

# Tax havens and corruption: A global struggle

A minimum of USD 1 trillion of dirty money flows annually into offshore accounts, approximately half of which originates from developing countries. Despite the plethora of anti-money laundering initiatives, the failure rate for detecting dirty money flows is astonishingly high. Tax dodging corrupts the revenue systems of the modern state and undermines the ability of the state to provide the services required by its citizens. It therefore represents the highest form of corruption because it directly deprives society of legitimate public resources; this is the reason why international tax abuse has to become the next big front in the battles over international development, corruption, inequality, and globalization.

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## The parallel economy

The stage is being prepared for one of the epic struggles of our times. Secretly and audaciously, over the past half century, professional elites and their powerful clients have constructed a parallel global economy – often referred to as tax havens – to remove themselves from ‘onshore’ taxes and regulation. This parallel economy provides an enabling infrastructure of banks, legal and accounting businesses, minor legislatures and judiciaries, and related financial intermediaries, which combine to serve as an ‘offshore interface’ between the illicit and the licit economies.<sup>2</sup> This interface has encouraged and facilitated capital flight from poor countries to rich ones on a truly awesome scale. It has enabled tax dodging, shifting the tax burden from capital to labour and significantly contributing to widening inequality. It has undermined the integrity of tax systems and respect for the rule of law.

Democracy itself is undermined by covert deals and special treatments. The offshore interface has distorted global markets to the disadvantage of innovation and entrepreneurship, and slowed economic growth by rewarding free-riding and misdirecting investment. It is identified as a major causal factor behind the growth of high-level corruption. It functions through collusion between private sector financial intermediaries and the governments of states which host offshore tax haven activities. The forthcoming struggle requires a radical rethink of the nature and geography of corruption, forcing civil society to tackle major flaws in the global financial architecture and overcome the political power of major vested interests.

International tax abuse must become the next big front in the battles over international development, corruption, inequality and globalization. Partly because of the complexity of these issues, civil society organizations have mostly shied away from some of the most important aspects of these debates, leaving these fields to be colonized by highly paid experts beholden

to powerful and wealthy interests. The time has come for civil society to step up and take them on.

Contrary to the evocative images conjured up by the term ‘offshore’, it would be wrong to think of offshore as disconnected and remote from mainstream nation states. Geographically, many of the offshore tax havens are located on small island economies dispersed across the spectrum of time zones (see Table 1), but politically and economically the majority of tax havens are intimately tied to major Organisation for Economic Cooperation and Development (OECD) states, and the term ‘offshore’ is strictly a political statement about the relationship between the state and parts of its related territories.<sup>3</sup>

In the case of Britain, for example, the bulk of offshore transactions are controlled by the City of London, even though many City financial intermediaries operate from offices located in UK overseas territories and crown dependencies. These jurisdictions project the impression that they operate autonomously, but in practice they largely act as booking centres for instructions issuing out of the City of London and other major finance centres. They are primarily of use to the City because they offer zero or minimal tax rates combined with secrecy arrangements (including non-disclosure of beneficial ownership of companies and trusts) and regulatory regimes which are more permissive than those prevailing onshore. Many tax havens are directly linked to Britain, either through overseas territory or crown dependency status, or through membership in the Commonwealth. When asked at the conclusion of her enquiries into the Elf scandal which engulfed the French oil giant in the 1990s whether corruption on a similar scale could occur in the United Kingdom, the Norwegian anti-corruption campaigner Eva Joly commented that many of the world’s biggest tax havens, most notably the City of London itself, are under British control, adding: “The United Kingdom has maintained its privileges by allowing British companies to operate from their own tax havens. The expansion in the use of these jurisdictions has a link to decolonization. It is a modern form of colonialism.”

