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International Tax Competition, Anti-Money Laundering Efforts and Capital Flow: Implications for South Asia as part of the Global South

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In the last few decades, numerous tax experts from international organisations such as the Organisation for Economic Co-operation and Development, the European Commission and G20 have declared a 'war on anti-tax competition'. However, this paper asserts that the efforts of these organisations have not been successful in lowering international tax competition. Conversely, there has been an increase in functioning tax havens in the Global North that enforce an umbrella of strong anti-money laundering efforts (AMLEs) within their jurisdictions. Conceptualising this paradox as "anti-money laundering efforts in tax havens", this paper argues that AMLE can secure the interest of these jurisdictions of easing inflow and preventing outflow of capital. Capital is often retained with a 'carrot and stick' approach, given AMLE provisions and robust financial institutions. Yet, in contrast with these tax havens, the Global South countries, including those in South Asia, lack such a strategy. This may explain why long-term capital has not been flowing to the South, despite

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increasing economic liberalisation. For South Asia, this phenomenon can hinder long-term capital retention and have spill-over effects in the economy unless AMLEs are strengthened.

Introduction and Background

In the past few decades, numerous tax experts from international organisations such as the Organisation for Economic Co-operation and Development (OECD), the European Commission and G20 have declared a 'war on anti-tax competition'. They have done this on the premise that tax competition creates a problem of 'fiscal externalities' or unpredictability of fiscal income of a higher-taxation country against a lower-taxation country. Winner (2005) describes tax competition as 'a situation where the fiscal activities in one jurisdiction induce the fiscal externalities in other jurisdictions'. The predicted consequence is an under-provision of public goods in the former as competition may erode their tax base, forcing them to adopt lower taxation rates (Wilson, 1986; Zodrow & Mieszkeoski, 1986; Slemrod & Wilson, 2009). As for tax havens themselves, others like Branchard, Deaton and Lustig assert that they serve 'no useful economic purpose' as their tax policies undermine the countries' ability to collect taxes, with poor countries proportionally the biggest losers (Oxfam, 2016). Furthermore, high bank secrecy, one of the integral characteristics of tax havens, is said to cause social ills by creating opportunities for laundering the proceeds of political corruption, embezzlement and global drug trade (United Countries, 2006). With the above rationale, the OECD specifically introduced a 'Harmful Tax Practices' initiative which utilised the naming-and-shaming mechanism of labelling certain countries as 'tax havens'. The 'tax havens' provide preferential tax regime for foreign investors and share minimal information with the international tax authorities (Dharmapala, 2008). In 1999, the International Monetary Fund (IMF) published a list of jurisdictions with 'offshore financial centres' which provides robust corporate and commercial services to non-resident offshore companies and investments (Unger & Ferwerda, 2008).

Nonetheless, this paper asserts that the above have not been successful in lowering international tax competition. Conversely, there has been an increase in functioning tax

havens[2] in the Global North (North) which enforce anti-money laundering efforts (AMLEs) within their jurisdictions. This phenomenon – we term it the 'anti-money laundering efforts in tax haven paradox' – arguably can secure the interest of these jurisdictions to ease inflow and preventing outflow of capital. Capital is often retained with a 'carrot and stick' approach, given AMLEs provisions and robust financial institutions.[3] In contrast with these tax havens, the Global South countries have been weak in AMLEs, and that could be the reason long-term capital has not been flowing to the South despite increasing economic liberalisation. With weak AMLEs and poor monitoring in the South, capital flowing out to the Global North tax havens hardly returns. This phenomenon can hinder long-term capital retention and damage the economy unless AMLEs are strengthened. This paper will explain how the Global North countries maintain their tax haven functions. It will then end with a discussion on the feasibility of the Global South countries joining the global tax competition to become functioning tax havens.

Defining Tax Haven

In existing economic literature, 'tax haven' usually refers to jurisdictions that impose none or low taxation and possess other features such as non-transparency and ring-fencing of mobile capital (Nicodeme, 2009). While this concept has been widely used since the 1950s, the difficulty in identifying tax havens continues to be a challenge as there are ample opportunities for tax evasion in various jurisdictions around the world. Previously, the OECD attempted to identify tax havens based on such criteria as the imposition of no or nominal taxes and whether non-residents could use the place for tax avoidance (OECD Committee on Fiscal Affairs, 1998). However, such a narrow definition unintentionally tarnished some of the OECD members' tax systems that appear to offer nominal taxes ("Tax Haven Criteria", 2008). Therefore, the OECD subsequently devised a second and a third determinant, that is, the lack of transparency (such as absence of ownership information) and unwillingness to exchange information with other tax administrations among the OECD member countries.

[2] This is with reference to countries listed on the relatively comprehensive Financial Secrecy Index despite it being plagued by the complexities of assessing transparency and hence Tax Haven (See Figure 1 – Financial Secrecy Index List).

[3] While state governments may or may not directly impose orders or requests for these foreign capital to be directed at real economic activity such as infrastructure development or other forms of investments, the natural occurrence is that if everyone else's capital is flowing in the formal economy and if one does not react to this occurrence, it is more likely that such owner of static foreign capital may be monitored.

Similarly, a more comprehensive Financial Secrecy Index by the Tax Justice Network looks into international transparency and judicial cooperation of jurisdictions. It takes into account their AMLEs, as assessed by their adoption of the Financial Action Task Force (FATF) recommendations, and the number of bilateral and multilateral treaties individual jurisdictions sign (Tax Justice Network, 2016).

