The good, the bad and the Ugland

Havens serve clean as well as dirty money

February 16, 2013

DETRACTORS DESCRIBE THE offshore phenomenon as one of the more noxious features of financial globalisation that is now, mercifully, in retreat. The half-dozen senior lawyers gathered in the wood-panelled boardroom of Ugland House, the head office of Maples and Calder in George Town, the Cayman Islands' capital, have heard it all before, and they beg to disagree. Offshore centres oil the financial interface between larger economies, insists Alasdair Robertson of Maples. Grant Stein of Walkers, another Cayman firm, thinks of it as "the plumbing that connects the global financial system". His peers nod vigorously. At times they seem touchy, but then Ugland House, the registered address of more than 18,000 companies, is held up by critics as a symbol of all that is wrong with OFCs.

The lawyers are members of the IFC Forum, a group of "magic circle" law firms from British dependencies that have joined forces to counter those jurisdictions' bad press. IFC stands for international financial centres. "Offshore" is considered pejorative, "tax havens" unmentionable.

They enjoy support from some fierce ideological warriors, including libertarians at the Cato Institute in Washington, DC. Their opponents can be equally strident. For the moment the critics have the wind in their sails. They include a number of increasingly well-organised NGOs and even the odd government, most notably Norway's. Who is right is hard to say, because much of the offshore industry lies in the statistical shadows, with little academic work to illuminate it.

The lawyers argue that many offshore transactions are about tax neutrality, not cheating. For example, if a joint venture with partners from Germany, Turkey and Argentina were registered in one of those countries, the government concerned might seek to tax the flows through the vehicle as well as the investors' gains. By going offshore they can pool their resources in a jurisdiction that is willing to act as a mere receptacle and refrain from taking a cut other than registration fees. Taxes are still payable by the investors in their home countries. "It's not about evasion but about avoiding an extra, gratuitous layer of tax," says John Collis of Conyers Dill & Pearman, a Bermuda law firm.

Such structures offer legal neutrality too. In a joint venture in, say, the BVI, no shareholder has a home advantage; all get a sophisticated, predictable common-law system with a small but well-regarded local commercial court and Britain's Privy Council as the ultimate arbiter.

Asians are particularly fond of using BVI companies for initial public offerings and international investments. Indeed, on paper the BVI ranks as the second-largest investor in China (see chart 2). Mr Sharman of Australia's Griffith University believes there is a lot more to it than hiding criminal money or tax-dodging, though these play a part. Indeed, the flows have continued to grow even as tax incentives have been largely withdrawn and as the BVI has become somewhat less friendly to dirty money. The investors now seem to be using it for institutional arbitrage, he says, attracted by the ease of raising funds, cheaper access to capital markets, speed of set-up and access to reliable courts.

Even when the use of an offshore centre means a loss of tax revenue, it may still provide other benefits for the country concerned. Several African countries have signed tax treaties with Mauritius, hoping that this will help them attract investment from Asia routed through the Indian Ocean haven. They would miss out on some tax revenue but may gain from the extra investment. "This whole area is riddled with trade-offs," says James Hines of the University of Michigan.

One thing about tax havens that governments onshore might quietly welcome, he adds, is that they allow those governments unofficially to tier domestic tax rates. They can let multinationals and other big, mobile investors use havens and thus pay a lower effective rate but require smaller, more domestically oriented companies to pay the full rate. By differentiating tax burdens in this way, countries can maintain sizeable domestic tax bases in the face of growing international competition. A 2006 study identified another way in which tax havens may reduce the costs of entering high-tax countries: the use of offshore affiliates to facilitate debt financing, which had been fuelling investment in Japan. A later study concluded tentatively that firms which had cut their costs by establishing offshore operations sometimes expanded their activities in poor countries nearby.

Individuals' use of offshore centres, too, is often misunderstood, say their defenders. Many people believe that only those with something to hide would want a bank account in Jersey. In fact, it offers several legitimate advantages for British nationals working abroad who are not subject to tax at home until funds are repatriated. These include multi-currency services (not available on domestic accounts) and global portability. And for foreign "non-doms" residing in Britain, whose non-British income is not subject to British tax if held offshore, it can make sense to park it in a nearby jurisdiction with broadly similar banking and legal systems.

