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Richard Gordon
Andrew P Morriss

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Richard Gordon

Professor of Law, Director of Financial Integrity Programs, and of the Institute for Global Security Law and Policy, Case Western Reserve University

richard.gordon@case.edu

&

Andrew P. Morriss

D. Paul Jones, Jr. & Charlene A. Jones Chairholder in Law & Professor of Business, University of Alabama

Research Scholar
Regulatory Studies Center, George Washington University

Senior Fellow
Reason Foundation

Senior Scholar
Mercatus Center at George Mason University

amorriss@law.ua.edu

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Richard Gordon* & Andrew P. Morriss**

Abstract

Recent publicity over enormous estimates of “missing” wealth and the use of sophisticated tax strategies by companies like Apple, Google, and Starbucks have produced a demand that the wealthy pay a “fair” amount of tax regardless of their compliance with the letter of tax laws. In particular, the Tax Justice Network’s claim that $21-$32 trillion of “hidden” wealth remains untaxed has garnered considerable attention. In this paper we argue that these claims rest on poor data and analysis and mistakes about how financial transactions work. We further argue that the disputes are about fundamentally conflicting visions of how financial transactions ought to operate: whether the goal is “wealth maximization” or “control first” to stop potential bad acts from occurring. Putting the debate in these terms clarifies what is at stake.

Money “moves” internationally in high volume: By the 1980s, financial flows exceeded the movement of goods by a factor of 50.¹ Money moves among financial institutions and non-financial institutions, through electrons and physically, as part of global trade in legitimate goods and services, and as part of criminal enterprises in illicit goods and services. Some analysts argue that the movement of a large amount of these funds² through offshore financial centers (OFCs) suggests a problem with the financial system that puts “global financial capital … beyond the control of any one national government, able effectively to cast judgment on the fiscal and monetary policies of nation states themselves through the disciplinary fear of capital flight.”³ Many of these analyses purport to distinguish between “onshore” transactions that are “fully regulated and taxed” and “offshore” transactions “where some regulations and taxation are

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¹ John Stopford, Susan Strange, & John S. Henley, RIVAL STATES, RIVAL FIRMS: COMPETITION FOR WORLD MARKET SHARES (1991) at 44.
² See, e.g., Mark P. Hampton & Jason P. Abbott, The Rise (and Fall?) of Offshore Finance in the Global Economy: Editors’ Introduction, in OFFSHORE FINANCE CENTERS AND TAX HAVENS: THE RISE OF GLOBAL CAPITAL (Mark P. Hampton & Jason P. Abbott, eds. 1999) (noting claim that “as much as half the world’s stock of money either resides in or is flowing through tax havens”).
³ Hampton & Abbott, supra note 2, at 2.
withheld.” Most recently, the Tax Justice Network caught public attention by arguing that “[a] significant fraction of global private financial wealth … has been invested virtually tax-free through the world’s still-expanding black hole of more than 80 ‘offshore’ secrecy jurisdictions.” Similarly, the popular press often portrays “offshore” transactions as sources of criminal activity: Following the revelation that Jean-Jaques Augier, the former campaign treasurer for President Hollande held undeclared bank accounts in the Cayman Islands, the French newspaper *Le Monde* printed a front page editorial entitled “The offshore system, this patent enemy of democracy.” The piece attacked “fiscal paradises,” generally interpreted as offshore centers, as a source for money laundering.6

Much of the discussion of international financial transactions revolves around arguments about “unfair competition” and “distortions” introduced into financial and legal arrangements by jurisdictions with tax structures that differ from developed world norms. For example, offshore critic Ronen Palan argues that what sets offshore finance apart is that “it drives economic activities into jurisdictions they should not have been in the first place.”7 As a result, critics contend that the existence of these jurisdictions “distort[s] the relocation policies of international capital.”8

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4 Ronen Palan, *Offshore and the Structural Enablement of Sovereignty* in Offshore Finance Centres & Tax Havens (Mark Hampton & Jason Abbott, eds. 18, t 21 (1999)).


7 Palan, *Structural Enablement*, supra note 4, at 35. Places that economic activities “should not” be include the Cayman Islands, about which Palan says “[s]trictly speaking, it does not make economic sense for the Cayman Islands to serve as the world’s fifth largest financial centre”. Palan, *Structural Enablement, supra* at 35. Thus Palan argues that

it does not make sense for the Marshall Islands, Vanuatu or Liberia to be the world’s giant shipping nations. There is no obvious economic reason why small Pacific islands are at the forefront of the telecommunications revolution, nor why Guyana and Niue are the central routing areas for Internet porn. In direct contradiction to the theory of comparative advantage which assumes that economic activities tend to gravitate towards geographically relevant areas, offshore has the opposite effect.

Id. In a similar vein, another critic, Sol Picciotto, argues that “[b]y providing a haven for routing global flows through the use of artificial persons and transactions, ‘offshore’ has helped to dislocate the international state system and induce its substantial reconstruction.” Sol Picciotto, *Offshore: The State as Legal Fiction*, in OFFSHORE FINANCE CENTRES AND TAX HAVENS: THE RISE OF GLOBAL CAPITAL 43, 43 (Mark P. Hampton & Jason P. Abbott, eds., 1999). To some extent, all taxes have such impacts. Corporate taxes “cause capital to flow to unincorporated productive sector” and “distort investment and financing decisions, and may discourage the distribution of dividends.” Emilio Albi, *The challenges of corporate income taxes in a globalized world*, in THE ELGAR GUIDE TO TAX SYSTEMS 131, 162 (Emilio Albi & Jorge Martinez-Vasquez, eds. 2011).

These arguments rest on a profound misunderstanding of how financial transactions occur. We argue below that much of this “tax justice” literature is driven by its assumptions about money, business, finance, and government and that these assumptions are incorrect. The assumptions are disguised by often over-heated rhetoric and pseudo-scientific, or often completely unscientific, calculations. Like a three card monte dealer rapidly shifting cards on a box while distracting his victims with rapid chatter, some proponents of “tax justice” divert debates over tax policy, global finance, and international business away from the economic underpinnings of financial transactions and the fundamental substantive policy differences that should be the focus of discussion. Although they seek to persuade policymakers that adopting their proposed policies will not limit the beneficial aspects of the existing financial system, what they are advocating is a fundamental reordering of global finance in ways that we contend would reduce social welfare.

Our argument is that there are two conflicting visions of the world financial network competing to shape how these movements will be governed by legal systems. The first vision, which we term the “Wealth Maximization” framework, sees the primary purpose of the world financial architecture to be facilitating voluntary transactions among people and firms that wish to trade and invest with one another. By reducing the transactions costs of “moving” money from one place to another, the legal system can help in the creation of wealth. The result has been to push the cost of capital towards a “world interest rate modified by appropriate risk premiums” determining the cost of equity capital. This encourages globally efficient allocation of capital.

Wealth Maximizers (including the two of us) argue that this produces substantial benefits. For example, the Peterson Institute for International Economics calculates that Americans alone benefitted from trade liberalization by nearly $1.4 trillion in 2012. It is not just rich countries that benefit. By 1970s, “[e]conomic growth in the open world market economy has been so great that few governments are now in strong enough control over their civil societies to be able to deny them the chance to participate in this wealth-creating system.” In 1998 the then-head of the World Trade Organization...
(WTO) cited the growth in trade as a cause of the doubling of income in ten developing countries with 1.5 billion population and overall annual growth in the world economy of 1.9% per year since World War II, a historically high figure. This was the dominant vision in international private law until the 1990s and underlies how international financial institutions were constructed.

The second vision, which we term the “Control First” framework, sees the “movement” of money as a problem—unless information on the money has been reported to governments and/or quasi-governmental organizations, which will then be able to use the information to prevent transactions that represent the proceeds of crime, including the evasion (and, increasingly, the legal avoidance) of taxes. In this vision, transfers of money, international finance, and globalization are the means by which the powerful exploit others, depriving the victims of their livelihoods and resources. For example, the Tax Justice Network argues in its widely cited report The Price of Offshore Revisited that $21 to $32 trillion in “financial” wealth in 2010 was “hidden” in OFCs and so is “virtually tax free”. Similarly, analyst Raymond Baker contended in the early 2000s that $1 trillion in “dirty money” crosses borders annually and that there was $5 trillion in accumulated hidden assets (as of the early 2000s). Proponents of the Control First framework argue that financial openness’ most important impact is to allow the looting of developing country economies by a coalition of local elites, multinational businesses, and multinational financial institutions.

The disagreement between these frameworks is partly philosophical. Regardless of the size of “undertaxed” money flows, who gets the money, or benefits of financial freedom, one might believe that taxing every dollar of wealth trumps any benefit, that a poorer but more equal world is preferable to a richer but less equal one, or, alternatively, that ensuring investors are free to shift assets wherever they prefer is worth any reduction in tax revenues anywhere, or that eradicating absolute poverty trumps concerns over inequality. The Tax Justice Network, for example, rarely concedes that there is any benefit to the movement of money in the international financial system. As its name suggests, it is focused on applying its definition of “justice” to the tax system, largely to the exclusion of any benefits of financial freedom. However, the disagreement is also

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14 Henry, The Price of Offshore Revisited, supra note 5, at 5. The difference between $21 and $32 trillion is substantial – with the upper bound over 50% higher than the lower bound – but TJN’s argument is essentially that the amount is large, regardless of the precise figure.) The report has been frequently cited in news accounts. See, e.g., Heather Stewart, £13bn hoard hidden from taxman by global elite, The GUARDIAN (21 July 2012) available at http://www.theguardian.com/business/2012/jul/21/global-elite-tax-offshore-economy
16 See, e.g., Henry, BLOOD BANKERS, supra note 9, at xxiv (“the conventional portrait of the global development crisis is an economist’s fairy tale. It leaves out all of the blood and guts of what really happened—all the payoffs, corrupt privatizations, fraudulent loans, intentionally wasteful projects, black market ‘round trip’ transfers, arms deals, insider information, and the behind-the-scenes operation of the global haven banking network that facilitated this behavior.”).
empirical – there are important disagreements about the facts: does making international financial flows cheaper help or hurt the global economy, particular economies, or particular individuals?

The relative influence of these visions over future measures governing the international financial architecture in particular countries, in treaties among countries, and in multilateral governance structures will profoundly shape the future of the world economy. In part, the choice between them reflects a disagreement about the mix of different kinds of transactions in the world economy. For example, the more criminal transactions that occur, the greater is the justification to implement preventive measures. At the same time, however, Control First measures necessarily add transactions costs, which by definition will reduce legitimate, value-maximizing transactions while blocking criminal ones. How to balance the costs and benefits of such measures will depend in part on views about the relative importance of reducing crime, including fiscal crime, (as well as the effectiveness of these measures in actually reducing crime) and of increasing the volume of private, wealth-maximizing transactions. That, in turn, rests not only on disagreements within and across societies over the appropriate size and scope of governments but also over the costs and the effectiveness of different financial infrastructures.

As the global financial crisis provided the opportunity for substantial changes in the world’s financial infrastructure, understanding this clash of visions is important. In this Article, we make several contributions. In Part I, we contrast the Wealth Maximization and Control First frameworks, examining their different assumptions about how the world economy functions. In Part II, we set out the financial “plumbing” through which money “moves” and show why this infrastructure is important and how it affects the two frameworks’ policy prescriptions. In Part III, we analyze the evidence provided by the Tax Justice Network, among the primary proponents of the more extreme Control First framework measures, and show that it fails to support their claims. Part IV concludes by setting out some criteria for evaluating policy trade-offs in decisions about financial architectures.

I. Alternative Frameworks for International Finance

Before we can discuss international financial flows and the regulatory frameworks that can be used to shape them, we need to understand what it is that financial transactions do. Not surprisingly, views differ about why money “moves” across borders and the impacts of its movements. Moreover, the Control First attack on “offshore” jurisdictions makes it important to consider these jurisdictions’ role in the global economy and to recognize these “offshore” locations do not exist in isolation.18 Their interconnectedness with the rest of the global financial network makes it necessary to understand how they function – how money “moves” through them – to evaluate these

18 Even a OFC critic like Ronan Palan “‘offshore’ financial transactions are very much ‘onshore’, conceived, organised and handled in the traditional financial centres of London, New York, Tokyo, and so on.” Palan, Structural Enablement, supra note 7, at 21.
competing visions. Having a clear view of the alternative conceptual frameworks is necessary to understand the legal and policy choices international capital flows present.

A. Wealth Maximization

The standard economic view of global capital flows is that reducing the obstacles to the flow of money across borders maximizes total global wealth by shifting resources from less efficient to more efficient uses.\(^{19}\) Crucially, firms are willing to engage in international operations only when the “greater complexity and risk” involved in creating and maintaining “costly systems of command and control that can work effectively over large distances and deal with the hazards of markets that differ from their own” if they believe the gains outweigh these costs.\(^{20}\) This view sees virtues flowing from the movement of financial resources of individuals and firms across borders, allowing them to reduce concentration risk by engaging in portfolio diversification. It also permits investors to avoid or hedge against risks due to poor quality regulatory frameworks or other causes.\(^{21}\)

This view can be summarized as follows: Obstacles to financial flows constitute transactions costs. In pursuit of wealth maximization, the transactions costs of financial flows should be reduced and financial innovations that promote lower transactions costs welcomed. Increasing financial flows creates a range of benefits, from generally facilitating trade and investment to specifically allowing both the reduction of overall risk and the efficient allocation of remaining risks among voluntary parties. The more these are reduced or eliminated, the more efficiently are resources allocated. As resources move about the world, states compete for resources by providing attractive environments for labor and capital in pursuit of wealth-creating activities that can then fund the provision of public goods.\(^{22}\) This exerts pressure on states to adopt policies that attract resources, and so generate wealth. Among those policies are limits on tax rates.\(^{23}\)

In this view, regulatory measures should primarily aim at facilitating markets, not obstructing transactions in pursuit of other policies. This view is embedded in modern

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\(^{19}\) For example, Peter Cohen and U. Srinivasa Rangan argue that capital’s movement toward higher returns creates pressure to upgrade countries’ “Entrepreneurial Ecosystems”, which involves “enhancing corporate transparency, streamlining capital markets, and building more globally competitive human capital networks.” Peter Cohen & U. Srinivasa Rangan, CAPITAL RISING: HOW CAPITAL FLOWS ARE CHANGING BUSINESS SYSTEMS ALL OVER THE WORLD 4 (2010).

\(^{20}\) See Stopford, Strange, & Henley, supra note 1, at 69.

\(^{21}\) See, e.g., Michael E. Porter & Martin R. Kramer, Creating Shared Value, HARB. BUS. REV. 2, 12 (January / February 2011) (“the ways in which regulations are designed and implemented determine whether they benefit society or work against it.”).

\(^{22}\) See Stopford, Strange, & Henley, supra note 1, at 209 (“Without wealth or the prospect of future sources of wealth, even if there is no external security threat, the state begins to fall apart.”); Morriss, Role, supra note 8, at 105-109.

\(^{23}\) Albi, Challenges, supra note 7, at 142 (low tax jurisdictions “have established limits and lowered CIT [corporate income tax rates.”). Research into distortions caused by high rates may also push rates down. See Richard M. Bird, Tax system change and the impact of tax research, in ELGAR GUIDE, supra note 7, at 413, 430 (“The downward pressure on personal and corporate income tax rates has certainly been supported, if not initiated, by the increasing research measuring the distortions caused by high marginal tax rates.”).
international financial institutions such as the International Monetary Fund (IMF) and later the World Trade Organization (WTO). Promoting it has been an important part of the work of the Organization for Economic Cooperation and Development (OECD). It is also embedded in the European Union’s financial architecture, which emphasizes the free movement of capital, and the creation of the euro. Indeed, so pervasive is this view that one can reject this view only by rejecting the intellectual framework underlying the post-World War II system of international trade law and finance adopted by virtually every nation.

The Wealth Maximization framework has four central implications for international financial flows. First, financial flows are a necessary component of facilitating trade. One can argue – as anti-globalization activists do – against efforts to lower barriers to trade, but if one accepts that comparative advantage makes trade welfare increasing for both parties, one must also accept the virtue of reducing the transactions costs of trade. Second, global financial flows reduce the costs of jurisdictional arbitrage, encouraging jurisdictions to compete for wealth-creating activity by reducing transactions costs. Third, globalized finance inevitably allows tax planning to occur, which reduces the transactions costs of doing business across borders as well as limits tax revenue. Fourth, globalized finance provides financial privacy, which is a good in its own right as well as a means to encouraging additional wealth creation.

1. Facilitating Trade

One important reason why Wealth Maximization proponents favor removing obstacles to financial flows is to facilitate trade. Increased financial flows facilitate trade in important ways. Even in relatively simple exchanges of cash and goods, financial

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24 Rawi Abdelal, CAPITAL RULES: THE CONSTRUCTION OF GLOBAL FINANCE 7 (2007) (“Policymakers then wrote the [liberal] consensus into the institutional architecture of the international monetary system. The rules were codified in three international organizations: the IMF, the European Community (EC), and the OECD.”).

25 Andrew P. Morriss & Lotta Moberg, Cartelizing Taxes: Understanding the OECD’s Campaign Against “Harmful Tax Competition”, 4 COLUM. J. TAX L. 1, 21-22, 27-32 (2012); Abdelal, CAPITAL RULES, supra note 24, at 7. Since the 1990s, however, the OECD’s efforts on tax harmonization (but not its work in other areas) has switched to a Control First perspective. See Morriss & Moberg, supra, at 39-48 (describing and explaining transformation of OECD tax program).

26 See Abdelal, CAPITAL RULES, supra note 24, at 3 (“European policymakers conceived and promoted the liberal rules that compose the international financial architecture. The most liberal rules in international finance are those of the EU, and the United States was irrelevant to their construction.”).

27 See David Marsh, THE EURO: THE POLITICS OF THE NEW GLOBAL CURRENCY 10 (“the liberalism of an integrated European financial market is one of the essential conditions within the Euro area required to provide the economic flexibility and financial lubrication to offset the rigidity of permanently fixed exchange rates.”).

flows facilitate trade by allowing trading parties to shift activities to the location with the comparative advantage in each activity. Reducing the costs of even simple transactions is important. For example, London owes its historical position as a financial and insurance center to the lower cost of handling trade conducted in sterling there; Hong Kong’s entrepôt activities led to the development of its role as an Asian financial center; and New York City developed its role as a financial center out of its role as a domestic capital market for the United States.

The competitive advantage of a multinational firm will depend on where it locates its activities (either those it does directly or those it contracts for in the marketplace). Structuring a multinational business involves more than one-off exchanges of goods and services for cash; it also requires more complex transactions that reduce the transactions costs of cross-border activity. Among the important risks for cross-border investments are principal-agent conflicts; building longer-term relationships can reduce principal-agent

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29 Ranald Michie, A Financial Phoenix: The City of London in the Twentieth Century, LONDON AND PARIS AS INTERNATIONAL FINANCIAL CENTRES IN THE TWENTIETH CENTURY 15, 17 (Youssef Cassis & Eric Bussiere eds., 2005) (London was “the payments centre of the world economy, for through these connections it was possible to settle almost any international transaction there. Hence the fact that the ‘bill on London’ was the near universal currency of international trade and finance, whether it involved transactions between China and the United States or France and Australia.”).

30 Catherine R. Schenk, The Rise of Hong Kong and Tokyo as International Financial Centres after 1950, in CENTRES AND PERIPHERIES IN BANKING: THE HISTORICAL DEVELOPMENT OF FINANCIAL MARKETS 81, 86 (Philip L. Cottrell, et al. eds., 2007) (“Hong Kong’s role as a regional and international financial centre arose from the strong commercial heritage of banking and financial services, which continued to dominate activity in the colony throughout the 1950s and 1960s, and positioned Hong Kong as the regional centre for the exchange of information and expertise on Asian and Western market opportunities. In this sense, Hong Kong clearly fits into the model of an IFC emerging from an international commercial entrepot.”).

31 Youssef Cassis, CAPITALS OF CAPITAL: A HISTORY OF INTERNATIONAL FINANCIAL CENTRES 1780-2005 115 (2006) (New York’s importance due to “three reasons: the total amount of foreign capital investment in the United States, the dynamism of the American economy, and the city’s position as the country’s financial centre” in period before World War I.).

32 Michael Porter, THE COMPETITIVE ADVANTAGE OF NATIONS 60 (1998) (Over time, however, successful global firms usually combine advantages drawn from their home base with those resulting from locating particular activities in other nations and those emerging from the overall world-wide network. … The combination of home base advantages, the benefits of locating selected activities in foreign locations, and advantages growing out of the worldwide system, not each alone, underpins international success.”); Beenakker, supra note 28, at 31 (“If the global competitor locates its different activities in different countries according to each country’s comparative advantage, it will then, at the same time, achieve competitive advantage. For instance, components can be made in South Korea, software written in India and basic R&D performed in Silicon Valley.”)
conflicts and so reduce the risks involved in cross-border transactions.\textsuperscript{33} Similarly, sophisticated financial arrangements enable parties to reduce the costs of transacting by allocating or hedging risks (e.g. currency risk) among the parties.\textsuperscript{34} Making such arrangements requires both financial service providers (banks, accountants, insurance companies, lawyers) and well-developed legal and regulatory systems. Because these are often not available or too costly in some jurisdictions, structuring transactions through jurisdictions where such services are available or are less expensive facilitates trade.\textsuperscript{35}

Consider a relatively simple trade arrangement between a manufacturer in one country and a retailer in another. The parties to the trade deal face a number of risks, including currency risks, legal risks, and political risks. For example, a U.S. retailer contracting with a Chinese supplier to send it goods to be sold in the United States would need at a minimum to address risks due to differences in the U.S. and Chinese legal systems, currency risks for dollar-renminbi conversions, and political risks that U.S.-China relations would be disrupted in a fashion that would affect the transactions. If the relationship were even slightly more complex, as it would be if the U.S. retailer and Chinese manufacturer wanted to enter into a joint venture that required the U.S. partner to invest in China and transfer intellectual property rights to the joint venture, these risks would be greatly increased. Relationships between a U.S. firm and a French firm, a Chinese firm and a South African firm, or a British firm and a Chilean firm would face a similar array of risks, even if the details of the particular risks might differ. Because any contract defining the rights of the parties would necessarily be incomplete,\textsuperscript{36} the parties would need confidence that any future disputes would be resolved fairly and efficiently.

\textsuperscript{33} For example, accounting serves as a crucial means of facilitating cross-border investment. Indeed, the development of the accounting profession in the United States is at least partly due to the need to persuade European (and particularly British) investors to invest in American railroads. See Paul J. Miranti, Jr., ACCOUNTANCY COMES OF AGE: THE DEVELOPMENT OF AN AMERICAN PROFESSION, 1886-1940 34 (1990) (“The certificate of a well-known accounting firm was thought to improve the marketability of American securities among European investors.”); Thomas A. King, MORE THAN A NUMBERS GAME: A BRIEF HISTORY OF ACCOUNTING 14-17 (2006) (describing issues involved in railroad and other securities).

\textsuperscript{34} See, e.g., Björn Döhring, Hedging and invoicing strategies to reduce exchange rate exposure: a euro-area perspective, EU Economic and Financial Affairs Directorate Economic Papers No. 299 1 (2008) available at http://ec.europa.eu/economy_finance/publications/publication11475_en.pdf (“Exchange rate risk can also be neutralised ("hedged") through financial instruments, such as exchange rate derivatives or foreign currency debt (financial hedges), as well as through the operational setup of the exporting firm (operational hedges). Financial derivatives have today become standard tools for hedging risks related to exchange rates, interest rates or commodities prices.”); Ron Box, Reducing Pricing Risks with Effective Hedge Strategies, Corporate Finance Insider (Feb. 3, 2011) available at http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2011/CorpFin/ReducePricingRisks.jsp (“Mitigating financial risk with hedge transactions can be very helpful to businesses of all sizes, particularly as those risks become more pronounced. Many circumstances beyond the control of financial executives can affect the commodities critical to business operations or the interest rates required for capital.”).

\textsuperscript{35} Stopford, Strange, & Henley, supra note 1, at 222 (In many developing countries, legal systems are antiquated, contradictory and impenetrably obscure. Firms need to know the extent of their legal obligations and of their legal rights. Although it is reasonable for a government to reserve the right to change the rules, the changes should be consistent, pointed in the same direction, and transparently clear. Arbitrary decisions provide one of the biggest disincentives to investors.”).

\textsuperscript{36} See, e.g., Eric Maskin & Jean Tirole, Unforseen Contingencies & Incomplete Contracts. 66 REV. ECON. STUD. 83, 83 (1999) (“Most real contracts are vague or silent on a number of significant matters.”).
One way to do so is through sophisticated financial transactions. For example, valuable assets of the joint venture might be owned by a legal entity that was bankruptcy-remote from either of the joint venturers. Another means of coping with incomplete contracts is to choose the law and legal institutions of a jurisdiction other than the home jurisdictions of the contracting parties (to avoid potential bias).

Currency risks are a simple example of a problem parties face in international trade. Changes in exchange rates, including changes in the value of outstanding financial obligations incurred prior to a change in exchange rates, changes in the present value of firms due to changes in the net present value of future operating cash flows, and accounting-derived changes in owners’ equity from the translation of foreign-currency denominated assets and liabilities into the currency in which accounts are reported. The risk of inflation differs dramatically across jurisdictions. An important means of managing these risks is by hedging currency exposures. Another is through contractual provisions, shifting the risk to the party most willing or able to bear it at the lowest cost.

The foundation for the case for trade is comparative advantage, the idea that productivity differentials across jurisdictions (differences in the cost ratios for producing different goods and services) translate into opportunities for gains from trade. However, global competition does more than just promote trade based on existing comparative advantages; it also spurs innovation. Cohen and Rangan describe how the evolution of the personal computer industry over the last thirty years illustrates this:

Far from being a vertically integrated, few-firms-dominated industry as its predecessor main-frame industry used to be, the new industry has from its beginning been highly decentralized. The splintering of the vertical chain was facilitated by the standardization of various parts, components, operating systems, and microprocessors. In turn, this led to the springing up of a large number of new manufacturers specializing in key parts of the value chain in many parts of the world and especially in Asia, a classic case of global spur to entrepreneurship...

As a result, they argue that the growth in international trade resulted from a combination of micro developments (“such as advances in product design and process technology”) and macro developments (“such as the acceptance of a liberal international trading order”) that facilitated it.