As the above poses problems with assessing the transparency of individual jurisdictions, as will be shown later, this paper takes another approach. It seeks to establish that any jurisdiction with a preferential tax regime comprising regulations that can potentially 'pull' foreign capital and capture rent from mobile capital while allowing opportunities for tax avoidance, could be charged as an intending tax haven (Palan, Murphy & Chavagneux, 2011). For a jurisdiction to become a functioning tax haven, however, profit-maximising actors (firms and their owners) must 'push' themselves into performing tax non-compliance in their home countries by finding earnings and transferring assets to be taxed in that particular jurisdiction for various reasons such as the average effective income tax rate, unemployment rate, public dissatisfaction with government and per capita real gross domestic product (Liege & Cebula, 2011). In this process, both the jurisdiction's authorities and the participants would expect a certain level of mutual coherency in reporting to other parties that could include authorities in the home country and international organisations.

Anti-Tax Haven Regime and Constant Demand for Tax Haven in the Global Economy

The origin of contemporary tax havens can be traced back to the practice of state-backed tax reduction (to the state's benefit). For instance, in the 1880s, New Jersey and Delaware enacted liberal corporate laws for low taxation in order to attract businesses to incorporate their "offshore corporations". By the 1920s, various Swiss cantons began to mirror the United States (US) offshore experiences by allowing the creation of dummy companies that were nominally Swiss while the actual assets remained abroad. Coupled with the legal guarantees of banking secrecy under the Swiss Banking Law of 1934, the general characteristics of a tax haven were formed (Palan, 2002).

Tax havens offering preferential taxes to foreign potential tax evaders elsewhere have sprung up largely on the assumption that tax incentives will stimulate investment. According to the Marginal Effective Tax Rate Model, the higher the tax incentives, the lower the marginal effective tax rate, and this encourages investment in the tax-preferred activity until the after-tax rates of return are equalised, notwithstanding the impact of tax competition against other economies (Shah & Boadway,1992). Moreover, the Effective Tax Rate and Return-Over-Cost Models by Feldstein (1987) point out that net investment is dependent on the net-of-tax real return to capital. In order to increase the earnings of a firm after interest, taxation, depreciation and amortisation, the effective tax rate should be lowered. This is also consistent with Shah's and Slemrod's (1991) finding that the relationship between the average effective tax rate and inward foreign direct investment is negatively correlated; this means that for every decrease in a unit of tax rate, there will be an increase in the unit of inward foreign direct investment (FDI).

In the case of American corporations, the earnings from foreign subsidiaries are not liable for taxation until the earnings are repatriated to the parent entity in the US. Therefore, the corporations are incentivised to devise profit-shifting methods towards overseas locations with a lower tax rate than the US (Gravelle, 2009). One such method is 'earnings stripping' that allows the corporation to artificially reduce its taxable revenue through interest deduction provisions (Gravelle, 2009). For instance, a corporation based in the US may lend to its subsidiaries in low-tax jurisdictions and take the interest from the equity financing as a deduction in its own revenue. Another approach is to exploit 'cross-crediting'. This was initially conceived by governments to avoid imposing double taxation on locally incorporated firms that operate overseas by crediting the excess tax difference between jurisdictions (Giovannini, Hubbard, & Slemrod, 1993). However, corporations utilise this legal mechanism to offset taxable income from low-tax jurisdictions by acquiring tax credits by artificially increasing the liable taxes paid in another high-tax jurisdiction through 'transfer pricing'. The above-mentioned exploitation of tax differences shows that countries attempting to apply optimal tax theories to harmonise the effects of tax differences between jurisdictions will not succeed as corporates will continue to seek jurisdictions which allow them to legally pay lower tax rates while exploiting the legal loopholes in countries that set higher tax rates.

Fast forward to contemporary developments, the increase in tax havens is said to be, by no means, an accident. Despite anti-tax-competition measures at the international level, Kudrle (2008) finds through his time-series analysis that the OECD initiative has had no significant impact. He claims that the "the literature of effectiveness of international regimes is still in its infancy" (Eden & Kudrle, 2005). More intriguingly, according to World Bank data, nine of the world's richest jurisdictions are identified as having characteristics of tax havens. Furthermore, Nicodeme (2006) notes that the OECD countries have made considerable reductions in their corporate tax rates while achieving relatively stable revenues from 1980-2010. Dharmapala (2008) similarly notes that the share of US tax revenues from corporate taxes rose between 1994 and 2006 despite an increase in outward FDI towards tax havens during the same period. Swank (2016) finds that corporate tax rates across the world and, on average, have been significantly reduced from 49 per cent in 1982 to 28 per cent in 2010 in order to attract foreign capital. The irony is that while these North institutions do not condone the formation of tax havens elsewhere, they appear to benefit from participating in an ongoing global tax competition themselves. The evidence suggests that global tax competition, and in proportion the global demand for tax havens, at least in the North, may continue steadily in the next few decades.

The Paradox of AMLEs in Tax Havens

Having established the existence of a constant demand for tax havens in the Global North, we explore an empirical surge in AMLEs occurring among them. Bank secrecy worldwide appears to have loosened among countries in the past few decades via massive ratification of various international anti-money-laundering conventions over the years such as the United Nations (UN) Convention against Transnational Organised Crime, UN Convention against Corruption and the 1988 Vienna Drug Convention. These commitments are known under an umbrella term as AMLEs. The AMLEs may include criminalisation for money laundering and related offences, setting threshold amount in transactions and report requirement for financial institutions, reduction of bank secrecy by introducing "Know Your Customer" policy, bilateral and multilateral legal mutual assistance and asset forfeiture for suspected money laundering offences (Zagaris, 1992). Global North countries are also showing willingness to exchange information with other tax administrations by signing conventions

such as the OCED Multilateral Convention on Mutual Administrative Assistance in Tax Matters and the OECD Common Reporting Standard Agreement. This suggests they are becoming more transparent (OECD, 2016).