Joly refers to tax havens as the principal target in the emerging phase of the anti-corruption debate,

arguing: “There is nothing more important for those who want to tackle poverty in the world than to make it possible to trace dirty money flows and impose sanctions on those territories which don’t cooperate with this process.”<sup>4</sup>

Offshore secrecy, either created through banking secrecy laws or through de facto judicial arrangements and banking practices, is a major barrier to tracing dirty money flows and tackling corrupt activities. This ‘secrecy space’ creates an effective barrier to investigation of activities in the offshore financial centre by external authorities,<sup>5</sup> and facilitates the laundering of proceeds from a wide range of criminal and corrupt activities, including fraud, embezzlement and theft, bribery, drug trafficking, illegal arms trafficking, counterfeiting, insider trading, false trade invoicing, transfer mispricing, and tax dodging. Elaborate schemes are devised to ‘weave’ dirty money into commercial transactions and to disguise the proceeds of crime and tax evasion using complex offshore structures. According to one expert investigator:

Methods to launder money vary dramatically from low-level, relatively simple to highly structured and complex business scenarios or transfer of money offshore. What is being increasingly identified is the infiltration of criminal identities into otherwise legitimate business interests. None of these people could get away with a lot of what they were doing if it wasn’t for lawyers, accountants, financial advisers, and the like, knowingly assisting them to launder and hide assets.<sup>6</sup>

A minimum of USD 1 trillion of dirty money<sup>7</sup> flows annually into offshore accounts, approximately half of which originates from developing countries.<sup>8</sup>

1 <www.taxjustice.net>

2 For a detailed analysis of the origins of tax havens and their linkages with the global economy see: Hampton, M. (1996). *The Offshore Interface: Tax Havens in the Global Economy*. Basingstoke: MacMillan.

3 Palan, R. (1999). “Offshore and the Structural Enablement of Sovereignty”, in Hampton, M.P. and Abbott, J.P. (eds). *Offshore Finance Centres and Tax Havens: The Rise of Global Capital*. Basingstoke: MacMillan.

4 Quoted from “Pour Eva Joly: Le G8 ne lutte pas vraiment contre la corruption”. Interview in *La Tribune*, 6 June 2007.

5 Christensen, J. and Hampton, M.P. (1999). “A Legislature for Hire: The Capture of the State in Jersey’s Offshore Finance Centre”, in Hampton, M.P. and Abbott, J.P., *op cit*.

6 Detective Superintendent Des Bray, of the Commercial and Electronic Crime Branch, interviewed in the *Adelaide Advertiser*, “Lawyers helping to launder money”, 4 June 2007. Available from: <www.theadvertiser.news.com.au/?from=nl\_story>.

7 Dirty money is defined as money that is obtained, transferred or used illegally.

8 Baker, R. (2005). *Capitalism’s Achilles Heel*. Hoboken, New Jersey: John Wiley & Sons.

Despite the plethora of anti-money laundering initiatives, the failure rate for detecting dirty money flows is astonishingly high. According to a Swiss banker, only 0.01% of dirty money flowing through Switzerland is detected.<sup>9</sup> It is unlikely that other offshore finance centres are any better. Crucially the techniques used for tax dodging and laundering dirty money involve identical mechanisms and financial subterfuges: tax havens, offshore companies and trusts, foundations, correspondent banks, nominee directors, dummy wire transfers, etc.

Legal institutions granted special status and privilege by society have been subverted to purposes for which they were never intended. For example, the original purpose of trusts was to promote the protection of spouses and other family members who are unable to look after their own affairs, and to promote charitable causes. Incredible as it must appear to those not familiar with the offshore economy, charitable trusts are regularly set up in offshore tax havens for the purposes of owning 'special purpose vehicles' used for international tax planning and for hiding both assets and liabilities offshore, as happened with Enron and Parmalat.<sup>10</sup>

The remarkable growth of the offshore economy since the mid-1970s reveals a major fault line in the financial liberalization process. Whilst capital has become almost totally mobile, the systems for tracking cross-border dirty money flows remain largely nationally based. The unsurprising outcome has been a massive increase in cross-border dirty money flows, often taking the form of falsified trade invoicing and transfer mispricing between subsidiaries of multinational companies. The vast majority of these funds are laundered via complex offshore ladders operating through the global banking system. Huge sums are involved, particularly for developing countries prone to capital flight. Estimates of capital flight from Africa vary considerably, but according to the African Union USD 148 billion leaves the continent every year through dirty money flows.<sup>11</sup>

Most analysts agree that the outflows of dirty money originating from Africa tend to be permanent, indicating that between 80% and 90% of such flows remain outside the continent.<sup>12</sup> Another study concludes that Sub-Saharan Africa is a net creditor to the rest of the world in the sense that external assets (i.e. the stock of flight capital) exceed external liabilities

9 *Ibid*, p. 174.