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37 See, e.g., The Report on the First Five Years of the Hong Kong Special Administrative Region of the People’s Republic of China (2002) available at http://www.info.gov.hk/info/sar5/content_e.htm at 25 (“The most important [advantage over the Mainland] is Hong Kong’s legal system, which is trusted, tried and tested by international business.”).
38 Beenhakker, supra note 28, at 149.
39 Id. at 149-50.
40 Id. at 29.
41 Cohen & Rangan, Capital Rising, supra note 19, at 13.
42 Id. at 14.
Trade thus expanded the number of firms and diversified their location, producing a greater demand for cross-border financial transactions above and beyond the increase that would result from firms diversifying their own operations across borders. The benefits of such expansion goes well beyond the immediate benefits from trade: opening economies brings in both new physical technology and knowledge embedded “in the brains of people, in organizational structures and in behavioral patterns, which in turn are conditioned by the strategies of different social factors and their patterns in conflict and co-operation.”43

Finally, expanding trade increases the need for access to deep capital markets and, crucially, to legal systems capable of handling complex business organization and contractual matters. The common practice of raising capital on the New York and London financial markets by non-American and non-British companies, respectively, illustrates this.44 To accommodate such needs, a legal system needs both a group of sophisticated decision makers and regulators capable of adding value without imposing excessive costs and a body of law that allows transaction engineering to structure transactions to predictably accomplish clients’ goals.45 Financial transactions may thus be structured to take advantage of such jurisdictions by legally locating crucial steps (e.g. issuing bonds) in them (discussed below).

2. Facilitating jurisdictional arbitrage

While traditional trade theory focuses on differences in factor endowments (e.g. natural resources) or skill levels or costs in the workforce,46 differences in legal and regulatory regimes also play an important role in structuring cross-border transactions. In particular, jurisdictions may compete to provide services, regulatory regimes, or dispute resolution services that facilitate business across borders.47 Businesses make use of these differences across jurisdictions; within jurisdictions, policy entrepreneurs respond to such opportunities by pursuing strategies to provide services in the marketplace. Erin O’Hara and Larry Ribstein describe how this market for law functions within the U.S. federal system; the same process encourages competition among jurisdictions internationally.48

43 Stopford, Strange, & Henley, supra note 1, at 72 (quoting Ernst & O’Connor).
45 David Howarth, LAW AS ENGINEERING: THINKING ABOUT WHAT LAWYERS DO 3 (2013) (“Clients come to lawyers, as they come to engineers, with problems that they cannot solve themselves. The service both engineers and lawyers provide is the solving of those problems.”).
46 Beenhakker, supra note 28, at 29.
47 See O’Hara & Ribstein, supra note 8.
48 Morriss, Role, supra note 8, at 112-117. See also Stopford, Strange, & Henley, supra note 1, at 1 (“states are now competing more for the means to create wealth within their territory than for power over more
Thus, the Netherlands Antilles developed a significant business after World War II in facilitating U.S. businesses issuing bonds in the Eurocurrency market as the result of a combination of a fortuitous extension of the U.S.-Netherlands tax treaty to non-European Dutch territories, the growth of a huge pool of dollars outside the United States, and an entrepreneurial notary’s efforts.\(^49\) Similarly, the Cayman Islands created a legal framework for company formation, banking, trusts, and insurance through the collaborative efforts of local political leaders, lawyers and other professionals, and British officials;\(^50\) and Guernsey and Jersey developed financial services businesses through their proximity to the City of London financial district, the high costs of post-World War II British exchange control regulations for multinational businesses, and their jurisdictional distinctiveness relative to the UK.\(^51\) Once the legal and regulatory environment are recognized as factors of production, developing a sophisticated regulatory environment conducive to financial transactions becomes a development strategy.

In particular, a jurisdiction’s legal and regulatory environment may provide it with a significant comparative advantage because of the quality of its legal system. For example, courts in the Hong Kong SAR, Delaware, and Britain are all widely recognized as capable of addressing competently and fairly sophisticated business transactions.\(^52\) Jurisdictions whose legal systems have ties to the UK similarly have an advantage in this regard because of the availability of appeals to the Privy Council.\(^53\) Because many legal systems recognize choice of law and choice of forum clauses in business agreements, parties to international business transactions can exploit the comparative advantage of a jurisdiction in law by electing to have a contract governed by, and disputes addressed in, that jurisdiction.\(^54\) The existence of jurisdictions that specialize in providing legal and


\(^50\) Freyer & Morriss, supra note 8, at 21-24.


\(^54\) O’Hara & Ribstein, LAW MARKET, supra note 8, at 6-7.
regulatory systems that efficiently structure transactions is thus not a mystery to be explained but the logical outcome of a system of relatively free trade, legal systems’ enforcement of choice of law and choice of forum provisions, and the operation of comparative advantage. As demand for legal and regulatory services to support a global economy grows, the opportunity for jurisdictions to earn revenue by providing those services increase as well. The wider market for such services, including for specialized products like protected cell companies and international investment funds, also offers opportunities for jurisdictions to compete for niche products.55

Within the United States, Delaware is the leader in providing business organizations’ law and dispute resolution, with a well-regarded statutory framework, court system, and network of service providers.56 Delaware entered the market for corporate law as the U.S. economy grew and transitioned from a primarily agricultural and extractive industries-based economy into a diversified manufacturing economy.57 It won the business away from New Jersey by offering a better product and has maintained its competitive edge by continually innovating and offering the best corporate law court system in the United States.58 Similarly, Vermont is widely recognized as a jurisdiction with laws and regulators that facilitate captive insurance.59 Internationally, jurisdictions such as Bermuda, the Cayman Islands, the British Virgin Islands, Guernsey, Hong Kong, Ireland, and Jersey all compete for business by offering a combination of cost-efficient regulatory frameworks that facilitate particular businesses, low or neutral direct taxation regimes, and high quality courts.60 In exactly the same way, New York City and London compete for international business by offering access to well-organized, deep capital markets with legal frameworks and agglomerations of service providers that protect investors and facilitate financial transactions.61 The rapid rate of financial innovation in the major financial markets after World War II has also tended to shift transactions to those jurisdictions that compete for the business most aggressively.

55 See Paul Scrivener & Thomas M. Jones, Incorporated Cells: The latest development for Cayman Islands segregated portfolio insurers, CAYMAN FIN. REV. (July 12, 2013) available at http://www.compasscayman.com/cfr/2013/07/12/Incorporated-cells/ (discussing introduction of new legislation to enhance market appeal of Cayman entities); Freyer & Morriss, supra note 8, at 33-37 (discussing efforts to compete for additional markets).
58 Parsons & Slichts, supra note 52.
60 Even critics of OFCs like Ronen Palan concede that “[o]ffshore offers many benefits and it is doubtful whether the modern international economy can function as smoothly as it does without it.” Palan, Structural Enablement, supra note 7, at 26.
In addition to the benefits this competition provides directly to parties structuring international business transactions, this competition pushes other jurisdictions to innovate as well. Just as Delaware competes for corporate charters in the United States, and London and New York compete for financial services business internationally, so too do jurisdictions compete for specific slices of the financial business, and that spurs quality improvements in even large jurisdictions. Thus Vermont created onshore captive insurance legislation to compete for business with Bermuda and the Cayman Islands, and the United States created International Banking Facilities to compete with offshore centers.

Moreover, this competition offers a significant advantage to individuals and firms outside the major, developed economies. Entrenched interests in governments may make it difficult to change policies within poorer economies: “When change will create too many local ‘losers’, it will be resisted no matter how strong are the rational arguments.” It levels the playing field between firms and individuals in jurisdictions with advantageous legal systems and those in jurisdictions that are not by allowing the latter to opt into a higher quality legal system. For example, such competition allows firms from outside the developed world to tap into First World capital markets and other institutions. As a result, “[i]n nascent or growing industries like nanotechnology or biopharmaceuticals, firms from countries like India and China are now competing intensely because they are able to tap into the global entrepreneurial ecosystem through capital access,” with the result that they are making “the lives of managers and owners of firms in many industries less comfortable.” This is because “[t]he availability of capital” has allowed firms from India to “acquire companies in other advanced countries by tapping into the global capital market.”

3. Tax Planning

In the Wealth Maximization framework, tax planning is a rational response to tax laws. Indeed, it is the only response possible for an individual or firm faced with the need

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62 Lindsay Kelly, Percepcion drives more captives to form onshore, THE ROYAL GAZETTE ONLINE, April 18, 2012 available at http://www.vermontcaptive.com/assets/files/Royal%20Gazette.%20Percepcion%20drives%20more%20captive%20to%20form%20onshore%20April%202012.pdf (quoting Vermont insurance commissioner that “We’re not the first onshore domicile but we really pursued it and made a success out of it,” he said. “Because Vermont is a very small state with 600,000 people with a tourist-based economy, it meshed really well for us.”). See also Morris, Role, supra note 8, at 136-138.

63 Palan, Structural Enablement, supra note 7, at 33 (at end of 1970s “as the result of a prolonged and complicated battle between the US Treasury, the Swiss government and a number of Caribbean tax havens. With the active encouragement of the New York banking community, particularly Citibank and Chase, the US Treasury came to the conclusion that rather than fight the onset of offshore, the USA stood to gain by encouraging its own offshore centre …. A swift volteface took place, culminating in the establishment of the New York offshore market, the New York International Banking Facilities (IBF), on 1 December 1980.”).

64 Stopford, Strange, & Henley, supra note 1, at 30.

65 Cohen & Rangan, CAPITAL RISING, supra note 19, at 23.

66 Id. at 23.
to comply with the conflicting provisions, definitions, and exemptions of multiple jurisdictions’ tax laws. As Vito Tanzi notes, tax systems are like “icebergs, much of the action may take place below the visible part ….” Navigating around such ice bergs requires careful planning. Moreover, under the Wealth Maximization framework, tax law is conceptualized as a multi-period interaction in which governments create tax statutes and regulations, taxpayers react by reorganizing their affairs to reduce their net payments of taxes (taking into account the costs of tax planning services), governments respond by changing tax laws to limit opportunities to make such reorganizations, and taxpayers respond. Through multiple cycles of such efforts, governments strike a balance between tax revenue collection, tax complexity, and the other policies that might be served by tax law provisions (e.g. inducing investment). Both taxpayers and tax authorities must strike such balances. As Albi notes, “Complexity … is the rule in tax systems, steering discussions toward less distortionary and costly solutions, within the established constraints, as opposed to more prefect, albeit impracticable, alternatives.” Changes in levels of tax avoidance and tax evasion can be explained at least in part by changes in tax systems. For example, as even some OFC critics concede, tax planning’s growth is undoubtedly due at least in part to the shift away from indirect taxation to direct taxation over the twentieth century. Together with rising rates, this increases the incentive to avoid and evade taxes. It is thus an endogenous response to tax provisions, including but not limited to rates.

Moreover, tax avoidance is conceptually distinct from tax evasion: avoidance is minimizing taxes within the rules of the law, while evasion is breaking the rules by not paying taxes due under the rules. This approach is well summarized by the response of a member of the band U2 to a journalist’s inquiry about the band’s relocation of its music publishing business to the Netherlands after a change in Irish tax law that would have led to higher taxes on the band’s royalties: The Edge (David Evans) stated “Of course we're trying to be tax-efficient. Who doesn't want to be tax-efficient?” Who indeed? Moreover, trying to be tax-efficient by moving a company from one jurisdiction to another is conceptually no different from a firm issuing debt rather than equity to take advantage of the deductibility of interest, an individual buying a house rather than renting to take advantage of the deductibility of interest.

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67 See, e.g., Robin Boadway, Individual income taxation: income, consumption, or dual?, in ELGAR GUIDE, supra note 7, at 93, 117 (treating different sources of income differently virtually required by various considerations but creates system “that invites tax planning opportunities and perhaps even tax evasion.”); Albi, Challenges, supra note 7, at 131 (“In an international system, the CIT induces tax competition among governments and income shifting between nations in the search for lower tax liabilities by multinational firms. Compliance and enforcement costs, or avoidance and anti-avoidance schemes, consume real resources and lead to reduced welfare.”).

68 Vito Tanzi, Tax Systems in the OECD: recent evolution, competition, and convergence, in ELGAR GUIDE, supra note 7, at 11, 17.

69 Albi, Challenges, supra note 7, at 130.

70 Picciotto, Legal Fiction, supra note 7, at 48.


advantage of the mortgage interest deduction, or a firm with unused non-refundable tax credits choosing to merge with a firm with net income that would allow the use of the credits.

This approach is reflected in many jurisdictions’ laws. For example, in the United Kingdom and many other Commonwealth countries, following the literal statutory construction of the tax law may be all that is needed to avoid tax, even if the form of the transactions do not reflect the economic substance that was the object of the law. As explained in the House of Lords’ decision in the 1935 opinion of Lord Tomlin in IRC v. Duke of Westminster, “Every man is entitled, if he can, to order his affairs so as that the tax attaching under the appropriate Acts is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.” In the United States, since the landmark case of Gregory v. Helvering, the economic substance of transactions typically triumphs over their form, at least when the clear purpose of the statutory construction is to address the economic substance. But even in America, to quote Judge Learned Hand, in his opinion in the Gregory case at the Appeals Court level, “any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.”

Challenges, supra note 7, at 161 (noting that innovations in finance are “making it increasingly difficult to distinguish between debt and equity instruments”).

The Center for Budget and Policy Priorities, a left-leaning group sympathetic to expanding federal spending, called the mortgage interest deduction “one of the largest federal tax expenditures” and estimated that it reduced federal tax revenue by $70 billion per year. Will Fischer & Chye-Ching Huang, Mortgage Interest Deduction is Ripe for Reform, Center on Budget and Policy Priorities (June 25, 2013) available at http://www.cbpp.org/cms/?fa=view&id=3948. Moreover, they concluded that “the bulk of its benefits go to higher-income households.”

This was the goal of the merger in question in the landmark Smith v. Van Gorkom case. 488 A.2d 858 (Del. 1985).

IRC v Duke of Westminster [1936] AC 1, 19-20. The Duke reduced his taxes by covenanting to pay some of his employees yearly sums as an annuity, regardless of work done or whether they remained in his service; in practice this substituted for their wages. As the wages were not deductible from the Duke’s income but the annuity payments were, this reduced his tax liability. The circumstances are described in detail in Assaf Likhovski, Tax Law and Public Opinion: Explaining IRC v Duke of Westminster, in 2 STUDIES IN THE HISTORY OF TAX LAW 183 (John Tiley, ed. 2007).

Gregory v. Helvering, 239 U.S. 465 (1935). The taxpayer had followed the technical rules for avoiding a tax on capital gains by selling shares as part of a tax-free corporate reorganization, even though the result was not, in fact, a real “reorganization” of the type the statute was attempting to address. The Court upheld the conclusion of the Bureau of Internal Revenue, which had ruled that the economic substance of the transactions should prevail over the legal form. The substance over form view has been recently reaffirmed by the Supreme Court in PPL Corp v. Commissioner, Sup. Ct. Dkt. No. 12-43 (2013).

Helvering v. Gregory, 69 F.2d at 810-11. Later, Hand extended this view. “Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.” Commissioner v. Newman, 159 F.2d 848, 851 (2d Cir. 1947) (Hand, dissenting).
In short, under the Wealth Maximization framework governments set rules for tax obligations and individuals and firms then react by structuring their affairs to minimize the total of structuring costs and taxes. If a particular set of tax laws produces too little tax revenue for a government’s purposes, the government then responds by altering the tax laws (increasing rates, broadening the base, changing definitions, limiting exemptions, and so forth) to increase its revenues. The problems with such transactions are primarily the result of poor statutory or regulatory drafting rather than bad behavior by firms or individuals (except where they violate the law). Typically, the solution to tax evasion is to focus on structuring taxes to be collected at the source and requiring entities to report payments.

4. Financial Privacy

Privacy may be seen as a good sought in its own right by individuals, either because it meets their preferences or because it reduces other costs. Thus, an individual may not want his personal financial affairs known because that is his personal preference or a firm may wish details of its business strategy not to be known to rivals. Of course, criminals also seek to conceal their activities. Legal systems regularly seek a balance between privacy interests and law enforcement interests, permitting intrusion into private matters only under limited circumstances. Privacy in financial affairs can thus be seen as an outgrowth of the general principle that a person’s privacy (including the privacy of an association of persons) should be respected unless there are circumstances that suggest a crime has been committed or there is some other significant social interest at stake.

Financial privacy is not a novel concept: Many jurisdictions’ laws recognize this interest. As Rose-Marie Antoine notes,

In my view, confidentiality has been used largely as a scapegoat, blamed for encouraging money laundering and tax evasion. The result of linking it so intimately to such criminal activity has been that confidentiality in the offshore sector has acquired a negative image. On examination of the jurisprudence, however, confidentiality remains a viable and much

78 See Amitai Etzioni, THE NEW GOLDEN RULE: COMMUNITY AND MORALITY IN A DEMOCRATIC SOCIETY, at 12 (1996) (arguing that steps to limit privacy should only be taken in face of a “well-documented and macroscopic threat to the common good, and not merely a hypothetical danger and that if the threat can be minimized by less intrusive means than invasion of privacy, those means should be adopted instead); Kenneth Einar Himma, Privacy Versus Security: Why Privacy Isn’t an Absolute Right, 44 SAN DIEGO L. REV. 857, 874 (2007) (arguing that the two dimensions to balancing privacy and security are: “(1) the importance of the interest relative to the type of interest involved, and (2) the number of people whose security are implicated compared to the number of people whose interest in privacy are implicated.” However, he has little to contribute to the means of weighing these interests); Fred H. Cate, The EU Data Protection Directive, Information Privacy, and the Public Interests, 80 IOWA L. REV. 431 (1994-95) (European Parliament overwhelmingly supported legislation that personal data can only be used for the purpose collected, which can only be processed under consent, or to protect public interests or the legitimate interest of a private party when that interest does not exceed the fundamental rights and freedoms of the data subject).

79 There are a wide range of reasons why an individual or firm might want information kept confidential which do not involve illegal activities. Professor Rose-Marie Antoine has described these in detail. See Rose-Marie Antoine, CONFIDENTIALITY IN OFFSHORE FINANCIAL LAW 33-38 (2002).
respected principle in areas of commercial endeavor not associated with offshore investment. For example, the United States and Canada have fought long and hard to protect the principle of financial confidentiality in terms of trade secrets, arguing precisely that it is essential for business.\textsuperscript{80}

Most importantly, confidentiality in financial affairs has long been provided by attorneys advising their clients and by financial firms handling client money and property. Such confidentiality has been guaranteed by jurisdictions in which those persons work. Financial privacy in the common law world has been well-established since at least the 1924 English Court of Appeal decision in \textit{Tournier v National Provincial and Union Bank of England}.\textsuperscript{81} This decision has been called “one of the most respected and celebrated instances of judicial law making in the entire field of banking.”\textsuperscript{82} The decision “has been approved, applied and reaffirmed by courts in every common law jurisdiction, including Australia, Canada, Hong Kong, Ireland and New Zealand.”\textsuperscript{83} Based in contract, \textit{Tournier} held a bank liable for disclosing to a customer’s employer that the customer had paid a bookmaker by cheque. In addition to this contractual duty, a number of non-common law jurisdictions have created statutory duties of confidentiality.\textsuperscript{84} For example, Swiss law imposes criminal penalties on those who disclose banking information without authorization.\textsuperscript{85}

Moreover, the business reasons for privacy is which make businesses’ affairs worthy of protection. For example, firms need data that reflects business plans, trade secrets, or strategic decisions to be kept confidential.\textsuperscript{86} Similarly, a law firm or bank’s client would not want its plan to purchase a company—a plan likely based on a significant expenditure of resources in research—to be broadcast to others, who could free-ride on that research and rob the client of a legitimate competitive advantage.\textsuperscript{87} This is particularly likely to be true in the investment fund business, where strategies are closely guarded by fund managers.\textsuperscript{88} Equally obviously, wealthy clients would want to hide from

\textsuperscript{80} Rose Marie Belle Antoine, \textit{The Legitimacy of the Offshore Financial Sector: A Legal Perspective}, in \textit{REGULATORY COMPETITION}, \textit{supra} note 8, at 30, 35.

\textsuperscript{81} [1924] 1 KB 461.

\textsuperscript{82} George Weaver and Charles Craigie, \textit{The Law Relating to Banker and Customer in Australia} (2009) vol 2 at [2.3400] [quoted in Chaikin].


\textsuperscript{84} Antoine, \textit{CONFIDENTIALITY}, \textit{supra} note 79, at 23-33 (describing Swiss statutory model).

\textsuperscript{85} Swiss Banking Act (1934) Article 47.


\textsuperscript{87} Jemison &. Sitkin, \textit{supra} note 86.

\textsuperscript{88} See Mary Margaret Frank, James M. Poterba, Douglas A. Shackleford, and John B Shoven, \textit{Copycat Funds: Information Disclosure Regulation and the Returns to Active Management in the Mutual Fund Industry}, 47 J. L. & ECON. 515 (Feb 2004) (disclosure of positions allows other investors to free-ride on investment strategies undertaken by a fund); Russ Wermers, \textit{The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance}, 7 \textit{PERSPECTIVE} 1, available at http://www.icinet.net/pdf/per07-03.pdf (disclosure can reduce profits for fund managers by allowing speculative investors to front-run, or trade ahead of the fund).
criminals the size and location of their wealth. In countries where crimes such as kidnapping for ransom are common, the desire for confidentiality may be greatest.\(^8^9\) And while concerns about confidentiality of financial information can be alleviated to some extent by restricting access to law enforcement only, it should be noted that in many countries in the developing world (as well as some in the developed world) law enforcement officials may not keep such information to themselves. Mandatory breaching of confidentiality with respect to financial information relating to transactions can significantly raise the costs of those transactions.

Of course, confidentiality or privacy of any kind can also hinder enforcement of criminal and tax laws. In such circumstances, and others, disclosure may be appropriate. Indeed, the decision in *Tournier* explicitly recognized that disclosure of otherwise private financial information was appropriate “(a) where disclosure is under compulsion by law; (b) where there is a duty to the public to disclose; (c) where the interests of the bank require disclosure; [and] (d) where the disclosure is made by the express or implied consent of the customer.”\(^9^0\) Thus there is no question that financial privacy is an interest subject to qualification – the tricky question is just when such qualifications occur. How a society balances these competing interests will depend on a variety of factors, including cultural ones.\(^9^1\) The key is that there must be a balance even if striking that balance is difficult.

Both because there are such good reasons to avoid exposing confidential information and because reporting clients would reduce those clients’ willingness to do business with them, financial firms have an incentive to err on the side of confidentiality. For this reason, reporting requirements are generally enforced by sanctions for failure to report.\(^9^2\) As a result, financial institutions are forced into weighing the relative costs of effective compliance with the probability that sanctions will be imposed, introducing more uncertainty, and more costs, to compliance.

Resolutions of that question can be arrayed along a spectrum from “no disclosure without specific evidence of wrongdoing” to “automatic exchange of all relevant information about all transactions.” Within the Wealth Maximization framework, because of the increased costs associated with disclosure we would expect such questions to be

\(^8^9\) See, e.g., Andrew Osborne, *Russian tycoon ‘pays ransom’ to free kidnapped son*, THE TELEGRAPH (22 April 2011) available at http://www.telegraph.co.uk/news/worldnews/europe/russia/8468779/Russian-tycoon-pays-ransom-to-free-kidnapped-son.html (quoting experts that up to 300 children a year are kidnapped in Russia).


\(^9^2\) See, e.g., 31USC 5318(g).
resolved more frequently close to the “no disclosure without specific evidence of wrongdoing” end of the spectrum—unless costs could be reasonably contained. Indeed, many jurisdictions concerned with privacy generally tend toward enhancing privacy rights outside of financial matters, and we observe considerable concern among civil libertarians over intrusion into citizens’ non-financial affairs. With a few exceptions (e.g. the quite strong privacy Switzerland traditionally provided for numbered bank accounts), by the end of the 1980s, most jurisdictions had created at least some mechanism for exchange of information where there was evidence of wrongdoing. The degree of financial privacy would thus be the subject of a combination of a rights-based inquiry (to the extent that privacy concerns generally were protectable) and a cost-benefit analysis of specific measures that eliminated contracted-for privacy in particular instances.

Over the past decade, however, initiatives of the Financial Action Task Force (FATF), the Organization for Economic Cooperation and Development (OECD) and the European Union (and of their key member states) have successfully moved international standards to the “automatic exchange of all relevant information about all transactions.” This movement from the “no disclosure without specific evidence of wrongdoing” end of the spectrum, as well as its significant accompanying costs, will be discussed below.

5. Summary

Viewed through the Wealth Maximization framework, the key issue with respect to regulating global movement of money is the reduction of transaction costs to facilitate the creation of more wealth. In Stopford, et al.’s analogy of governments to gardeners, the main concern is not maintaining a fence to keep out marauders but husbandry: improving the water supply, enhancing the fertility of the soil, and keeping a proper balance of sun and shade: “Forward-looking gardeners are now learning about becoming good husbandmen rather than effective fence-keepers.”

Jurisdictions that lubricate trade by facilitating international financial transactions play an important role by offering transaction-cost-reducing innovations and services (e.g. a tax treaty network that reduces double taxation, such as Barbados; a high quality business court and arbitration system, as in Hong Kong; efficiently created, inexpensive

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93 Imagine the uproar if a government suggested automatic exchange of information on whether individuals were HIV positive or if a jurisdiction like Saudi Arabia where homosexual acts are criminal offenses insisted that European and North American governments automatically provide it with information that could reveal sexual acts by Saudi citizens in Europe or North America or the sexual orientation of those countries’ citizens applying for Saudi visas.

94 Antoine, Legitimacy, supra note 80, at 38-39; Freyer & Morriss, supra note 8, at 48-50.

95 Stopford, Strange, & Henley, supra note 1, at 210-11.

96 See Barbados Tax Treaties, Barbados Offshore Advisor, available at http://barbadosoffshoreadvisor.com/barbados-tax-treaties/ (Barbados’ reputation as “well regulated, offshore jurisdiction” due to its “extensive tax treaty network with other counties” with a focus on transparency.).

business entities to serve as asset protection vehicles for persons fearful of government expropriation, as in the British Virgin Islands; flexible business entities like protected cell companies, as in Guernsey; estate planning entities unavailable in neighboring legal systems, such as common-law-based trusts in the Channel Islands (which offer options to Continental clients not available in the clients’ own legal systems); legal environments that make it inexpensive to repackage assets, as with the Cayman Islands and asset securitization, where the combination of a knowledgeable regulator, recognized exchange, and experienced service providers facilitates creating packages acceptable to wide markets; industry clusters, as with Bermuda and re-insurance, or by creating service agglomerations that serve the many needs of different types of businesses. To the extent there are undesirable impacts of these jurisdictions’ provisions of such services on particular other jurisdictions (e.g. by making it more difficult to track proceeds of crime or through impacts on tax collections), these must be weighed against the benefits provided by the increased financial activity and resolved through international negotiations.

B. Control First

98 See, e.g., Kun Fan, The New Arbitration Ordinance in Hong Kong, 29 J. Int’l Arb. 715, 722 (2012) (“a leading arbitration centre in the Asia-Pacific region. With its strong legal infrastructure, abundance of professional expertise, world class arbitration institutions (such as HKIAC), connection with Mainland China, and New York Convention signatory status, Hong Kong is a natural option for dispute settlement in Asia.”).


