BUSINESS

Why Tax Havens Are Political and Economic Disasters

Seeking prosperity through lax business and tax regulations leaves countries worse off.

By Brooke Harrington

The business district of "Little Manhattan" is visible behind riot police in Panama City during protests over the sale of public land. (Arnulfo Franco / AP)

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In the early 1990s, economists coined the term "the resource curse" to describe a paradox they observed in countries where valuable natural resources were discovered: Rather than thriving, such countries often crumbled, economically and politically. The newfound wealth, instead of raising living standards for all, generated violence, as well as accelerating the growth of inequality and corruption. Terry Karl, a Stanford political science professor, dubbed this the "paradox of plenty." The same story has played out again and again all over the world, from Venezuela (where Karl did her research on the destruction wrought by oil wealth) to Sierra Leone (home of blood diamonds) and Afghanistan (which, despite $3 trillion in mineral wealth, remains among the poorest and most corrupt countries in the world).

A similarly insidious pattern has developed in recent years among the countries serving as offshore financial centers. Many, like the countries affected by the resource curse, are former colonial states struggling to stay fiscally viable; the "resource" they discover is human capital, in the form of a population literate and numerate enough to provide financial services, such as the filing and compliance tasks linked to offshore corporations, trusts, and foundations. For these economically and politically fragile countries, the influx of cash provided by involvement in international finance seems like an unmitigated blessing, offering jobs and revenues for a relatively small investment in infrastructure, such as high-speed internet access.

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But as many are finding, becoming a tax haven has unexpected costs. Precipitous economic, political, and social declines have occurred so often in such states that observers have coined a new term for it: “the finance curse.” When the "finance curse" strikes a country, there is a recurrent pattern: While its democracy, economy, and culture remain formally intact, they are increasingly oriented to and co-opted by international elites. In other words, such countries gradually become organized around the interests of people who don't even live there, to the detriment of those who do. The services produced by these countries protect cosmopolitans’ wealth, but the riches never flow to the the local producers, undermining their capacity for self-governance and social cohesion, as well as the development of infrastructure and institutions.

This has led to increasing economic fragility for offshore financial centers, along with political corruption and social decline, as evidenced by a rise in crime and violence. I experienced the latter in my own research on the global wealth-management industry: In the course of visiting 18 tax havens in every major region of the world, I encountered this social decay directly through a number of experiences, including being robbed at Pae Moana in the Cook Islands. A local fisherman I met afterwards said the rise in burglary and violent crime in the islands began with the growth of the offshore industry. Not only the wealth it brought in, but also the new value system focused on exploitation and greed, meant that “everyone calls us the ‘Crook Islands’ now.” The finance industry had begun to eat away at the nation’s democratic institutions: Referring to a recent political-corruption scandal, the fisherman said, “They’ve got our government in their pockets. I hate what they've done to my country.”

But as I learned, the workings of the finance curse have shaped not only the development of small post-colonial nations like the Cook Islands, but also that of seemingly wealthy and well-established ones. For example, recent reporting on the Channel Island of Jersey has documented the crippling of the country's economy, government, and society in one of the world's leading financial centers—a place that was once considered a "miracle of plenty" and a role model for other would-be tax havens.

The corrosion described by the finance curse has affected even some of the wealthiest financial centers, such as Luxembourg, which is the domicile of choice for $3.5 trillion worth of mutual-fund shares and over 150 banks. As a result of a robust financial-services sector that contributes 27 percent of the country's economic production, the Grand Duchy boasts the highest per capita GDP in the Europe, far outstripping its nearest rivals, Norway and Switzerland. At first blush, Luxembourg would appear to be in terrific shape: a wealthy democracy, thriving in the center of Western Europe.

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However, as the economist Gabriel Zucman has shown, Luxembourg's role as a leading tax haven has benefitted foreigners at the expense of locals, across the board. Over 60 percent of the country's workforce is comprised of foreigners, who reap virtually all the benefits of the wealth generated by the Duchy. The society, as a result, is fracturing along expat-versus-local lines, both in economic and political terms.

