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Five not-so-convincing ways that tax havens justify their existence

By Naomi Rovnick March 27, 2013

Developing countries lose more money (pdf) every year to both legal tax avoidance and illegal evasion routed through havens than they receive in development assistance, according to Christian Aid. And the US loses an estimated $150 billion a year to havens, including from corporations shifting their profits legally to low-tax countries. This could easily offset the $85 billion of budget cuts the US government has approved for 2013, which will hit special needs education and the military, among other things.

Still, white collar professionals working in havens at law firms, banks or company incorporation agencies have a few arguments to defend what they do. Most are partial truths, but they are worth reviewing sensibly. Here are the main ideas the offshore financial industry promotes to justify itself:

1. “We have well-managed, modern legal systems”.

As a financial journalist based in the Caribbean tells Quartz—anonymously due to havens’ tendency to persecute dissenters—lawyers in the British Virgin Islands and the Cayman Islands claim business people from developing companies set up companies in these offshore centers because their legal systems are based on British law.

“They say it is a robust, well respected legal jurisdiction,” he confides.

The idea is that commercial disputes involving such companies will not be subject to the vagaries of China’s or Russia’s unstable courts.

I have heard the same argument. When visiting the British Virgin Islands on a reporting trip in 2011, a senior partner of the local branch of an international law firm told me, “people come here to set up companies because of our superior legal system.”

Then again, the BVI is not exactly a world-class legal center. It has just three resident judges. And any foreign national who wishes to set up a company whose contracts are protected by British law can do so in the United Kingdom.

2. “Offshore financial centers encourage tax competition between countries and prevent high-tax nations charging even more.”

The role of tax havens, according to their fans, is to prevent governments in non-haven countries from taxing the life out of rich individuals and corporations, by reminding them wealth has other places to go. The Adam Smith Institute, an influential right-wing think tank, promotes this idea. And Singapore has drawn money out of heavily-taxed Manhattan (paywall) to this end.

Yet it cannot be proven tax havens affect government’s decisions on revenue collection. French politicians last year failed in a bid to tax the rich at a 75% rate because of France’s own constitution. Greece has raised taxes, meanwhile, because Athens needs the cash.

And tax competition between nations is an unfair game. Governments in large nations need tax to provide public services such as health and education. Tax havens tend to be small and affluent (pdf p.1) to start with. They have less need to dip into their peoples’ pay packets so will always do better in the competition than larger nations with bigger commitments.

Meanwhile, the competition havens put up against bigger countries creates a follow-on injustice for small businesses. As their revenues come from multiple geographies, multinationals are legally free to set up a company in the lowest-tax country they can justify, and shift taxation of their profits there. This, the OECD said in a report (p. 8) published earlier this year, gives global corporations “unintended competitive advantages,” over companies that operate in one country and cannot afford to set up convoluted international tax structures or justify doing so legally.

3. “Transacting here gives foreign companies a neutral place to do business.”

The Economist explains this argument here. Tax advisers working in havens often say that when companies from multiple countries get together to strike joint ventures, they risk each businesses’ home government claiming rights to tax the joint entity’s income. Setting up a JV in an offshore center makes the company what the havens' promoters call "tax neutral." This is a good argument but it does not detract from the reality that, as the Economist writes, "much commercial investment through havens has no good economic rationale."

4. "We protect individuals and businesses from having their assets stolen by governments."

The phrase tax haven is something of a misnomer. Generally, places that offer low taxes also offer a good deal of financial secrecy. For example, the Cayman Islands (pdf p.8) does not require ownership of companies to appear on any public record. The CATO Institute, an American libertarian think tank, argues that secrecy jurisdictions protect businesspeople in unstable regimes from having their assets seized by governments. That is probably true in the case of seizure of money. The Russian government could freeze a bank account within its own borders, but not in Singapore, where banks are legally bound not to reveal client's identities. But headquartering a business in a tax haven does not guarantee immunity from government interference. In 2009, when Cayman Islands-headquartered Chinese dairy giant Taizinai fell on hard times, a Chinese municipal government seized its factories.

5. "Financial secrecy helped protect the Jews."

An argument I have personally heard from the chief operating officer of a Swiss private bank and the Singapore head of a US law firm is that Switzerland introduced banking secrecy to protect European Jews from having their money seized by the Nazis during WWII. The claim also appears in print here in a New York Times op-ed. Financial author Nicholas Shaxson writes in his book Treasure Islands (extracted here) that the idea that Swiss bank secrecy was invented to protect the Jews first surfaced in a 1996 bulletin by a forerunner to Credit Suisse. An independent historical commission ruled in 1998 that Swiss banks were major repositories of Nazi gold, including some which central bank officials knew was stolen from Holocaust victims.