100 Gordon Dawes, LAWS OF GUERNSEY 137 (2003) (describing court decisions and legislation to enable trust use).


102 See Marianne Burge, Captives: Bermuda, Colorado, Taxes and Beyond, reprinted from Business Insurance (April 10, 1972) in FOREIGN TAX HAVENS: CHOOSING THE RIGHT ONE 141, 145 (Marshall J. Langer & Roy Albert Povell, chairmen) Tax Law and Practice Course Handbook No. 55 (PLI), J4-2482 (1973) (“Bermuda has the advantage of being able to offer more of the sophisticated business facilities than most island jurisdictions. It has thriving banking and office facilities, communications and hotels, and grants work permits to foreigners. Bermuda has been an insurance center for many years and has legal and technical expertise available. It is very much concerned to maintain its reputation as a business center for reputable enterprises and screens applicants for local incorporation carefully.”)


104 For example, the Cayman Islands signed a Mutual Legal Assistance Treaty (MLAT) with the United States in 198_., providing a mechanism by which the United States could request information from the Cayman government about specific individuals and transactions the United States could demonstrate were involved in criminal activities. Freyer & Morriss, supra note 8, at *48-50.
Like Wealth Maximization proponents, Control First framework proponents believe globalization unleashes competitive forces that constrain governments. However, unlike Wealth Maximization proponents, Control First proponents find this problematic. Rather than increasing welfare, they see these trends as the means for powerful groups to extract resources from less powerful groups. For example, James Henry argues “the First World has bled the Third, of the financial and human capital that it desperately needs for growth.”105 Similarly, Steven Hiatt argues that developing nations were “lured by economic hit men … to take on debt to build grandiose projects … [while] large sums flooding in could be useful in winning the allegiance of new Third World elites, who were under pressure to deliver prosperity to their political followers, allies, and extended families.”106 They thus see globalization as primarily an expansion of the arena in which bad actors can operate.

The primary remedy Control First proponents advocate is to increase national governments’ control of individuals’ and firms’ actions in the expanded international arena outside of the governments’ own jurisdictions rather than to focus national regulation on bad actors in the jurisdiction where bad acts occur. For example, with respect to recent reports that $750 million is missing from the Angolan treasury in a corruption case, Corruption Watch UK (which we classify as a Control First proponent) argues that the money was stolen from the Angolan and Russian governments through the use of “an unnecessary middleman, Abalone Investments” which “made hundreds of millions of dollars in profit from the transaction despite offering no discernible services or value, at the expense of the Russian and Angolan treasuries.” As a result, Corruption Watch UK alleges that “[a] number of Russian and Angolan individuals, including … the richest member of Russia’s Duma …, benefited from the deal, and Swiss Bank Corporation (SBS), which through merger later became UBS, facilitated it.”107 In short, Corruption Watch UK alleges that individuals in the Angolan and Russian governments conspired to steal money from their governments by routing a government-to-government transaction through a firm with ties to Switzerland and the Isle of Man. Although critical of the Russian or Angolan portions of the transaction, Corruption Watch UK’s report emphasizes the roles of actors in Switzerland, Isle of Man (where Abalone was created), and elsewhere.108 This suggests, at least implicitly, that something about Swiss or Manx law makes corruption more likely than if the transaction were limited to Angolan and Russian legal structures, although Corruption Watch UK provides no evidence that either

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105 Henry, BLOOD BANKERS, supra note 9, at 182. Henry argues that this is a literal phenomenon, pointing to purchases of blood plasma from developing countries, which he claims has led to massive HIV infections. Id. However, he ignores the parallel blood scandals in France (which he cites for its ban on blood sales). See Mark Hunter, Blood Money, DISCOVER (Aug. 1993) available at http://discovermagazine.com/1993/aug/bloodmoney250#.UW89c7_0tdQ.


108 Of course, no firm or individual in either Switzerland or the Isle of Man could have accomplished the allegedly corrupt transactions without the active participation of individuals with positions of responsibility in both the Russian and Angolan governments. It thus seems peculiar to focus primary attention on governments other than Russia and Angola.
Angolan or Russian law is better at preventing corruption than Swiss or Manx law. Angola ranked 157th on Transparency International’s Corruption Perceptions Index, Russia ranked 133rd and Switzerland ranked 6th (the Isle of Man was not ranked but the United Kingdom was ranked 17th).100 There is some evidence this is not likely to be true.

Although they sometimes concede there are some positive impacts of globalized financial markets and increased trade,110 Control First proponents focus almost exclusively on increasing governments’ control over financial transactions to control the bad effects. They argue this is necessary for three reasons. First, they contend that the global financial system makes it possible for bad actors to engage in more bad activity than they would be able to accomplish in a less financially open environment. For example, The Price of Offshore Revisited argues that “pirate banking” by private banks and law firms are engaged in “hiding and managing offshore assets for the world’s elite”.111 Second, they argue that greater financial openness produces greater tax evasion and tax avoidance, which deny governments revenues needed to provide public goods. Thus The Price of Offshore Revisited contrasts the “hidden wealth” going untaxed with “governments around the world [which are starved for resources].”112 Third, they argue financial openness constrains the ability of governments to adopt policies that the governments believe are beneficial. For example, Palan argues that offshore finance is the space where “states choose to withhold some or all of their regulations and taxation.”113 The result is to “subvert” public regulation of onshore jurisdictions, which “is supposed to be the imposition of political control and norms of behavior for social ends.”114 In general, Control First proponents focus on the illegitimate ends that might be pursued within a global economy in which transactions are not carefully regulated by competent and benevolent governments.115 Where particular governments are incompetent or malevolent, other jurisdictions’ governments must act to control bad actors.116

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100 Transparency International, Corruption Perception Index 2012, available at http://cpi.transparency.org/cpi2012/results/#myAnchor1 (lower scores reflect lower perception of corruption). Interestingly, among the 25 least corrupt jurisdictions on this index, there are six (Singapore (5th), the Netherlands (9th), Luxembourg (12th), Hong Kong (14th), Barbados (15th), and the Bahamas (22nd)) which have substantial offshore financial center roles. Id.

110 See note 17 supra.

111 Henry, The Price of Offshore Revisited, supra note 5, at 43.

112 Id., at 40.

113 Palan, Structural Enablement, supra note 7, at 25.

114 Id. at 36. For an organization that supposedly loves transparency, TJN provides remarkably little of it in the report.

115 Strangely, the Tax Justice Network believes that “many key ‘source’ countries don’t even have domestic income tax regimes in place, let alone the power to enforce such taxes across borders.” Henry, The Price of Offshore Revisited, supra note 5, at 42. If these countries have no income tax (or no functional income tax), the reasons their wealthy citizens are moving money out of the country do not seem to be tied to taxation.

116 Henry, The Price of Offshore Revisited, supra note 5, at 42 (“developed countries have a responsibility as well as the capacity to help [developing countries] solve” the tax problems). In addition, “institutions like the World Bank, the IMF, the US Federal Reserve, the Bank of England, and the Bank for International Settlements” must “live up to their promises, and work with organizations like TJN on a research and policy agenda that finally gives this offshore sector the attention it deserves.” Id. at 45. That would certainly solve TJN’s funding issues for the foreseeable future! Unmentioned by TJN are the many conflicts over policy objectives that underlie particular choices of tax structures. For example, a key role of multi-jurisdictional tax planning for individuals concerns their estate plans, including who gets the estate.
It follows that the limits on governments imposed by capital markets are illegitimate. For example, Hampton and Abbott argue that since 1992 we have witnessed a catalogue of economies and government policies wrecked by speculation and rapid capital flight. Since the 1992 ERM crisis forced the UK government to take sterling out of Europe’s fixed exchange rate system at a cost of over $10 billion in foreign currency reserves, the financial markets appear to have taken one scalp after another, from Mexico in 1994 to a whole series of economies across Asia between 1997 and 1998 whose collective collapse threatens to have global consequences. Even as this book was being completed (August 1998) there was the spectacle of Boris Yeltsin being forced to devalue the ruble only three days after he and his finance minister had adamantly resisted calls from the most famous of speculators, George Soros, to do so. In Indonesia the financial crisis even brought down the country’s ageing President, Suharto, after 32 years in power.  

These examples are revealing as each reflects a government’s inability to maintain fixed exchange rates in the face of market pressures. One interpretation of these failures is that it is the speculators (such as Soros, who profited significantly from the UK’s failure to maintain the value of sterling) who are responsible for the problems, rather than the governments that adopted dysfunctional policies. Control First framework proponents often suggest this is the appropriate way to view such events rather than seeing them as a failure of a government to make appropriate policy decisions, which allows a clever or lucky individual like Soros to profit by risking his capital in betting that the government cannot sustain a dysfunctional policy against market pressures. Because Control First proponents appear to not recognize as legitimate any limits to government actions other than the limits they themselves propose (e.g. restrictions on tax competition), they see all market-derived limits as the result of illegitimate private actions. In particular, they appear to believe any government ought to be able to dictate any exchange rate the government believes is useful to it. Moreover, they do not appear to recognize that any governments might be illegitimate. That a financial crisis brought down former Indonesian dictator Suharto, whose rule the New York Times’ story on his death termed “one of the most brutal and corrupt”, might be a feature of globalized finance rather than a bug.


117 Hampton & Abbott, supra note 2, at 14.

118 For example, Britain’s exit from the ERM, the Russian and Mexican devaluations, and the various Asian currency collapses might be attributable to failures of the governments in question to have sustainable fiscal and monetary policies rather than malevolent action by speculators.

Control First proponents also find efforts by attorneys and accountants to structure transactions in ways beneficial to their clients to be problematic. “[T]he scope of the state’s power to regulate private activities and transactions in world markets is elastic”, thus enabling the use of “creative lawyers” to “accommodate formal legal requirements to the strategies of capital accumulation.”120 Using “abstract legal concepts, or fictions”, these lawyers then can pursue strategies to minimize taxes.121 According to these Control Firsters, such efforts are “distortions” or involve something other than “real” economic activity. As a result, these efforts are illegitimate.

They argue that the answer to all of these problems is to control the movement of money, which in the absence of such measures evades what Control Firsters see as legitimate social controls. In particular, if all the beneficial owners and controllers of interests in all transactions were identified, all transactions could be regulated, taxed, or simply stopped by governments when a government determined that a particular transaction was illegitimate. Thus, for example, the Tax Justice Network contends “nation-states need to work together to take steps now to [take] control over all this out-of-control global ‘financial pollution.’”122 Doing this requires “automatic information exchange among tax authorities, country-by-country corporate reporting, and the deployment of public registries for beneficial ownership of companies, trusts, and foundations.”123 In addition, there need to be “stiffer sanctions” for “’pirate banking’ misbehavior” by banks and bank managers.124 A successful approach will limit not just behavior of OFCs but also jurisdictions within larger countries: Nevada and Delaware will have to be “curb[ed]”.125

Such expanded control measures are not merely hypothetical proposals. Recent proposed regulations by the Financial Crimes Enforcement Network (FinCEN), designed to improve anti-money laundering controls (discussed in further detail below) would require financial institutions to identify, on a current basis, the ultimate human beings who are the beneficial owners and controllers of all their clients (with some exemptions, e.g. for publically listed companies), without regard to whether there is any suspicion that such persons might be engaged in illegal activities.126 While this proposal has resulted in

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120 Picciotto, Legal Fiction, supra note 7, at 47. He also attributes the creation of tax haven jurisdictions to “enterprising lawyers or accountants who could persuade government officials or legislators to enact the necessary provisions.” Id. at 53.
121 Id. at 47-48.
122 Henry, The Price of Offshore Revisited, supra note 5, at t 44. One of the endearing features of The Price of Offshore Revisited is that it appears to not have been proof-read and so contains quite a few typos, missing words, etc. This does not inspire confidence in the unreleased details of the calculations.
123 Id. at 44.
124 Id. at 44. These are extraordinary steps, much harder and costlier than they appear. Countries without direct taxation do not collect the same information as countries that rely on direct taxation. Who funds the collection of information that must be exchanged ‘automatically’?
125 Id. at 44.
significant push-back from regulated financial institutions and others, the fact that FinCEN seeks to implement a requirement of the Financial Action Task Force’s (FATF) global anti-money laundering standards suggest that some version of it will ultimately be enacted.\textsuperscript{128} Certainly such requirements would be impossible to implement in such a way as to catch actual bad guys intent on avoiding detection, but they would generate significant additional costs by requiring financial institutions to identify ultimate beneficial owner and controllers in the vast majority of clients who are not involved in illegal activities.\textsuperscript{129} But for the Control Firsters, adding significant costs to legitimate financial activities is not a primary concern. (Nor, perhaps, is the effectiveness of the controls demanded in accomplishing the stated objective of reducing crime, as we discuss below). Adding complexity to tax codes is also problematic: Tanzi analogizes it to “termites” which “weaken the structure, increase the complexity of the systems and the cost of compliance, and reduce the efficiency and the equity of the tax systems” and argues compliance costs are a regressive tax.\textsuperscript{130}

The Control First vision focuses on four key policy areas. First, Control First proponents believe that controlling crime via efforts to limit the ability of criminals to make use of the proceeds of crime is an important law enforcement tool. This has been important in persuading jurisdictions to adopt Control First measures, since it is difficult to resist pressures to control crime. Second, they contend that corruption is best controlled by generally applicable controls on international financial transactions. Third, they believe that all governments should be unconstrained by international tax competition in designing domestic tax systems and every jurisdiction should have complete information on all transactions by any taxpayers who operate in it to facilitate collection of any tax any government wishes to impose. Fourth, they similarly believe that jurisdictional competition should impose no limits on any government’s ability to redistribute resources among entities and individuals under its jurisdiction and that all governments must therefore have access to complete information on all of their citizens’ wealth and income.

1. **Controlling Crime via Money**

In the 1970s and 80s, it became clear to most observers that the global “war” against trafficking in illegal drugs was not working. Rather than re-think whether their strategies of prohibiting the use of narcotics was itself fundamentally flawed or take the

\textsuperscript{127} Accessible at [http://www.regulations.gov/#!docketDetail;_dct=PS;_rpp=25;_po=0;_D=FINCEN-2012-0001](http://www.regulations.gov/#!docketDetail;_dct=PS;_rpp=25;_po=0;_D=FINCEN-2012-0001). The requirement to identify beneficial owner and controller of accounts is also central to the Foreign Account Tax Compliance Act, discussed below at .


\textsuperscript{129} The easiest being to use a confederate or front person as the beneficial owner/controller, and to lie about it.

\textsuperscript{130} Tanzi, *Tax Systems*, supra note 68, at 32-34.
sort of draconian steps necessary to significantly curtail domestic drug usage.\textsuperscript{131} the United States and a number of other wealthy countries where drugs were imported to meet domestic demand began to focus instead on measures to reduce the profitability of the international drug trade by making it more difficult for those involved to use or invest the proceeds of their illegal activities.\textsuperscript{132} This they did primarily by enlisting banks, and later other financial institutions, as unpaid adjuncts of law enforcement agencies. In effect, financial institutions were required to identify exactly who their customers were, to determine if the origin of their customers’ funds or financial transactions might be the proceeds of narcotics trafficking (and, later, of other serious crimes such as corruption and tax evasion) and, if so, complete an internal investigation of those customers, funds, and transactions and file a report with the government if the institution suspected that the funds or transactions involved criminal proceeds. A key to this anti-money laundering program was the elimination of client confidentiality in financial matters.\textsuperscript{133} In addition, financial institutions had to develop expertise in evaluating patterns of transactions and other indicia of illegal activity.\textsuperscript{134} Over time these anti-money laundering requirements were regularly extended and made more onerous, raising the costs to all customers.\textsuperscript{135} This marked the first major international adoption of a Control First approach to financial transactions.

Efforts to control crime via financial institutions could not be effectively implemented by a single jurisdiction because of the interconnectedness of the global financial system. Those countries that took the lead in developing such anti-money laundering preventive measures founded an international task force, the FATF, both to standardize such measures and to encourage all jurisdictions to adopt them.\textsuperscript{136} These international standards, now known as the FATF 40 Recommendations on Money Laundering and Terrorism Finance, also include provisions regarding the freezing and forfeiture of criminal proceeds and instrumentalities and international assistance in investigating and prosecuting crime, including the sharing of extensive and detailed client financial information. Over time, the FATF membership expanded to 34 jurisdictions.\textsuperscript{137}


\textsuperscript{133} Gordon, \textit{Trysts, supra} note 132, at 712-719.

\textsuperscript{134} Id., at 726-7.

\textsuperscript{135} Id., at 712-719.

\textsuperscript{136} The G-7 Heads of State or Government and President of the European Commission convened the FATF from the G-7 member States, the European Commission and eight other countries. FATF, History of the FATF, available at http://www.fatf-gafi.org/pages/aboutus/historyofthefatf/.

\textsuperscript{137} FATF, About Us, available at http://www.fatf-gafi.org/pages/aboutus/.
including such emerging market countries as India and China, while allied regional organizations known as FATF-Style Regional Bodies or FSRBs have brought the number of jurisdictions pledged to implement the FATF’s Recommendations to over 140.\footnote{IMF, Anti-Money Laundering and Combating the Financing of Terrorism, available at http://www.imf.org/external/np/leg/amlcft/eng/} Assessments of compliance with the Recommendations are undertaken by members based upon a detailed methodology of compliance, and are published on the websites of the FATF and FSRBs.\footnote{Id.} In addition, following the attacks of September 11\textsuperscript{th}, 2001, the International Monetary Fund (IMF) and the World Bank began to participate in the compliance assessments.\footnote{Id.} The experience with the FATF Recommendations is thus a good model for assessing how Control First measures work in practice.

A key aspect of the Recommendations has long been that financial institutions must determine if financial institutions with which they do business in other jurisdictions comply with the Recommendations; if not, financial institutions must raise their own required due diligence or cease engaging in business with those non-compliant institutions.\footnote{Recommendations 13 and 19, FATF 40 at 16, 19.} Crucially, all of these measures rely heavily on conscripting financial service providers to implement control measures and on transnational bodies to evaluate compliance, shifting control of jurisdictions’ financial systems out of their own hands and into bodies that may be controlled by others.\footnote{While FATF preventive measures are a Control First unfunded mandate that forces financial institutions to engage in law enforcement, the mandate does not discriminate among those jurisdictions that are suffering the ill effects of crime and those that bear the increase in costs that the mandate generates. Richard Gordon, Losing the War against Dirty Money: Rethinking Global Standards on Preventing Money Laundering and Terrorism Financing, 21 DUKE J. COMP. & INT’L L. 503, 529-44 (2011). For example, while the vast majority of the users of illicit narcotics (who are the source of illegal proceeds) tend to reside in large jurisdictions like the United States, other jurisdictions with fewer such problems, many of which are offshore centers, are required to bear the costs of the preventive measures. The same can be said of other serious predicate offenses like grand corruption and income tax evasion. (Grand corruption “consists of acts committed at a high level of government that distort policies or the central functioning of the state, enabling leaders to benefit at the expense of the public good.” Transparency International, FAQs on Corruption, available at http://www.transparency.org/whoweare/organisation/faqs_on_corruption.) As noted earlier, the Control First approach is to impose control measures that raise costs on all with little or no discussion of the actual benefits achieved by the measures. Recently, however, the FATF has adopted new Recommendations that allow jurisdictions to apply preventive measures on a risk-weighted basis, and to assess compliance in part on effectiveness of implementation. While these changes are only now being implemented, they do demonstrate a new and commendable willingness on the part of the FATF to address some of the problems that arise under the Control First impulse. Recommendation 1, FATF 40, at 11.} A central activity of the FATF has been to determine which jurisdictions pose significant money laundering and terrorism financing risks and to encourage them to improve their systems. A primary part of such “encouragement” has been the threat of “countermeasures,” or requiring financial institutions from compliant jurisdictions to increase due diligence in transactions with institutions in non-compliant ones, or to stop
engaging in business entirely with those financial institutions. The first such initiative was the Non-Cooperative Country and Territories initiative, began in the early part of the last decade. There were a number of complaints about that initiative, focusing on what the IMF believed was a degree of arbitrariness in both the selection of which jurisdictions would be subject to special monitoring and the method for assessing compliance in those jurisdictions. The most recent version, the High Risk and Non-Cooperative Jurisdictions initiative, relies on a far more evenhanded and transparent approach to assessment and evaluation. It targets “jurisdictions that have strategic AML/CFT deficiencies and to which counter-measures apply, [and] jurisdictions with strategic AML/CFT deficiencies that have not made sufficient progress in addressing the deficiencies or have not committed to an action plan developed with the FATF to address the deficiencies.”

Even though there is often no obvious benefit to them, offshore jurisdictions have become among the most compliant jurisdictions with the FATF 40. The High Risk and Non-Cooperative Jurisdictions initiative includes only one traditional offshore center, Antigua and Barbuda, and that only on the “Improving Global AML/CFT Compliance: on-going process” list. Indeed, Jersey and Guernsey have been assessed as the jurisdictions that are most compliant with the FATF standards.

In effect, OFCs have raised the costs of financial transactions implemented through financial institutions located within their jurisdictions for the purpose of fighting crime that occurs elsewhere and which adversely affects the citizens of other places rather than their own citizens. This has been particularly true with respect to measures directed against the use of offshore centers by corrupt foreign officials. Recent studies by the World Bank and the noted scholar Jason Sharman conclude that among the most compliant jurisdictions with respect to the laundering of proceeds of corruption are offshore centers, while among the least are the United States and the United Kingdom.

There are three key lessons from the FATF 40 experience with Control First measures. First, they are dictated by a small group of powerful jurisdictions to the rest of the world without broad participation. Second, they shift costs from the jurisdictions that benefit to other, generally smaller or less well off jurisdictions and the private sector by

146 Id.
147 Onshore Financial Centers: Not a palm tree in sight, The Economist, Special Report, 8 (February 16th, 2013).
148 EMILE VAN DER DOES DE WILLEBOIS, EMILY M. HALTER, ROBERT A. HARRISON, JI WON PARK, AND J. C. SHARMAN, THE PUPPET MASTERS: HOW THE CORRUPT USE LEGAL STRUCTURES TO HIDE STOLEN ASSETS AND WHAT TO DO ABOUT IT (2012); Shima Baradaran, Michael Findley, Daniel Nielson, and J.C. Sharman, Does International Law Matter?, 97 MIN. L. REV. 734, 826-837 2013). There is also “at least some support for the argument that corruption and taxation are substitutes”. Bird, Tax system change, supra note 23, at 415. This would greatly complicate TJN’s analysis.
requiring expensive compliance and monitoring measures to benefit others. Third, neither the standards’ efficacy or cost-effectiveness are regularly (if ever) discussed once they are promulgated. Once a Control First measure appears, it becomes a permanent feature of the financial network.

2. Dettering Corruption

Once the Control First approach was established in anti-drug crime efforts, proponents soon sought to expand it to control other problems. In particular, the widespread publicity surrounding a number of banking scandals involving corrupt individuals in the 1970s and 1980s led to efforts to control corrupt politicians via banking controls. Proponents of the Control First framework see transnational financial institutions as playing a key role in the theft of assets from developing country governments. For example, James Henry argues that there is a “general phenomenon” of “the export of vast quantities of capital and tax-free incomes by the elites of poor countries, even as their countries were incurring vast debts and struggling to service them. Individual kleptocratic regimes and evil dictators come and go, but this sophisticated transnational system remains more vibrant than ever.” A series of “perverse capital

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150 Henry, BLOOD BANKERS, supra note 9, at xxv. A problem for Control First framework proponents is that some of the policies they object to are the result of domestic politics in developing economies. For example, Henry notes that the Bangko Sentral ng Pilipinas (the Philippine Central Bank), “under pressure from domestic interest groups to maintain a strong peso, low taxes and interest rates,” borrowed money that financed the peso’s appreciation from 1976 to 1982. The result was a growth in imports and capital flight, including by business people, lawyers, accountants, doctors and dentists. Henry, BLOOD BANKERS, supra note 9, at 68. The problem is that those “squirreling” away money outside the Philippines were behaving rationally – faced both with an overvalued domestic currency and the political risk that the Marcos regime would end (a risk that was increasing over time). Similarly, Henry’s complaint that Venezuelans “decapitalized” their economy during the late 1970s and early 1980s when the bolivar was “seriously overvalued”, Henry, BLOOD BANKERS, supra note 9, at 104, making dollars cheap, mistakenly ignores the rationality of the behavior of those who sought to escape a currency that would inevitably devalue for the safety of an alternative. To the extent that it was politicians “stashing away government revenues and foreign aid funds in numbered accounts” and helping to precipitate financial crises, the problem is as much an internal one as it is an external one. See Stopford, Strange, & Henley, supra note 1, at 105. Moreover, even in Henry’s account, the Filipino’s problems stemmed in significant part from theft of gold from the Central Bank – an illegal act that occurred in the Philippines. Henry, BLOOD BANKERS, supra note 9, at 71-72. The Philippine example is not the only one. Henry also points to Venezuela’s practice of borrowing money for development projects from international banks while depositing oil revenues in those same banks under President Carlos Andres Perez. Henry explains this as a mechanism to siphon off funds to the bank accounts of Pres. Perez and other Venezuelan officials. Id. at 98-99. Among other means of doing so, Henry argues that Venezuelan government agencies circumvented legal restrictions on long term borrowing by switching to short term loans. Id. at 102-103. Similarly, he argues that Argentine central bankers facilitated looting the country. Id. at 244-245. More of the problems – as Henry admits – come from “the highest rate of tax evasion in Asia” because “tax resistance is deeply engrained in Filipino attitudes” after “twenty – one years of dictatorship and a parade of corrupt administrations” and “an extraordinary number
flows” are facilitated by “preeminent global financial institutions.” This has led to a “global bleed-out” of assets from developing economies. This includes “wasteful projects and arms purchases”, the use of “[h]undreds of billions of Third World loans” for “nonproductive projects and corruption”, many of which had “harmful long-term consequences.” A “sophisticated transnational system of influential institutions,” rather than “random policy mistakes” or “purely indigenous corruption”, contrived to produce similar mistakes over and over again, in every region of the world. This is the result of “an interlocking global system of institutions and interests” which is “self-organizing” and “consists of an amazing array of mutually reinforcing interests” which “takes no prisoners.” Control First proponents argue that to overcome this problem requires tighter controls over the financial institutions that make the looting possible.

