Tax Havens, Evasion and Banking Secrecy: A Review of the State of Financial Privacy vs. Financial Transparency

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This paper explores recent developments regarding financial privacy with a special focus on taxation. After introducing the concept of privacy and linking it to financial information, we will move on to the principles of taxation, compliance and evasion. The next part identifies the major interest groups focusing on the role of the Organisation for Economic Cooperation and Development. In the next part, the case of Switzerland will be presented. One aim is to show that with the current financial crisis, governments are in the unique position to push forward their calls for information disclosure as well as the loosening of banking secrecy and that it is very unlikely to find strong supporters of financial privacy. I will also argue that in the discussions about tax evasion a lot of "black and white painting" is conducted especially by high-tax jurisdictions, but that there is a strong notion of hypocrisy.

Introduction

> "In this world nothing can be said to be certain, except death and taxes." - (Benjamin Franklin, 1789)

With regard to the current financial crisis and excess government spending, this quote might hold true for the future more than ever in the sense that today's spending will represent tomorrow's tax (BBC One, Panorama; The Economist, Apr. 4, 2009). As far as taxes are concerned, states are in the most need of international cooperation but are also least able to achieve it. Since the 1990s with the rapid development of IC Ts and changes in the global economy, corporations and individuals have been able to undermine governments' ability to tax (Sharman, 2006). With the collapse of the financial system, the calls for regulation and transparency have become very strong. The current situation does not only offer a unique opportunity to regulate the financial system in a new way but also to exercise more control over tax, i.e. cracking down on "tax havens" and ensuring that corporations and individuals meet their tax liabilities. Putting pressure on tax havens ranks high on the agenda of mostly European governments and the US, e.g. Obama supporting the "Stop Tax Haven Abuse Bill" (Stewart, The Observer, Feb. 22, 2009). Prior to the G20 summit, Gordon Brown already appealed for tough regulation for tax havens and banking that will cover every country. He wants "the whole world to take action" and "changes (…) to apply to all jurisdictions around the world" (Watt, The Guardian, Feb. 19, 2009).

As the estimates of the amount of money held offshore ranges from $1.7 to $11.5 trillion, there is a strong incentive for governments to find ways to "secure" this tax foregone (Owens & Saint-Amans, 2009; The Economist, Apr. 4, 2009).

All this has led to increased pressures for information disclosure on countries like Liechtenstein or Switzerland. In the case of UBS, the handing over of the names of about 300 customers to the US government has been approved in February this year. It was the first time that Swiss regulators have allowed a bank to bypass the banking secrecy laws that had been introduced in 1934 (Gallu & Logutenkova, Bloomberg, Mar. 13, 2009; The Economist, Feb. 21, p. 8).

Privacy and financial information

First, let us now take a broader view on the phenomenon of privacy and find out how it is related to taxation. It has been argued that surveillance has to be considered a central feature of the modern society and that it is somehow the flipside of the coin of democracy. An essential element in this respect is the creation and collation of files or dossiers on individuals – also with regard to the collection of taxes. The following quote shows how the disclosure of personal - also financial - information simultaneously is a means of social control as well as a guarantee for the rights of social participation in a society:

> "To exercise the right to vote, one's name must appear on the electoral roll; to claim welfare benefits, personal details must be documented."

As it is such a crucial element for participation, why is there a need to worry? The issue arises with administrative surveillance that has once been limited by the borders of nation-states, spilling over old territorial boundaries, most obviously in the form of international intelligence networks. This becomes a highly political question of power and of how individuals experience the surveillance since capacities with regard to the size of files, the degree of centralization, the speed of information flow and the number of contacts between administrative systems and subject populations have grown systematically (Lyon, 1994).

Taking a look at the socio-cultural level of privacy, it is frequently determined by the individual's power and social status. Westin (2003) argues in the first place that the rich can withdraw from society when they wish to, whereas the lower classes cannot – this is also one of the main arguments used to preach against tax avoiders. The reasoning is that the rich are not in need to receive subsidizing support from the government by revealing sensitive information to authorities. But Westin also concludes that with increased "virtually universal" record-keeping and credentials review, even the wealthy and powerful become enmeshed in all-pervasive data-collection processes.