The fact that these conventions have been signed by highly secretive jurisdictions like Switzerland, the United Kingdom and the Netherlands implies there might exists a paradoxical contradiction between 'disclosure' and 'compliance' within these North jurisdictions. While they are on the 2018 Financial Secrecy Index List (see Figure 1), which suggests their lack of financial transparency can serve as a prerequisite to attract tax evaders into their preferential tax regimes, they have on the other hand long achieved a sufficient degree of compliance with the FATF recommendations to improve AMLEs. That sees them cleared from the money laundering blacklist (see Figure 2).

Unger and Ferwerda (2008) attempt to rationalise this contradiction as the result of ambiguity and inconsistency in investigating elements of transparency between the various money laundering and tax haven measurements. However, real-life cases suggest that this may be the work of "good governance façade", a concept finding by Kalle Moene and Tina Søreide (2014). Batory (2012) conducted a study on why anti-corruption laws fail in Central Eastern Europe and found that the formation of anti-corruption agencies in Eastern Europe shows "the desire to please an external actor (international organisation) or to flaunt anti-corruption credentials to voters", but in reality results in no more than a symbolic action. In the case of Switzerland, though it was pressured to sign the 2013 Foreign Account Tax Compliance Act obliging it to reveal information about US account holders, the ensuing scrutiny only targeted Swiss banks rather than the entire functioning and secrecy of its preferential tax regime. Swiss authorities continue to allow non-resident companies to benefit from the different tax rates in various Swiss cantons while offshore companies are not obligated to file accounting records and financial statements with the Swiss Registrar of Companies (Financial Secrecy Index, 2018; Deloitte, 2015).

Like the Global North tax havens, Afghanistan also appears to exhibit a façade of contradiction between disclosure and compliance. In 2014, the Afghan government imposed stronger anti-money-laundering and terrorism financing laws (Mone & Søreide, 2014). However, the laws were implemented only after the FATF threatened to blacklist Afghanistan if it did not criminalise money laundering; the Afghanistan administration

complied in order to avoid blacklisting and being cast aside by the international banks (Trindle, 2016). However, as Katzman notes, post-Taliban governance in the country and enforcement assets or oversight are almost non-existent; there is little effort to ensure disclosure of financial information.

So, as we see, anti-money-laundering laws do not necessarily reduce financial secrecy or hinder business in functioning tax havens. Instead, they can allow jurisdictions to portray themselves as having a legitimate and conducive business environment.

Capital Inflows: Using Anti-Money-Laundering Laws to Increase the Tax Base

AMLE laws may also help reduce stringency of capital inflows. This is due to the fact that there are structural difficulties in enforcing compliance with AMLEs laws. For example, there is the dilemma between rule-based and discretionary reporting by financial intermediaries required under AMLEs laws across many jurisdictions. The IMF acknowledges the problem of 'crying wolf' when excessive rule-based reporting to avoid hefty fines dilutes the information value of reports (Takáts, 2007). In the US, the subsequent introduction of discretionary reporting termed "Suspicious Activity Report" initiated by the US Financial Crime Enforcement Network to resolve the problem appeared to be futile too, when banks failed to detect true positives given that the cost of compliance at times is higher than the cost of non-compliance (Takáts, 2007). Hence adopting either type of reporting or both would lead to information overload and inaccuracy – conditions in which lowered bank secrecy no longer becomes a hindrance to tax havens since due diligence measures have already been set in place by their authorities; the onus for reporting suspicious transactions as an integral element in AMLEs enforcement is delegated to financial intermediaries like banks in tax havens since capital is expected to flow in through them before entering the jurisdiction (Takáts, 2007; Harvey, 2004). Hence, enacting a legitimate but implicitly ineffective AMLEs becomes an instrument to allow tax evaders to access the tax havens' economy easily.[4] After all, real stringent scrutiny for incoming funds may be detrimental to tax havens as it can

[4] While the FATF will make further tough recommendations in view of the less than efficient anti-money laundering monitoring by the jurisdiction, it is believed that the problem of 'crying wolf' and the limitation of the banks' efforts in compliance remains a structural one. Due diligence is key in accounting for AMLEs.

hinder expansion of the tax base despite their attractive lower tax rate incentive that supposedly encourages additional investments according to the Marginal Effective Tax Rate Model mentioned earlier in the paper (Shah & Boadway, 1992).[5] This explains the 'pull' force that defines an intending tax haven through the use of AMLEs.

However, since becoming a functioning tax haven requires tax evaders willing to 'push' themselves into participating within the jurisdiction, the more prioritised objective, it appears, is for tax haven jurisdictions to absorb incoming funds into the formal economy rather than the source of the fund. Nonetheless, such a 'push' would not happen naturally just because the barrier to inflow of capital is eased; Tobin's Q-theory model asserts that the decision by rational tax evaders to 'push' themselves into pouring in capital depends significantly on whether 'a dollar spent buying capital raises the market value of the firm by more than one dollar' (Shah & Boadway, 1992). In this case, it remains important that tax havens make an effort to make sure that their economic environment allows such a phenomenon to occur. This appears to be achieved via AMLEs controls too.

Regulating, Retaining and Moving Capital

Once capital flows in, tax haven jurisdictions have control to discretionally investigate whether suspected transactions are related to money laundering. Here, we see a stark contrast in the strength of AMLEs within tax haven jurisdictions as compared to the period when capital is flowing into it. Essentially, the argument is that while tax haven jurisdictions can condone the illegitimate source of capital inflows, they may not necessarily condone the act of money laundering within their jurisdiction because that could affect their financial stability and international reputation. In Switzerland, the authorities can lift bank secrecy at any point of time when there is 'suspected' money laundering; Article 47, Para 4 of the Bank Act in Switzerland includes provisions for the authorities to use federal and cantonment laws to retrieve information prior to court hearings (Bekker, Dolzer & Waibel, 2010).