Some offshore champions consider tax competition a good thing because it discourages countries from trying to tax their way out of trouble. This view occasionally meets with sympathy onshore: the OECD dropped its war on "harmful" tax competition after George W. Bush's administration objected. It has since focused on promoting tax transparency.

Andrew Morriss, an expert in offshore law at the University of Alabama, thinks that OFCs impose an important discipline on onshore jurisdictions through innovative regulation to lower transaction costs. Such places, the argument goes, can tailor their rules more closely to the needs of particular sectors or subsectors than large countries can.

An example is "captive" insurance, corporate self-insurance of risks that would be difficult to insure in the usual way. The business was first developed in Bermuda, later spreading to other OFCs, including the Cayman Islands, which specialises in medical risks. Today three-quarters of America's leading 500 firms have active captives in Bermuda alone. The business blossomed offshore rather than onshore because America's state-by-state regulatory regime could not accommodate it—though a number of states, including Vermont, subsequently rewrote their rules to attract captives.

Even offshore's fiercest critics acknowledge that captives have some virtues. However, they argue that much commercial investment through havens has no good economic rationale. A much-cited example is "round-tripping", in which domestic investment is routed offshore to qualify for tax breaks reserved for foreign investors. Some suspect this accounts for a sizeable portion of "foreign" investment in India and China.

A bigger gripe concerns tax and regulatory competition. Mr Shaxson argues that competition between jurisdictions is not like competition between companies. If a firm cannot hold its own, the result is creative destruction; yet a country that cannot compete could become a failed state. In fact, some of the indicators used to measure a country's competitiveness, such as education or infrastructure, suggest that higher taxes might have a beneficial effect. Mr Hines accepts that tax competition is "unresolved, even as a theoretical matter". Mr Morriss acknowledges that regulatory competition sometimes backfires. Antigua, for instance, dropped its standards to the point where it became too easy for Allen Stanford to perpetrate a $7 billion fraud through a Ponzi scheme in the Caribbean and America.

Opacity is another problem. On a systemic level it makes the monitoring of financial stability more difficult. Murky vehicles held offshore, and off-balance-sheet, played a part in the financial crisis by concealing risks that banks had built up, though not even the fiercest critics of tax havens claim they were the main cause of the crisis.

Something in reserve

The fog also creates problems for statisticians, and by extension for economic policymakers. Gabriel Zucman of the Paris School of Economics examined anomalies in portfolio-investment data, concluding that official statistics significantly underestimate the net foreign assets of advanced economies because they fail to capture funds stashed away in tax havens. He estimates that 8% of all private financial wealth is held offshore, with three-quarters of it unrecorded. If he is right, the euro zone, officially a big net debtor, becomes a net creditor.

Dodgy funds from poor countries, too, are attracted by the secrecy offered by some jurisdictions. Even the most conservative estimates suggest that the outflow of funds linked to money-laundering, corruption, tax evasion and avoidance and deliberately mispriced commercial transactions exceeds total inflows of aid. Mr Henry calculates that the elites of 139 low-middle-income countries have parked up to $9.3 trillion of unrecorded wealth offshore. As with the euro zone, that turns some of them from big debtors into creditors. "Developing countries as a whole don't face a debt problem, but a huge offshore tax-evasion and money-laundering problem," he says.

Offshore moneymen insist that tighter controls have caused inflows of illicit funds to slow down dramatically. The Cayman Islands, for instance, largely complies with global anti-money-laundering standards. Yet questions linger over its implementation of its own rules. A recent American investigation revealed that in 2008, two years after the most recent peer review of its rules, HSBC accounts in Cayman were subject to "massive misuse…by organised crime" from Mexico and elsewhere, as one compliance officer put it. The bank had no information at all about the beneficial owners of 15% of the accounts, suggesting either incompetence or wilful blindness on the part of regulators.

Alex Cobham, an economist with Christian Aid who has studied financial flows to and from tax havens, thinks they attract as much money from poor countries as from rich ones, if not more. This not only deprives the countries concerned of much-needed tax revenue but gives the elites less incentive to build institutions at home.

This, though, is a problem onshore too. Ill-gotten gains often receive a warm welcome in large OECD countries, some of which offer more corporate secrecy than the leading tax havens. This is important for financial crime-fighting because anonymous shell companies and trusts are favourite ways of moving tainted money into the banking system.