Another aspect of privacy is that it has to be considered as an elastic concept. One view is that it "protects behavior which is either morally neutral or valued by society" (Warren & Laslett, 1977 in: Margulis, 2003). Others take a more neutral stance, as they believe that privacy can also support illegitimate activities – here it is often claimed that banking secrecy represents an obstacle to law enforcement and the prevention of money laundering (Rahn & De Rugy, 2003).

Government plays a role as a threat to and a defender of privacy. It conducts extensive collection of personal information and with regard to information privacy laws is also legitimating the use of personal information by the government for a purpose other than that for which it was collected. This is in most of the cases justified in the name of efficiency as well as for reducing waste and fraud (Margulis, 2003). Rahn & De Rugy (2003) take a more critical stance as governments are "infamous for abusing information" and argue for selective and limited sharing of financial information. According to them, financial privacy concerns the ability to keep confidential one's income, expenditures, investments and wealth. Without financial privacy, many other fundamental freedoms, such as the right to property and freedom of speech are endangered.

Before having a closer look at the role of financial privacy today on the macro-level of different interest groups including the OECD, individual governments of high-tax jurisdictions and those jurisdictions that are accused of having "harmful tax practices", let us make a detour to the principle of taxation and compliance, tax avoidance, planning and evasion, as well as the motivations for evasion, and the morality issues linked to it.

Taxes, compliance and evasion

An important question to ask at this point is: Why do we pay taxes? Governments have the power to set and to enforce some of the "rules of the game" by which economic relationships are supposed to abide. With regard to tax evasion, they are rule makers and victims at the same time. The basic assumptions are that there are private and collective goods and that the individual as part of the community has an obligation to reciprocity i.e. to contribute to the finance of collective goods. Governments need money to finance public expenditure and transfers. The law attempts to specify the portion of the individual's resources to which the state is entitled. The alternative to taxation would be borrowing and selling the goods and services it provides (Cowell, 1990).

Tax compliance is defined by James & Alley (1999, in: Braithwaite, 2003) as

> "the willingness of individuals and other taxable entities to act (…) within the spirit as well as the letter of tax law and administration, without the application of enforcement activity."

The management of tax systems is very complex; often tax law cannot catch up, so that new legislation also comes with loopholes. People, who resist vocally and challenge the tax authority decisions with being openly critical of the institution, are not necessarily less tax-compliant than others, but they can provide valuable feedback for tax administrations.

It is also worth to keep in mind that the regulated are not powerless – they can cooperate or withdraw. Bogardus (in: Braithwaite, 2003) identifies a "social distance" that can emerge as well as five motivational postures towards tax compliance: commitment, capitulation, resistance, disengagement and game playing. All this already hints at the fact that the scope of the problem of tax evasion is not limited to one dimension. Cowell (1990) identifies three dimensions:

1. legalistic (inside/outside law),
2. moralistic (good/bad) and
3. agnostic (evasion and avoidance merely as two arbitrary segments of a continuum "stretching from innocent tax planning to outrageous fraud").

These perspectives are difficult to apply on a consistent basis. There is a very thin line between tax planning, avoidance and evasion. In fact, laws differ from each country so that, e.g. in Liechtenstein tax evasion is punished with the payment of a higher tax, without resulting in a criminal conviction which would be only the case when tax fraud, e.g. if falsifying documents had been committed (BBC One, Panorama). This explains also why one of the major attractions of putting money in tax havens is privacy, because tax evasion cannot be a crime where there are no direct taxes to evade. In that case authorities in such jurisdictions are (technically) not under any legal obligation to cooperate with investigations by foreign tax authorities (Sharman, 2006).

The phenomenon of private knowledge of individuals and the lack of omniscience pose major challenges to the authorities – one way of preventing tax evasion is to make it difficult for people to avoid telling the truth, e.g. deducting income tax on a pay-as-you-earn basis (Cowell, 1990).