A key component of this argument is that developing countries misapply the proceeds of the loans they receive. For example, in Blood Bankers Henry argues that the Philippines’ problem was “not so much overborrowing per se, but the question of what was done with the money.” In The Price of Offshore Revisited, he argues that “private elites” in developing countries “accumulated $7.3 to $9.3 trillion of unrecorded offshore

of tax concessions” made to businesses and individuals. Henry, Blood Bankers, supra note 9, at 84. Even when a government complicit in this activity is toppled, Control First framework proponents object to developed countries’ legal obstacles to returning allegedly stolen assets. See, e.g. Henry, Blood Bankers, supra note 9, at 48 (“Overall, it turns out that if the loot is large enough, leading havens like Switzerland, Liechtenstein, and the US as well as the court systems in developing countries, are much more scrupulous about returning stolen property than about receiving, protecting, and concealing it in the first place.”).

151 Henry, Blood Bankers, supra note 9, at xxvii.
152 Id. at xxviii.
153 Id. at xxviii. Opinions may differ on what constitutes a ‘wasteful’ project, of course. Reviews of multinational companies’ projects in developing countries have found large numbers of “negative economic outcomes” associated with projects “where government offered high rates of tariff protection for import-substituting projects”. Stopford, Strange, & Henley, supra note 1, at 151-52. It is not clear that Henry would count a project as “wasteful” simply because it had a negative economic return. There are certainly no shortage of poorly conceived and/or poorly executed development projects funded through international borrowing by developing country governments. (Richer governments can fund such projects on their own.) But it is also true that “greater capital mobility has permitted many governments … to initiate development projects that previously had been starved by capital shortage and has helped raise the levels of ambition for future competitiveness and importance on the world stage.” Stopford, Strange, & Henley, supra note 1, at 34. Not all of these projects were misguided or poorly executed.

154 Henry, Blood Bankers, supra note 9, at xxviii. Henry repeatedly excuses foreign governments. Nicaragua’s Sandinista regime is referred to as “courageous, well-meaning, and rather naïve young Marxists and social democrats” who “had almost no experience managing a small developing country.” Id. at 183. Later, he concedes that the Sandinista-controlled central bank “printed cordobas like crazy” when the Sandinista’s lost power in 1996 and admits the lame duck Sandinista legislature “rushed through several new laws that granted title for all this expropriated property to its current possessor—in most cases, FSLN party leaders and their supporters.” Id. at 201-202.

155 Id. at 223.
156 Id. at 66. Similarly, Argentina’s heavy borrowings during the twentieth century was caused by “[l]eaders of foreign banks” not bad policies in Argentina. The banks “not only provided a huge amount of finance for misguided government spending” but also “private tutorials to Argentina’s elite on how to move vast amounts of their ‘rich’ country’s wealth to New York, Miami, and Switzerland.” Id. at 226-227. Yet Henry concedes that “[a]nyone could see that the junta’s economic policies, on top of the repression, were approaching a dead end.” Id. at 242. What exactly were people in Argentina supposed to do? Wait for the losses devaluation would impose?
wealth” from the 1970s to 2010, even as their governments borrowed $4.08 trillion, and their economies proved to be the source of $10.1 to $13.1 trillion of capital exports.\footnote{Henry, The Price of Offshore Revisited, supra note 5, at 5-6.} The private capital exports and public debts are “intimately linked”.\footnote{Id. at 6. Similarly, Henry complains of the role of international institutions in the promotion of coffee growing in Vietnam, which turned out to be a lower cost producer than many Central American countries. Henry, BLOOD BANKERS, supra note 9, at 214. Despite support for the policy from Vietnam’s authoritarian government, Henry finds the problem was in the World Bank and other international lenders’ pressure on Vietnam to liberalize its economy. Henry, BLOOD BANKERS, supra note 9, at 212-13. Indeed, almost nothing cannot be excused by Henry in his search for oppressive behavior by international financial institutions: even Saddam Hussein’s invasion of Kuwait was the act of “a bungler, driven into a corner by his country’s economic crisis and isolation”, Kuwaiti “insults”, and Henry’s view of that Kuwait was an illegitimate British construction rather than a nation. Id. at 307, 355, 358, 362.}

The Control First framework recognizes the problem of weak domestic institutions within the “exploited” jurisdictions. For example, Henry notes that Venezuela’s banking supervisor in the 1970s and 1980s had only six professional auditors for its banking sector and “limited enforcement powers,” while the banks were “protected from oversight by heavyweight political connections.”\footnote{Henry, BLOOD BANKERS, supra note 9, at 112. Henry appears to see no contradiction between such points and his acceptance of the later Chavez government’s assertion that the Venezuelan state oil company, PDVSA, had had too much autonomy which required the government to take control of its finances. Id. at 120. On the problems with the Chavez-run PDVSA, see Peter Wilson, Venezuela’s PDVSA oil company is bloated, ‘falling apart’, USA Today (May 28, 2012) available at http://usatoday30.usatoday.com/money/world/story/2012-05-28/venezuela-oil/55248628/1; Jason Simpkins, Hugo Chavez is Dead, But His Legacy of Inefficiency Will Live On, Oil & Energy Daily (March 7, 2013) available at http://www.oilandenergydaily.com/2013/03/07/hugo-chavez-pdvsa/. He also ignored the widespread consensus that the pre-Chavez PDVSA was a model of efficiency and transparency. For example, William Ascher noted that PDVSA had “escaped the rampant inefficiency and corruption that are so prevalent in state oil companies in other many countries” and achieved “relative competence, cost consciousness, professionalism, and efficiency” precisely because the pre-Chavez governments had not “used the firm as a serious off-budget laundering mechanism.” William Ascher, WHY GOVERNMENTS WASTE NATURAL RESOURCES: POLICY FAILURES IN DEVELOPING COUNTRIES 221 (1999).} The solutions offered by Control First framework proponents to these problems are not to strengthen the weak institutions (although they presumably would not object to doing so) but to prevent the transfer of wealth from developing countries to financial institutions outside them and change laws to allow later governments to recover what they allege is previously looted wealth.\footnote{Id. at 42 (“For developing countries, then, the true so-called ‘development finance’ problem is precisely that all this unrecorded wealth is now offshore, in the hands of private bankers and their own rapacious elites. That means their ‘debt’ problem has really become a tax justice problem – one that the developed countries have a responsibility as well as the capacity to help them solve.”).}

As with the crime control measures described above, the Control First prescription for corruption is a set of standards dictated by a small group of countries and NGOs to be imposed by fiat on other jurisdictions. Much of the costs will be borne by jurisdictions and institutions with little or no say in the development of the standards.
3. Deterring Tax Avoidance and Tax Evasion

Many Control First proponents appear to believe that there is a ‘correct’ (or perhaps “fair”) amount of tax owed on any particular amount of income, that any effort to reduce that amount is illegitimate, and that such efforts are, or ought to be, illegal. Thus, they rarely distinguish between tax evasion (breaking the law) and tax avoidance (structuring one’s affairs to reduce the tax owed while complying with the law). For example, Prof. Phyllis Lai Lan Mo argues that “There is little doubt that all cases of tax avoidance are at odds with national interest”¹⁶² and she sees “the distinction between avoidance and evasion” as “tenuous at best in practice.”¹⁶³ Similarly, the Tax Justice Network “feel[s]” that it has “effectively demolished pretty much every” argument in favor of offshore financial centers playing a positive role.¹⁶⁴

For Control First proponents, taxes are central to most international financial transactions. For example, Picciotto asserts that “the main spur for the creative exploitation of disjunctures in the international state system has been the avoidance of taxation…”¹⁶⁵ Tax avoidance, or at least that degree of it which is contrary to the intent of the government that proposed the tax law, is seen as at least the moral equivalent of breaking the law and potentially illegal in its own right. Thus, when the band U2 moved its music publishing company from Ireland to the Netherlands, saving substantial sums in taxes because of the Netherlands’ favorable treatment of royalty income relative to Ireland’s, the band was engaged in tax avoidance: legal behavior to minimize its taxes.¹⁶⁶ One might criticize this strategy on the grounds that the band had some kind of moral obligation to pay more taxes than the letter of the law required, but there was nothing illegal about its behavior.¹⁶⁷ Similarly, complaints in the UK over Starbucks’ and Amazon’s tax strategies, which reduced their UK tax bills, brought complaints from UK Prime Minister David Cameron and others that they were “immorally” minimizing their

¹⁶³ Id. at 3.
¹⁶⁵ Picciotto, Legal Fiction, supra note 7, at 48.
¹⁶⁷ The controversy over the move is summarized in Mackey, supra note 166, that notes that the charge that U2 was hypocritical for advocating for greater aid to developing countries while avoiding Irish taxes depending on U2’s charitable work. Had U2 simply spent all its money on itself, there would be no hypocrisy in making the tax move. Id. U2 responded to the charge of hypocrisy by arguing that Ireland had itself lured business to its economy through low tax rates. Therefore, Bono contended that

What’s actually hypocritical is the idea that then you couldn’t use a financial services center in Holland. The real question people need to ask about Ireland’s tax policy is: ‘Was the nation a net gain benefactor?’ and of course it was — hugely so. So there was no hypocrisy for me — we’re just part of a system that has benefited the nation greatly and that’s a system that will be closed down in time. Ireland will have to find other ways of being competitive and attractive.

Mackey, supra note 166.
Cameron told MPs that he would make “damn sure” that such companies paid their fair share of UK taxes. Cameron rejected the notion that being “within the law” was sufficient; “really aggressive tax avoidance” might be legal but would not be “playing fair”. As a result, Starbucks has begun making substantial payments in excess of its legal obligations to the UK government. Similar complaints have been leveled at Apple by both Democratic and Republican members of the United States Senate, who have noted that Apple has used Irish subsidiaries to reduce the amount of income tax owed the U.S. Treasury. While Apple was simply applying the law as enacted by the U.S. Congress, there seemed to be a view that the company should, in effect, voluntarily increase the amount of tax paid. Thus, Control First proponents contend that there is a “fair” allocation of tax independent of what tax laws actually say. Tax laws are thus seen as something other than the messy process of complex bargaining among interest groups within governments, often pursuing multiple and even contradictory objectives. Rather they are “the main link between state and citizen, and are experienced as the most direct intervention by the state in economic activity.”

The first goal of the financial regulatory network must therefore be to enable collection of the “fair” amount of taxes by various governments. To accomplish this, the Control First solution is built on that deployed earlier in pursuit of the proceeds of drug deals and corruption: identifying and tracing beneficial owners and transactions.

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169 Id.

170 Terry Macalister, Starbucks pays corporation tax in UK for for first time in five years, The Guardian (23 June 2013) available at http://www.theguardian.com/business/2013/jun/23/starbucks-pays-corporation-tax (quoting Starbucks that decided to forgo certain deductions which would make us liable to pay £10m in corporation tax this year and a further £10m in 2014. We have now paid £5m and will pay the remaining £5m later this year.


172 Dominic Rushe, Senators accuse Apple of ‘highly questionable’ billion-dollar tax avoidance scheme, The Guardian (20 May 2013) available at http://www.theguardian.com/technology/2013/may/20/apple-accused-tax-avoidance-billions-scheme (noting that U.S. Senator John McCain said his constituents were "mad as hell" to learn that Apple was paying tax rates that were sometimes lower than 1%. "I've never seen anything like this." While Apple argued that "Apple complies fully with both the laws and spirit of the laws. And Apple pays all its required taxes, both in this country and abroad.

173 More generally, Stopford, et al. note that

A state has objectives that are multiple, often conflicting, always shifting. It cannot in reality be a rational actor in the game-theory sense of having a fixed order of priorities in its policy goals. It always wants incompatible, conflicting values. It wants to be efficient and competitive and to preserve social peace and the cohesion of the state with society. It wants autonomy and the freedom to choose its own path to economic development and access to advanced technology and overseas markets. It is playing a trade-off game in which the variables are never constant.

Stopford, Strange, & Henley, supra note 1, at 135.

174 Picciotto, Legal Fiction, supra note 7, at 48.
However, these are more difficult to accomplish in the context of taxes, in part because of the much larger set of transactions that must be monitored. Rather than focusing on individuals suspected of drug crimes and those whose behavior fits a profile of an individual involved in such crimes (e.g. depositing large amounts of cash regularly), a tax-focus expands the pool of suspicious behavior to everyone involved in a cross-border transaction.

A significant part of the history of income taxation across jurisdictions is related to efforts to minimize tax evasion by making it difficult to fail to report income. To attempt to ensure that taxpayers declare all of their income, jurisdictions typically require parties that make payments that may constitute income to the taxpayer to inform the tax authorities of such payments and, occasionally, to withhold estimated tax on those payments as well. In fact, modern income taxes fundamentally depend on systems of third party reporting and withholding to ensure compliance. Thus both Britain and the United States adopted withholding at the source for wage income as part of their imposition of broad-based income taxes. More recently, the United States has extended reporting requirements for non-wage payments to individuals to ensure that such income does not go unreported. For many years, Britain used a complex system of tax withholding on dividend and retained corporate income to ensure that individual taxpayers paid the appropriate personal income tax. As tax revenues as a share of GDP have largely risen throughout the world between 1965 and 2000, and were up “sharply” in most OECD countries in that period, demand for tax strategies to reduce tax bills increased.

However, such requirements to report and perhaps to withhold normally applied only to payors who were resident of the jurisdiction imposing the tax. After all, the laws of Country A do not normally apply to the residents of Country B, so Country A

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176 Gordon, Use and Abuse, supra note 144, at 516-7; 519-521.

177 26 U.S.C §3402; Income Tax Act 2007 c.1 Pt 15

178 26 U.S.C. § 6041-6050W.

179 J.A. Kay & M.A. King, THE BRITISH TAX SYSTEM (5th ed. 1990) (describing the imputation system used to tax corporate dividends in the UK from 1973). Although alien to Americans’ current conception of corporate taxation, this is in accord with at least some tax theory. See Badoway, supra note 67, at 94 (“One role of the corporations tax is to act as a backstop or withholding device for the individual tax”; to the extent it serves this function “such withholding should be recognized by providing a credit against individual taxes when these taxes are eventually paid on corporate source income.”); 107 (describing how corporate tax functions as a withholding tax); Albi, Challenges, supra note 7, at 131 (“The withholding function of [corporate income taxes], acting as a backstop to personal taxation, makes sense in the case of resident and non-resident shareholders, particularly if the latter are non-resident in name only.”).

180 Tanzi, Tax Systems, supra note 68, at 12-14 . The OECD total rose from 24.2% of GDP in 1965 (with a low of 10.6 in Turkey) to 36.1% in 2000 (with a low of 18.5% in Mexico). Id. at 13. (From 2000 to 2007, tax revenue as a percentage of GDP fell in 24 of 30 OECD countries.) Id. at 14-15.

181 Freyer & Morriss, supra note 8, at 21-24.

182 Id. at 520-21.
could not require payors who are under the jurisdiction of Country B to send Country A’s tax authority information. Residents of Country A who were keen on evading taxes could take advantage of this situation by accumulating income in Country B and not declaring it to Country A’s tax authority. Successful evasion would work only if Country B did not tax the income either. Because the income tax is generally a residence-based system, Country B might not tax the income if the taxpayer declares herself or himself not to be a resident of Country B. Also, and more simply, evasion would work if Country B did not have an income tax at all. The current “scandal” involving Jérôme Cahuzac, who recently resigned as the Socialist Party’s Budget Minister in France, involved just this type of issue: M. Cahuzac had undeclared bank accounts in Switzerland and Singapore, which he may have used to evade French taxes on income paid directly to that account. Of course, if the financial institutions in Country B discovered which of its customers were actually residents of Country A, and then reported to the tax authorities of Country A all financial information on those customers, then Country A could ensure that its residents did not commit tax evasion by failing to declare that income.

This is exactly what the G-7, the OECD, the United States, the European Union have been advocating. Previously larger, mostly on-shore jurisdictions that depend on the income tax had pressed low or no income tax jurisdictions only to provide information on particular accounts when the taxing jurisdiction believed that one of its residents was committing tax evasion by receiving undeclared income in the low or no tax jurisdiction. Although no offshore center or other jurisdictions with low or no income tax would ever need to request such information from high tax jurisdictions, nearly all have signed tax information exchange agreements with onshore jurisdictions. Given the disparity in benefits, such agreements have been signed under pressure from onshore jurisdictions, organized in part through the OECD’s two initiatives, the Harmful Tax Practices initiative and the Global Forum on Taxation, later renamed the Global Forum on Transparency and Exchange of Information.

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183 In part to prevent such evasion, the international tax system had long included a provision that payments that typically represented income paid by residents to non-residents include a gross withholding tax. So, if the taxpayer in the above example opened an account at a bank in Country B, any payments to that account from Country A that typically represent income would be subject to a gross tax of 30%. However, many countries, including the United States, have over time exempted many types of transnational payments including, for example, bank interest and portfolio bond interest, from withholding taxes as a way of reducing interest costs to US borrowers. In other cases, bilateral income tax conventions reduced or eliminated gross withholding taxes on other types of payments.


185 Moriss & Moberg, supra note 25, at 44-47.


However, realizing that this did not *uncover* tax evasion but only facilitated prosecution of otherwise identified instances of tax evasion, these high tax jurisdictions are now seeking to require that financial institutions in other jurisdictions routinely report to the high tax jurisdictions details of the financial transactions of the residents of high tax countries when these transactions occur outside the high tax countries. In other words, the high tax countries wish to treat the financial institutions of low or no tax countries as if they are under the jurisdiction of the high tax countries. For example, the European Union’s Council Directive on Administrative Cooperation in the Field of Taxation does this (starting in January 2014) for members with respect to wages, director’s fees, and income from life insurance products, pensions, and immovable property.\(^{189}\)

Perhaps the most extensive (and intrusive) expansion of transnational reporting is the U.S. Foreign Account Tax Compliance Act (FATCA), which requires foreign financial institutions identify to the United States their U.S. account holders and to disclose to the United States the account holders’ names and addresses, and the accounts’ balances, receipts, and withdrawals.\(^{190}\) Failure to do so would result in the United States applying a gross withholding tax of 30% on *all* payments of gross income to those financial institutions.\(^{191}\) And, to uncover exactly who is a resident of the high tax country, foreign financial institutions will need to determine if legal persons and arrangements with accounts in those countries are actually beneficially owned by U.S. residents.\(^{192}\) In spite of such burdensome and expensive requirements, many low or no tax offshore centers have reached agreements or are expected to reach agreements with the United States to avoid the sanctions, including the Cayman Islands, Guernsey, Jersey, The Isle of Man, Singapore, and Switzerland.\(^{193}\) In a classic example of a race-to-the-bottom in

\(^{189}\) In addition, they must also provide information when one EU country has reason to suppose that there may be a loss of tax in the other EU country; a person liable to tax obtains a reduction in, or an exemption from, tax in one EU country which would give rise to an increase in tax or to liability to tax in the other EU country; business dealings between two persons liable to tax in different EU countries are conducted through one or more countries in such a way that a saving in tax may result in either or both of the EU countries; the competent authority of one EU country has grounds for supposing that a saving of tax may result from artificial transfers of profits within groups of enterprises; information forwarded to one EU country by another EU country’s competent authority has enabled information to be obtained which may be relevant in assessing liability to tax in the latter EU country. Administrative Cooperation in the Field of Taxation, Council Directive 2011/16/EU (15 February 2011), accessible at [http://europa.eu/legislation_summaries/taxation/fi0006_en.htm](http://europa.eu/legislation_summaries/taxation/fi0006_en.htm).

\(^{190}\) 26 USC 1471 -1474.

\(^{191}\) Id., at 1441.

\(^{192}\) For this reason, FATCA requires foreign financial institutions to determine if a client has a “substantial U.S. owner.” This means, in the case of any corporation, any specified U.S. person that owns, directly or indirectly, more than 10% of the corporation’s stock (by vote or value). For any partnership, it means any specified U.S. person that owns, directly or indirectly, more than 10% of the profits interests or capital interests in the partnership. For a trust, it means a specified U.S. person treated as an owner of any portion of the trust under the grantor trust rules and any specified U.S. person that holds, directly or indirectly, more than 10% of the beneficial interests of the trust. Id.

regulation, European nations are creating their own “son-of-FATCA” laws to require similar efforts.\textsuperscript{194}

In other words, high tax countries are forcing low or no-tax jurisdictions to serve as unpaid income tax law enforcement officers of the high tax countries, even if the low tax country itself has no income tax and would therefore not normally be reporting on the financial transactions of its own residents. Given that in many cases the on-shore countries are far wealthier than the offshore jurisdictions, such appropriation of free services could be seen as a reverse Robin Hood-style rich robbing the poor—all through increasing costs in the Control First model. An alternative, of course, would be for the high tax countries to provide their own tax authorities more resources, but this, of course, would cost money. Clearly it is better for the onshore country to require foreigners to provide free services. Nevertheless, all nearly offshore and other low or no tax jurisdictions are complying. They have little choice since their economies are dependent on access to the larger onshore economies.

A further issue involves tax avoidance through transfer pricing. The international system of allocating the profits of transnational companies among different jurisdictions for purposes of income taxation evolved during the 1920s, primarily under the auspices of the League of Nations (and since the end of the Second World War, the OECD).\textsuperscript{195} In essence, the system began with the assumption that each country should be permitted to tax the income of companies that arose within that country—in effect, to become “silent partners” with a share equal to the income tax rate.\textsuperscript{196} The problem with such a system was that many companies were transnational, with either branches of the same company or separate companies operating as subsidiaries of a parent company located in different countries. Creating vertically integrated firms is one way that firms cope with the risks of international operations.\textsuperscript{197}

As these groups of branches and subsidiaries operated as a single, integrated whole, they did not need to keep track of goods, services, and capital assets as they moved among branches or from one company to another. How, then, to allocate taxable income among different jurisdictions? The solution was, in effect, to pretend that the economic activity by the single, integrated group of branches and companies was divided into independent companies, one for each jurisdiction in which the integrated whole


\textsuperscript{196} It has long been argued that levying an income tax on companies separately from their human owners makes little economic sense, other than as a withholding tax on income to be distributed later to those human owners. See generally Graeme S. Cooper & Richard Gordon, \textit{Taxation of Enterprises and Their Owners} in \textit{TAX LAW DESIGN AND DRAFTING} (Victor Thuronyi ed. 2001), and sources cited.

\textsuperscript{197} Stopford, Strange, & Henley, supra note 1, at 71. Similarly, various intangibles such as “investments in technology, marketing and skills of organization” play important roles in NFP structures. Id. at 75.
operated. Each “separate” company would then be required to keep separate books of account, calculate its “separate” earnings, and report these to each jurisdiction. The only way to accomplish this, however, was for the integrated whole to invent prices for the goods, services, and capital assets that were transferred between each “separate” entity.

However, to calculate an accurate allocation of income among each “separate” entity, it would be necessary to compute these ‘transfer prices’ based on the prices that would have applied had the parties not been related, i.e. market-determined or “arms length” prices. As there was no business reason for the integrated group to keep records of intra-group transfers, the group was compelled by taxation authorities to create them. In those cases where goods, services, or assets were transferred to persons outside the group this was easy. But in other cases, often the majority of instances (at least with respect to value) there were no such arms length prices available, requiring companies to find “comparable” transactions between companies that are not subject to the same control, and to make adjustments to those comparable transactions. As Michael Durst, one of the world’s foremost authorities on the issue, has put it, “[t]he basic tenet of arm’s-length transfer pricing — the availability of ‘uncontrolled comparables’ for transactions between commonly controlled parties — is based on a fundamental misunderstanding of practical economics.”

Professor Stephen Shay, formerly Deputy Assistant Secretary for International Tax Affairs at the U.S. Treasury Department and another of the world’s experts on transfer pricing, recently noted with respect to a particularly important transfer pricing rules, the so-called “cost-sharing rule, that

the application of theory and models in the messiness of the real world can lead to unintended or unanticipated results. As demonstrated by the repeated efforts to strengthen the cost sharing regulations and the continued evidence of income shifting to lower tax countries, the application of cost sharing in the context of the international taxation has proven to be highly problematic. This is in part because assumptions necessary for the theory of cost sharing to be valid, including that all contributions are fully accounted for, are nearly impossible to control in a real world setting.

Creating such prices for the taxation authorities became an onerous and expensive process, one that has become even more onerous and expensive as the value of *sui generis* intellectual property has increased over time.

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201 Id., at 7 (“The difficulties with administering transfer pricing rules in relation to a sophisticated multinational group are compounded where comparable third-party transactions are unavailable or inexact, as is the case with respect to most high-value intangible property, and by the flexibility afforded a
To make matters more complicated, such groups of companies often operate in countries with varying rates of income tax—or no income tax at all. In such cases, international groups have a clear incentive to allocate as much of the group’s total income in member companies located in low or no tax countries. The way to do so would be to err on the side of overstating deductible costs in companies located in high tax countries, with a correlating overstating of income in companies located in low or no tax jurisdictions, when inventing transfer prices. And, obviously, such incentives would work more effectively on the taxpayer’s behalf if one or more constituents of the group were located in a low or no tax jurisdiction. On the other hand, taxation authorities from high tax countries have exactly the opposite incentive: to understate deductible costs in companies located in their countries when auditing taxpayers transfer prices.

Moreover, while, at least in theory, economic rates of return are equalized in the long run across firms, the transfer pricing rules use accounting rates of return rather than economic rates of return, and these “would not be equalized even in competitive markets, poised in long-run equilibrium, much less in the imperfectly competitive markets in various states of disequilibrium that are the norm.” Reliance on accounting data has important consequences for evaluations of transfer prices:

1. “Tax authorities in different jurisdictions are likely to allocate individual multinational firms’ consolidated income across countries in different ways.”
2. “Individual multinational corporations cannot accurately anticipate their country-specific tax liability in the absence of an Advanced Pricing Agreement [with tax authorities].”
3. “The current transfer pricing regime produces inequitable results.”
4. “Multinational and domestic firms are not treated uniformly for tax purposes.”

multinational corporate group in planning and executing its global legal and pricing structure to minimize tax.”).


204 Id.

205 Elizabeth King, TRANSFER PRICING AND CORPORATE TAXATION 7 (2010). As King notes, “there is no reasonable basis for assuming that one firm will earn the same accounting rate of return as a similarly situated competitor.” Id. To take just one example of why this is so, note that the book value of assets—a key component of the accounting rate of return—will be based on the accounting conventions followed by each company and so even identical assets may be recorded differently. Moreover, the accounting rates of return will be heavily influenced by the price paid for each asset (which will vary over time) and the extent to which the asset has been written off. Id. at 16.

206 King, TRANSFER PRICING, supra note 205, at 8-9.
In short, “a tested party’s tax liability under the [US or OECD methods] is entirely dependent on the particular profit level indicator chosen and the specific unaffiliated companies included in one’s firm sample.”

