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Money launderers and tax havens: Two sides of the same coin?☆

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ABSTRACT

This paper investigates whether tax havens have an incentive to maintain low regulatory standards in order to attract black money activities. Using a new dataset on money laundering regulation, the results of this study show that tax haven and money laundering services coincide within the same country. This effect is especially observable for regulative instruments which increase the probability of detecting money laundering; whereas in the case of punitive regulation for money laundering the complementary relationship is weaker, perhaps due to a "false friends" effect. If we classify tax havens according to their per capita GDP, poorer tax havens in particular tend to supply both services, because the gains from their tax haven status are low compared to those of wealthier and well-established tax havens. From a policy perspective the results add new insights to the debate on the welfare effects of tax havens since the results suggest that poorer tax havens might be reluctant to provide the necessary regulatory environment in order to constrain money laundering. This externality is beyond the familiar tax revenue effects caused by tax havens.

1. Introduction

Countries whose money laundering legislation is lax are often classified together with tax havens as offshore financial centers (OFCs) (Rose & Spiegel, 2007). OFCs are countries or territories offering low regulatory standards, strict bank secrecy laws and favorable tax treatment to businesses or financial investors (Palan, 2002). This paper examines the determinants for becoming a provider of lax money laundering regulatory standards. Because tax haven services and money laundering are subcomponents of OFC activities, we investigate in particular whether tax havens also provide low regulatory standards for money laundering. Although the termini "tax haven" and "money launderer" are often used interchangeably in academic debate, from a theoretical perspective it is less clear whether tax havens actually promote money laundering.

Because money laundering and tax evasion are hidden activities, it is difficult to estimate their real extent (for an overview of estimates on money laundering: Gnutzmann, McKarthy, & Unger, 2010). The focus of the paper is not on the magnitude of these crimes; however, but on the regulatory instruments states use in order to constrain such activities. Up to now, no study has analyzed the nexus between money laundering and tax havens, although recent attempts by the G-20 countries suggest that cross-border tax evasion and the regulation of the financial sector are important topics in cross-border governance. However, five studies do relate to our work, namely, Rose and Spiegel (2007), Dharmapala and Hines (2009), Masciandaro (2005, 2008) and Slemrod (2008). Rose and Spiegel (2007) consider the determinants for a country becoming an OFC, taking tax haven and money launderer status as explanatory variables. The authors show that countries which are considered to be tax havens or money launderers are more likely to appear on the list of OFCs. This result is consistent with the definition of an OFC because OFCs are countries who offer favorable tax treatment and low regulatory standards (Errico & Musalem, 1999; Palan, 2002). In addition, Dharmapala and Hines (2009) provide empirical evidence for the formation of tax havens. Using the list of tax havens in Hines and Rice (1994) and the OECD (2000) these authors conclude that tax havens are not only less populated countries, but also that they provide a healthy regulatory climate. This result is also confirmed by a recent study from Masciandaro (2008) who shows that OFCs are politically stable countries. Having such a stable environment is an important criterion in order to qualify as a tax haven.

Perhaps, the study most closely related to our research question is from Masciandaro (2005) because he concentrates on the question of whether tax havens and money launderers share the same characteristics. Whereas Dharmapala and Hines (2006) recognize that tax havens and money launderers have similar characteristics, but that the regulatory quality in tax havens is much higher than

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in countries providing money laundering services, Masciandaro (2005) goes one step further and analyzes the determinants for becoming a tax haven and a money launderer. The tax haven variable in his study is a dummy variable compiled from the above mentioned OECD report; the dummy variable for money laundering activities is obtained from a report by the Financial Action Task Force (FATF) (2000). Whereas a high percentage of land usage, low per capita GDP and large per capita cash deposits encourage money laundering, they do not influence the decision to become a tax haven. Only organized crime and terrorism seem to negatively influence a country's choice to become a tax haven or money laundering center. Thus, the results of Masciandaro's (2005) study suggest that the underlying causes for becoming a tax haven are different from those for becoming a money launderer. These results are also supported by a recent cross-sectional study by Slemrod (2008). Whereas tax havens are often well-governed, strongly economically integrated small islands, none of these variables by itself explains a country's decision to become a money laundering center. The only variable which is negatively associated with money laundering is per capita GDP.

This paper contributes to the small existing empirical literature on OFCs in two ways. First, in our study the question of whether tax havens also provide money laundering services is central. Many tax havens are accused not only of fostering tax evasion but also of promoting other negative externalities like financial crises or money laundering (Errico & Musalem, 1999; Masciandaro, 2008). In this study we try for the first time to determine whether or not this is the case, and to address the problem that the tax haven status of a country might be endogenously chosen. Because it is not clear whether tax havens really are the major providers of low regulatory standards, Section 2 of this paper considers the pros and cons of tax havens acting as providers of lax regulation on money laundering. Second, the above cited studies constructed a nominal or ordinal index of money laundering regulations based on reports from the FATF. This measure has some shortcomings, which will be discussed in more detail in Section 3. Instead, this study uses a new dataset on money laundering regulation, which enables us to distinguish between regulations regarding the punishment of money laundering and the efforts of a country to increase the probability of detecting money laundering. The results of the analysis are presented in Section 4. Finally, Section 5 gives a brief summary and conclusion.