Why do people evade taxes? Economics of crime seem insufficient for explaining the motivations for breaking the law. Some important factors are the individual's perception of the fairness of the tax rate, social consent, attitude towards risk, and the structure of production and market transactions as well as the structure of their social relationships (Cowell, 1990; Braithwaite, 2003).

Ho & Wong (2008) have been drawing from the field of ethics. The factors playing a role for unethical behaviour were defined as the expected gain from behaving unethically or the expected loss when getting caught, the individual's perception of the likelihood of getting caught, the individual's attitude to risk and the individual's ethical reasoning levels. Evasion can also be seen as a simple form of gambling. Here, the rich ones tend to stake more and evasion rises with the tax rate. Studies have also shown that a greater level of education is linked to a higher level of non-compliance (Cowell, 1990; Ho &Wong, 2008).

The consequences of large scale tax evasion and avoidance are the "wrecking" of governments' macro-economic plans as well as the undermining of their capacity by eroding the tax base and shifting the tax burden to less mobile factors as to small businesses or low income individuals. In this respect, it is also important to note tax base externalities, i.e. the tax rate set by one jurisdiction affects the tax revenues of the other jurisdiction. This is an important factor when we come to the OECD and its stance towards tax competition which can frustrate the attempt of elected governments to achieve desired levels of tax and public spending (Johnson & Holub, 2003; Sharman, 2006). The equity criterion as to how the burden should be distributed is often used with the appeal to fairness to argue against mobile, better educated and higher salaried workers who are claimed to be best placed to escape from increased taxes, but also to argue against "irresponsible" behaviour of corporations, both "operating beyond the normal rules of society" (Murphy, 2008; OECD Working Paper, 2000).

After having set the scene, let us now take a look at the global regulation of taxation with the major groups of interest.

Who is who?

Taking a look at the global regulation of taxes, we can state that the OECD represents the major actor. There is no International Tax Organization (yet), but there has been a proposal by the UN for an organization that "could take a leading role in restraining the tax competition designed to attract multinationals" and would be operating a global system of taxing emigrants (Rahn & de Rugy, 2003). What constitutes a tax haven or offshore financial center (OFC)? First, we have to note the extreme flexibility of the term. By some measures the City of London can be classified as one of the largest OFCs, others would state America as the world's biggest tax haven (Mitchell, 2001; Sharman, 2006). It is worthwhile to keep in mind that there tends to be a misconception about tax havens – they are neither restricted to small island states, as advanced countries also offer economic incentives to attract non-residents, nor are they a homogenous group as the services they provide vary considerably. The Financial Stability Forum (FSF), a group consisting of major national financial authorities such as finance ministries, central bankers, and international financial bodies, released the classification of 42 jurisdictions as OFCs in Group I to III in May 2000.

An OFC is defined by the FSF through the fulfilment of one or more of the following criteria (Johnson & Holub, 2003):

Zero or low taxation, including the absence of withholding taxes

- Little regulatory or financial supervision
- The availability of flexible corporate structures
- No requirement for a physical presence
- Secrecy
- Little or no sharing of information or cooperation with other jurisdictions

As the OECD also releases lists of tax havens that are referred to in most newspaper articles and discussions, the next part is dedicated to present the organization's work.

The OECD and its standards

Offshore tax evasion is not seen as a new problem, but according to the OECD has become more complex and serious with the scope for illicit use of the international financial system in a globalised world. In 1996, the OECD governments recognized the need for a coordinated approach and initiated a project on "harmful tax practices". The criteria for those were (OECD Working Papers, 2000):

1. Lack of effective exchange of information
2. Lack of transparency
3. Ring-fencing or attraction of investment without substantial activities

The initiative itself is carried out through the Forum on Harmful Tax Practices, a subsidiary body of the Committee on Fiscal Affairs (CFA). The first major output was the report "Harmful tax competition: An emerging global issue" from 1998 that "initiated a period of intense dialogue" aiming at eliminating harmful tax practices (Owens & Saint-Amans, 2009).