[5] This means that money from illegal sources may be tolerated to some extent. The focus, instead, may be on how the capital can be channelled to constructive usage in the economy, for instance, in infrastructure development, investment banking, etc.

Should any financial intermediaries within tax haven jurisdictions come under the international limelight for money laundering activities, we observe a uniform empirical practice – the local authorities, as in any other jurisdiction, enforce AMLEs actions on the personnel involved. For instance, in the recent Malaysian 1MDB financial scandal probe by the US Department of Justice for alleged money laundering, the Swiss attorney- general's office stepped in to ask its counterparts in Malaysia to assist in its own probe into 1MDB even though Switzerland has the highest financial secrecy, according to the Tax Justice Network (Middleton, 2016; Broom, 2013). Similarly, Hong Kong and Singapore which rank fourth and fifth in the 2018 Financial Secrecy Index have joined the investigation and frozen a large number of accounts in connection with the international 1MDB probe (Tan, 2016).

Such seemingly strong AMLEs in times of financial scandals send a strong signal to various actors in the international community – at least to those seeking shelter from higher taxes in their home countries – that stability will be maintained in the financial industry so that each dollar invested in properties and assets can continue to generate more than a dollar in market value. This is the 'carrot' dangled before tax evaders by AMLEs. Unlike those seeking tax havens to launder money, corporate entities and wealthy individuals who want to enjoy lower tax rates and profit-seeking opportunities in the longer run are not tempted to put their money in economies where there is widespread money laundering. That goes against their interests; AMLEs enforcement is what they need. The economic rationale by Vito Tanzi (1997) is that the existence of uncovered and unchecked money laundering activities in an economy would allow large sums of laundered money to enter the economy disguised as legitimate capital. This could result in unexpected currency appreciation and inflation, reducing the value of the property and assets held by the investors.

Furthermore, sudden capital inflow and flight can result in an increase in 'Net Errors and Omissions' in a country's balance of payment account. That is what happened in the Global South jurisdictions like Turkey and Nigeria, both which have been listed by the FATF as non-cooperative countries in the last decade (Altinkaya & Yecel, 2013; Kehinde Adekunle, 2012).

AMLEs enforcement reminds tax evaders that, if they treat a tax haven jurisdiction as a mere short-term 'garrison for their capital' and commit hoarding behaviour, they will be treated like money launderers by the authorities, and this will be a blot on their international

reputation and shake their investors' confidence.[6] While there is a lack of visible evidence for this assertion, there have been cases of 'dormant' investors getting the 'stick' in preferential tax regimes. For instance, in Malaysia, when tax holidays failed to promote investments in target activities despite an inflow of capital, the government imposed penalties on firms that had been unprofitable during the holiday period (Boadway, Chua & Flatters, 1995). Conversely, in the Netherlands[7], which has adopted and implemented the 2005 the European Union Third Money Laundering Directive, the directive's 'Principle-Based Approach' allows its institutions to make their own assessment of risks entailed by particular customers, transactions or products; that is similar to the discretionary-based reporting mentioned above (FATF, 2011). Nonetheless, the Netherlands allows 'mail box' companies to continue to increase. Also known as 'special financial institutions' (see Figure 3), these do not have a substantial commercial presence in the country, but they are allowed to come up because they have stimulated production, high-grade financial employment, research and development, and trade (Weyzig, Dijk & Murphy, 2006). This may suggest that jurisdictions like the Netherlands plan to continue to operate as functioning tax havens due to their ability to channel capital into their formal economy.

Other cases suggest that vigilant jurisdictions would enact AMLEs measures when there is a large outflow of capital within a short period of time. For instance, a 2016 amnesty law enacted by Indonesia which sought to re-route tax-evaded money back into its economy from elsewhere saw private banks in Singapore sharing with the local police the names of their clients who were embracing the amnesty programme (Azhar & Daga, 2016). The Monetary Authority of Singapore (MAS) maintained that such a move was in keeping with the FATF's standard of filing a 'Suspicious Transaction Report' when dealing with tax amnesty cases and this was a common practice in jurisdictions that complied with the FATF's AMLEs (Azhar & Daga, 2016).

Increasingly, high-growth economies like China are also making substantial efforts to curb capital outflow. For instance, China's State Administration of Foreign Exchange issued a regulation that domestic banks should report any overseas credit card transaction of S$203

[6] In this case, we assume that, as long as capital flight does not occur, authorities in tax haven jurisdictions would ensure that capital hoarding by these tax avoiders be minimised. This can be through encouraging them to invest in infrastructure projects and investment products, given that a robust financial sector exists.

[7] Netherland is ranked 41 among the Top 50 jurisdictions with highest secrecy score - the higher the score, the more likely they can provide safe havens for tax evaders.

since September 2016. By August 2017, the deficit in China's capital and financial account had shrunk by at least 15 times from the previous year (Sender, 2017). The Chinese government continued to issue stringent regulations in 2017 for certain domestic sectors where overseas direct investments are prohibited, restricted or encouraged.

Capital Controls and AMLEs in the Global South

Various examples in the above section may suggest that jurisdictions remain vigilant about a spectrum of issues – economic stability, hoarding, inter-state tax competition and capital flight; hence, they use AMLEs in taking measures to (1) stabilise the economy by regulating unpredictable money laundering activities; and (2) prevent large capital outflows at a rate that can harm the tax base and money circulation in the economy. Intriguingly, this risks contradiction with the assumptions made by the Marginal Effective Tax Rate Model and Feldstein's Effective Tax Rate and Return-Over-Cost Models that capital (inflows of equity) would definitely flow out to places that offer lower tax rates and provide a higher rate of returns.