If there ever was a Control First reporting requirement with high cost and little chance of success it is the world’s transfer pricing regime. The OECD has provided, and continues to provide, hundreds of pages of guidance on how to estimate arms-length prices, while individual higher tax jurisdictions have created their own libraries of regulations. But ultimately, it is essentially impossible to for private sector actors to invent accurate arms length prices where there has been no arms length bargaining. The same is true for tax authorities. While this truth has been obvious to both practitioners and scholars for at least 30 years, the OECD and higher tax countries have continued to reaffirm the arms length standard. Once again, the Control First impulse has turned private sector actors into unpaid adjuncts of the government, in this case by requiring them to invent arms length prices where no market for those prices actually exists. As with other Control First impulses, these controls add significantly to costs of doing business, while critics attack the private sector for not voluntarily guessing at transfer prices that result in transferring more profits to governments rather than less. Instead, the OECD continues to argue in favor of more, and earlier, mandatory transparency and disclosure by taxpayers, without discussing the additional costs such disclosure might entail.

Given the impracticability of creating a system of accurately allocating income among related members of a group though arms-length-transfer pricing, different alternatives that are far simpler to apply have been proposed. However, these systems either are fundamentally inaccurate (e.g. factor apportionment, where income is allocated

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207 Id. at 17. These problems exist for other methods as well. See id. at 17-41.
based on relatively arbitrary formulas based on the location of factors such as sales, work force, and real property)\textsuperscript{212} or deviate substantially from an income tax (e.g. the “destination” system proposed by members of the Oxford University Center for Business Taxation),\textsuperscript{213} and none is likely to be implemented any time soon.\textsuperscript{214}

In other words, the world’s wealthiest and most powerful governments have created and persevered with a system to allocate transnational income that cannot work, but that they nevertheless fruitlessly try to implement by adding more and more costs to both private and public sectors. However, a fundamentally more radical “solution” has been proposed by governments of high tax countries that would, while not making it any easier for taxpayers or tax administrations to invent transfer prices, at least eliminate the incentive for taxpayers to err on the side of higher prices paid by constituent members of the group located in their high tax jurisdictions. And, conveniently, it would eliminate the general incentive for businesses to locate in lower tax jurisdictions. The solution is to force all low or no income tax jurisdictions to adopt relatively high corporate income taxes. While so far largely ineffective, the efforts of the EU, and many of the constituent member countries, to fight what they see as unfair tax competition by forcing low tax countries to raise their effective rates continues. The clamor over the recent bailout of Ireland (in which many EU members demanded that Ireland raise its corporate rates in exchange for credit support) and over the use of Irish subsidiaries by Apple and other companies suggest that these efforts are far from over.\textsuperscript{215} A victory would represent the epitome of the Control First view: controlling not only the collection and reporting of financial information, but tax systems—and tax rates—theirselfs.\textsuperscript{216}

Is this wise or fair? Many offshore centers chose not to have income taxes, perhaps because they made little sense from an administrative or economic perspective.\textsuperscript{217} For example, a consumption tax (such as sales tax or a value-added tax (VAT)) does not depend on tax reporting by those earning income but rather by those selling covered goods and services. The expansion of VATs is “[t]he most important tax development of

\textsuperscript{212} Gravelle, Tax Havens: International Tax Avoidance and Evasion, supra note 203 at 26.
\textsuperscript{213} Michael Devereux, How we can make global companies pay their fair share of tax, THE FINANCIAL TIMES 11 (May 23, 2013). At least internationally; US states use a factor apportionment system. Avi-Yonah & Clausing, REFORMING CORPORATE TAXATION, supra note 214 at 13.
\textsuperscript{216} Another tax evasion issue involves the use of offshore companies to generate fictitious losses. Because these are instances where the taxpayer must reveal the existence of the offshore company, the tax authorities can require the taxpayer to provide further proof of the losses. More traditional exchange of information agreements can be used to help confirm or deny the reality of such losses.\textsuperscript{217} Gordon, Use and Abuse, supra note 144, at 521; See, e.g., Boadway, supra note 67, at 119 (“Taken together, these arguments [summarized by the author] based on administrative ease, efficiency, and equity conspire against comprehensive income as an ideal form of taxation.”). Consumption taxes are also superior to income taxes because they tax “present and future consumption at the same rate, while income and scheduler (dual) taxation tax future consumption at a higher rate than present consumption.” See, e.g., Boadway, supra, at 118. They also avoid “many of the problems of income taxation” by avoiding calculating capital income and indexing capital gains. Id. at 120.
the last half-century.” Collection of consumption taxes poses a different set of challenges to tax authorities. For example, cash purchases may be made without being recorded for tax purposes, and so made without collecting the tax. Applying consumption taxes to transactions across borders also pose problems in deciding which jurisdiction is entitled to tax the transaction. Internet transactions posed such a problem in the United States, with internet retailers without a physical presence in a particular state not collecting sales tax on shipments to that state’s residents. Efforts to persuade consumers to report and pay taxes on out-of-state purchases generally failed. In some instances, specific types of consumption and excise taxes are avoided by shifting transactions to different jurisdictions, as with tobacco sales on Native American reservations relative to sales in stores in states where tobacco taxes apply and bootlegging. Similarly, locating transactions in low tax jurisdictions can defeat efforts to apply taxes based on physical presence.

All systems of taxation thus present challenges to tax authorities in ensuring that all relevant transactions or income are taxed. Each type of tax presents different challenges, however. For example, efforts to tax at progressive rates based on total income require a consolidated tax return that reports the entire income of the taxpayer. Hong Kong uses a schedule-based income tax system that precludes progressive rates because taxpayers report different forms of income on different schedules to different tax authorities. Without a total income, it becomes impossible to tax on a progressive rate

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221 Steven Maguire, State Taxation of Internet Transactions, Congressional Research Service (May 2013), at 1, available at http://www.fas.org/sgp/crs/misc/R41853.pdf (consumers are required to remit use taxes to their taxing jurisdiction for the use of the product purchased. Compliance with this requirement, however, is quite low).

222 See Philip DeCicca, Donald Kenkel, and Feng Liu, Reservation Prices: An Economic Analysis of Cigarette Purchases on Indian Reservations,(May 2010), at 1 (as of 2010, New York did not collect taxes on cigarettes sold on Indian reservations. The sales on these cigarettes appear substantial—a consumption rate 20 times higher than the average New York resident, if consumed only by tax immune citizens. This allows an inference of sale to Non-Native Americans.). http://uknowledge.uky.edu/gradschool_diss/155.

223 Littlewood, supra note 91, at 385-86.
schedule. Is this a feature (as the Anglo and Chinese business communities thought when the system was adopted after World War II) or a bug?

There are policy arguments for and against particular forms of taxation. Moreover, “tax policies have been increasingly used to promote non-revenue objectives.”225 To a considerable extent, the debate over the appropriate form and level of taxation can be resolved only by resort to political preferences; without an agreement on the purpose of the tax system (redistribution or non-distortionary funding of public goods, for example) there can be no agreement on the “best” system. With respect to the debate about the impact of Jurisdiction A’s tax system on Jurisdiction B’s tax system, arguments that Jurisdiction A is engaged in “unfair” tax competition assume the outcome by failing to recognize that different jurisdictions simply make different policy choices.226 Moreover, efforts to skew the debate by labeling jurisdictions that rely primarily or entirely on indirect taxation as “zero tax” or “low tax” jurisdictions is misleading. Even a jurisdiction relying entirely on indirect taxes is not a “zero tax” jurisdiction – without any tax revenue, such jurisdictions would have trouble funding even the most basic government services.227

### 4. Redistribution

Many Control First framework proponents want to make use of control over money flows to redistribute income and wealth. For example, Henry, author of TJN’s The Price of Offshore Revisited, argued in his 2003 book The Blood Bankers: Tales from the Underground Global Economy that “[r]ising inequality is an important anomaly for conventional economics to explain, because it predicts that competitive markets and free trade should lead to the convergence of global income and wealth levels over time”228

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224 Id. at 386.

225 Tanzi, Tax Systems, supra note 68, at 11.

226 The structure of an economy affects the design of the tax system. See Bird, Tax system change, supra note 23, at 417 (“tax design is … strongly influenced by economic structure.”). Moreover, as Winer, et al, note, “there is no reason to limit international competition to that over taxation, since there are other types of policy instruments that can often serve as good substitutes.” Stanley L. Winer, Lawrence W. Kenny, & Walter Hettich, Political regimes, institutions, and the nature of tax systems, in ELGAR GUIDE, supra note 7, at 376, 402.

227 Jorge Martinez-Vasquez, et. al, Direct versus indirect taxation: trends, theory, and economic significance, in ELGAR GUIDE, supra note 7, at 37, 54 (noting that smaller population countries tend to rely more on indirect taxes because they have a more mobile tax base).

228 Henry, BLOOD BANKERS, supra note 9, at xxi. This is nonsensical – economic theory makes no such prediction. In particular, Henry’s example of post-Soviet Russia (where he asserts “living standards have fallen farthest” while “inequality has increased the most”), Henry, BLOOD BANKERS, supra, at xxi, illustrate the problems with such superficial claims. Exploitation theorists like Henry focus on cherry-picked and misleading statistics. For example, Henry’s claims that inequality has risen “the most” in post-Soviet Russia certainly fails to take into account the inequality that existed in Soviet Russia in which the elites enjoyed access to goods, privileges, and services unavailable to ordinary Soviet citizens. See, e.g., Milton and Rose Friedman, FREE TO CHOOSE 146-47 (“Russia [the Soviet Union] is a country of two nations: a small privileged upper class of bureaucrats, party officials, technicians; and a great mass of people living little better than their great-grandparents did. The upper class has access to special shops, schools and luxuries of all kinds; the masses are condemned to enjoy little more than the basic necessities.”) See also Abram Bergson, Income Inequality under Soviet Socialism, 22 J. ECON LIT. 1051 (1984). However, even addressing only the post-Soviet experience of Russia, Henry’s analysis falls short by failing to account for
Similarly, in *The Price of Offshore Revisited*, he concludes the report with an emphasis on inequality: “all of our conventional measures of inequality sharply understate the levels of income and wealth at both the country and global level.”

Offshore wealth has an “astonishing” impact on inequality: “We have estimated, for example, that less than 100,000 people, .001% of the world’s population, now control over 30 percent of the world’s financial wealth.”

As a result, he concludes that active measures, including redistributive taxation, are necessary to address inequality.

The ability of individuals and firms to move assets around the world constrains the ability of a government to redistribute income and wealth. Famously, Canadian millionaire Harry Oakes moved to the Bahamas in the 1930s, fleeing high levels of redistributive taxation.

In the United States, retirees leaving the Midwest for Florida found not only sunshine and warmer winters but also avoided the higher estate taxes imposed in the states where they worked.

Control First proponents see such efforts as illegitimate and reject constraints imposed by markets on governments’ ability to redistribute wealth.

Such constraints may be behind the trend away from comprehensive, progressive income taxes in recent years.

More generally, the evidence suggests that globalization has the effect that “all countries are becoming small open economies” and so are “forced to lower their reliance on direct taxes vis-à-vis indirect taxes.”

Moreover, “[a]n obvious reason why most developing countries reap little from the problematic nature of post-Soviet Russian governmental institutions. There is no basis for claiming that economic theory would predict an evolution toward equality between countries with and without developed legal institutions, for example.


Id. at 40.

Id. at 42 (suggesting a “modest OECD-wide withholding tax on ‘anonymous assets under management’ in the top 50 banks, with the proceeds devoted to aid and climate change.”) Absent from TJN’s discussion of inequality is any appreciation for the complexity of the issues. For example, there is evidence that the burden of corporate taxation is borne by labor rather than capital (by reducing new savings and investment, leading to lower wages) and shareholders (due to “tax-induced managerial underperformance” and the inability to shift the tax on ‘old’ capital).

Albi, *Challenges*, supra note 7, at 131. This suggests corporate tax burdens may ultimately increase inequality.


See generally Jeffrey A. Cooper, *Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective*, 33 PEP. L REV. 835 (2006) (Florida’s estate tax scheme created a national concern as early as 1925, leading to a national estate tax with state tax credits available).

For example, TJN promotes “progressive and equitable taxation” as the ideal. See, Tax Justice Network, *Tax Havens Cause Poverty*, available at http://www.taxjustice.net/cms/front_content.php?idcatart=2&lang=1. The current trend is towards dual income taxes with lower rates on capital income, in part as a response to international capital mobility. Albi, *Challenges*, supra note 7, at 150. One reason for this is that high marginal rates “clearly induce a variety of changes in the behavior of taxpayers, with resulting economic costs. Tax-induced changes may include changes in hours worked and in labor force participation, the substitution of non-taxable for taxable consumption, changes in the timing of income realization, changes in the form of compensation (including incorporation), use of deferred compensation and other tax shelters, and increased evasion.”

Bird, *Tax system change*, supra note 23, at 426. Rather than recognizing that tax competition imposes limits on their preferred policies, TJN rages against the idea of competition.

Tanzi, *Tax Systems*, supra note 68, at 25 (noting “gradual movement toward the scheduler income taxes that had been common in continental Europe in the early part of the last century. This movement has been in part forced by globalization and by tax competition.”).

Martinez-Vasquez, supra note 227, at 57.
either income or property taxes is their continued inability to administer such taxes effectively.”

Again, the question is whether any government or a particular government has a “right” to tax those subject to its jurisdiction that requires insulation from the forces of inter-governmental competition and the consequences of the laws and regulations adopted to enforce its tax policy choices. The ability to raise tax rates, as happened in OECD countries through at least 2000, incentivizes tax avoidance measures by taxpayers. Indeed, there is evidence that cutting corporate rates has not reduced tax revenue. And, of course, there are other constraints on tax design that require trading off competing goals. In short, “[t]he administrative problems of implementing a comprehensive income tax are nigh insuperable.”

More generally, tax scholar Vito Tanzi noted that “[t]here is no theory that can tell us what should be the optimal level of taxation for a country. That level would depend on (1) how well governments use the tax revenue; (2) how good are the tax laws used to collect the revenue; (3) how good is the tax administration; and (4) how citizens react to the inevitable disincentive effects that high tax rates generate.” Moreover, tax structures depend on details of political arrangements. As we noted above, the current Control First initiatives also raise the question of who is to pay for these costs, as many of these initiatives externalize the compliance costs on to governments, firms and individuals without an interest in other governments’ enforcement of particular tax policy choices.

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237 Bird, Tax system change, supra note 23, at 418.
238 Tanzi, Tax Systems, supra note 68, at 12. Direct taxes account for an increasing share of total taxes in OECD countries. Martinez-Vasquez, supra note 227, at 40. This has a similar impact.
239 Id. at 27; Albi, Challenges, supra note 7, at 137-38 (noting rising revenues while rates on corporate taxes fell from late 1980s to 2008 in Europe and the OECD generally).
240 See, e.g., Boadway, supra note 67, at 103 (describing constraints imposed by differences in elasticity of the supplies of capital and wage income and by the possibility of tax evasion and restraints on possible penalties).
241 See, e.g., Id. at 117.
242 Tanzi, Tax Systems, supra note 68, at 14-16. Bird puts it similarly

The best tax system for any country is presumably one that reflects its economic structure, its capacity to administer taxes, its public service needs, and its access to such other sources of revenue as aid or oil. In addition, it must also take into account such nebulous but important factors as ‘tax morale’, ‘tax culture’, and, perhaps above all, the level of ‘trust’ existing between people and their government. Tax policy decisions are not made in a vacuum. Nor are tax systems implemented in one. The taxes that are adopted in a country and how they are administered are always and everywhere both path-dependent and context-specific. They reflect the outcomes of complex social and political interactions between different groups in society in an institutional context established by history and state administrative capacity.

Bird, Tax system change, supra note 23, at 423.
243 Winer, Kenny, & Hettich, supra note 226, at 378-79 (noting roles of “differences in political transactions costs and the role and importance of veto players in a particular political setting.”); 393 (discussing degree to which differences between the United States and Canada in tax may be related to political structure).
5. Summary

The Control First framework is a virtual photographic negative of the Wealth Maximization framework. Rather than focusing on gains from the movement of money, the primary issue is controlling the negative side effects of financial flows. These include any competitive pressure on states that constrain their political choices. This includes political choices by even non-democratic governments, for Control First proponents both deny the need for protection of citizens against autocratic regimes and fail to distinguish between obligations owed to autocratic governments and those owed to democratic governments. In addition, it is individuals and corporations with money who pose the threat rather than governments: These must be restrained to permit freer state action.

This implicitly assumes that all financial market constraints on governments are problematic. In turn, this accords governments, even those without democratic systems, a presumption of legitimacy. It is unclear whether even governments like Iraq under Saddam Hussein or Zimbabwe under Robert Mugabe lose this presumption. Moreover, Control Firsters appear to reject the argument that even democratic governments may be constrained in beneficial ways by market pressures.

However, Control First proponents selectively apply this presumption of legitimacy, according it only to the constrained jurisdictions’ governments and rejecting it with respect to the jurisdictions whose policies create the constraints. Since even reasonable policies endorsed by democratic majorities of one jurisdiction may not be reasonable policies endorsed by democratic majorities in another jurisdiction, this is problematic. More particularly, while the government of one jurisdiction may conclude

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244 Henry, *The Price of Offshore Revisited*, supra note 5, at 25 (“it is very hard to defend ‘tax enforcement at any price’ when the tax collector is the Burmese junta, Gaddafi’s Libya, or perhaps even the City of Chicago.”) However, TJN concludes that “most countries operate very, very far from this hypothetical ‘tax compliance vs. freedom-and-prosperity margin’

245 Id. at 25 (dismissing such concerns).

246 See, e.g., Stopford, Strange, & Henley, *supra* note 1, at 101 (“Regulation can vary from laissez-faire to the oppressive and capricious.”). Further, consent in a democratic regime may make income taxes more administratively feasible. See Winer, Kenny, & Hettich, *supra* note 226, at 383-85 (noting that democratic regimes rely more heavily on income taxation than authoritarian ones, and suggesting that consent makes a difference). The lack of consent in authoritarian regimes may account for some of the “looting” that occurs there.

Control First proponents have a ready answer to these points – it is the existence of a network of “secrecy jurisdictions” which facilitates the looting by corrupt government officials. In short, make it harder to hide the fruits of corruption and there will be less corruption. This argument has some appeal: if corruption is more costly, surely there will be less of it. However, the Control First arguments rarely engage in any cost-benefit analysis of the measures they seek to use to reduce corruption and put little weight on the need for the country where the looting is occurring to stop the initial theft, preferring to concentrate on the proceeds. International competition may constrain sovereignty in helpful ways. For example, political decision makers may want to be able to use domestic monetary and fiscal policies to promote full employment but be constrained by international pressures on their currencies. Whether that is a good thing or not depends on whether the analyst believes that governments make responsible choices in engaging in stimulative monetary and fiscal policies. The long-standing consensus among economists that central bank independence is a key to restraining excessively inflationary policies suggests that this issue is at least open to question. Nonetheless, the key point is that in the Control First framework, finding evidence to support these claims is not a precondition to efforts to enhance control over international financial flows.
that it is worth imposing significant financial transaction costs on its own residents to achieve some, no matter how marginal, anti-crime or tax evasion objective, there is no reason to suppose that the governments of all other jurisdictions share the same conclusions. While this is far more likely to be the case when the benefits of such additional transaction costs accrue to the residents of on-shore than off-shore places, it may also be that different governments have reached different conclusions as to whether to adhere more closely to the Wealth Maximization view than the Control First view or vice versa. A more reasonable view of national sovereignty suggests that on-shore jurisdictions should neither be able to order off-shore jurisdictions to run up costs to the benefit of onshore places nor impose their views of appropriate trade-offs in economic policy.

Control First advocates have sometimes conceded that onshore jurisdictions have helped to create the legal framework in which offshore jurisdictions are able to provide opportunities for tax avoidance, but argue that the onshore jurisdictions “helped create a monster they could not properly control.”\textsuperscript{247} Thus the dominant conceptualization of international finance is as a corrosive force in which “capital” or “capital markets” erode state sovereignty by imposing costs on the adoption of policies that impose costs on the owners of capital. Considerable resources exist in this zone outside of governmental control.\textsuperscript{248} We now turn to the ways in which money “moves”, examining how the reality of finance fits with these two frameworks.

\section*{II. The World’s Financial Plumbing}

Today’s global economy involves a great deal of money “moving” from jurisdiction to jurisdiction. Not only do firms and people in one jurisdiction frequently buy things from firms and people in another, but “the growth of Eurocurrency markets, international syndication of loans, government loans and foreign direct investment” together with “[t]he dismantling of restrictions on financial flows across borders, the deregulation of financial institutions international financial innovations” has “significantly” increased the movement of capital.\textsuperscript{249} This globalized financial environment both offers opportunities to firms and individuals and introduces new risks with which both must cope.\textsuperscript{250} In this section we describe how the world’s financial plumbing operates and the implications for both policy frameworks.

\textsuperscript{247} Picciotto, \textit{Legal Fiction}, supra note 7, at 54. There is little doubt that capital markets constrain government autonomy. \textit{See Stopford, Strange, \& Henley, supra note 1}, at 6 (noting that it “is the world financial] system in which the firms are but one set of players and are increasingly recognized as such” that “have constrained” governments’ autonomy). The debate is over whether these constraints are either desirable or able to be removed.

\textsuperscript{248} For example, Ronen Palan argues that “[t]he growth of offshore finance is being driven to a significant extent by private banking” and that 20 percent of the world’s private wealth is managed by private banks. Palan, \textit{Structural Enablement}, supra note 7, at 23. The Tax Justice Network estimates that private offshore financial assets range from $12.1 to $20 trillion, depending upon whether they use a 3.0 or 4.9 liquidity ratio. Henry, \textit{The Price of Offshore Revisited}, supra note 5, at 36.

\textsuperscript{249} Beenhakker, supra note 28, at 1.

\textsuperscript{250} Id. at 2.
A. How Money ‘Moves’

The use of metaphors to explain unfamiliar or complex systems can both enlighten and confuse, and such is the case with the use of the metaphor “moving money.” In reality, the modern bank-based payment system does not “move money,” but rather transfers claims. When the Control Firsters describe “moving trillions of dollars through offshore centers,” images of cash flowing through oil pipeline-like conduits through small islands on its way to a final destination do suggest unnecessary detours. Who would ever move anything that way, unless for some corrupt or nefarious purpose? But that is not what actually occurs. What does happen is that payors, in effect, chose to hire the legal regimes and management skills found in offshore centers to ensure that their funds are safely and efficiently managed as the funds make their way to ultimately buying goods and services.

How does this work? Before the development of the bank-based payment system, to engage in commerce beyond barter governments, firms, and individuals physically transferred specie from buyer to seller, or from investor to entrepreneur. Such transfers could be expensive and quite risky, with both increasing the further the distance the specie had to travel. The modern payment system developed to reduce both expense and risk, thereby cutting transactions costs and allowing goods, services, and investment to flow more abundantly.251 It was a significant step in the creation of the modern economy.252 As a result, however, since the creation of modern banking, nearly all of what we commonly refer to as “money” has no physical form and is really nothing more than a claim against a bank in the form of a deposit. The modern payment system, both nationally and internationally, is actually a system of adjusting claims by persons against their banks and among banks themselves rather than a system of “moving” money253.

Assume, for example, that Janet wishes to buy a house from Bill, paying the entire purchase price without recourse to a loan. She could give Bill physical money in exchange for title to the house, but Bill would then face the problem of safeguarding a large amount of currency and/or transporting it to his bank. If Janet instead makes a payment to Bill via a check, debit card, or an on-line transfer through her account with Bank A, Bill no longer faces those problems. Jill’s “account” with Bank A, whether checking or savings, is actually a claim she has against the bank for the amount in her account. In other words, Jill is a creditor of Bank A to the amount of the account. By using a check, debit card, or an on-line transfer, Jill is instructing Bank A to transfer part of her claim to Bill. If she used a check, Bill could simply stop in at Bank A, present the check, and exchange it for cash. But if Bill is also part of the payment system, that would mean that he, too, would have an account at a Bank, say, Bank B. Instead of cashing the check, he can receive the transfer of Jill’s claim against Bank A by adding to his claim

252 Id. at 17-20.
Moving Money

against Bank B. As a practical matter, that means that (1) Bank A will adjust Janet’s claim against it downward by debiting her account by the amount of the transfer, then (2) Bank B will credit its claim against Bank A by the same amount, and (3) finally, Bank B will credit Bill’s claim against it by the same amount. If Janet had wished only to transfer money from her account at Bank A to her account at Bank B without buying anything, the same process would be followed, except the final claim transfer would be to her claim against Bank B.

The process of changing claims is typically implemented through a clearinghouse, often operated through a jurisdiction’s central bank. In fact, a national currency—the units transferred via changing claims and claimants—is itself a claim against the central bank that issued the currency. In effect, much of both Bank A and Bank B’s assets are ultimately claims against the central bank that created the currency in the first place. It is this system of transferring claims among different banks, including central banks, that allows governments, firms, and individuals to engage in economic activity without the expense and risk of physically moving specie. The development of the electronic payment system, by which claim transfer can be done electronically rather than moving paper checks around, has further reduced cost and risk.

The vast majority of contemporary international money movements do not involve the transfer of specie for the same reason that domestic movements do not: expense and risk of loss. They follow essentially the same patterns as do domestic movements, only they involve banks located in different jurisdictions—i.e. transfers of claims from banks in one jurisdiction to banks in another. The international payment system allows governments, firms, and persons to conduct trade and investment across international borders (almost) as easily and inexpensively as does the domestic system. Moreover, when money “moves” by being reflected in accounts, it may move through a wide variety of channels. Different channels offer governments different degrees of control. Most jurisdictions impose restrictions on the physical movement of currency, for example. Thus when entering a jurisdiction, travelers are generally asked to declare currency in excess of set amount. As noted above, banks may clear transactions through a central clearing house. But banks may also clear transactions internally, as they sometimes do to avoid paying clearinghouse fees. For example, when a merchant and a consumer who both bank with Citibank engage in a credit card transaction, Citibank may clear the transaction in-house rather than through Mastercard or Visa. In addition, non-bank financial networks may clear transactions through exchanges of emails or other means. For example, the hawala remittance system used in South Asia need not involve any entries in an account for the participants but instead often relies on offsetting

254 Id at 20-22.
255 See, e.g., 31 U.S.C. 5316 and FinCEN Form 105 Report of International Transportation of Currency or Monetary Instruments (available at http://www.fincen.gov/forms/files/fin105_cmir.pdf) requiring, with some exceptions, those entering or leaving the United States to declare amounts in excess of $10,000.
transactions between entities in various jurisdictions. While such transactions may be a relatively small portion of international movements of money, they may also include a disproportionate share of illegal transactions precisely because of the lack of account records.