2. Do tax havens promote money laundering?

Obviously there is no clear-cut answer to this question. Whereas some scholars support the view that tax evasion and money laundering are complements (Simmons, 2001, p. 606; Yaniv, 1999), other authors emphasize that this should not necessarily be the case (Mitchell, 2002). Those authors claiming that money laundering and low or lax taxation are substitutes or at least independent from each other refer to the impact of norms. With respect to tax havens it is less clear whether tax evasion is never justifiable. The most obvious case why tax evasion might be acceptable comes from the Leviathan view of the state (Brennan & Buchanan, 1980). If political decision makers use tax revenues mainly for their own personal gain, evasion of taxes would be justifiable. However, the critical point of the Leviathan view is that it may be the sovereign leaders themselves who wish to transfer their wealth outside their country. Former Philippine dictator Ferdinand Marcos is an example of just such a case where an authoritarian ruler, fearing revolution or assassination, transferred his (country's) wealth into a tax haven (Palan, Murphy, & Chavagneux, 2010).

Banks in tax havens behave neutrally towards their potential clients: they (normally) do not ask where the money comes from. The highly negative perception of money laundering results instead from the intent to conceal the root of profits earned from past crimes. Thus the problem is to a lesser extent the money laundering itself than it is the circumstances under which that activity evolves. Because money laundering frequently goes hand-in-hand with criminal activities such as drug or human trafficking and may be used, for instance, to finance terrorism it is hard to justify (Slemrod, 2008). Because of the ambiguities surrounding money laundering, the degree to which a country is integrated into the international community becomes crucial for that country's decision to supply lax regulation. The more closely knit a country's relation to the international community, the more it may have to fear retaliation – perhaps in other policy areas – from other members of the community. Thus, politically and economically more integrated countries are more vulnerable compared to those who remain outside the international community and should therefore less often opt for lax regulatory standards.

Instead, a view more closely related to economics would postulate that tax havens and money launderers do not share the same characteristics because the abolishment of money laundering does not destroy the business model of the tax haven. While there might exist some complementarities between individual tax evasion and money laundering, it is less obvious whether such ties exists for tax havens specializing in high business profile activities, because empirical studies on tax havens find that they perform well. Hines and Rice (1994) show that tax havens attract not only more capital than their counterparts, but are able to create jobs from US-MNEs locating in their territories. Tax havens have experienced higher growth rates compared to non-tax havens in the last decades (Hines, 2004) and they may promote more investment in industrialized countries (Desai, Fritz, & James, 2004). In addition, tax havens may target their incentives mainly to mobile factors. This targeted tax competition implicates that revenue losses can be limited, because the scope of competition is constrained to the mobile part of the tax base (Keen, 2001). Moreover, investment-enhancing effects can outweigh revenue losses through profit shifting (Desai et al., 2004; Hong & Smart, 2010). Although MNEs might profit from the incentives provided by tax havens, they need, however, a stable regulatory climate and should be aware of the consequences if the country in which they operate is accused to foster criminal policies. Given that the main motive for the large capital flows into tax havens is tax evasion or avoidance, tax havens do not have to relinquish these huge gains if they act strictly against money laundering. Moreover, they might even gain, if MNEs respond strongly to negative publicity.

However, this view rests critically on the assumption that (a) most cross-border capital flows are not undertaken for money laundering purposes and (b) strict regulatory standards against money laundering do not void the opportunity for tax havens to profit from tax evasion or avoidance. Whereas one might agree that the first assumption holds, it is less obvious whether tax havens can so easily discriminate between providing a tax-friendly environment and money laundering. Especially in the case of private capital income tax evasion, it is necessary for tax havens to offer strict bank secrecy laws and to be reluctant to supply information to other fiscal authorities on the deposits of foreign citizens. Strictly protecting the identity of tax evaders is crucial to the success of tax havens. This is the reason why many OFCs like Switzerland or the Netherlands Antilles opted for a (low) withholding tax instead of providing information to other fiscal authorities from EU member states in the case of the EU savings tax directive (Schwarz, 2009).

Some of the criteria the FATF (2000, 2001) has used to identify money laundering centers – e.g. inadequate customer identification requirements through anonymous (bank) accounts, or a lack of information exchange between fiscal authorities – may hurt tax havens too. Other criteria – for instance, criminalization of money laundering – may be implemented by tax havens more easily.