As the success or failure of a tax haven is more dependent on its reputation than on any other factor and they are very much concerned about projecting an image of secure, stable and well-run investment destinations, the next step would be to target the tax havens' reputation as coercion (Sharman, 2006).

Therefore, in 1999 a more confrontational style was adopted, so that instead of white listing and capacity building the new tactics were "naming and shaming". It ultimately resulted in a report issued in 2000 that identified a number of jurisdictions which the OECD categorized as tax havens. Between 2000 and 2002, the OECD worked with those jurisdictions to secure their commitment to implement its standards of transparency and exchange of information - in total, 35 jurisdictions made formal commitments, three still remained under the classification of uncooperative tax havens, namely Andorra, Monaco and Liechtenstein (Owens & Saint-Amans, 2009).

Another active organisation is the Global Forum on Transparency and Exchange of Information consisting of OECD and non-OECD countries that have made commitments to the OECD standards. It has worked on developing the international standards for transparency and effective exchange of information in tax matters. The major achievement of this collaboration was the development of the 2002 Model Agreement on Exchange of Information on Tax Matters that has been used as the basis for the negotiation of more than 70 Tax Information Exchange Agreements (TIEAs).

The standards require:

- Exchange of information on request where it is "foreseeably relevant" to the administration and enforcement of the domestic laws of the treaty partner.
- No restrictions on exchange caused by bank secrecy or domestic tax interest requirements.
- Availability of reliable information and powers to obtain it.
- Respect for the taxpayer's rights.
- Strict confidentiality of information exchanged.

Since 2000, 49 TIEAs have been signed, out of them 27 in 2008, with 20 signatures since November 2008. By now, the Global Forum standard is claimed to have become the internationally agreed standard for the exchange of information and transparency in tax matters. It has also been incorporated by the UN Committee in its own model tax convention in October 2008. Another area that is of special interest for the work of the OECD Committee on Fiscal Affairs is the investigation of the extent and improvement of access to bank information for tax purposes. Here the "Improving access to bank information for tax purposes" report was published in 2000 setting out an ideal standard of access to bank information; it states that:

> "All member countries should permit access to bank information, directly or indirectly, for all tax purposes so that tax authorities can fully discharge their revenue raising responsibilities and engage in effective exchange of information with their treaty partners."

Under this agenda, the 2003 Progress Report also set out a common definition of tax fraud which was endorsed by all OECD member countries except for Luxembourg and Switzerland (Owens & Saint-Amans, 2009). With this links were drawn between banking secrecy, money laundering and tax evasion (Sharman, 2006).

High tax jurisdictions

The most active participants of the "high-tax jurisdictions" are the US and the EU. The US has its Financial Action Task Force (FATF), an inter-governmental body primarily concerned with developing and promoting international policies to fight against money laundering and terrorist financing (www.fatf-gafi.org). The EU has a slightly different focus. It is concerned about tax competition, the integrity of its single market, as well as the corrosive effect of tax competition on the welfare state (Sharman, 2006).

The following G20 statement from a meeting of finance ministers and central bank governors in November 2004 sheds light on the position adopted on Transparency and Exchange of Information for Tax Purposes:

> "We regard this as vital to enhance fairness and equity in our societies and to promote economic development.
>
> Financial systems must respect commercial confidentiality, but confidentiality should not be allowed to foster illicit activity. Lack of access to information in the tax field has significant adverse effects. It allows some to escape tax that is legally due and is unfair to citizens that comply with the tax laws." (Owens & Saint-Amans, 2009)

Again, with this statement we can encounter the appeal to morality and fairness.

