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Places in the sun

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Offshore financial centres are booming, thanks to their easy-going tax regimes. But the best of them are more than tax havens: they are good for the global financial system, argues Joanne Ramos

IF THE deal over North Korea's nuclear-weapons programme holds, Kim Jong II may be able to indulge his penchant for fine wines and Hollywood blockbusters again. Banks around the world had severed ties with North Korea after America last September blacklisted a Macau bank accused of doing business with the hermit kingdom, making foreign money tighter for the Great Leader. But a move towards more normal relations with America could help restore the flow.

The financial system is modern warfare's newest front. In a globalised economy money moves instantly and anonymously across borders. This can benefit terrorists, drug traffickers and rogue nations in need of cash. Keeping such customers out of the world's sprawling financial system is becoming ever harder.

Financial regulators have another big concern. Footloose capital transmits not just tainted money but financial crises too. The huge growth in the use of esoteric derivatives and the rise of hedge funds have made it increasingly difficult to understand where financial risk lies, partly because much of it is hidden away on islands with variable supervision.

But the most vexing problem that highly mobile financial flows pose for governments is that when they cross borders they may take tax revenues with them. This is particularly serious for rich Western countries with ageing populations that they will have to support in retirement. Such countries have launched a raft of initiatives to strengthen the international financial system against the undesirable side-effects of financial globalisation: financial crime, financial contagion and tax evasion. The idea is to prod financial centres worldwide to adopt international best practice on bank supervision, the collection of financial information and the enforcement of money-laundering rules.

One group has become the object of special scrutiny: offshore financial centres (OFCs). These are typically small jurisdictions, such as Macau, Bermuda, Liechtenstein or Guernsey, that make their living mainly by attracting overseas financial capital. What they offer foreign businesses and well-heeled individuals is low or no taxes, political stability, business-friendly regulation and laws, and above all discretion. Big, rich countries see OFCs as the weak link in the global financial chain.

In the past OFCs have indeed permitted various dodgy doings. Critics think their dependence on foreign capital encourages them to turn a blind eye to crime and corporate fraud within their borders. Sani Abacha of Nigeria, Mohammed Suharto of Indonesia and Ferdinand Marcos of the Philippines are just a few of the

corrupt leaders who have looted their countries, helped by the secrecy offered not just by certain tax havens but also by some onshore financial centres, a point often ignored by the OFCs' critics. Some of the money used for the terrorist attacks of September 11th 2001 was funnelled through Dubai, which has recently set itself up as a financial centre. The accounting scams at Enron, Parmalat and Tyco were made easier by complicated financial structures based in OFCs (though, again, also in onshore centres such as Delaware).

Tax wars

But the most obvious use of OFCs is to avoid taxes. Many successful offshore jurisdictions keep on the right side of the law, and many of the world's richest people and its biggest and most reputable companies use them quite legally to minimise their tax liability. But the onshore world takes a hostile view of them. Offshore tax havens have "declared economic war on honest US taxpayers", says Carl Levin, an American senator. He points to a study suggesting that America loses up to \$70 billion a year to tax havens.

The Tax Justice Network, a not-for-profit group that is harshly critical of OFCs, reckons that global tax revenues lost to OFCs exceed \$255 billion a year, although not everybody believes it. Canadians were alarmed by a government report showing that Canadian direct investment in OFCs increased eightfold between 1990 and 2003, to C\$88 billion (\$75 billion)—a fifth of all Canadian direct investment abroad. The bulk of this was in financial services, mostly in a few Caribbean countries.

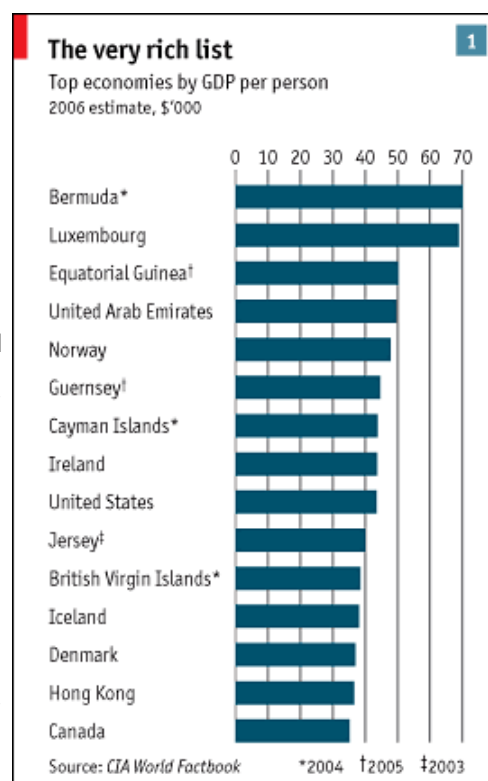
Business in OFCs is booming, and as a group these jurisdictions no longer sit at the fringes of the global economy. Offshore holdings now run to \$5 trillion-7 trillion, five times as much as two decades ago, and make up perhaps 6-8% of worldwide wealth under management, according to Jeffrey Owens, head of fiscal affairs at the OECD. Cayman, a trio of islands in the Caribbean, is the world's fifth-largest banking centre, with \$1.4 trillion in assets. The British Virgin Islands (BVI) are home to almost 700,000 offshore companies.