More importantly, it also suggests that the classical economic theory of convergence which hypothesises that capital will flow from a developed to a developing country may not be the case in reality. On the other hand, our analysis appears to be more compatible with the Lucas Paradox which asserts with empirical evidence that we do not observe the North to South capital flow as it should be.

While Lucas (1990) does not deny there has been an increase in FDI to the South, he claims that, going by neoclassical models, his findings would have already seen the marginal product of capital of India being at least 58 times that of the US. However, it is not so in reality. Hence, he provides two sets of explanation for this phenomenon; the first being differences in fundamentals such as factors of production, government policies and institutions among countries, and the second being international capital market imperfections. In fact, Alfaro, Kalemli-Ozcan and Volosovych (2008), through their empirical research, had found that the most important variable explaining the Lucas Paradox is the institutional quality dividing the Global North and South. This may be consistent with our hypothesis –

the strength of AMLEs enacted at the various stages in Global North tax havens can attract and lock capital within them, hence depriving other intending tax havens the experience of the ‘push’ element.

Conversely, for the Global South countries, we find their AMLEs have been consistently weak to attract and retain capital. Hence, unlike the Global North tax havens, they experience more frequent capital flight and, as a result of high money laundering activity, fail to push tax evaders into their preferential tax regimes. For instance, all the eight countries in South Asia are members of the Asia/Pacific Group on Money Laundering. Nonetheless, only India managed to become a member of the FATF. To be a member of the FATF, a country has to support the 2013 FATF recommendations, agree to undergo mutual evaluation and compliance assessment with FATF membership criteria, and take an active part in the FATF.

On the other hand, Sri Lanka has been listed as one of the FATF’s high-risk jurisdictions since 2015 on the grounds that its effectiveness in prosecuting terror financing cases with foreign elements is lower than the average for developing countries. Sri Lanka’s performance has also been poor, according to the FATF, in several areas such as customer due diligence, internal controls, wire transfer, and money value transfer service (Asia/Pacific Group on Money Laundering, 2015). Empirically, Bangladesh was also previously found to be easy for channelling illicit funds. For instance, at least 10 non-government organisations, including the Revival of Islamic Heritage Society, Rabita Al-Alam Al-Islami, Islamic Relief Agency and Muslim Aid Bangladesh, many them based in Saudi Arabia, were found to have channelled funds to local Islamic extremists in Bangladesh in the aftermath of a series of bomb blasts in August 2005 (Kumar, 2009).

The South Asian countries generally do not statistically fare well in controlling illicit financial flows. For instance, based on the latest Global Financial Integrity database, illicit financial flows from Bangladesh, India and the Maldives, respectively, have been experiencing a compounded average growth rate of 12 per cent, 17 per cent and 19 per cent from 2004-2013. Although India has sufficient anti-money-laundering laws and implementation measures consistent with FATF requirements, India’s share of the total cumulative illicit financial flows across all South Asian countries from 2004-2013 comes to a staggering 85 per cent.

Implications for the Global South (and South Asia)

The above may have serious implications for the economic development of the Global South countries, particularly when it comes to preventing the erosion of the tax base and profit shifting, which some countries may highly depend on for government revenue. However, there may be several characteristics within such a North-South political economy. Firstly, while we do not deny there has been a huge FDI inflow into the Global South emerging markets, some low-tax jurisdictions in the Global North have purportedly reported higher portfolio equity inflows than the FDI inflow into the Global South countries, arguably because the Global South countries may not be as efficient in pulling capital from foreign investors as effectively as the Global North low-tax jurisdictions. This can be due to a lack of size and depth of financial industries and/or a lack of AMLEs to insure and stabilise capital markets.

Secondly, the seriousness of unaccounted capital outflow in the Global South countries can be observed through the higher percentage of Net Errors and Omissions in the respective countries' balance of payment accounts to their total capital outflows.

For basic illustration, we compare all the South Asian countries to six Global North low-tax jurisdictions listed high on the Financial Secrecy Index in Figure 4. Using the 2016 World Bank's data we find that that all the South Asian countries' FDI net inflows (except that of India) are significantly outweighed by portfolio equity net inflows of certain the Global North low-tax jurisdictions such as Hong Kong, Luxembourg and the Netherlands. This suggests that FDI inflows to the general Global South countries are not exceptionally high even when compared to the Global North countries' portfolio equities. Furthermore, the Net Errors and Omissions of countries like Nepal, Bhutan, the Maldives and Afghanistan far exceed the FDI net inflows they received in 2016. Similarly, unaccounted Net Errors and Omissions form a significant portion of total capital outflow in Bangladesh – 97.4 per cent, Pakistan – 93.7 per cent, Afghanistan – 99.1 per cent and Sri Lanka – 45.8 per cent.

Conversely, for the Global North low-tax jurisdictions (except Switzerland), their Net Errors and Omissions, which translate to unaccounted outflows, do not exceed their FDI net inflows. All six Global North low-tax jurisdictions also have a significantly lower Net Errors and

Omissions to Total Capital Outflow ratio, as compared to the South Asian countries, excluding India.

Conclusion

In this paper, we firstly assert that the OECD's efforts to reduce tax competition remain largely ineffective because tax havens continue to provide economic incentives through their individual preferential tax regimes and a financially stable environment that matches the demand for economic rationale actors. Such a stable environment is achieved singlehandedly through the multi-functions and level of anti-money laundering laws used. While jurisdictions are pressurised to comply with anti-money laundering laws as required by the Financial Action Task Force, we find that, through these laws, they can strengthen their legitimacy as cooperative members of the international community in fighting money laundering within their jurisdictions for the sake of economic stability. Yet, these laws are simultaneously used to attract, retain and move capital within their formal economy in order to achieve economic prosperity. This creates a self-reinforcing effect whereby capital gets retained easily in the developed North instead of the South.