Even in transactions that do involve account entries (as the vast majority among businesses by volume certainly do, because a record of transactions is essential to most business accounting efforts), the identification of the owner of accounts is not straightforward. In our simple example above, the money comes from an account owned by Janet and is deposited into an account owned by Bill. But perhaps Janet is acting on behalf of Tom (who may not want Bill to know who is buying his house because he believes Bill would charge a higher price if he knew that Tom was buying the property or who may have acquired the funds through illegal activity and so be attempting to protect the ownership of the property from confiscation by law enforcement officials by using Janet as a straw purchaser). Or perhaps Sarah is the actual owner of the property but has listed it in Bill’s name to avoid having her name on the public record, for either legitimate or nefarious reasons. Janet’s and Bill’s banks can therefore not simply rely on the information given them by Janet and Bill if they are to make a determination about the true beneficial owner of the account, but must also seek information on the source of the funds Janet is using (e.g. by asking to see financial records) and the source of the ownership of Bill’s house (e.g. by asking to see records documenting how he acquired it and the source of any funds used to do so).

Moreover, it is obvious where physical persons and physical objects are; it is less obvious where legal persons like companies and trusts are located. Legal persons exist only in law, and are granted attributes, including rights and powers, only by the operation of law. Legal persons have many of the rights to do things that physical persons possess, such as own property and enter into contracts, and to sue and be sued for breach of someone else’s legally protected interest. Banks are organized as legal persons, and may have physical ‘brick and mortar’ locations for management, computers, employees, and even vaults to hold physical currency. In general, the bank’s “location” is where it received its banking charter and where it is subject to primary regulation and supervision. If Bank A is headquartered in London, for example, then the UK regulatory authority will exercise primary jurisdiction over it. However, as a general matter, jurisdictions prefer that banks that wish to operate within their borders—which means that they offer banking services directly to the jurisdiction’s residents—first secure a local charter and be subject to local regulation and supervision. This means that the multinational branches of Bank A that are located in other jurisdictions, even if those branches are completely owned and controlled by Bank A, will have separate banking licenses in each place and are subject to

260 Id. Over time, mechanisms have been put in place to ensure effective supervision in difference jurisdictions, and to coordinate supervision among jurisdictions when a bank has a presence in more than one. Gordon, Use and Abuse, supra note 144, at 541-563.
supervision in each place. So, from the perspective of the person transferring money internationally—meaning the person transferring a claim from, say, Bank A to Bank B, its branch in Japan—what matters is that Bank B respects and enforces that transfer. Similarly, in a non-bank transaction (e.g. via a hawala network), what matters for the person transferring the money is that the other participants in the network are trustworthy. In large part for banking networks, this means that the person transferring the claim can trust in the supervisory authorities and the courts in Japan. But from the point of view of identifying the beneficial owners of the resources being transferred, quite different information will also be needed. Crucially, this information has little or nothing to do with the functioning of the system of transfers. Collecting and disseminating that information increases the cost of conducting transactions.

In the course of millions and billions of both national and international transactions each day, much netting goes on among deposit-taking banks and central banks, and of course, most of this is done via electronic instruction implemented by various interconnected record-keeping systems. But when one refers to the “international movement of money,” one is really referring to the shifting claims among people and banks that are subject to the regulation and supervision of different jurisdictions. Once that money is used to purchase a good, a service, or an asset, the person now owns either a fleeting benefit or a more lasting one. Getting these transfers “right” is quite important to the participants: both a U.S. company paying its Chinese supplier and the supplier want to be sure the payment goes to the correct entity in China. Not surprisingly, international financial institutions have invested in ensuring they can accomplish these transactions as the participants desire. Their investment in control infrastructure to accomplish governmental aims is quite different, since it does not advance the financial institutions’ businesses.

Moreover, the development of “non-equity and contractual forms of association, the so-called New Forms of Investment (NFI) that have been growing rapidly” since the 1980s, complicates things still further. These include “licensing agreements, franchising, sub-contracting, management contracts and joint ventures” and “are an important new feature of the global financial structure. Multiple layers of agreements exist in such cases and the complexities will quickly overwhelm any effort at standardized reporting. For example, Stopford, et al. describe the evolution of Firestone’s Kenya investment in the 1970s from a majority stake in a firm with local owners holding a minority interest, with a royalty arrangement negotiated directly with the country’s president to a minority stake in a firm majority owned by Kenyans, with a management fee on net sale that was twice earlier fees, higher prices and lower interest rates allowed because of the local majority ownership, and a monopoly on imports of types of tires not made locally. They conclude “Firestone increased its profit flow from Kenya with

262 Stopford, Strange, & Henley, supra note 1, at 16. See also Albi, Challenges, supra note 7, at 131 (incentive to shift to unincorporated entities created by corporate taxation).
263 Stopford, Strange, & Henley, supra note 1, at 48 (quoting UNCTC).
264 Id. at 148-49.
reduced asset exposure and risk.”265 None of these features would fit easily into even the most rigorous reporting framework being discussed today. These forms of investment are ‘invisible investments’, just as earnings of foreign exchange by sale of banking, insurance and other services to foreigners are described as ‘invisible exports’. Essentially, what the firm is doing is to reap an additional return on the capital already invested at home in developing the product by transferring its know-how across frontiers.” Such investments may not even appear in any financial institution’s accounts. How would the “beneficial owner” of a contractual right be identified?

It is this system of transferring claims from banks in different jurisdictions that permits governments, firms, and individuals to engage in economic activity that is not bound by national borders. It is, in short, what permits a modern global economy to function with considerably less value lost to transaction costs. Wealth Maximizers applaud this system; it minimizes transaction costs and thereby allows a more efficient system of creating wealth. In doing so, it also fosters jurisdictional competition by rewarding those countries where keeping and transferring claims are most efficient and the least risky. However, Control Firsters find this system troubling, arguing that it represents some kind of nefarious, secret international “movement” of wealth, when it is essentially the same system used domestically. What is different with respect to the use of offshore centers as intermediaries is that the person “moving” the funds from an onshore center has chosen to use the legal and managerial benefits of an offshore center rather than to continue to use those of his own jurisdiction. We have already noted the possible efficiency benefits of investors choosing superior legal systems, and that offshore centers may have a comparative advantage in this area. We have also shown that offshore centers have superior records with respect to implementing anti-money laundering standards, and that they have been cooperative at implementing the ever more onerous and expensive reporting and transparency rules demanded by onshore tax authorities. Given that offshore centers have a recent history of solid banking supervision,267 there can be no reason to infer nefarious activity when money is “moved” through an offshore center. In fact, given the recent history of banking problems in onshore jurisdictions in the U.S. and Europe, the use of offshore center banks makes a good deal of sense.

An added wrinkle arises in dealing with intra-firm transfers. Intra-firm trade is an important part of international trade.268 Not only do firms trade with each other, different

265 Id. at 149.
266 Id. at 48. For example, Stopford, et al., cite an example of General Motors sending “at its own expense” a “regiment of engineers” to Brazil from Detroit for “months” in the 1980s to assist Brazilian suppliers in meeting GM’s requirements so that GM could comply with local content laws. These engineers, paid in the United States, were a transfer of services to the Brazilian companies but almost certainly did not appear as income on the Brazilian firms’ tax returns as income, although they would have been expensed by GM in the United States. This boosted GM’s operations in Brazil, effectively shifting income from the United States to Brazil. Id. at 48-49.
267 Gordon, Use and Abuse, supra note 144, at 562-63.
268 Mo, TAX AVOIDANCE, supra note 162, at 7 (noting that “a significant proportion of foreign trade [in China, Brazil, and Mexico] consists of transactions between related entities of … multinationals.”)
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Divisions within firms trade across borders. These trades require that the firm make book-keeping entries both internally and in accounts in financial institutions. In the regular course of business, such transfers of claims shift revenues between jurisdictions and can fall afoul of tax regulations without any ill intent. For example, Mo describes a U.S.-China transaction in which a Sino-U.S. joint venture marketed detergent in China by attaching a free box of stain remover to each box. “Because the small boxes of stain remover were treated as free gifts, the joint venture transferred the stain remover at cost, thus reporting no profits in China. Since the stain remover cannot be sold in the market separately, there was no market price readily available. Although all information including the costs had been disclosed, the transfer of stain remover at full cost was considered ‘unacceptable’ avoidance and against the spirit of the law, which normally expects a return from a joint venture investment.”

The complexity necessary to cope with modern business arrangements makes transfer pricing regulation costly to design and implement.

Of course, it is certainly true that one goal in shifting revenues is to minimize taxes net of avoidance costs. However, tax avoidance is merely one goal among many. For example, any tax minimization strategy must also take into account factors such as impacts on divisional operating results, import duties, harmony among divisional managers, currency fluctuations, overall and local competitive positions, the role of foreign partners in subsidiaries, and labor relations. Taking all these factors into account, Shulman concluded that corporate management needs for measurement, evaluation, and motivation were significant determinants of multinationals’ “control systems” and a “willingness to tinker incessantly with transfer prices” was “dysfunctional”. Moreover, what revenue authorities perceive as overly aggressive tax minimization strategies can also attract regulators’ attention and companies may value minimizing tax investigations over tax savings.

These are not simple problems to manage. For example, Shulman reported that a multinational operating in Brazil in the 1960s, when inflation there was high, preferred to ship goods to its Brazilian subsidiary at a low price “to assist it in profitable operation” and because the Brazilian government required importers to post of a cash deposit equal to six months imports, which lost value due to inflation. However, another multinational operating in Brazil at the same time preferred to charge its local subsidiary a high price,

\[269\] Beenakker, supra note 28, at 31.
\[270\] Mo, TAX AVOIDANCE, supra note 162, at 3.
\[272\] Id., at 5.
\[273\] Id. at 7.
\[274\] Id. at 7 (firms strive to move funds out of countries with inflation).
\[275\] Id. at 11-12.
\[276\] Id. at 13.
\[277\] Id. at 14 (noting that Mexican requirement of profit sharing with employees meant local profits must be “reasonable” to avoid labor strife).
\[278\] Id. at 19-20.
\[279\] Id. at 6 (“Another company neglects the impact of taxes on pricing entirely, arguing that simple and consistent pricing practices tend to minimize tax investigation problems.”).
to get its money earned out of the high inflation environment, despite having to lose money on the cash deposit and pay higher taxes in the United States.\textsuperscript{280}

Even where transfer-pricing efforts are aimed at shifting resources between jurisdictions, they may not be motivated primarily by tax considerations. For example, where local laws prohibit remission of royalties abroad, increasing the transfer prices of goods can substitute for royalty payments.\textsuperscript{281} Is this an illegitimate evasion of local law or a reaction to a legal system banning one transaction but permitting another?\textsuperscript{282} Which “intent” matters – the intent to ban royalty payments or the intent to permit sales? Similarly, is use of higher transfer prices to shift resources out of a country where the resource owner fears expropriation a legitimate reaction to uncertainty over political risk or illegitimate evasion of “legal” confiscation of foreign-owned assets?\textsuperscript{283} Shulman describes how one company used this to avoid losses from expropriation during and after the Cuban Revolution.\textsuperscript{284}

\section*{B. Why Money ‘Moves’}

Claims are transferred internationally because of individual transactions. Some of these transactions reflect transfer of funds to accomplish a business purpose: a U.S. retailer importing goods from a Chinese supplier must pay the supplier by transferring money from an account the U.S. retailer controls to one the Chinese supplier controls.

Claims are also transferred because the demand for investment opportunities and the supply of those opportunities differ across jurisdictions. In general, “capital flows out of countries where there is a surplus of saving over domestic investment opportunities into countries where there is a deficit (savings less investment).”\textsuperscript{285} The Tax Justice Network argues that developing countries exporting capital is a sign of bad behavior by

\begin{itemize}
\item \textsuperscript{280} Id. at 8.
\item \textsuperscript{281} Id. at 9.
\item \textsuperscript{282} Consider that Delaware treats each section of its corporate law as having “independent legal significance.” Orzech v. Englehart, 195 A.2d 375 (Del. 1963) (“[A]ction taken in accordance with different sections of that law are acts of independent legal significance even though the end result may be the same under different sections.”) It is a “bedrock” of Delaware jurisprudence. Warner Commc’n s Inc. v. Chris-Craft Indus., Inc., 583 A.2d 962, 970 (Del. Ch.) aff’d 567 A.2d 419 (Del. 1989). The doctrine “has played a role in many of Delaware’s landmark decisions”. Robert K. Clagg, Jr., Note, An ‘Easily Side-Stepped’ and ‘Largely Hortatory’ Gesture?: Examining the 2005 Amendment to Section 271 of the DGCL, 58 EMORY L. J. 1305, 1319 (2009). This doctrine is as “formalistic” as any about which the Control First advocates complain.
\item \textsuperscript{283} Shulman, TRANSFER PRICING, supra note 271, at 10-11.
\item \textsuperscript{285} Brendan Brown, WHAT DRIVES CAPITAL FLOWS? MYTH, SPECULATION AND CURRENCY DIPLOMACY 2 (2006).
\end{itemize}
investors in those countries. However, countries with persistently large savings surpluses are those where the public is “seeking to accumulate wealth (measured net of government debt) at a faster pace (in absolute terms) than the expansion of the domestic capital stock.” Where money can move freely, there is no reason to expect savings and investment to balance within a jurisdiction. Chinese citizens have a high savings rate; U.S. citizens a much lower one. If opportunities to invest internationally exist for Chinese investors, this will cause a movement of capital from China to the United States. (For political reasons and because of the restrictions on the convertibility of the Chinese currency, a major portion of Chinese investment into the United States is undertaken by the Chinese government.) A substantial amount of money moves for this reason, as “[t]he main ultimate sources of net capital outflows are the advanced economies in East/South East Asia (Japan, South Korea, Taiwan, Hong Kong, and Singapore), with an estimated $230bn, Middle East oil exporters, $220bn, Western Europe excluding the UK (euro-area, Switzerland, Norway, and Sweden), $120bn, and Asian-developing countries (China, India, and others), $130bn.”

Claims are also transferred because of firms’ and individuals’ investment preferences. There may be more investment opportunities of a desirable type in one jurisdiction rather than another, which will draw funds in. The desirability of the investment may be due to the presence of natural resources, relative labor costs, or other advantages related to factors of production. But it may also be related to the desirability of the legal and regulatory framework provided by a jurisdiction. Particularly for international investors, the agency problems involved in portfolio investment are significant. Moreover, investment across borders may occur because firms and individuals desire asset diversification. Asset diversification will do more than lead to reciprocal swaps between jurisdictions: investors from jurisdictions which are less stable, which have poorer economic performance, or which provide less robust property rights protections will need to diversify out of their jurisdictions more than will those in stable,

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286 See, e.g., Henry, The Price of Offshore Revisited, supra note 5, at 23 (“since net outflows from developing countries have continued over sustained periods of time, and since little offshore wealth or the earnings that it produces have been repatriated, the most important factors driving it are not those that drive ‘hot money,’ but long-term decapitalization.”)


289 Ma & Yi, supra note 288, at Table 1 (noting U.S. savings rate was under 20% during 2000s).

290 See Philippe Gugler and Bertram Boie, The Emergence of Chinese FDI: Determinants and Strategies of Chinese MNE, at 4-5, (Oct 2008), available at http://gdex.dk/ofdi/20%20Gugler%20Philippe.pdf (until 2003, outward Chinese investment was principally only allowed by state-owned enterprises. Since then, the Central government has maintained the lion’s share of outward FDI (73.5% in 2003, 82.3% in 2004, and 83.2% in 2005).

291 Brown, WHAT DRIVES CAPITAL FLOWS?, supra note 285, at 19.

292 Id. at 8 (“A considerable amount of two-way capital flows can be explained by the simple arithmetic of diversification. If there were no home biases (preference to hold domestic rather than foreign assets) investors in any country would tend to hold the same portfolio of assets drawn from all over the world. That would mean large inflows and outflows of capital being the norm for each country as part of the process of wealth accumulation. Relative to national income these would be greater for small countries (whose assets formed only a small part of the world portfolio) than for large.”).
better performing economies with strong property rights protections. Claims are transferred under many labels in business deals. Firms evaluating investment projects care about all of the cash flows generated. These include “dividends, plus royalties, management fees, trademark fees and the effects on profitability of operations in other countries.”

In addition, capital flows towards deep, well-functioning capital markets where it can then find its way on to appropriate investments. There is an important role for capital markets as aggregators and repackagers of funds that will travel on to other destinations. Indeed without introducing some real world facts such as “currency risk, political risk, and other heterogeneous factors, we would have a hard job explaining a salient feature of global capital flows – the turntable.”

A “turntable” is “the phenomenon of a country (or group of countries forming a currency area) importing capital on a net basis from another region of the world and exporting it (net) to another. Typically the turntable would import capital from the savings surplus countries and re-export (capital) to the savings deficit countries. Turntables can also have relationships with each other.

Often assets are repackaged in capital markets, changing their legal characteristics. Thus a dollar moved from New York to London becomes a “Eurodollar” rather than a “dollar”, and is capable of being held at a lower cost by a financial institution in London than it would be in New York. This is because a London bank holding a dollar is not required by either the Bank of England or the Federal Reserve to set aside the same level of reserves for lending based on that dollar as the Bank would require for a British bank holding an equivalent amount in sterling or the Federal Reserve would for a U.S. bank.

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293 Stopford, Strange, & Henley, supra note 1, at 150.
294 London has long played this role. Catherine Schenk describes it in the 1960s as

London was a genuine entrepôt where financial institutions intermediated between customers abroad and between domestic and foreign customers. This reflected the sophistication of financial services that had been developed over the past century; through the Gold Standard, the subsequent pre-eminence of sterling, and the role of Britain as the world’s major trading nation.

295 Brown, WHAT DRIVES CAPITAL FLOWS?, supra note 285, at 8.
296 Id. supra note 285, at 8-9. There are well-documented examples of turntable effects. For example, Brown describes how in 2003-04, savings surpluses in Asia (particularly from Japan and the more advanced economies in east and south Asia) were filling the U.S. savings deficit. Because Asian investors wanted not just U.S. assets but also euro-area assets, and euro-area residents sought to borrow low interest yen to finance euro-area activity, Asian funds flowed into the euro-area, while euro-area funds flowed out of the euro-area. Id. Similarly, in 1999-2000, European investors were buying U.S. equities and companies, while a global demand for euro-area assets was appearing in reaction to the new European currency and development of deeper capital and money markets in Europe that resulted. Id.
holding the dollar in the United States. The loan can thus be made at a lower cost than it would otherwise be and the deposit can be paid a higher rate than it would otherwise receive. There is nothing nefarious about this – it merely reflects the lower transactions costs of packaging a particular set of claims in large sizes and outside of the reserve requirements imposed on more retail banking operations. Moreover, the Eurodollar market expanded in part in response to corporate treasurers’ efforts to maximize the value of their short-term cash holdings, not tax-based motives. It grew further as banks switched from asset management to liability management as their strategy for matching assets to liabilities on their books.

Of course, some claims are transferred as part of a criminal enterprise. For example, Columbian cocaine exporters need to be able to spend money in Columbia that was generated by the sale of their cocaine in the United States. Similarly, claims may be transferred across jurisdictional boundaries to another to pay for terrorist activity. Claims may also be transferred because they represent stolen assets (either by private actors or by political actors) in one jurisdiction and an attempt is being made to hide the assets in another.

A key difference between the two frameworks described above concerns the legitimacy of the constraints imposed by flows of claims. (We discuss the Tax Justice Network’s effort to estimate the size of illegitimate flows in the next section.) If individual decisions by firms and individuals to move money from one jurisdiction to another reflect decisions about how best to allocate their resources, broad trends in money movements provide information on how jurisdictions are perceived by economic actors and reflect economic activity. A jurisdiction whose government found itself constrained by such pressures because its policies made it an inhospitable place for investment would have to choose between continuing the policies and suffering the consequences or changing the policies. For example, Papaioannou concludes that “the evidence implies that improving inefficient bureaucracies, tackling corruption, and enhancing legal system competence are crucial for attracting foreign bank capital” and that “political liberalizations, privatization and other structural policies (which are followed by a decline in political risk), can enhance domestic liquidity by attracting

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298 Aliber, supra note 297, at 179-80. In a further example of how regulatory policies create new financial markets, American banks moved into Europe in the 1960s in part as a response to the Kennedy Administration’s creation of the Interest Equalization Tax in the United States, which was intended to increase the cost of foreigners and U.S. companies with foreign operations raising capital in the United States. Stefano Battilossi, Introduction: International Banking and the American Challenge in Historical Perspective, in EUROPEAN BANKS AND THE AMERICAN CHALLENGE, supra note 294, at 1, 14. Thus the system that Control Firsters object to grew in response to an effort to restrict legal capital export from the United States, precisely the sort of policy they endorse today.

299 Aliber, supra note 297, at 176-77.


301 Battilossi, Banking, supra note 300, at 107 (“Both CDs and Eurodollars represented key factors that allowed banks to strengthen the liability side of their balance sheet, by compensating shrinking deposits with funds borrowed at market rates. By doing so, they promoted a radically different way of banking, based on what was known as ‘liability management’, under which commercial banks increasingly tended to accommodate liabilities to loan demand by borrowing funds in the money markets.”).
substantially more foreign capital.” Subsequently, Venezuela’s economy is experiencing significant inflation (bordering on hyperinflation) largely as a result of the Venezuelan government’s policy choices. Wealth Maximization proponents see this as a market reaction to the institutional environment presented by the government’s choices. Control First proponents see this as a barrier to governments’ ability to adopt policies. In addition, they argue that illegitimate motives drive a substantial number of decisions to move money across borders. Because they view tax avoidance as illegitimate, they reject jurisdictions’ ability to compete for wealth creation through creation of a favorable investment climate.

Capital markets discipline governments to some extent, although the degree varies with the degree of openness to the world economy. Governments seek to avoid such discipline; as a former Brazilian central bank economist noted “Governments, for whatever reason, usually for political reasons, often try to defend situations that are clearly unsustainable.” Similarly, economists Reuven Glick and Michael Hutchinson concluded an empirical study of efforts to prevent financial crises through capital controls by noting that “Extensive capital controls and other restrictions on exchange payments may contribute to greater vulnerability of countries to currency crises by leading to inconsistent policies, poor policy design, and, at worst, substantial corruption in the financial and international sector that eventually erodes confidence in the exchange rate system.” A government that chooses to isolate itself can survive without such links, at considerable cost. For example, both Iran and North Korea have managed to maintain

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303 See Ezequiel Minaya, *Venezuelan Inflation Surges*, WALL ST. J. (July 9, 2013) available at [http://online.wsj.com/article/SB100014241278873234507404578596153737072578.html](http://online.wsj.com/article/SB100014241278873234507404578596153737072578.html) (inflation rate hit 39.6% in June and noting Venezuelan President “Maduro’s mentor and predecessor, the late Hugo Chávez, won re-election in 2012 with lavish government spending that critics say put a strain on the country’s international reserves, despite Venezuela’s vast oil fields.”); Benedict Mander, *Venezuela hit by fears of hyperinflation and recession*, FIN. TIMES (June 9, 2013) available at [http://www.ft.com/intl/cms/s/0/b41fbc34-d0f1-11e2-be7b-00144feab7de.html#axzz2cGeeJiQS](http://www.ft.com/intl/cms/s/0/b41fbc34-d0f1-11e2-be7b-00144feab7de.html#axzz2cGeeJiQS) (attributing inflation to “a tangled web of price and currency controls which, together with problems in the oil industry that supplies 96 per cent of export revenues, have generated a shortage of foreign currency, on which the import-dependent economy relies.”).

304 Markets react to government policies. See Jeffry A. Frieden, *The Politics of Exchange Rates*, in MEXICO 1994: ANATOMY OF AN EMERGING MARKET CRASH 81, 81 (Sebastian Edwards & Moises Naim, eds. 1998) (stating that exchange rate pressure is markets “responding to expectations about the relevant policies of monetary and other authorities”). See also Arminio Fraga, *Capital Flows to Latin America*, in INTERNATIONAL CAPITAL FLOWS (Martin Feldstein, ed. 1999) 52 (describing how capital controls gave central bank in Brazil “a false sense of security and probably allowed Brazil to avoid or postpone a number of important macroeconomic policy changes and structural reforms.”).

305 See, e.g., Henry, *The Price of Offshore Revisited*, supra note 5, at 25-26 (“that when the public sector has been starved for capital (perhaps having had to rely on high-cost loans or inflationary finance rather than tax revenue), the rate of return on public investments is often higher than on private investment. Tax, by producing better roads and educated populations and so on, can ‘crowd in’ private investment, rather than crowd it out as many people believe.”).

306 Fraga, *supra* note 304, at 50.

regimes despite considerable outside financial pressures. However, the Mitterand
government in France in the 1980s “was forced by the external deficits and the
exhaustion of foreign credit into a major U-turn in policy away from state-owned
enterprises and organized labour and toward productivity in export industries.”
Were the constraints imposed on the Mitterand government analogous to those imposed by the
laws of physics (e.g. a feature of the natural world to which politicians must adjust) or the
result of undemocratic behavior by outside speculators? Wealth Maximizers tend to see
such pressures as the former, Control Firsters as the latter.

For more connected economies, the pressures from capital markets can be even
more significant. For example, capital market discipline has made policies aimed at
overvaluing currencies unsustainable, with the benefit of discouraging inefficient
importation of capital-intensive producer goods and luxury consumer goods. Even in
this constrained world, governments “retain considerable negative power to disrupt,
manage or distort trade by controlling entry to the territory in which the national market
functions. They cannot so easily control production which is aimed at a world market and
which does not necessarily take place within their frontiers.” This discipline helps
restrain governments from adopting policies in which politics rather than markets
allocates scarce resources.

Capital markets exert discipline by offering capital alternatives to local
investments when governments adopt policies that reduce rates of return. For example,
Russia experienced considerable capital flight during 2008 ($74 billion of foreign capital
left Russia between August and October 2008). Wealthy Russians also lost money
during this time: Russian oligarchs were estimated to have lost $230 billion in this same
period. Presumably additional capital left Russia by both recorded and unrecorded
means. Why did this happen? One possible explanation is Russian citizens were
illegitimately evading the controls on their wealth and behavior that their government
sought to impose so it could collect taxes to fund public goods. Another possible
statement is that Russia was an economy where the

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308 See Kenneth Katzman, Iran Sanctions, Congressional Research Service, available at
http://www.fas.org/sgp/crs/mideast/RS20871.pdf (detailing some of the methods Iran has implemented as a
work-around to trade embargos and noting that “Government-linked entities are creating front companies
and making increased use of barter trade. Iranian traders are using informal banking exchange mechanisms
and, benefitting from the fall in the value of Iran’s currency, increasing non-oil exports such as agricultural
goods, minerals, and industrial goods. Affluent Iranians are investing in hard assets such as real estate.”); Robert Carbaugh, Are Economic Sanctions Useful in Discouraging the Proliferation of Weapons of Mass Destruction, 9 WORLD ECON. 181 (Oct 2008) at 191-92 (arguing that only about a quarter of UN countries actively participate in sanctions against North Korea).
309 Stopford, Strange, & Henley, supra note 1, at 206.
310 Id. at 107.
311 Id. at 14.
312 Id. at 170 (“Where the state becomes both the engine of development and the arbiter of social relations,
benefits are distributed by ‘concessionary’ bargaining with local and foreign groups. Over time, state-
controlled dispensation of ‘favours’ becomes important for maintaining the regime.”).
313 Cohen & Rangan, CAPITAL RISING, supra note 19, at 33.
314 Id.
most powerful companies control natural resources—so wealth stems not from human capital but from the willingness of a select group of financially skilled oligarchs to support the policies of the existing power structure in exchange for control of those natural resources. Russia uses its court system to harass executives who speak in opposition to government policies. And its financial markets lack the transparency and depth to support IPOs. … [T]hrough its willingness to oust executives representing Western interests … Russia sent a strong signal to foreign capital providers that it would be happy to take outside capital but that it would not allow that capital to earn a return on it. Rather, Russia provided a stark example to those foreign capital providers that it would use its court system to drive out the representatives of its Western partners and take full control of the venture once it had the foreign capital it needed to launch it.315

Were anti-oligarch efforts legitimate or illegitimate? Partly both? How does one tell? Similarly, Malaysia, a prominent “victim” of capital flight in the late 1980s, had a policy of discrimination in employment, education, and investment against its ethnic Chinese and Indian citizens, which created “both an exodus of talent from the country and capital flight.”316 Were the anti-Chinese and anti-Indian policies legitimate policies to which its Chinese and Indian-origin citizens were morally obligated to submit or illegitimate acts they could legitimately resist by shifting assets out of the country by any means available?