All this has been very good for the OFCs' economies. Between 1982 and 2003 they grew at an annual average rate per person of 2.8%, over twice as fast as the world as a whole (1.2%), according to a study by James Hines of the University of Michigan. Individual OFCs have done even better. Bermuda is the richest country in the world, with a GDP per person estimated at almost \$70,000, compared with \$43,500 for America (see chart 1). On average, the citizens of Cayman, Jersey, Guernsey and the BVI are richer than those in most of Europe, Canada and Japan. This has encouraged other countries with small domestic markets to set up financial centres of their own to pull in offshore money—most spectacularly Dubai but also Kuwait, Saudi Arabia, Shanghai and even Sudan's Khartoum, not so far from war-ravaged Darfur.

Globalisation has vastly increased the opportunities for such business. As companies become ever more multinational, they find it easier to shift their activities and profits across borders and into OFCs. As the well-to-do lead increasingly peripatetic lives, with jobs far from home, mansions scattered across continents and investments around the world, they can keep and manage their wealth anywhere. Financial liberalisation—the elimination of capital controls and the like—has made all of this easier. So has the internet, which allows money to be shifted around the world quickly, cheaply and anonymously.

The growth in global financial services has helped too. Financial services are in essence the business of managing data. "It is zeros and ones," says Urs Rohner, the chief operating officer of Credit Suisse, a Swiss bank, adding that "in no other industry do you see the impact of globalisation as enormously and dramatically as in finance." This is because these zeros and ones can be traded, structured, lent and sold anywhere. Profits can be booked almost anywhere, too, and are increasingly being shifted to OFCs.

The growing importance of the financial-services industry in many economies means that a greater chunk of profits—and tax liabilities—are easily moved offshore. A paper published last year by Alan Auerbach of the University of California at Berkeley found that whereas in 1983 financial corporations accounted for only about 5% of all corporate-tax revenues in America, between 1991 and 2003 they made up roughly a quarter.



The taxman also has to worry about non-financial companies that are acting like financial ones. The main profit engine for General Electric, a large American conglomerate that makes everything from jet engines to plastics, is its finance division. Non-financial companies run pension funds and stock-option plans for their employees across the world, manage their corporate treasuries in myriad currencies and increasingly employ esoteric financial products such as derivatives to hedge risks and raise money. All of these activities can be set up in OFCs and often are, supported by an army of lawyers, accountants and investment bankers.

Parasites or pioneers?

OFCs are often portrayed as financial parasites that survive by diverting tax and other revenues from “real” economies, offering a haven for tax cheats and money-launderers. Some of this undoubtedly goes on—but it goes on in big onshore economies as well.

Businessmen and wealthy individuals insist that OFCs can play a legitimate role in reducing tax liabilities. The business community in particular argues that in a fiercely competitive global economy where national tax regimes can vary widely, minimising tax payments is a competitive necessity and OFCs are one solution. OFCs themselves insist that they are specialist financial centres and have far more to offer than just low taxes.



The main argument against OFCs is that by allowing companies and affluent individuals to avoid taxes, they sap tax revenues from “real” countries, limiting those countries' ability to pay for public services and forcing them to tax less mobile factors such as labour, housing and consumption. The big risk is that “globalisation is perceived to be rigged against the average citizen,” says David Rosenbloom, formerly the international tax counsel at the Treasury Department in America.

Critics also worry that OFCs do not supervise business within their borders tightly enough, which gives crooks an opportunity to enter the global financial system and could allow sloppy practices that might spark wider financial crises. Certainly, as many OFCs themselves will admit, only a couple of decades ago regulation in many offshore jurisdictions left much to be desired and bad money found its way in with the good. OFCs argue that this has changed and their supervision is now at least as good as onshore, sometimes better.

Libertarians say that tax, regulatory and other competition is healthy because it keeps bigger countries' governments from getting bloated. Others argue that OFCs may be an inevitable concomitant of globalisation. “Even if today's OFCs were somehow stamped out, something like them would pop up to take their place,” says Mihir Desai of Harvard Business School. Some academics have found signs that OFCs have unplanned positive effects, spurring growth and competitiveness in nearby onshore economies.

Should anything be done about OFCs? Countries try to discourage investment in tax havens through the tax

code and pour resources into tracking down tax cheats. But this is a Sisyphean task—close one regulatory loophole and lawyers will open another; convince one OFC to co-operate in the fight against tax evasion or financial crime and another will take its place.

International organisations have launched various initiatives to try to get OFCs to tighten supervision, co-operate more with foreign governments to catch tax cheats and, at least in Europe, eliminate “harmful” tax practices. OFCs think such initiatives are designed to force them out of business. The countries that set these standards “are an oligopoly trying to keep out smaller competitors. They are both players and referees in the game. How can they be objective?”, asks Richard Hay, a lawyer in Britain who represents OFCs.

What is clear is that globalisation has changed the rules of the game. It has produced many benefits for rich countries, but has also provided more opportunities for tax leakage, which explains their anxiety over OFCs.

OFCs, for their part, have by and large done well out of globalisation. Two decades ago, they were mainly passive repositories of the cash of large companies, rich individuals and rogues. Some jurisdictions still ply this trade today and should be put out of business. But the best of them—for example, Jersey and Bermuda—have become sophisticated, well-run financial centres in their own right, with expertise in certain niches such as insurance or structured finance.

This special report will argue that although international initiatives aimed at reducing financial crime are welcome, the broader concern over OFCs is overblown. Well-run jurisdictions of all sorts, whether nominally on- or offshore, are good for the global financial system.

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