The "tax havens"

In this section, I would like to review the arguments which support the use of tax havens. One argument is that many of the same tax-related inducements that tax havens are often accused of, are also offered by OECD economies on a "ring-fenced" basis, i.e. they are only available to foreign investors (Sharman, 2006). Another example is the state of Delaware as the leading provider of anonymous companies (FT, Mar. 5, 2008). During a meeting of the Commonwealth small state law ministers in 1998, there has been protest against "blurring the distinction between tax evasion and avoidance". They also pointed at the facilitation of "fishing expeditions" that would seek the disclosure of information where there was no evidence of criminality (Sharman, 2006). The primary reason that tax havens have financial privacy laws is that they protect their economic competitiveness. For many small island states offshore finance represents a viable solution to their development problems; it has also been recommended by the World Bank, for example. In order to attract mobile capital, small jurisdictions had to offer a tax rate at or near zero. For Bermuda and the Cayman Islands this has resulted in first world standards of living (Sharman, 2006). As World Bank data shows, jurisdictions with low taxes on capital income and a strong commitment to financial privacy are also the world's richest (Rahn & de Rugy, 2003). Furthermore, there is no evidence that tax havens attract an unusually high share of the world's "dirty money" (Mitchell, 2001).

The case of Switzerland

It is said that 27 % of the world's wealth managed outside the country of residence is managed in Switzerland. It is also considered to be the global leader in cross-border asset management. Today, it is under pressures due to turbulences in the financial markets and criminal misuse of financial institutions. It is mostly renowned for its banking secrecy (Frei, 2004; Gallu & Logutenkova, March 13, 2009, Bloomberg). In Switzerland, banking secrecy laws have been of great importance with regard to their historical development. The introduction of criminal sanctions for the violation of secrecy about bank customers by the Swiss federal parliament in 1934 and its influence on Swiss thinking can be traced back to two events: In 1931, Nazi Germany intensified foreign exchange controls and Adolf Hitler passed a law under which Germans with foreign capital were punished to death. The Gestapo also started to espionage on Swiss bank accounts where many Jews had placed their assets and some Germans were put to death for holding Swiss accounts. With the second event in 1932, a list of two thousand French citizens who had deposited their holdings was discovered and had been made public by the police. The list included senators, a former minister, bishops and generals. The French government jumped at this and announced that it would pressure Switzerland in order to gain legal authority over the accounts of French citizens held in Switzerland (Rahn & de Rugy, 2003; Sharman, 2006).

As Frei (2004) points out, banking secrecy is often misunderstood as it does not protect terrorists and other criminals. The purpose of financial privacy is not to safeguard the interests of the banks but to protect the private sphere of their clients. The secrecy legislation was amended in 1998 to stop banks from shielding identities of those suspected of money laundering or tax fraud. Shortly before the G20 summit, in the case of UBS, information of 300 customers was handed over to the US government. With this, the Swiss Banking Association was expecting to put an end to the international criticisms of Switzerland and its legal system, but also to put an end to threats to be put on the OECD black list. Switzerland's Finance Minister Rudolf Merz announced the renegotiation of agreements with other countries and cooperation on cases of tax evasion and fraud. He also pointed out that his nation does not want to land on the OECD list. He confirmed the softening of absolute banking secrecy but regards it as necessary, as a place on "the list" would hurt the whole economy, not only the banking sector (Gallu & Logutenkova, Bloomberg, Mar. 13, 2009). This did not prevent that Switzerland is on the list again, although it recently agreed to loosen its strict banking secrecy and to comply with the OECD standards for information exchange in order to fight tax evasion (Reuters, Apr. 3, 2009).

It's all rhetoric…

One conclusion we can draw at this point of analysis is that all discussions regarding financial privacy in relation to taxation are clouded by very emotional terminology and a plethora of pejorative terms (Cowell, 1990). Going through newspaper articles, a clear distinction between the "good" and the "bad" is drawn, although we have seen that this distinction is not easily applicable as high-tax jurisdictions use the same incentives as tax havens, so that we can state hypocrisy and double-standards with regard to the accusations they make. In most of the cases, there is the narrative of the "betrayal of the elites", the "greedy managers", the "unpatriotic companies" that chose reincorporation in tax havens to increase their profits, and the "theft from the fellow citizens" (Kulish, NYT, Febr. 18, 2008; Spiegel Online, Febr. 16, 2008; Johnson & Holub, 2003; FT, Mar. 5, 2008), all confirming the increased gap between the ordinary people, the rich, and the government (BBC One, Panorama). The scandals around tax evasion and the current economic climate are not particularly helpful for making the case for financial privacy, either.