10 Brittain-Catlin, W. (2005). *Offshore: The Dark Side of the Global Economy*. New York: Farrar, Strauss and Giroux, p. 55-76.

11 See "The Other Side of the Coin: the UK and Corruption in Africa". A report by the UK Africa All Party Parliamentary Group, March 2006, p. 14.

12 Raymond Baker from the Center for International Policy, Washington, quoted from oral evidence given to the UK Africa All Party Parliamentary Group in January 2006.

**TABLE 1. Tax havens of the world**

The Caribbean and Americas	Europe	Africa
Anguilla	Alderney*	Liberia
Antigua and Barbuda*	Andorra	Mauritius
Aruba*	Belgium*	Melilla*
The Bahamas	Campione d'Italia*	The Seychelles*
Barbados	City of London	São Tomé e Príncipe*
Belize	Cyprus	Somalia*
Bermuda	Frankfurt	South Africa*
British Virgin Islands	Gibraltar	
Cayman Islands	Guernsey	<b>Middle East and Asia</b>
Costa Rica	Hungary*	Bahrain
Dominica*	Iceland*	Dubai*
Grenada	Ireland (Dublin)*	Hong Kong
Montserrat*	Ingushetia*	Labuan
Netherland Antilles	Isle of Man	Lebanon
New York	Jersey	Macau*
Panama	Liechtenstein	Singapore
Saint Lucia*	Luxembourg	Tel Aviv*
St. Kitts & Nevis*	Madeira*	Taipei*
Saint Vincent and the Grenadines*	Malta*	
Turks and Caicos Islands	Monaco	<b>Indian and Pacific Oceans</b>
Uruguay*	Netherlands	The Cook Islands
US Virgin Islands*	Sark	The Maldives*
	Switzerland	The Marianas
	Trieste*	Marshall Islands
	Turkish Republic of Northern Cyprus*	Samoa*
		Tonga*
		Vanuatu

Note: This list excludes territories with some tax haven features but which are not commonly used as such. Territories marked with an asterisk (\*) have developed their activities in the last 25 years, representing almost a doubling in the number of tax haven territories during that period.

Source: *Tax us if you can*, Tax Justice Network, 2005.

(i.e. external debt).<sup>13</sup> The problem is that the assets are largely held in private hands, whilst the liabilities belong to the African public.

### Rethinking the nature and geography of corruption

Tax dodging corrupts the revenue systems of the modern state and undermines the ability of the state to provide the services required by its citizens. It therefore represents the highest form of corruption because it directly deprives society of legitimate public resources. Tax dodgers include institutions and individuals who enjoy privileged social positions but see themselves as an elite detached from normal society and reject "any of the obligations that citizenship in a normal polity implies."<sup>14</sup> This group comprises wealthy individuals and high income earners, plus a 'pinstripe infrastructure' of profes-

sional bankers, lawyers, and accountants, with an accompanying offshore infrastructure of tax havens with quasi-independent polities, judiciaries and regulatory authorities. This type of corruption therefore involves collusion between private and public sector actors, who exploit privileged status to undermine national tax regimes.

The failure to tackle these major flaws in the globalized financial system has generated a spirit of lawlessness and corruption which acts as a cancer on our trust in the integrity of the market system and democracy. Tax dodging by rich individuals forces governments to switch the tax burden to the less well-off, increasing inequality and harming development prospects by reducing the revenues available for investment in education and infrastructure. Company directors committed to good governance and ethical policies find themselves competing on an unfair basis against corporate delinquents prepared to push tax planning to the limits. Governments committed to equitable tax practices and fair trade find themselves drawn into a wholly bogus process known as tax competition

13 Boyce, J.K. and Ndikumana, L. (2005). "Africa's Debt: Who Owes Whom?" in Epstein, G.A., *Capital Flight and Capital Controls in Developing Countries*. Cheltenham: Edward Elgar.

