would agree that Singapore ranks amongst the worst and most aggressive supporters of these activities. 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.

Conclusions

In his classic novel *Heart of Darkness*, Joseph Conrad described a supposedly civilised and educated man, Kurtz, driven by greed, ambition, and isolation from the pressure of public opinion into pillage and barbarity. I have come to the conclusion that tax havens represent the heart of darkness of contemporary capitalism. Educated and powerful elites use tax havens to secretly carry out actions that they know would suffer public disapproval. Without the secrecy space provided by these jurisdictions they would be far less inclined to break the law as they currently do with almost complete immunity.

Economic libertarians argue that tax havens 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 places 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.

Thank you for your attention.

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Some proposals for discussion:

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

- **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;**

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

- **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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