As Zucman documents, inequality in the Grand Duchy has skyrocketed, with poverty doubling since 1980, and real wages for ordinary Luxembourgers stagnating for the past 20 years. Meanwhile, salaries for expat wealth managers have exploded, tripling housing prices in Luxembourg City. However, even this new wealth has not benefitted the local economy: Due to Luxembourg's tax policies, public institutions such as the educational system are in "accelerated decline," mainly to the detriment of locals. The result, Zucman observes, is that Luxembourg has become more of a free-trade zone than a state.

This represents a threat to European democracy. As Zucman points out, Luxembourg has full membership in the European Union based on the premise that the government represents the citizens of the Duchy. However, having "sold its sovereignty" to multinational corporations, Luxembourg has also made itself the political arm of international finance, effectively giving those multinationals voting and veto privileges over European public policy.

A similar situation has played out in Panama. One of the less-explored angles on the Panama Papers scandal—the leak of nearly 40 years' worth of confidential client data from the wealth-management firm Mossack Fonseca—is how Panama's role as an international tax haven has affected the country internally. Financial services, which are mostly directed at foreigners moving wealth offshore, contribute an estimated 7 percent of Panama's GDP, and have led to a steadily growing economy for more than a decade. Coupled with dominance over the shipping trade via the Panama Canal, which brings in billions of dollars to the country's economy, Panama would seem well-positioned for prosperity.

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Yet in reality, Panama remains one of the most economically unequal states in the world: a so-called "Fourth World country," signifying an extreme degree of material deprivation. More than one-third of its population lives in poverty. According to World

Bank estimates, 25 percent of Panamanians lack basic sanitation and 11 percent suffer from malnutrition. The country's indigenous people of color, representing almost 13 percent of the population, have been almost completely shut out from any benefits Panama has reaped from the offshore business; most still lack access to clean water or health care.

This is because all the benefits of Panama's economy, including the offshore finance industry, have been tightly constrained to elites. This is particularly true of those tied to "little Manhattan"—the district of the capital city where financial firms are based. But across the board, in all areas of the economy, Panama's growth primarily benefits foreigners.

With this unequal sharing of Panama's wealth has come increased violence and a decline in democratic institutions. Murder rates doubled between 2006 and 2012, and 22 percent of the population reported being a victim of crime just within the previous four months. In 2012, a week of riots, arson, and looting followed the government's manipulation of the legislature to force sale of public lands. The state, which has no army, has deployed Panama's border-defense officers to put down public protests demanding democratic representation. The previous president has been accused by his own vice-president of taking a $30 million bribe from a foreign corporation. (The previous president denies the allegations.) Thus, despite the country's apparent economic health and its central role in the offshore finance network, it remains a classic case of the "finance curse": stunted by inequality, violence, and a weak democracy with recurrent tendencies toward authoritarian rule.

Countries affected by the "finance curse" are essentially captured states. But captured by whom? As with Luxembourg, the case of Antigua and Barbuda—a single country composed of several islands at the intersection of the Atlantic Ocean and the Caribbean Sea—suggests that the answer is usually foreign elites. This means high-net-worth individuals, multinational firms, and finance professionals from abroad not only wring disproportionate benefits from the country's economy, but come to control its political system as well.

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The problem of state capture was exemplified by the American financier R. Allen Stanford, who essentially bought Antigua—in some cases through, an indictment alleged, outright bribes, but more often with a series of quid-pro-quo moves. As the country's former prime minister said of Stanford, "This man has a lien on our whole country." For example, *The Guardian* reported in 2009, Stanford gave the Antiguan government $30 million to build a new hospital, and let the regime take credit publicly for the move, ensuring the goodwill of voters. In return, according to *The Guardian*, the regime gave Stanford and his firm enormous legal and financial concessions, enabling Stanford's personal fortune to reach $2.2 billion—nearly double the GDP of the island.

To complete his capture of the island's economy and government, Stanford became the second-largest employer in the country, and the owner of its primary newspaper. As a result, he exerted a controlling influence over both the livelihoods and political discourse of most Antiguans. Throughout this process, Antigua's own political leaders enriched themselves through association with Stanford, while maintaining their positions of public authority by seeming to invest in public goods that were covertly being funded by Stanford.