If we take a look at how the call for the transparency of financial information has evolved, we can identify three stages or lines of argument for more disclosure: In the 1970s and 80s, one of the primary concerns was claimed to be the detection of drug money laundering. Then, there is the more general goal of detecting and fighting crime finance, followed by new demands of information disclosure after 9/11 in the name of fighting terrorism (Sharman, 2006; Westin, 2003). We have seen that over the last decades more and more disclosure has been put forward. A question that needs to be asked is where the line will be drawn. More disclosure of information might result in law enforcement getting diverted as it no longer concentrates on individuals and the "good" law-abiding citizens' freedoms will be permanently undermined with the full disclosure of their financial activities. The alternative ways to broad and systematic information sharing do not seem to be very popular these days (Rahn & de Rugy, 2003), but more disclosure of information does not imply a better use of it.

The sovereignty of individual countries, the principle of non-intervention and the search for dialogue representing the foundational norm of the modern international system, are replaced by the coordinated "bullying" of tax havens by high-tax jurisdictions. As morality is often referred to while arguing against tax havens, the question also needs to be asked the other way round: Is it fair to sanction small non-OECD member countries that are dependent on their financial services (Sharman, 2006)? Another aspect is the proportionality of measures. Governments have been abusing information in many ways in the past and it remains questionable whether information sharing can really stop capital flight once and for all as it is argued that there will always be tax loopholes (Rahn & de Rugy, 2003). Increased information sharing might as well result in information overload.

Privacy has always been a negotiated state in society (Margulis, 2003) and we are seemingly entering a new stage of negotiation concerning financial information. The OECD blacklist has turned out to be a very effective and powerful tool for putting pressure on countries that do not "play by the rules of the game", as nobody wants to be on it. As Germany's chancellor Angela Merkel recently put it:

> "The more clearly we say that those who don't cooperate will be put on a list, the more they will try to cooperate." (Bloomberg, March 12, 2009)

Given the reactions to the new OECD list that has been released in conjunction with the G20 summit, the determination for collective action against tax havens and the disappointment, e.g. from Switzerland, the tendency goes towards more cooperation and disclosure from tax havens.

This paper tried to present the different aspects of financial privacy linked to taxation in a balanced way, but one factor that has not been touched explicitly so far is the role of curiosity and jealousy as possible explanations for the lack of strong support for financial privacy. Last year, the Italian Finance Ministry published the official income statements of all tax payers online. The website had to be shut down due to privacy concerns as it was overrun by curious Italians who wanted to see what their neighbours or favourite actors earned. Beppo Grillo, a comedian and activist, called it "pure folly", as it would be too dangerous to pay taxes when criminals are supplied with income information and the address. Although this is common practice in Scandinavian countries, in Italy's case, the claim was that these measures would not help the country or tax payers, but rather add to its problems allowing individuals to see what a co-worker or neighbor earns (Scherer & Salzano, Bloomberg, Apr. 30, 2008). This example represents the realization of living in a class society and that having more openness does not necessarily result in a better society.

Conclusion

One thing that should be evident by now is that the argument for financial privacy is not an easy one to make as a lot of things are mixed together in discussions. This paper has tried to present some of the many facets of financial privacy and to avoid going too deep into the discussion of morality. As an outlook, we will see banking secrecy become a relic of the past and the number of tax havens will diminish significantly. Evaders will also be pushed to the margins of the system, so that paying taxes might become more attractive than risking fraud in jurisdictions with lax rules. Tax evasion by itself might become obsolete, as the current developments push towards the extremes of complying with the law of the home country or to leave the country and move to a tax haven (Economist, Apr. 4th, 2009). It remains to be seen whether a new path will be taken to create a cooperative culture and change in attitude, as this would be a way to build a "natural sense" of compliance.

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