14 Reich, R. (1992). *The Work of Nations*. New York.

which undermines their revenue base and increases inequality.

Regrettably, Transparency International, despite its commendable role in putting corruption onto the political agenda, has undermined the efforts of reformers through its publication of the Corruption Perception Index (CPI) which reinforces stereotypical perceptions about the geography of corruption. The CPI identifies Africa as the most corrupt region of the world, accounting for over half of the 'most corrupt' quintile of countries in the 2006 index. African countries account for about one half of the countries identified as most corrupt, with Chad, Côte d'Ivoire, the Democratic Republic of the Congo, Equatorial Guinea, Guinea and Sudan ranking amongst the bottom ten of the 163 countries surveyed. Ghana fares relatively well, ranking at a joint 70th position in 2006, though the ranking score of 3.3 out of a possible 10 still places Ghana at the low end (i.e. more corrupt) of Transparency International's corruption spectrum. But despite the attention given to the CPI in the African and global press, these statistics provide a very partial and biased perspective. A more critical examination of the index reveals that over half of the countries identified by the CPI in 2006 as 'least corrupt' are offshore tax havens, including major centres such as Singapore (ranked 5th overall), Switzerland (7th), the UK and Luxembourg (jointly 11th), Hong Kong (15th), Germany (16th), the USA and Belgium (jointly 20th). For good measure, Barbados, Iceland, Malta, New Zealand and the United Arab Emirates (all tax havens) also fall into the 'least corrupt' quintile. What do these rankings tell us about the current politics of corruption?

This distorted geography of corruption may well arise from Transparency International's definition of corruption as "the misuse of entrusted power for private gain." Operationally, this has led to an obsessive focus on public officials (politicians and state employees) and a lack of attention to other elites, including company directors or financial intermediaries. Now the focus must shift to the enablers on the supply side,<sup>15</sup> including:

- Governments of jurisdictions (not exclusively those categorized as tax havens) which supply the secrecy spaces where corruption can take place.
- Private sector agents, including and especially professional intermediaries such as bankers, lawyers, accountants, company formation agencies and trust companies, whose activities facilitate (or overlook) corrupt financial practices.<sup>16</sup>
- Company directors responsible for illicit transactions that contribute to capital flight, tax evasion and tax avoidance.

15 See, for example, UK Africa All Party Parliamentary Group, *op cit*.

16 US Senate (2006). *Tax Haven Abuses: The Enablers, the Tools and Secrecy*. Permanent Subcommittee on Investigations.

Public understanding of what constitutes corruption needs to be radically shifted to encompass any activity which involves the abuse of the public good or which undermines public confidence in the integrity of the rules, systems and institutions that promote the public good. Insider trading, tax evasion and avoidance, market rigging, non-disclosure of pecuniary involvement, embezzlement, and trade mispricing would all be recognized as corrupt within such an analytical framework.

### An economic blind spot

Many economists overlook the role of the offshore economy in their analysis, which arguably underlies their inability to explain the 'uphill' movement of capital from poor to rich nations despite the predictions of their economic theories.<sup>17</sup> Political risk or the prospect of financial crises might be primary causes of capital flight, but tax-free status creates a strong incentive for wealthy domestic asset holders in developing countries to retain their assets offshore. By doing this on an anonymous basis, they can protect their wealth from potential currency devaluation and from taxes. But not all the capital that flees developing countries stays out. Some returns disguised as foreign direct investment. This is the consequence of the flight money being re-cast offshore during the laundering process prior to reinvestment in the country of origin: a process known as 'round tripping'. The preferential treatment offered to many foreign investors provides an incentive to round trip.