The perils of this strategy became apparent when Stanford was convicted of fraud and sentenced to a prison term of 110 years. When his $7 billion investment scheme collapsed, it wasn't just a personal failure: He took an entire country down with him. Overnight, Antigua lost 10 percent of its GDP, and—perhaps surprisingly—25 percent of its tourism revenues. It wasn't just ruined as an offshore financial center, but tainted in such a way that its main alternative source of economic survival was damaged as well.

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While many studies have pointed out the ways that tax havens damage the countries where wealthy people have made their fortunes, the examples of Luxembourg, Panama, and Antigua illustrate a related, but often overlooked point: The practice of offshore finance often damages the countries where these people stash their fortunes as well. The locals who bear the brunt of the damage are rarely heard from in international discourse. Their media outlets and opportunities for political expression have been all but usurped by the handover of their countries to the financial-services industry; in order to maximize the freedom and mobility of capital and its elite owners, the industry turns many tax havens into what Nicholas Shaxson, an export on offshore finance, describes as a group of "repressive places" with a "contempt for democracy." It is extremely difficult to disentangle a country from the tax haven business once that industry becomes a monoculture.

Whatever benefits the tax-haven business might bring to a country, it seems to be a Faustian bargain. There may well be impressive economic growth, as the cases of Luxembourg and Panama illustrate, but the wealth created generally goes directly to expat workers in the financial-services industry or to corrupt local politicians. These gains don't just bypass local people, but are often made at their expense, in the form of rising prices for housing, food, and other necessities; locals are also hit hard by regressive taxes on consumption, imposed to make up for losses from low or nil taxes on income and investments. As for politics, the rights of local people are often curtailed, lest they interfere with the preferences of transnational capital and its agents. Inquiry and transparency are discouraged using threats of detention and deportation, including against foreign journalists and researchers.

For this and other reasons, a group of 300 of the world's leading economists called recently for an end to tax havens—or at a minimum, an end to the financial secrecy they provide. This is unlikely to happen. For one thing, as the Panama Papers showed, the people directly empowered to make the necessary changes are themselves deeply enmeshed in the world of offshore finance; that is, they reap significant personal

benefits from the perpetuation of the system. For the same reason, leaders of small nations struggling to find their feet economically may be reluctant to forego the temptations of the quick riches that offshore finance seems to offer. By the same token, it is extremely difficult to disentangle a country from the tax-haven business once that industry becomes a monoculture, dominating the economy as well as the government; as the cases of Jersey and Antigua show, there is often nothing left to build upon once the offshore business dries up or leaves.

Perhaps the only viable solution is to offer an alternative development model, based on countries that escaped the resource curse. Norway, which is endowed with vast oil resources, used its long tradition of strong, trustworthy democratic institutions to distribute the country's burgeoning wealth in a relatively equitable fashion. But what of countries already plagued by poverty or struggling to establish good governance after colonial rule?

Botswana is often mentioned as a success story in this context. The small nation, a British protectorate until 1966, used to be among the very poorest in the world. But since the discovery of rich mineral resources, it quickly became an upper-middle-income country, while at the same time boasting one of the least-corrupt governments in the world. Among the keys to Botswana's success has been economic diversification—the refusal to put all its eggs in one basket. This enables the country to maintain its independence, not only fiscally but politically.

It is unclear, however, how applicable this model is to nations considering the move to offshore finance or already entangled with it. The lesson from Botswana seems to be that sources of new wealth must be tightly controlled in their influence on a country's economy and society. But is that really possible when the source of wealth is not owned by the country—as Botswana's diamonds are—and is highly mobile, as mineral reserves are not? Unlike natural resource wealth, the wealth involved in offshore finance doesn't come from within a country's boundaries, and its owners can move it to another country should the economic or political situation of the haven not be to their liking; this gives them the power to dictate terms to host countries. Maybe the economist Jeffrey Sachs, one of the 300 signatories to the letter stating that tax havens have "no economic justification," was correct in his simple conclusion: “They just need to end.”

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