While this topic requires further research, we suggest that the South Asian countries should aim to attract, retain and move capital within their formal economies vis-à-vis highly secured and retained capital in the Global North tax haven jurisdictions. While it is contentious for them to emulate the behaviour of tax havens under such a tax-competitive global political economy, they need capital attracting and retention strategies to ensure the efficient long-term circulation of inflow capital. The first step appears to be setting standards for domestic compliance laws that are consistent with the international AMLEs.

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Figure 1: 2018 Financial Secrecy Index List

Rank	Jurisdiction	FSI Value[6]	FSI Share[7]	Secrecy Score[4]	Global Scale Weight[5]
1	Switzerland[2]	1589.57	5.01%	76.45	4.50%
2	USA[2]	1298.47	4.09%	59.83	22.30%
3	Cayman Islands[2]	1267.68	4.00%	72.28	3.79%
4	Hong Kong[2]	1243.68	3.92%	71.05	4.17%
5	Singapore[2]	1081.98	3.41%	67.13	4.58%
6	Luxembourg[2]	975.92	3.08%	58.20	12.13%
7	Germany[2]	768.95	2.42%	59.10	5.17%
8	Taiwan[2]	743.38	2.34%	75.75	0.50%
9	United Arab Emirates (Dubai)[2,3]	661.15	2.08%	83.85	0.14%
10	Guernsey[2]	658.92	2.08%	72.45	0.52%
11	Lebanon[2]	644.41	2.03%	72.03	0.51%
12	Panama[2]	625.84	1.97%	76.63	0.27%
13	Japan	623.92	1.97%	60.50	2.24%
14	Netherlands[2]	598.81	1.89%	66.03	0.90%
15	Thailand	550.60	1.74%	79.88	0.13%
16	British Virgin Islands[2]	502.76	1.59%	68.65	0.38%
17	Bahrain[2]	490.71	1.55%	77.80	0.11%
18	Jersey[2]	438.22	1.38%	65.45	0.38%
19	Bahamas	429.00	1.35%	84.50	0.04%
20	Malta	426.31	1.34%	60.53	0.71%
21	Canada[2]	425.84	1.34%	54.75	1.75%
22	Macao	424.92	1.34%	68.25	0.24%
23	United Kingdom[2]	423.76	1.34%	42.35	17.37%
24	Cyprus[2]	404.44	1.28%	61.25	0.55%
25	France	404.18	1.27%	51.65	2.52%
26	Ireland[2]	387.94	1.22%	50.65	2.66%
27	Kenya[2]	378.35	1.19%	80.05	0.04%
28	China	372.58	1.17%	60.08	0.51%
29	Russia	361.16	1.14%	63.98	0.26%
30	Turkey[2]	353.89	1.12%	67.98	0.14%
31	Malaysia (Labuan)[3]	335.11	1.06%	71.93	0.07%
32	India[2]	316.62	1.00%	51.90	1.16%
33	South Korea	314.06	0.99%	59.03	0.36%
34	Israel[2]	313.55	0.99%	63.25	0.19%
35	Austria[2]	310.41	0.98%	55.90	0.56%
36	Bermuda	281.83	0.89%	73.05	0.04%
37	Saudi Arabia	278.58	0.88%	69.88	0.05%
38	Liberia[2]	277.29	0.87%	79.70	0.02%
39	Marshall Islands	275.29	0.87%	72.93	0.04%
40	Philippines	269.81	0.85%	65.38	0.09%
41	Italy[2]	254.14	0.80%	49.48	0.92%
42	Isle of Man	248.68	0.78%	63.58	0.09%
43	Ukraine	246.25	0.78%	69.15	0.04%

44	Australia[2]	244.36	0.77%	51.15	0.61%
45	Norway[2]	242.85	0.77%	51.58	0.55%
46	Liechtenstein	240.86	0.76%	78.28	0.01%
47	Romania[2]	232.30	0.73%	65.53	0.06%
48	Barbados	230.95	0.73%	73.85	0.02%
49	Mauritius[2]	223.47	0.70%	72.35	0.02%
50	South Africa[2]	216.44	0.68%	56.10	0.18%
51	Poland	215.40	0.68%	57.35	0.15%
52	Spain	213.89	0.67%	47.70	0.77%
53	Belgium[2]	212.97	0.67%	44.00	1.56%
54	Sweden	203.55	0.64%	45.48	1.01%
55	Latvia	195.65	0.62%	57.38	0.11%
56	Anguilla	195.04	0.62%	77.50	0.01%
57	Indonesia	188.79	0.60%	61.45	0.05%
58	New Zealand[2]	178.56	0.56%	56.23	0.10%
59	Costa Rica	168.78	0.53%	68.65	0.01%
60	Chile	168.64	0.53%	61.60	0.04%
61	Denmark[2]	166.12	0.52%	52.50	0.15%
62	Paraguay	158.52	0.50%	84.33	0.00%
63	St. Kitts and Nevis	152.55	0.48%	76.65	0.00%
64	Portugal (Madeira)[3]	151.63	0.48%	54.68	0.08%
65	Puerto Rico	151.06	0.48%	77.20	0.00%
66	Vanuatu[2]	149.27	0.47%	88.58	0.00%
67	Uruguay	148.20	0.47%	60.83	0.03%
68	Aruba[2]	148.05	0.47%	75.98	0.00%
69	Dominican Republic	147.09	0.46%	71.60	0.01%
70	Czech Republic	145.10	0.46%	52.93	0.09%
71	Finland	142.23	0.45%	52.70	0.09%
72	Iceland	139.69	0.44%	59.90	0.03%
73	Brazil[2]	138.00	0.44%	49.00	0.16%
74	Hungary	132.73	0.42%	54.70	0.05%
75	Tanzania[2]	128.92	0.41%	73.40	0.00%
76	Slovakia	127.89	0.40%	54.90	0.05%
77	Seychelles	125.26	0.40%	75.20	0.00%
78	Guatemala[2]	123.63	0.39%	73.10	0.00%
79	Croatia	119.36	0.38%	59.28	0.02%
80	Greece	118.58	0.37%	57.88	0.02%
81	Samoa	115.90	0.37%	77.60	0.00%
82	Mexico	107.57	0.34%	54.38	0.03%
83	Gibraltar	107.44	0.34%	70.83	0.00%
84	Curacao[2]	105.66	0.33%	74.80	0.00%
85	Venezuela	105.03	0.33%	68.53	0.00%
86	US Virgin Islands	101.89	0.32%	73.08	0.00%
87	Turks and Caicos Islands	98.08	0.31%	76.78	0.00%
88	Bolivia	94.82	0.30%	80.35	0.00%
89	Bulgaria	91.38	0.29%	54.18	0.02%
90	Belize[2]	86.30	0.27%	75.18	0.00%
91	Brunei	85.60	0.27%	84.05	0.00%
92	Monaco	82.93	0.26%	77.50	0.00%
93	Estonia	79.47	0.25%	50.85	0.02%
94	Maldives	74.87	0.24%	81.08	0.00%