In March 2005 the Tax Justice Network published a briefing paper – *The Price of Offshore*<sup>18</sup> – which estimated the stock of private wealth held 'offshore' by rich individuals, and largely undeclared in the country of residence, at about USD 11.5 trillion. The paper estimates that the annual worldwide income on these undeclared assets is about USD 860 billion, and that the annual worldwide tax revenue lost on such undeclared income is about USD 255 billion. That figure, which has had huge media coverage since its publication, and which we consider to be on the conservative side, significantly exceeds the annual funds needed to finance the UN's Millennium Development Goals.<sup>19</sup> Whilst the majority of this USD 11.5 trillion of undeclared assets originates from developed countries, a significant proportion comes from developing countries. For example, over 50% of the cash and listed securities of rich individuals in Latin America is reckoned to be held offshore.<sup>20</sup> Data for Africa are scarce, but most analysts assume the ratio to be comparable to Latin America or higher.

17 Guha, K. (2006). "Globalisation. A share of the spoils: why policymakers fear 'lumpy' growth may not benefit all", *Financial Times*, 28 August, p. 11.

18 <[www.taxjustice.net/cms/upload/pdf/Price\\_of\\_Offshore.pdf](http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore.pdf)>

19 For more details about the MDGs see Joyce Haarbrink's article on sexual and reproductive health and rights in this Report.

20 Boston Consulting Group (2003). "Global Wealth Report".

But the figure of USD 255 billion in tax revenue lost to tax evasion on assets held offshore is only one part of the equation. Developing countries also lose out to tax evasion in the domestic context (often from activities in the informal economy), from tax avoidance on cross-border trade, and from pressures to compete for investment capital through offering unnecessary tax incentives. In combination these issues are estimated to cost developing countries approximately USD 385 billion annually in tax revenues foregone.<sup>21</sup> This clearly represents a massive haemorrhaging of the domestic financial resources of many developing countries, which undermines sustainability in a number of ways:

- Declining tax revenue income from the wealthy and high income earners forces governments to substitute other taxes (typically indirect) with a consequent regressive impact on wealth and income distribution.
- Falling tax revenues force cutbacks in public investment in education, transport and other infrastructure.
- Tax dodging corrupts the integrity of tax regimes and creates harmful economic distortions which penalize those who follow ethical practice and benefits those who bend the rules.
- Tax dodging undermines public respect for the rule of law and the integrity of democratic government.

Declining tax revenues in developing countries have stimulated a vicious circle of decline in investment in the human capital necessary to create an attractive environment for both domestic and foreign investors. In a 2006 report on Latin America, the World Bank argued that governments must give higher priority to spending on infrastructure likely to benefit the poor and increase expenditure on education and health care. In practice, a large proportion of government spending in Latin America is skewed in favour of the well-off, and governments are collecting far too little tax, especially from the wealthy. The World Bank report concludes that "on the tax front, first items in the agenda would be strengthening anti-tax evasion programs and addressing the high levels of exemptions."<sup>22</sup>

### Civil society: wake up!

In April 2007 the author addressed a parliamentary session in London on the subject of "Why are aid donors frightened of taxation?" Several reasons were offered, including the complexity of the subject and fears about the future of some small island

21 Cobham, A. (2005). "Tax Evasion, Tax Avoidance and Development Finance". Queen Elizabeth House Working Paper Series No. 129, Oxford.

22 Perry, G.E., Lopez, J.H., Maloney, W.F., Arias, O. and Serven, L. (2006). *Poverty Reduction and Growth: Virtuous and Vicious Circles*. The World Bank, p. 101.

economies which are dependent on their tax haven roles. But other factors were also raised: Are some aid agencies compromised by their relations with powerful governments? Do some of them have a vested interest in preserving the aid industry? Are some too closely tied to corporate interests? Whatever the reasons, it is astonishing that it has taken so long for these issues to become the focus of attention for the development community.