Control First proponents focus almost exclusively on instances in which governments are robbed by corrupt politicians and bureaucrats in collusion with private sector actors, as in the Angola-Russia example discussed earlier.317 They are thus able to ignore arguments based on questionable behavior by governments. The Tax Justice Network dismisses the idea that tax competition has beneficial effects on governments by blithely stating that, despite it being “very hard to defend ‘tax enforcement at any price’ when the tax collector is the Burmese junta, Gaddafi’s Libya, or perhaps even the City of Chicago,” that “Our sense, however, is that most countries operate very, very far from this hypothetical ‘tax compliance vs. freedom-and-prosperity margin,’ along which increased tax competition and reduced compliance automatically leads to increased liberty, entrepreneurship, and growth.”318 As this quote illustrates, rather than providing discipline that pushes governments to adopt policies that promote economic growth, Control First proponents argue that international financial institutions promote policies that facilitate looting public treasuries. They argue that what is needed is enhanced control over financial flows to prevent money from leaving the jurisdictions where it is being looted. At a minimum, this requires powerful assumptions about the mix of legitimate and illegitimate actions by governments. We now turn to analyzing the Tax Justice Network’s attempt to estimate illegitimate movement of money.

315 Id. at 34.
316 Stopford, Strange, & Henley, supra note 1, at 124.
317 See notes 107 to 108 supra.
C. How Much Illegitimate Movement of Money Occurs?

As we have discussed above, there are policy questions that need to be resolved in making choices about how to treat the movement of money. In addition, there are factual ones: there are disagreements over what types of transactions are occurring, why transfers occur, and where claims are ultimately being recorded. As noted earlier, one of the main arguments Control First proponents make is that illicit flows are large. In this section we examine the estimate made by the Tax Justice Network in its report *The Price of Offshore Revisited*. To the extent that we are interested in understanding the costs and benefits of particular policies – to weigh the costs and benefits of particular measures aimed at either enhancing the free flow of money or restricting it in pursuit of increasing tax collections or decreasing the funds available to criminals – the calculation will be affected by the magnitudes of legitimate and illegitimate flows involved.

Unfortunately, data on transactions which are, by definition, unreported is unsurprisingly hard to come by. As a result, Control First interest groups seek to establish large estimates to set the baseline for the debate on turf favorable to their efforts to exert controls over financial flows. In this section we examine the most recent effort to establish the benchmark by the Tax Justice Network. We use *The Price of Offshore Revisited* for this because it is the most recent effort, it claims to be the most comprehensive estimate, and it is widely cited as authoritative in public debates over financial control measures. Analyzing the best case scenario for the Control First approach is useful both to understand how the policy debate is being conducted and because the weaknesses in the effort reveal how dependent the Control First argument is on strong assumptions about the nature of financial activity. It is worth noting, however, that TJN’s estimate is an outlier even among other ideologically-sympathetic estimates. As TJN itself notes, its estimate in *The Price of Offshore Revisited* is substantially larger than either its own 2005 estimate or the estimates made by others who agree with TJN on policy preferences. That itself is a reason to be cautious in putting too much weight on the largest estimate.

There are other reasons to be cautious. *The Price of Offshore Revisited* purports to use “a more open, transparent, collaborative model for doing such research so that the data sources, estimation methods, and core assumptions are all exposed to the sunlight of

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319 Id. at 40.
peer review, and ultimately to public scrutiny.” To date no such materials have appeared on its website beyond a Powerpoint presentation lacking crucial details. When we asked a research assistant to contact the author and the Tax Justice Network in 2012 and 2013 to obtain the details of the model and the data that was not reported in the report, he received no reply despite multiple emails and other messages. For an organization promoting an “open, transparent” approach, the Tax Justice Network proved remarkably opaque and closed about its methodology. In addition, TJN, and Henry, are fond of anonymous quotations of “officials” who say witty things like “The problem is not that these countries don’t have any assets. The problem is, they’re all in Miami.” Sprinkling the report with such quips improves its readability but adds nothing to its legitimacy. TJN also relies heavily on unsupported factual assertions. For example, it claims that “we also know for a fact that wealthy investors from these [“key” Latin American] source countries [such as Venezuela and Mexico] account for a significant share of US bank deposits owned by non-residents.” How does TJN know this? They don’t say. What is a “significant” share? Who knows? The report is thus opaque on the crucial details about how its estimate was constructed, which is ironic in light of TJN’s focus on encouraging others to be transparent. Since it is impossible to reverse engineer the estimates based on the information provided in the report, we examine what TJN reveals about its methodology and probe the assumptions underlying it. We then focus on the “corrections” and “adjustments” TJN makes to its model’s estimates.

### 1. Methodology & Assumptions

TJN’s methodology and its implicit assumptions are problematic as a basis for public policy for five main reasons. To begin with, *The Price of Offshore Revisited* focuses on “measuring long-term unrecorded cross-border private financial capital flows and stocks”. It begins by attempting to estimate “underreported capital flows”, which it concedes might be due to both legitimate and illegitimate motives. Capital flows can be short-term (typically up to a year) or long-term (more than a year). (Simply noting an increase in claims recorded in one country and reduced in another tells us nothing about what type of claim is involved.) Income from portfolio investment – “the ownership of financial securities, broadly defined to include sales and purchases of securities and amounts of outstanding claims and liabilities reported by banks and nonbanking concerns” – and direct foreign investment are reported in countries’ current accounts; “exchanges in financial assets” are reported in the capital account. Inexplicably, *The Price of Offshore Revisited* fails to discuss or cite any of the rapidly growing literature on financial flows.

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323 Id. at xxvi.
324 Id., at 31.
325 Id., at 23 (emphasis in original).
326 Id. at 23.
327 Beenhakker, *supra* note 28, at 47.
328 Id. at 48.
329 In addition to works cited in this paper, see, e.g. IMF data and statistics on capital flows, available at [http://www.imf.org/external/data.htm](http://www.imf.org/external/data.htm); Masahiro Kawai and Shinji Takagi, *A Survey of the Literature on...*
This may not be surprising since this literature raises issues that undermine TJN’s focus on tax avoidance and instead demonstrate the impact of the quality of the legal environment in determining investment.\textsuperscript{330} If investors have rational reasons for avoiding investing in particular countries, this undermines TJN’s assumption that such investments would increase in the absence of OFCs. Instead, TJN assumes that “the most important factors driving” these flows are “long-term decapitalization” based on the observation that “net outflows from developing countries have continued over sustained periods of time.”\textsuperscript{331} This is a powerful assumption and not supported by the observation that firms and individuals have consistently shifted assets out of some jurisdictions and into others. It is at least plausible that such shifts might involve desires to move assets to jurisdictions with better quality legal institutions, more stable political environment, less corruption, and greater investment opportunities. TJN offers no evidence to support its rejection of more conventional explanations like these.

The method of examining residuals from official statistics might produce useful information. In theory, global current account balances should add up to zero, since money entering one country comes from another.\textsuperscript{332} However,

\begin{itemize}
\item [i]in practice there are large errors in measurement which mean that equality is not observed in the actual data. … If measurement techniques were perfect, and all the relevant economic transactions were traceable by the official statisticians, there would be no errors. It is important to realize, however, that these saving and current account surpluses, even perfectly measured, would be quite different for much of the time from the equilibrium concepts in which economists are interested.\textsuperscript{333}
\end{itemize}

For example, the world current account balance has swung from negative $14 billion in 1975 to a positive $125 billion in 1990, then back down to $50 billion in 1995, then up to $174 billion in 2000, and back down to $150 billion in 2005.\textsuperscript{334} Within that time, the United States’ current account balance swung between $18 billion in 1995 to negative $810 billion in 2005.\textsuperscript{335} That there is some random noise in the system is suggested by these dramatic movements in the total world current account balance as well as the U.S. current account balance. These differences suggest that there are substantial problems with measurement even in highly developed economies. Further, understanding these flows is made more complex because of the rapid pace of financial innovation, which complicates the valuation of securities and other financial instruments held by investors. Since the movement of money is merely the shifting of claims, as we explained above, not taking into account other forms of claims presents only a portion of the total picture.

\begin{flushright}
\textit{Managing Capital Flows}, in \textit{Managing Capital Flows: The Search for a Framework} (Masahiro Kawai, Mario B. Lamberte eds, 2012), and sources cited.
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\textsuperscript{330} See, e.g., Papaioannou, \textit{supra} note 302, at *7 (finding “a strong causal effect of legal system effectiveness indicators on the volume of cross-border lending activities.”).

\textsuperscript{331} Henry, \textit{The Price of Offshore Revisited, supra} note 5, at 23.


\textsuperscript{333} Id. at 3.

\textsuperscript{334} Id. at 4-5, Table 1.1.

\textsuperscript{335} Id.
Setting aside these complications, TJN estimates hidden funds by comparing the sum of sources of foreign capital (“foreign loans, net direct investment, and net portfolio investments”) with “recorded uses” (“financing current account deficits and increasing official reserves”). The difference for each country is (by definition) “unrecorded net capital outflows”. As TJN notes, every item on its list is measured with error. TJN assumes, however, that “over time and across dozens of countries, the errors should more or less cancel out.” This is another powerful assumption and would be true only if the errors were randomly distributed around a zero mean. If measurement errors have a systematic bias to them, this would be an invalid assumption. There is no evidence that such a restrictive assumption on error distributions is correct – measurement errors in capital flows are not merely the result of random transcription errors in recording transactions--although such errors surely occur. They are also the result of systematic errors in recording due to accounting conventions, the wide range of decisions about how to value and report assets, and other systematic features of international business, government, and accounting.

Next, TJN makes inappropriate assumptions about particular types of transactions. For example, TJN argues that round-tripping – where a country imports capital in one form and exports it in another to and from the same other country – is a sign of bad behavior. This is simply wrong. Round-tripping is “a pervasive feature of the global flow of funds.” There are a variety of reasons for such flows. First, equity markets are more developed in some countries. For example, the UK and Switzerland have deep, well-developed equity markets. “Global investors buy shares in UK or Swiss companies which themselves make large direct investments in the world outside. In effect the UK or Switzerland become equity intermediation centres – some direct investment outside the UK or Switzerland that first passes through a British or Swiss multinational has ultimate equity owners also outside.” Similarly, even countries with a population that has a strong investor home bias produce round-tripping. For example, Japanese investors have a particularly strong home bias for Japanese equity investments, while foreign companies

337 Id. at 28.
338 Id. at 28.
339 TJN claims to have “grudgingly” adjusted for fluctuations in exchange rates, although no details are provided. Since it also states that the adjustments made little difference, however, we can ignore the absence of information on what adjustments it made. Id. at 29 (it turns out not to make all that much difference to the estimates” but “for the sake of academic purity” adjustments made.).
340 The Tax Justice Network includes this among its dubious motives for unrecorded capital flows. While the paper suggests not to pre-judge motives, round-tripping is described as “taking money offshore, dressing up in secrecy structures then pretending to be ‘foreign’ investors in order to take advantage of tax breaks only available to ‘foreigners.’” Id. at 23.
342 Id. Roundtripping also occurs because managers in multinationals from some countries have a comparative advantage. For example, UK corporate managers have a comparative advantage “in undertaking and administering business in the English-speaking world (especially the US).” Id. at 12. Investors outside Britain and the United States may thus invest in British or American companies, which then buy assets in the investors’ home countries as a means of taking advantage of this management expertise.
Moving Money

are reluctant to acquire Japanese equity investments because of market barriers and other factors such as the lack of a market for corporate control. On the other hand, Japanese firms are willing to acquire foreign assets. As a result, the in-flow of funds into Japan is matched over time by Japanese firms’ outward investment, producing a roundtrip for profits sent back to Japan. 343

Third, some round-tripping is a result of discriminatory policies that oppress ethnic minorities, as with the circular flow of Malaysian Chinese or Indian citizens’ funds out and back into Malaysia, 344 which cleanses their money of the ethnic quality that disadvantaged it under Malaysian law.

Finally, round-tripping may occur because firms and individuals anticipate changes in currency valuations. For example, considerable funds flow in and out of China as a result of anticipated appreciation of the yuan, which leads Chinese firms to seek to borrow in foreign currency, interest by the Chinese diaspora in investment into China, and Chinese government purchases of dollar, euro, and other foreign currency-denominated assets. 345 Given all of these reasons for roundtripping, there is no basis to conclude that the existence of parallel flows of accounting claims between jurisdictions could only be evidence of illegal or even undesirable behavior.

Similarly, TJN claims that “under-taxed corporate profits and royalties that have been parked offshore by way of rigged transfer pricing schemes.” 346 Although it concedes that estimates of “transfer pricing abuses are more problematic” and does not include them in the headline estimates, the report concludes “they are likely to be significant” 347 and so suggests their exclusion renders their estimates a floor. TJN is selective in its consideration of transfer pricing issues, focusing on only examples that reinforce its position. As we described above, transfer pricing is an extraordinarily complex issue in which different firms operating in the same environment may have incentives to shift prices in opposite directions. In addition, TJN ignores the complications in relying on export figures introduced by Value Added Tax fraud, which can involve phony claims of exports. 348 The distinction is important since in a typical VAT fraud scheme the money would not actually move out of the jurisdiction but instead the party committing the fraud would claim a refund from the tax authority. 349 VAT frauds in developing countries would thus inflate recorded outflows (and so TJN’s estimates) without any actual shift of resources out of a jurisdiction as the result of fraud within the country. Since this does not fit TJN’s narrative, it is not mentioned.

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343 Id. at 13.
344 Stopford, Strange, & Henley, supra note 1, at 124.
347 Id. at 24.
349 Id. at 9-10.
Third, TJN makes a strong, and implausible, assumption about the destinations of the illicit funds. According to TJN, this money comes from the “myriad of illicit activities in the global underground economy – corruption, fraud, insider trading, drug trafficking, ‘blood diamonds’, and innumerable other for-profit crimes” that provide “illicit loot” which needs concealment. However, TJN assumes that the money from all of these activities ends up “idle in relatively-low-yield offshore investments”, which leaves the “public sector … starved for capital (perhaps having to rely on high-cost loans or inflationary finance rather than tax revenue.)” Offshore investments thus earn “a modest 6-month CD rate” which has been “‘grossed down’ to reflect the costs of offshore management.” This is an implausible assumption in three respects. First, it assumes that people engaged in high risk criminal activities choose “low yield” investments for their money once they have spirited it out of the jurisdiction where their crimes are committed. Why criminals would choose to invest like cautious senior citizens is not explained and is implausible considering the evidence of their appetite for risk from their choice of occupation. It is also counter to the usual assumptions about money laundering, which focus on the need to get the money into vehicles that permit using it. Second, even if TJN’s assumption of criminals buying low yield CDs from offshore banks is correct, this

350 Henry, The Price of Offshore Revisited, supra note 5, at 24. This is only a partial list – TJN asserts that “[t]here is a long laundry list of economic bads enabled by haven jurisdictions: not only tax evasion but also fraud, bribery, illegal gambling, money laundering, and traffic in contraband: drugs, sweatshops, human and sex trafficking, arms, toxic waste, conflict diamonds, endangered species, bootlegged software … the list is virtually endless.” Id. at 24.
352 Id. at 30. (It is unclear how much “grossing down” has been done, since no figures are provided.) We have attempted to find out where we can get a well-paying job managing wealthy people’s money by putting them in 6 month CDs from major banks but these jobs seem in short supply – in part because wealthy people seem to actually want their money managers to earn them money. The Price of Offshore Revisited refers to “our interviews with private bankers and other offshore industry experts” to determine that “the median private banking customer” is “much less interested in maximizing short-term returns than in securing an offshore nest egg – typically he or she is often taking quite enough risk, thank you, back home.” Id. at 30. This assumption is contradicted by one of The Price of Offshore Revisited’s key sources, the Merrill Lynch / Capgemini report, World Wealth Report. Merrill Lynch & Capp Gemini, World Wealth Report 2011 (2012) available at http://www.ml.com/media/114235.pdf. That report found that “Many HNWIs took on more risk in 2010 as markets continued to rebound from crisis-related losses. As a result, aggregate portfolio holdings shifted further toward equities and away from cash deposits and predictable fixed-income instruments.” Id. at 16.

Among the many peculiarities of these assumptions is that a considerable amount of OFC business is on behalf of businesses and banks, which are looking for returns. For example, many banks offer overnight investment sweep accounts, in which excess funds are moved automatically to short term investment vehicles in offshore markets. See, e.g., BNY Mellon, Investment Sweep, available at http://www.bnymellon.com/treasury/services/investmentsweep.html and Sovereign Bank, Automated Eurodollar Sweep, available at http://www.sovereignbank.com/institutional/investments/automated-eurodollar-sweep-institutional.asp. Moreover, a serious critique of international finance over the past few decades is that it has been overly focused on achieving high returns, taking on too much risk at times. See, e.g., Philip Augar, CHASING ALPHA: HOW RECKLESS GROWTH AND UNCHECKED AMBITION RUINED THE CITY’S GOLDEN DECADE (2009) (describing flaws in UK’s financial services sector). TJN appears to be arguing that at just the time when everyone else in finance was busy chasing high returns on everything from overnight deposits to longer term investments in hedge funds, the tax evading class of criminals, money launderers, and other undesirables was just looking for a nice quiet certificate of deposit with a low return.

does not support their conclusion that the money is idle. Once the money is transformed from the suitcase of cash into an accounting entry at the bank, the bank will invest the money itself (via loans, asset purchases, etc.) and so transform the money into productive capital. If the criminals are accepting low yields, the profits are accruing to the banks’ shareholders and so are taxed as the banks’ profits and/or through the shareholders when realized as dividends or capital gains.

Next, TJN bases its estimates on a claim about money in private banking institutions, where “First World private bankers employed by the top 50 or so institutions have orchestrated the systematic erosion of income and wealth bases in high- and low-income countries alike.” As “senior pilots in ‘Capital Flight Air’” these bankers have allegedly helped clients “move a significant share – more than half, in the case of Latin America and some Asian countries – of their liquid capital to offshore accounts under the cover of shell companies and trusts, beyond the reach of domestic tax authorities.” It is hard to know how TJN can know the numerator (the fraction of Latin American and “some Asian” investors’ assets), since the entire point of the OFC structures in TJN’s framework is to conceal ownership of the assets, or the denominator (the total wealth of these investors). While there are some people hiding some assets somewhere, the estimate of “more than half” seems to be pulled from thin air.

TJN estimates that the top 50 global private banks (which are not listed in the report) held $12.06 trillion in “private cross-border financial wealth” in December 2010. This estimate is based on unspecified and unreported calculations from “company annual reports and 10Ks, investment analysts, interviews with private banking industry experts, industry watchers like Wealth Briefing News and Money Laundering Alert, and a survey of recent market research studies for the private banking industry.” Setting aside the complete lack of transparency in these “calculations”, the estimates are implausible when compared to larger economic trends. Counter-intuitively, TJN’s estimate is that the amount of this wealth grew from $5.4 trillion in 2005 to $12.06 trillion in 2010 – a remarkable performance during an unprecedented global financial crisis. By comparison, consider that the advocacy group Better Markets (which we might expect to be aligned with TJN in general on policy questions) estimated that the financial crisis cost the U.S. economy at least $12.8 trillion. Mark Adelson, former chief credit officer at Standard and Poor’s (who we might not expect to be particularly ideologically sympathetic to TJN), estimated the cost of the financial crisis to the global economy at $15 trillion. The IMF estimated the cost of the crisis in 2009 at $11.9

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354 Henry, The Price of Offshore Revisited, supra note 5, at 31. Somewhat mysteriously, TJN asserts that these bankers have “assiduously recruited the world’s wealthiest people as their clients, including tens of thousands of developing countries.” Id. at 31-32. We’re sure TJN meant “people from” rather than “of” but given The Price of Offshore Revisited’s snide tone, we can’t resist a jab.

355 Id. at 32.
356 Id. at 33.
357 Id. at 32.
358 Id. at 31.
360 Mark Adelson, quoted in Al Yoon, Total Global Losses From Financial Crisis: $15 Trillion
For global private wealth invested in financial institutions to have more than doubled while those same institutions were undergoing an unprecedented crisis of liquidity and stability is truly remarkable performance – particularly if all that money was just in low yield CDs, as TJN hypothesizes.\(^{362}\)

As a result of these powerful assumptions, largely unsupported by anything other than vague references to secret sources, TJN’s estimates are unreliable. Because the case for Control First measures depends heavily on having a large estimate of the amount of potential revenue, not having a reliable estimate makes it more difficult to justify increasing financial transaction costs.

2. Corrections and adjustments

A second category of problems with TJN’s estimates is that the already problematic estimates are increased by additional corrections and adjustments. For example, TJN considers adjustments to principal and interest in arrears to be “fictional finance” rather than “actual cash flow”; since including it in the calculations produced “nonsensical results” (an undefined term but which appears to mean results that did not accord with TJN’s desired outcome), it is excluded.\(^{363}\) However, TJN counts debt forgiveness as a “use” of funds.\(^{364}\) Thus if a debt grows because of missed interest payments, TJN does not count this increased liability but if a debt shrinks because of forgiveness, this is counted. TJN does not discuss how this factors into TJN’s claim there is an accumulating stock of assets in OFCs. For example, if any of the assets TJN claims exist outside the recorded economy are invested in bonds issued by a developing country held in an offshore account, those investments will lose value when a portion of the debt is cancelled.\(^{365}\) Since TJN simply sums its estimates of flows out each year, failing to adjust for this leaves an overstatement of the stock it estimates exists offshore.

Similarly, TJN finds that following its methodology for China would yield an “implausible” estimate of Chinese foreign investment (13 percent).\(^{366}\) TJN suggests that

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\(^{361}\) The puzzle is presumably solved by the various government bailouts of large financial institutions. TJN does point to these bailouts as saving a number of “too big to fail” financial institutions, although it wonders why “Treasury Departments around the world” failed to realize “that these very same banks are leading the world in enabling tax dodging – indeed, to some extent, precisely because offshore investors know that they have been under-written by their Treasury Departments”. Henry, *The Price of Offshore Revisited*, supra note 5, at 33.

\(^{362}\) Id., at 28.

\(^{363}\) Id. at 29.

\(^{364}\) This seems likely. For example, hedge funds hold considerable Argentine public debt and have been engaged in extended legal battles with the Argentine government over the terms of repayment. See [*Argentina’s 11-Year War with Hedge Funds*], Business Week (November 29, 2012) available at http://www.businessweek.com/articles/2012-11-29/argentinas-11-year-war-with-hedge-funds. Since these are the sorts of funds TJN finds objectionable, they are likely to have investors TJN objects to as well.

“much of [China’s] unrecorded capital transactions with Hong Kong are probably double-counted. A significant amount of China’s apparent capital flight is actually just ‘round-tripping’ by way of intermediary companies based in Hong Kong and a few other key havens, notably the British Virgin Islands.”367 TJN also argues there is considerable trade misinvoicing through Hong Kong.368 Without providing evidence that these claims are true, TJN has adjusted the results of their calculations to get ones more to their liking instead of abandoning a method of estimation that yielded implausible results.369

It is worth unpacking this example because it is revealing of the flaws in TJN’s methodology. There is not a single source cited in the discussion of “China’s Story”, although numerous factual claims are made. According to TJN, Hong Kong is a major center facilitating both trade misinvoicing and flight capital from China.370 Yet Hong Kong is part of the People’s Republic of China and the national Chinese government has both de jure and de facto authority over it. Indeed, if there is any concern in Hong Kong over the territory’s relationship with China, it is that China exerts too much control, not too little. If Hong Kong was undermining the Chinese tax system and denying the Chinese national government access to tax revenue it needed to provide public services on the scale TJN alleges (US$125.9 billion from Hong Kong according to TJN’s estimates), surely the Chinese government would have noticed this and taken steps to halt the practice. After all, Hong Kong has only limited autonomy under its Basic Law and the Chinese constitution – the “one country, two systems” framework – and certainly does not have the level of legal autonomy that even British Overseas Territories or Crown Dependencies possess with respect to the United Kingdom.371 In short, there may be “two systems” but China is certainly “one country” with respect to enforcement of Chinese law. This leaves TJN in a difficult position: either Hong Kong is not an illegitimate tax haven or the Chinese government is somehow allowing massive wealth to escape through Hong Kong. For TJN to complete this argument, it must argue that the Chinese government is both corrupt (and so interested in allowing the looting to occur) and incapable of moving money out of China without a costly and elaborate charade involving Hong Kong’s financial system. No doubt there is corruption in China, as there is virtually everywhere. But the idea that Hong Kong is needed to facilitate corruption on the mainland is ludicrous. By making an ad hoc “adjustment” to the inconvenient results of their model in the case of China, TJN reveals the problematic nature of their calculations.