95	Ghana[2]	68.85	0.22%	61.75	0.00%
96	Dominica	62.02	0.20%	77.33	0.00%
97	Lithuania	58.75	0.19%	46.78	0.02%
98	Antigua and Barbuda	54.53	0.17%	86.88	0.00%
99	Montenegro	52.64	0.17%	63.15	0.00%
100	Cook Islands	44.97	0.14%	74.58	0.00%
101	Grenada	44.61	0.14%	77.08	0.00%
102	Macedonia	39.76	0.13%	60.68	0.00%
103	Botswana[2]	39.45	0.12%	68.73	0.00%
104	Slovenia	35.32	0.11%	41.83	0.01%
105	Andorra	35.05	0.11%	66.05	0.00%
106	Gambia[2]	34.51	0.11%	76.63	0.00%
107	Trinidad and Tobago	27.86	0.09%	65.25	0.00%
108	Nauru	26.32	0.08%	66.65	0.00%
109	San Marino	24.31	0.08%	64.00	0.00%
110	St. Lucia	21.52	0.07%	78.28	0.00%
111	St. Vincent and the Grenadines	21.38	0.07%	69.95	0.00%
112	Montserrat	16.53	0.05%	77.50	0.00%

Source: Financial Secrecy Index - 2018 Results. (2018). Financial Secrecy Index. Retrieved 10 March 2018, from https://www.financialsecrecyindex.com/introduction/fsi-2018-results.

Footnote 1: The territories marked in Dark Blue are Overseas Territories (OTs) and Crown Dependencies (CDs) where the Queen is head of state; powers to appoint key government officials rest with the British Crown; laws must be approved in London; and the UK government holds various other powers (see here for more details: www.financialsecrecyindex.com/PDF/UnitedKingdom.pdf). Territories marked in light blue are British Commonwealth territories which are not OTs or CDs but whose final court of appeal is the Judicial Committee of the Privy Council in London (see here for more details: http://www.taxjustice.net/cms/upload/pdf/Privy_Council_and_Secrecy_Scores.pdf).

To compute an FSI for the entire group of OTs and CDs (or also including the UK), we first need to calculate the group's joint Secrecy Score and joint Global Scale Weight. Calculating the joint Global Scale Weight is straightforward - we just sum up each jurisdiction's individual Global Scale Weight to arrive at 22.57% (or 5.2% excluding the UK). To combine the Secrecy Scores, we see at least four relevant options. Three of the four options result in the UK and its satellite network of secrecy jurisdictions to top the FSI by a large margin (read more on page 161, in: http://www.financialsecrecyindex.com/PDF/FSI-Methodology.pdf). Note that our list excludes many British Commonwealth realms where the Queen remains head of state.

Footnote 2: For these jurisdictions, we provide special narrative reports exploring the history and politics of their offshore sectors. You can read and download these reports by clicking on the country name.

Footnote 3: For these jurisdictions, we took the secrecy score for the sub-national jurisdiction alone, but the Global Scale Weight (GSW) for the entire country. This is not ideal: we would prefer to use GSW data for sub-national jurisdictions – but this data is simply not available. As a result, these jurisdictions might be ranked higher in the index than is warranted.

Footnote 4: The Secrecy Scores are calculated based on 20 indicators. For full explanation of the methodology and data sources, please read our FSI-methodology document, here: www.financialsecrecyindex.com/PDF/FSI-Methodology.pdf

Footnote 5: The Global Scale Weight represent a jurisdiction's share in global financial services exports. For full explanation of the methodology and data sources, please read our FSI-methodology document, here: www.financialsecrecyindex.com/PDF/FSI-Methodology.pdf

Footnote 6: The FSI Value is calculated by multiplying the cube of the Secrecy Score with the cube root of the Global Scale Weight. The final result is divided through by one hundred for presentational clarity.