Most of the problems outlined above can be remedied by strengthening international cooperation. Effective information exchange between national authorities would go a long way towards overcoming the problems of capital flight and tax evasion. The barriers posed by banking secrecy could be overcome by override clauses built into international treaties. The secrecy of offshore trusts would be reduced by requiring registration of key details relating to the identity of the settlor and beneficiaries. There is no reason why those who benefit from the privileges conferred by using companies and trusts should not accept the obligation of providing basic information about their identity.

Global frameworks could be agreed for taxing multinationals on the basis of where they actually generate their profits. Policies such as these could be implemented in a relatively short timeframe. The principal barrier standing in the way of progress towards achieving these goals is the lack of political will on the parts of the governments of the leading OECD nations, most notably Switzerland, the USA and the UK, all of which are leading tax haven nations. The reality of their commitment to 'globalization' is that they want liberalized trade on their own terms but continue to use fiscal incentives to distort the trade system in favour of their domestic businesses and to attract capital from developing and emerging countries.

The debate around development and persistent poverty is undergoing a major shift. Campaigners are looking beyond aid dependence and debt relief, and all the associated conditionalities, and asking questions about the domestic resources of developing countries. The issues of capital flight and tax evasion, which have gone largely ignored for so long, are moving to the centre stage. At the same time the corruption debate is shifting to focus on the role of enablers and the tax havens through which so much dirty money is shifted en route to the mainstream capital markets. Connections are being made between money laundering, corruption, financial market instability, rising inequality and poverty. And tax havens are being identified as a common denominator to each of these problems.

Addressing this issue in March 2007, anti-corruption campaigner Eva Joly spoke of the need to shift the corruption debate to Phase Two, in which the role of accountants, bankers, lawyers and offshore financial centres in enabling corrupt practices comes under far greater scrutiny.<sup>23</sup> ■

### Tax Justice Network and financing for development

The 2002 Monterrey Conference on Financing for Development identified capital flight and tax evasion as barriers to the achievement of this goal. In 2003 the UN General Assembly agreed the creation of a Committee of Experts on International Cooperation in Tax Matters, dedicated to tackling these problems.

In Autumn 2008 the member states of the United Nations will meet in Doha to review progress towards achieving the Monterrey Consensus on mobilizing domestic resources as a principal means of financing development. We must use the Doha summit as an opportunity to highlight the work of this Committee and to push for a new agenda for this Committee, giving primacy to pro-poor tax policies and enhanced international cooperation on tax matters. For those of us seeking solutions beyond aid dependence and debt relief, redesigning the global financial architecture to tackle capital flight and tax evasion is a major priority. This is a struggle which affects us all. Join us!

#### Further resources

Offshore Watch: <[visar.csustan.edu/aaba/jerseypage.html](http://visar.csustan.edu/aaba/jerseypage.html)>

Tax Research LLP: <[www.taxresearch.org.uk/Blog](http://www.taxresearch.org.uk/Blog)>

Tax Justice Blogspot: <[taxjustice.blogspot.com](http://taxjustice.blogspot.com)>

*Do we love globalisation?*: <[taxjustice.blogspot.com/2007\\_07\\_01\\_archive.html](http://taxjustice.blogspot.com/2007_07_01_archive.html)>

*Tax Justice Focus – the corruption issue*: <[www.taxjustice.net/cms/upload/pdf/TJF\\_2-2\\_print\\_edition\\_2006.pdf](http://www.taxjustice.net/cms/upload/pdf/TJF_2-2_print_edition_2006.pdf)>

*Tax Justice Focus – the tax competition issue*: <[www.taxjustice.net/cms/upload/pdf/TJF\\_2-4\\_print.pdf](http://www.taxjustice.net/cms/upload/pdf/TJF_2-4_print.pdf)>

*Tax Justice Focus – the inequality issue*: <[www.taxjustice.net/cms/upload/pdf/TJF\\_3-1\\_final.pdf](http://www.taxjustice.net/cms/upload/pdf/TJF_3-1_final.pdf)>

<sup>23</sup> *Africa Confidential* (2007). "Tax Havens: Financial secrecy – profits from the laundry". Vol. 48, No. 6, 16 March.