367 Id. at 31.
368 Henry suggests that many of China’s unrecorded capital outflows with respect to Hong Kong are double-counted. Id. at 31
369 Id. at 31 (Hong Kong capital outflows estimate “permits us to adjust China’s accumulated wealth estimates accordingly.”).
370 Id. at 38.
371 See Ray Yep, Understanding the autonomy of Hong Kong from historical and comparative perspectives, 24 China Information 235, 236 (2010) (“While the Basic Law prescribes the parameters for engagement between the central people’s government and the HKSAR government and the jurisdictional boundary of the latter, the flexibility of these limits is subject to decision by the former through its power to make, unmake, and interpret the Basic Law.”).
Hong Kong intermediates a great deal of China’s external trade and serves as a key vehicle for international investment into China. This provides a better explanation for the flows of claims through Hong Kong. What TJN ignores is that Hong Kong is a multinational financial services center and entrepôt, which provides sophisticated business and financial services to companies as well as a legal system recognized as sophisticated on business issues. The Hong Kong Stock Exchange is a deep and sophisticated capital market using a convertible currency (the Hong Kong dollar) that allows access to Chinese investments for investors who cannot invest through mainland stock exchanges because of China’s restrictions on RMB convertibility. Major Chinese businesses, including ones with substantial state ownership stakes, have listed on both the Hong Kong and Shanghai stock exchanges. There is little doubt that some Chinese investors seek to obtain the benefits of Hong Kong’s legal and business environment as well as tax and other advantages China offers to “foreign” investment by routing investment funds through OFCs like BVI. Indeed, since such activity is openly discussed in financial circles, it is certainly well known to Chinese authorities. By operating in a factual vacuum and ignoring the role that financial centers like Hong Kong play in the world economy, TJN reveals a deliberate ignorance of the world economy which undercuts the credibility of its estimates.

Once having created estimates of money flows, TJN augments its numbers using estimates of “how much these accumulated flows might be worth over time.” This is a particularly vigorous shifting of the cards in the three card monte game, since TJN simply “assumes that a significant portion – 50 to 75 percent, on average – of these tax-free earnings are not repatriated to source countries but are reinvested abroad in relatively ‘safe’, low-yielding investments, denominated in traditional reserve currencies like US dollars.” TJN supports this assumption with the “fact” that “most haven investments are made for longer-term motives like asset protection, money laundering, and diversification, which undercuts the credibility of its estimates.

373 See, e.g., *REPORT ON THE FIRST FIVE YEARS*, supra note 37, at 33 (“The rule of law is one of Hong Kong’s greatest strengths. It is the cornerstone of Hong Kong’s success as a leading international commercial and financial centre, providing a secure environment for individuals and organisations and a level playing field for business.”).
377 Id. at 29-30.
not just short-term speculation, with low turnover and high reinvestment rates.” Thus, not only are criminals bad investors, but they are world class savers! This is implausible.

Finally, TJN uses what it labels as “The Offshore Investor Portfolio Model” based on Bank of International Settlements (BIS) data on cross-border deposits, wealth management industry analysts’ assumptions about portfolios, and “interviews with actual private banks.” TJN begins with multiplying the amount of offshore deposit liabilities by non-banks (using figures from the BIS) by three, which TJN says is a “super-conservative” choice to account for high net worth individuals’ portfolios’ allocation of assets into offshore “security blankets” for more risk-averse investors. Multiplying things by three certainly makes numbers bigger, which appears to be TJN’s goal in such an arbitrary calculation. Finally, TJN assumes that illiquid investments in hedge funds, art, real estate, and private equity make up 10-17% of these individuals’ portfolios. Thus for every dollar of nonbank deposit liabilities in an offshore bank, TJN would add to its estimate of offshore financial wealth two more dollars, turning the $7.01 trillion into its lower estimate of $21 trillion. TJN also hints that more should be added to reflect the likelihood that the 3.0 multiplier is too low and to account for the illiquid assets.

There are many problems with this “multiply things by a number we made up” method of ‘estimation’. First, it assumes that all of the nonbank deposit liabilities in offshore banks are deposited there by high net worth individuals. This is false. Many deposits in banks in offshore jurisdictions made as part of Eurocurrency market lending by institutions and are derived from sweeps of overnight deposits. TJN’s first error in this regard is to assume that all OFCs resemble Switzerland, which has an active private banking business in which high net worth individuals do deposit money. However, OFCs are a diverse set of jurisdictions with many not pursuing individual clients in banking but focusing on other markets. Evidence that TJN’s approach is flawed can be seen in the drop in high net worth individual’s cash/deposits holdings between 2010 and 2011 from 17% to 14%, a drop that is not reflected in any adjustment in TJN’s estimates.

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Id. at 30. This adjustment is peculiar in that “diversification” and “money laundering” are dramatically different activities, which cannot be categorized as similar.

Id. at 34. We would have thought talking to private bankers would have been more productive than discussing things with the banks.

Id. at 35.

We’re not sure why the illiquid assets are broken out separately since the liquidity ratio would presumably reflect them already, but TJN does not explain the role of this adjustment. Henry, The Price of Offshore Revisited, supra note 5, at 35.

See Paul S. Pilecki, It Pays to Reduce Free Balances When Interest Rates Are Rising, Community Banker (Dec. 2005) available at http://winston.com/siteFiles/publications/websitversion.pdf at 2 (describing how “Larger organizations also use Cayman or Nassau branch deposits or commercial paper issued by a holding company affiliate as the investment vehicle in a sweep arrangement. If a bank has an offshore branch, a sweep can be operated without significant operational difficulties….”).

World Wealth Report, supra note 352. TJN might respond that since they are assuming a lower ratio, this does not matter. That is incorrect as what matters is the change in flow. Thus even if their point estimate is lower than Merrill Lynch / Capgemini’s, if they argue that wealth reports like Merrill’s are valid they need to accept that it can indicate a reduced percentage of cash holdings whatever their assumptions about the point estimates.
TJN’s second error in constructing this estimate is to assume that an investor’s overall portfolio is mirrored in the offshore portion of his or her portfolio. Thus even if TJN is correct that a customer of a Swiss private bank keeps his or her liquid assets in the Swiss account, there is no evidence to support the assumption that the less liquid assets are also kept in Switzerland. Moreover, it is unclear what it means for a Rembrandt painting to be “in” Switzerland, unless it is physically present in Switzerland, although its owner is elsewhere. As with other adjustments, TJN claims to have “checked” its liquidity ratio calculations “with private bankers and industry sources” for confirmation, but none of these people are identified.\(^{384}\)

TJN’s third error is to lump all high net worth individuals together. To take just one obvious source of differences, the Merrill Lynch / Cap Gemini \emph{World Wealth Report}, on which TJN relies, finds that individuals from different countries have different preferences for the percentage of their assets held in liquid form. For example, wealthy Japanese tend to hold “55% of their aggregate portfolio in fixed-income and cash/deposit vehicles at the end of 2010, up from 48% a year earlier and above the global average of 43%.”\(^{385}\)

A fourth problem is that the \emph{World Wealth Report} suggests that TJN’s assumptions about the looting of developing countries are incorrect. According to that report, 53% of total worldwide high net worth individuals live in the United States, Japan, and Germany. Nine of the top 10 nations for numbers of high net worth individuals in 2010 are all developed economies; the only exception is China.\(^{386}\) (Brazil and India rank 11\(^{\text{th}}\) and 12\(^{\text{th}}\).) The United States alone has over 40% of all high net worth individuals; China has 6.4%. The developed economies have 89.9%; the three largest developing economies just 10.1%. This suggests that TJN has vastly overstated the number of looters in developing countries who have managed to hold on to their ill-gotten gains.

The common theme among these adjustments and corrections is that TJN has manipulated its estimate to consistently increase the size of the estimate, while discarding any model predictions that would be seen as implausible.

\section{Coping with Uncertainty & Policy Choices}

How much money is “moving” around the world in criminal transactions? How many people and firms are illegally evading taxes? No one knows. TJN’s eye-catching estimate of massive hidden wealth ( languishing in low yield CDs) in offshore jurisdictions is largely the product of the assumptions made rather than a reasonable approximation of a concededly difficult number to estimate. Unfortunately, because it is huge number, it has attracted widespread attention – particularly from governments weary of austerity measures looking for easy fixes.\(^{387}\) In light of the uncertainty about the

\begin{footnotesize}
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  \item\(^{384}\) Henry, \emph{The Price of Offshore Revisited}, \emph{supra} note 5, at 36.
  \item\(^{385}\) \emph{World Wealth Report, supra} note 352, at 16.
  \item\(^{386}\) Id. at 7, Figure 3.
  \item\(^{387}\) See note 305 \emph{supra}.
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relative size of beneficial international and harmful financial transactions, rational policy discussions are difficult. How then to have a reasonable discussion of the costs and benefits of the various policy proposals made by Control First advocates? We suggest four important issues.

First, policymakers need to be clear about whether they are approaching financial issues from a Wealth Maximization or a Control First framework. Is the goal to facilitate creating wealth or prevent bad behavior? If a Control First approach is going to be taken, are there any limits to it? Are constraints imposed by capital markets legitimate or illegitimate? Do all governments get presumptions of legitimacy? Do all government policies get presumptions of legitimacy? Can a country confiscate one ethnic group’s wealth with impunity, as Zimbabwe did to white farmers? Can a country confiscate its citizens’ holdings in non-local currencies and involuntarily swap them for national currency, as Argentina did? Can a country print as many units of currency as it wishes, as Venezuela is currently doing? Can governments enact policies aimed at redistributing wealth from one ethnic group to another, as Malaysia has done?

Second, what are the constraints imposed by the need for the rule of law on Control First measures? Is tax avoidance – that is, following the rules to reduce one’s tax burden – legitimate? If not, how are tax obligations determined? By individual negotiation with tax authorities?

Third, what criteria will be used to judge the effectiveness of those Control First measures that are adopted? Are there specific revenue targets which must be reached? Is there a yardstick by which to determine if there are measures that are too expensive?

Finally, who pays for the costs of the Control First measures? Are all governments responsible for the costs within their jurisdiction? Are private actors responsible for the costs they incur? Are there limits to these costs? Who decides which measures are required? Do all jurisdictions have a voice in determining which measures are adopted?

To conclude, we turn to applying the frameworks to the policy issues facing governments with respect to the degree to which they will choose to facilitate or obstruct the movement of money across borders. We examine three key issues where the differences in approach between these two frameworks are critical to the policy choices: international investment, taxation, and financing governments.

A. International Investing

Investments are not equally easy in all jurisdictions. Investors must cope with country risks when investing across borders, and not all countries present the same risk profiles.\textsuperscript{388} In addition, there are other asymmetric obstacles to cross-border lending. Developing markets may present “cultural differences and lack of information” and

\textsuperscript{388} Beenhakker, supra note 28, at 51 (explaining country risk as “the possibility that unexpected events within a host country will influence a client firm’s or a government’s ability to repay a loan.”).
“differing accounting and disclosure practices,” while well-developed capital markets such as the United States, EU, or Japan offer well-understood practices that are easily accessible even to outside investors. Where legal systems are not as developed, investors face additional risks. Such risks include “(a) the rudimentary protection of intellectual property rights (patents, trademarks, copyrights), (b) the inadequate regulation of fair trading and competition, (c) problematic dispute regulation (unequal access to courts, unenforceable foreign judgments, and the inability to refer disputes to arbitration) and (d) limited rights to appeal.”

Many developing countries also seek to encourage foreign investment by offering incentives including tax incentives.

Access to well-functioning, liquid capital markets is an important means of reducing financing costs. Many countries do not have such markets, as a result of a variety of factors including: information barriers, particularly with respect to accounting standards and disclosure; transactions costs, including taxes on transactions and high fees for transactions; foreign exchange risk; regulatory barriers, including relatively high levels of capital gains taxation; lack of liquidity; and political risk, including concerns over government interventions, lack of capital market laws and institutions, and poor quality judicial institutions.

Where countries have tried to control capital movements, they have often created unintended bad consequences. Brazil’s efforts to control capital flight, which dated from 1962 to 1990, restricted capital remittances by taxing remittances above 12% heavily. When inflation created a black market for foreign currency, foreign firms found it worthwhile to repatriate funds above 12% at the official exchange rate, pay the tax, and then reinvest via the black market rate, more than offsetting the tax liability.

The fundamental question is whether cross-border investment is presumptively beneficial or presumptively harmful. If the former, then the policy goal should be to minimize the transactions costs of such investments, imposing burdens only when the cost can be justified as preventing a harmful activity (e.g. money laundering). This requires demonstrating that the effort actually accomplishes its goal. Current attempts to regulate international financial transactions using a Control First approach are virtually guaranteed to be ineffective. The volume of financial transactions in the world today makes it impossible to collect the information the Control First approach requires.

### B. Collecting Taxes

Collecting taxes is not a simple task. Indeed, a recent survey of tax issues concluded both that “[c]omplexity is the unavoidable rule of corporate income tax structures” and that tax administration “is typically … the most difficult to get right.”

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389 Id., at 51.
390 Id. at 56.
391 Mo, TAX AVOIDANCE, supra note 162, at 133.
392 Beenhakker, supra note 28, at 173.
393 Stopford, Strange, & Henley, supra note 1, at 105.
394 Emilio Albi & Jorge Martinez-Vazquez, Introduction, in ELGAR GUIDE, supra note 7, at 1, 4.
Many developing countries lack the government infrastructure to administer a complex tax system (such as the U.S. tax system). Among the problems contributing to tax administration difficulties are: lack of rule of law and transparency, including rapid changes and instability in tax laws; lack of a tradition of voluntary compliance with tax laws; lack of efficiency in administering tax laws, including lack of capacity to perform audits, non-existent third party information, and too few trained personnel; corruption, which allows poorly paid civil servants and poorly drafted, overly simplistic tax laws to become the source of bribes; frequent tax holidays used to attract foreign investment, encouraging businesses to report losses until a holiday occurs; competition for investment, which limits aggressive enforcement of tax laws. 396

When particular incentives are available, businesses and individuals structure transactions to take advantage of these incentives. For example, China offered a lower tax rate for firms receiving foreign financing at less than LIBOR plus 0.25%. At a time when LIBOR was 10%, a firm borrowing RMB10 million from a Japanese lender re-characterized its initial loan rate of 10.4% to be 10.2% plus a service fee of RMB200,000 and so qualified for the preferential tax rate. 397 Countries that create tax laws which offer such incentives should adjust their own tax laws to ensure that only transactions they seek to incentivize are able to take advantage of the provisions before asking other jurisdictions to alter their laws or restructure the entire financial system.

Moreover, jurisdictions need to take responsibility for their own policy choices and implementations. In many instances, poor quality tax policy can complicate tax administration and contribute to avoidance and evasion. For example, Mo describes Mexico’s tax evasion problems as the result of the combination of complex tax laws, “dysfunctional preference schemes,” a large informal sector, inflation, and inefficient tax administration.

Specifically, tax laws have been structured in which taxpayers are treated as potential tax dodgers. Therefore they have to comply with a huge number of formal requirements and different obligations. The requirements that taxpayers have to fulfill to take certain deductions are overcomplicated and formal.

In the past, legislation has repeatedly been based on exemptions, which has led to great complexity throughout the tax system. In many cases, the inspection efforts of tax authorities have been transferred to the taxpayers, who have to cover the resulting administrative costs. Every

396 Mo, TAX AVOIDANCE, supra note 162, at 12-13. Mo describes the impact on tax collections of the competition among local authorities in China for investment as producing “a flexible approach toward enforcing the [tax] law whereas statutes and regulations can be interpreted broadly to suit the need of other public policies. There are inconsistencies among local, provincial, and national laws and regulations. … For instance, receipts from enterprise income tax are shared between local and central government, while individual income tax revenue is destined only for local governments. Being dependent on revenue, individual local governments have more incentives to grant tax reductions to promote local businesses and attract foreign investment, thus creating inconsistencies.” Id. at 79-80.

397 Id. at 80-81.
effort has been made to give the tax authorities every facility to perform official inspections, which complicates the entire tax system.\textsuperscript{398}

This approach creates its own corruption and tax leakage problems.

The preferential treatments of taxpayers create significant loopholes. For example, the simplified tax regime allows small companies with less than $300,000 annual sales to pay income tax at a flat rate with a ceiling of 2.5\% of income earned, less an amount equal to three times minimum wages. This system tat taxes the difference between income and outlays on a cash-flow basis, not only makes inspection difficult, but also treats among other income tax payers unequally. In addition, large corporations can take advantage of this loophole by splitting into a number of small companies that are less scrutinized in underreporting earnings. Lack of administrative capacity at the provincial level is also a major impediment for progress.\textsuperscript{399}

More generally, Mo concluded from her study of four major developing economies that “an ineffective tax administration system is a key factor leading to a high level of noncompliance.”\textsuperscript{400} Although Mo is generally unsympathetic to tax avoidance measures, we find her description to fit closely to the Control First approach to taxes. Her proposed solution was the opposite of the Control First approach: simplification of tax structures as an important means for improving tax compliance.

A simplified tax structure will enable tax authorities to shift their attention from monitoring of eligibility for exemptions and special treatment give to firms and individuals, to more productive activities such as development of a master file of taxpayers, collections, and audits. In addition, it is easier for taxpayers to understand, and therefore comply with simplified uniform rules. With fewer special rules, there are also fewer opportunities to avoid or evade by mis-classifying income, overstating deductions, and claiming exemptions or credits. Finally, a simplified tax structure would reduce the scope for corruption since complexities and ambiguities in tax law facilitate many taxpayers to evade taxes.\textsuperscript{401}

This is consistent with a Wealth Maximization framework: simplifying and improving domestic tax law’s administration and content facilitates more transactions, which yields more wealth.

The same point is seen in the discussion of transfer pricing. As noted earlier, many Control First proponents argue that transfer pricing is a key method of illegitimate

\textsuperscript{398} Id. at 123-24.
\textsuperscript{399} Id. at 123-24.
\textsuperscript{400} Id. at 166-67.
\textsuperscript{401} Id. at 169.
shifting of money from higher tax jurisdictions to lower taxes.\textsuperscript{402} However, this assumption is not accurate. For example, a survey found that much of the writing on transfer pricing was about tax issues, while managers had a much broader set of concerns.\textsuperscript{403} The allocation of earnings across a firm’s operations is rarely a simple task and the models used by tax authorities to do so based on methodologies “founded on basic assumptions about market structure and firm behavior that are rarely empirically valid.”\textsuperscript{404} As a result of these methodological problems, “multinational firms are unable to accurately anticipate their tax liabilities in individual countries….”\textsuperscript{405}

The Control First approach to taxation is thus based on an unrealistic assumption that any tax system a government can imagine can be implemented. There are myriad constraints on governments imposed by the world. Tax competition provides one set but taxes are just one of many criteria used by firms and individuals in making financial plans.\textsuperscript{406} Moreover, the requirement of the rule of law that tax (and other) laws be written down in advance inevitably leaves opportunities for tax avoidance through structuring. In many instances, avoidance efforts take advantage not of “loopholes” but tax code provisions put in place deliberately to serve policy objectives (e.g. to promote investment), satisfy political preferences (e.g. a preference for indirect taxation), or special interests (e.g. tax credits for favored industries). To single out a single piece of a multi-dimensional policy, as the Control First approach does, is doomed to fail. What most of the Control First proponents fail to recognize is that governments face a series of tradeoffs in designing tax and other policies. In particular, tax policy is not simply a matter of announcing a rate and collecting the revenue.\textsuperscript{407} Different methods of taxation are susceptible to different methods of avoidance and evasion.\textsuperscript{408}

\textsuperscript{402}For example, Picciotto argues that multinational firms have a competitive advantage in their ability to “use a network of often fictional subsidiaries to exploit all the possibilities of the interaction of tax systems, as well as the growing tax treaty network.” Picciotto, \textit{Legal Fiction}, supra note 7, at 52-53. He describes this advantage as:

this entails a system of intermediary ‘stepping stone’ subsidiaries, which are used to channel the transfer of assets and returns on investment to and from foreign operating subsidiaries, through conduit companies (formed in a treaty country) and then on to holding companies in low-tax havens.

Picciotto, \textit{Legal Fiction}, supra, at 53.

\textsuperscript{403}Shulman, \textit{TRANSFER PRICING}, supra note 271, at 3.

\textsuperscript{404}King, \textit{TRANSFER PRICING}, supra note 205, at 1.

\textsuperscript{405}Id.

\textsuperscript{406}Albi, \textit{Challenges}, supra note 7, at 139 (a multinational may decide to establish itself in a country, in spite of taxes, to serve its consumers better or because of product transport costs. Other important factors in the location decision of foreign direct investment (FDI) are relatively low wages or a qualified workforce. Quality of infrastructure or the management skills of the country’s business community, with good goods and services providers, are also important for FDI location.”).

\textsuperscript{407}Consider Norway, sometimes touted as a model of relatively progressive tax rates by “tax justice” advocates. If one goes beyond the rates, one discovers that Norway “has a petroleum tax system with such generous depreciation allowances that, when added to interest payment deductibility, normal returns on investment in this sector are practically tax exempt.” Albi, \textit{Challenges}, supra note 7, at 134.

\textsuperscript{408}For example, income taxes can be evaded by illegally failing to report income to tax authorities. An American citizen who earns income in Britain could thus evade American income taxes by not informing the Internal Revenue Service of the British income and not paying the tax owed under the U.S. system of
Moreover, an important component of cross-border financial flows is external financing of government spending. For example, the large U.S. budget deficits in the 1980s combined with relatively high U.S. interest rates and the perceived safety of U.S. government debt led to large capital inflows into the United States. Similarly, the relative safety of U.S. government debt and today’s even larger deficits is drawing capital into U.S. financial markets despite low returns, since returns globally are depressed by central banks’ easy money policies. Focusing only on the tax portion and ignoring the borrowing portion is dangerously incomplete.

The Control First approach raises complex jurisdictional, ethical, and practical issues. To take just one example, as we noted earlier, it is difficult for financial institutions to identify the beneficial owner of an asset and to determine whether that entity or individual is subject to the tax laws of a particular jurisdiction. An individual who presents an American passport as proof of identity in satisfaction of an AML requirement, for example, is virtually certain to be an American taxpayer about whom information might need to be reported to the United States under a tax information exchange agreement. But what about an individual who presents a Cayman Islands passport but who also has American residency? The Cayman Islands have no direct taxation and so no income tax. But a Caymanian who is a U.S. taxpayer may owe U.S. taxes on UK income. How is a financial institution in the U.K. to determine which Caymanians are also U.S. taxpayers? This is not a hypothetical – there are large numbers of Caymanians who are U.S. residents and so subject to U.S. taxation.

Conclusion

As we have shown, the global financial network is a complex system that uses different jurisdictions for different purposes. Some of these purposes are legitimate while some are not. The question facing policy makers around the world is how much re-working the system can tolerate before the benefits it yields are eroded. Unfortunately, that debate turns in part on impossible to obtain data. The most recent effort by the Tax Justice Network falls so far short of any reasonable analysis that it cannot be considered seriously.

world-wide income taxation. A British citizen who was not resident in the United States would not be engaged in tax evasion for failing to report income earned in the United States, however, because under the British system of territorial taxation, British taxpayers owe income taxes only on income earned in Great Britain. Income taxes can be legally avoided by structuring a source of income so that the income is not taxable by a particular tax authority. Locating an asset in a low tax jurisdiction or a jurisdiction that does not tax a particular form of income thus reduces the tax burden. For example, a non-American taxpayer who deposits money in an interest-bearing account in the United States is not liable to the United States for income tax on the interest. If his home jurisdiction does not tax foreign source income, he would avoid tax on the interest income by depositing the funds in a U.S. bank rather than a home jurisdiction bank.


As a result, the debate is being conducted based on world-views rather than realistic cost-benefit appraisals. Certainly, as Bird argues, “tax researchers need to understand the real constraints and objectives facing [developing country] policy makers before offering them pre-cut solutions to what researchers think are their problems.”  

Control First proponents believe that the most important thing is to stop bad things happening in finance. By contrast, Wealth Maximization proponents, like the two of us, believe the most important thing is to promote economic growth. We think the debate needs to begin with discussion of those priorities rather than masked by the pretense of data. In conducting that debate, it is vital that competing policy proposals consider the benefits as well as the costs of jurisdictional competition. The rule of law is all too scarce in today’s world and jurisdictions that specialize in providing it to others provide a valuable service that needs to be recognized.

The overly simplistic, conspiracy-theory view of international finance promoted by the Tax Justice Network must give way to a realistic appraisal of the tradeoffs imposed by real world conditions before the international tax competition debate can find solutions to the difficult problems created by differences in national tax regimes. As Bird convincingly argues,

> The level and structure of taxation reflect deep-seated institutional factors that, in the absence of severe shocks, do not change quickly. Tax policy decisions are not made by a benevolent government. Taxation is not just a means of financing government; it is also a very visible component of the social contract underlyng the state. Citizens are more likely to comply with tax laws if they accept the state as legitimate and credible and are thus to some extent both willing to support it and afraid of what will happen to them if they don’t. …. [A]ny major tax reform is thus always and everywhere an ‘exercise in political legitimation’. Those who will have to pay more must be convinced that they will get something worthwhile for their money. Those who do not want to pay more must not be able to block reform and, in the end, must be willing to go along without taking to the hills in revolt or fleeing the country. Those within the government and in the private sector who have to implement the reform must support it or at least not actively sabotage it. And of course politicians have to see sufficient support to warrant putting reform not only on the agenda but on the ground.  

This suggests that the solution to tax evasion lies in substantial part in reforming governments to ensure they uphold their side of the social contract.

In addition, there are trade-offs to be made on virtually every margin in the design of tax systems and ignoring them is a recipe for dysfunction. Improving international tax systems is more likely to result from continuing “to eliminate tax preferences”, “a better

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413 Id. at 433.
approximation of tax depreciation to the actual depreciation of assets”, and continuing “the process of base-broadening and rate-moderating that started in the second half of the 1980s.”

However, these steps are much less likely to grab headlines than over-hyped, fanciful claims of trillions of hidden wealth and require boring discussions of technical details rather than rhetorical flourishes such as denunciations of “pirate bankers”. As Albi notes, “[g]ood tax administration performance is a must for all taxes”. Providing tax officials and policymakers with the information needed to tackle the messy job of real tax reforms in developing countries is thus key. Devoting more resources to creating honest, competent governments in jurisdictions where corruption and incompetence is the norm is critical and not addressed by denunciations of jurisdictions providing rule of law services to the rest of the world. Moreover, reality may constrain the choice of tax structures in ways that do not accord with individuals’ or NGOs’ preferences. For example, as Martinez-Vazquez and Bird argue, “even a bad VAT is often likely to be better than the possible alternatives in even the poorest countries”, shifting from income taxes to consumption taxes may be preferable to TJN’s desire for redistribution when other factors are weighed in with such preferences.

Finally, there are real issues of respect for sovereignty that must be addressed, and which the Control First view ignores. If we live in a world where international relations require respect for the sovereignty of all jurisdictions, the shifting of costs from large, wealthy jurisdictions to small ones demanded by the Control First proponents is illegitimate.

414 Albi, Challenges, supra note 7, at 162.
415 Id. at 163.
416 Id. at 169.
417 Bird, Tax system change, supra note 23, at 417 (“[Lord] Kaldor … was thus right in the important sense that countries that wish to tax more need to ensure their governing institutions facilitate the achievement of this goal. Doing so by such oft-suggested means as enhancing the rule of law, reducing corruption and the shadow economy, and improving tax morale, is neither simple nor easy.”).
418 Martinez-Vazquez & Bird, supra note 218, at 231.