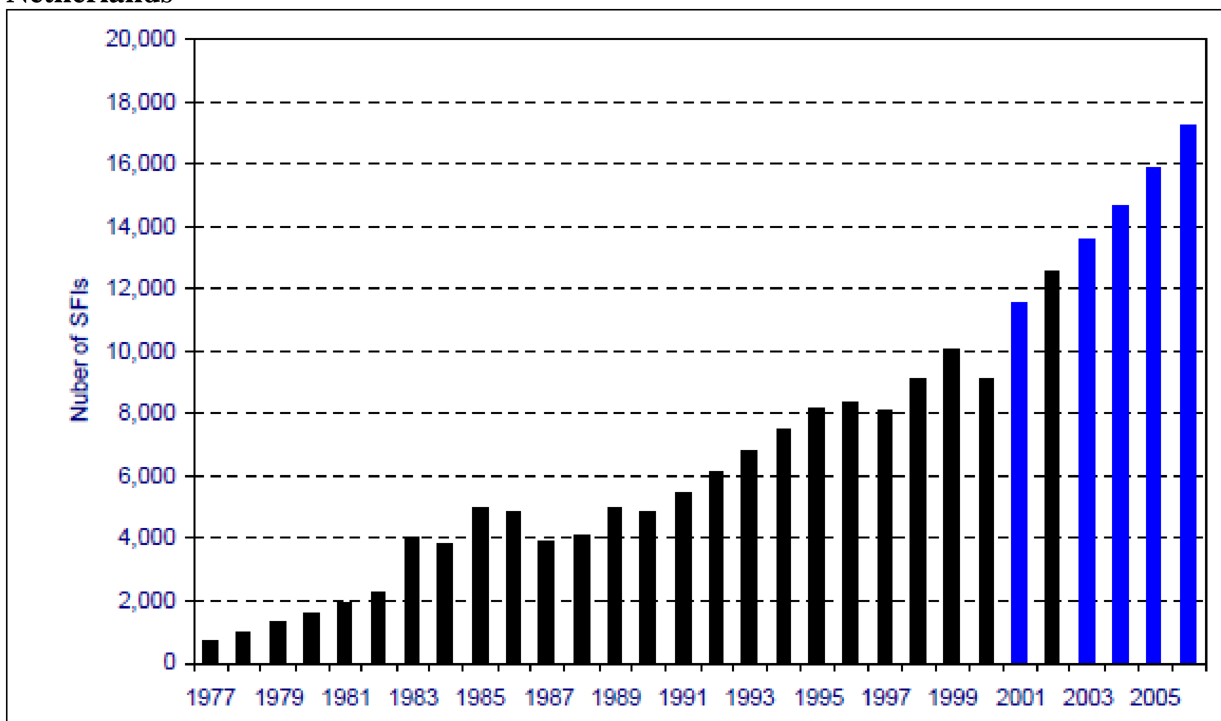
Footnote 7: The FSI Share is calculated by summing up all FSI Values, and then dividing each countries FSI Value by the total sum, expressed in percentages.

Figure 2: Gradual disappearance of jurisdictions that appear as possessing high financial secrecy from money laundering black list (1999 IMF List & FATF NCCTs list) over the years

Blacklist	N	European countries
IMF list 1999	69	19; Austria, Hungary, Ireland, Luxemburg, Netherlands, Russia, Switzerland, Ukraine, UK and 10 smaller European countries
FATF NCCTs 2000	15	2; Liechtenstein and Russia
FATF NCCTs 2001	19	3; Hungary, Russia and Ukraine
FATF NCCTs 2002	10	1; Russia
FATF NCCTs 2005	3	0; No European countries only: Nigeria, Myanmar and Nauru
FATF NCCTs 2006	1	0; Myanmar (Burma) removed as last country in October 2006

Source: Unger, B., & Ferwerda, J. (2008). Regulating money laundering and tax havens: The role of blacklisting. Discussion Paper Series/Tjalling C. Koopmans Research Institute, 8(12).

Figure 3: Number of Special Financial Institutions (SFIs) from 1977-2006 in the Netherlands



Source: Weyzig, F., Dijk, M., & Murphy, R. (2006). The Netherlands: A Tax Haven?. SSRN Electronic Journal. http://dx.doi.org/10.2139/ssrn.1660372.

Figure 4: Comparison of Net New Assets Inflow in Five Global North Tax Havens and Net Foreign Direct Investment Inflow in Five Global South Countries

2016	(1) Portfolio Equity, Net Inflows (USD millions)	(2) Foreign Direct Investment, Net Inflows (USD millions)	(3) Net Errors and Omissions (USD millions) (Regardless +/-)	(4) Foreign Direct Investment, Net Outflows (USD millions)	Net Errors and Omissions as Percentage of Total Capital Outflow (3)/ (3)+(4)
India	2336.74	44458.57	150	5047	2.8%
Bangladesh	115.46	1906.26	1559	40	97.4%
Pakistan	-338	2324	777	52	93.7%
Sri Lanka	24.36	898.08	200	236	45.8%
Nepal	N.A	105.99	544	N.A	N.A
Bhutan	N.A	8.07	20	N.A	N.A
Maldives	N.A	448	67	N.A	N.A
Afghanistan	N.A	98.99	2938	-0.76	99.1%
Switzerland (Europe)	-16981	-17717	15664	39797	28.2%
Hong Kong (East Asia)	2491	117109	949.59	71416	1.31%
United States	-141098	479415	74068	311582	19.2%
Luxembourg	139358	26857	763	31642	2.3%
Germany	-9069	52474	22466	76260	22.7%
Netherlands	62585	153975	6221	252440	2.4%

Source(s):

1. *Data.worldbank.org. (2016). Portfolio equity, net inflows (BoP, current US$) | Data. [online] Available at: https://data.worldbank.org/indicator/BX.PEF.TOTL.CD.WD?end=2016&start=2016 &view=chart*
2. *Data.worldbank.org. (2016). Foreign direct investment, net inflows (BoP, current US$) | Data. [online] Available at:* https://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?end=2016& start=2016&view=chart
3. *Data.worldbank.org. (2016). Net errors and omissions, net inflows (BoP, current US$) | Data. [online] Available at: https://data.worldbank.org/indicator/BN.KAC.EOMS.CD?end=2016&start= 2016&view=chart*
4. *Data.worldbank.org. (2016). Foreign direct investment, outflows (BoP, current US$) | Data. [online] Available at:* https://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?end=2016& start=2016&view=chart

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