Hide and Protect

A Role of Global Financial Secrecy in Shaping Domestic Institutions

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Abstract

This paper reviews the literature that explores the drivers and effects of financial secrecy on emerging economies. It shows that most of the research on financial secrecy has been focused on issues of tax avoidance, neglecting the problems of institutional arbitrage that go beyond taxation issues. The paper discusses the limits of the institutionalist paradigm that treats businesses solely as rule-takers and calls for more attention to business agency and responsibility. Discussions about corporate social responsibility in emerging economies should incorporate thinking about the potential role that businesses, and especially big corporations, could play in promoting more effective institutions at home. Further research is needed to understand the political and institutional effects of global financial secrecy at the domestic level. The paper suggests some promising avenues for future research as well as new items to be included on the policy-making agenda in relation to financial secrecy.

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Hide and Protect:
A Role of Global Financial Secrecy in Shaping Domestic Institutions

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1. Introduction

The 2020 health crisis has altered the future of globalization and the distinct aspects of the global economic system. The crisis has caused the largest and fastest decline in international flows in trade, foreign direct investments, and movement of people in modern history (Altman 2020). The pandemic emerged at the moment when the globalizing trends were already under pressure arising from the political sphere. The global march of populism became a powerful indicator of growing concerns and frustrations with the uneven outcomes of globalization. The nationalist impulses in countries as different as the United States, India, the United Kingdom, and the Russian Federation suggest a systemic-level reaction to what some scholars referred to as hyperglobalization, a situation when global trade expanded much more rapidly than global GDP (Rodrik 2011).

The coronavirus pandemic has exacerbated these trends. Many pundits call for re-nationalization (reshoring) of manufacturing the medical equipment, drugs, and technological supplies. The issues of diversifying other global supply chains and creating stockpiles of critical resources such as minerals used in advanced technologies are actively debated. Many nations are engaging in food nationalism expressed in global agricultural protectionism. The recent signs of financial nationalism in countries long committed to the cause of global finance, such as the United States and Germany, also signal the arrival of new times.

While protectionist policies emerge as a natural response to accumulated problems, policy makers need to find different answers to the challenges posed by the pandemic and the issues arising from the unbridled globalization. The uniqueness and pressing challenges of this historical moment create a window of opportunity for designing a more ambitious policy response to regulating the global economic and financial infrastructure. And the answer does not need to be nationalism and protectionism. To look for different responses, it is imperative not to lose sight of the debate on the outstanding problems and issues in the global system that might have been shadowed by the pandemic.

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3 https://www.nytimes.com/2020/05/03/opinion/coronavirus-economy-nationalism.html
but are still in need of addressing. Understanding how the crisis might relate to these issues, and what policy opportunities might present themselves in the times ahead is an ongoing challenge.

The focus of this study is on the issue of global financial secrecy and its institutional implications for emerging economies. Many policy discussions on making the global financial system ‘work for all’ focus on financial secrecy: its beneficiaries and losers. Over the last two decades and especially actively since the 2008 financial crisis, policy makers introduced new rules and regulations to counter the negative spillovers from secrecy jurisdictions around the world. However, as with many past crises, the 2020 pandemic is likely to intensify the adverse effects of these jurisdictions for developing countries as capital would try to flee the most vulnerable economies. Developed economies also need more caution and oversight as emergency fiscal spending related to Covid-19 creates a moral hazard and an increased potential for fraudulent activities. Global Financial Integrity (GFI), a DC-based think tank, has already issued warnings about a potential uptick in illicit financial flows even as legitimate economic activity slows down.5

Scholarly attention to these issues has been growing along with the enhanced policy attention. Besides intensifying public concerns, the infamous data leaks connected to the Panama and Paradise Papers also turned into a productive source of ‘big data’ for examining related issues. This paper reviews the key findings in the literature that explores the drivers and effects of financial secrecy on the emerging economies. We show that research on the drivers of financial secrecy has been focused on issues of tax avoidance, neglecting institutional arbitrage problems that go beyond taxation issues. Additionally, while the literature on economic effects of financial secrecy has advanced from country-level findings to firm-level observations, further research is needed to understand the political and institutional effects of global financial secrecy at the domestic level (in home countries). In the concluding section of this paper, we suggest some promising avenues for future research as well as new items to be included on the policy-making agenda in relation to financial secrecy. Specifically, we note the limits of the institutionalist paradigm that treats businesses solely as rule-takers and call for more attention to business agency and responsibility. We suggest that discussions about corporate social responsibility in emerging economies should incorporate thinking about the potential role businesses and especially big businesses could play in promoting more effective institutions at home.

Terms used to define financial secrecy in the global system, as well as policy attention to these issues, have evolved over time. We begin our review with a brief historical and conceptual background. The subsequent review of the key findings in the academic literature is structured to highlight the concepts that explain the demand and supply for secrecy jurisdictions in the emerging economies and identify the main differences in the effects of financial secrecy on different countries.

2. Financial Secrecy as a Global Policy Problem

The issue of financial secrecy goes to the heart of relationships between the state and the capital. It speaks to the capacity of the government to control a capitalist economy. While the government has the public mandate to provide for public goods and services, its capacity to deliver on its mandate is circumscribed by the control of capital over the production and investment decisions (Przeworski and Wallerstein 1988). Globalization, deregulation and the heightened mobility of financial capital have been associated with the expansion of the power of the financial industry and its influence in regulatory affairs (Underhill and Zhang 2008; Strange 1996). The growing significance of private standards and self-regulation, along with the increasing complexity and opacity of financial instruments, created global imbalances revealed, most recently, during the 2008 global financial crisis (Helleiner 2011). This largely unexpected crisis and the recession that followed generated debates about the efficiency of financial markets and regulatory failures that need to be addressed to create more ‘shock-proof’ financial markets.

One important aspect of the debate on ‘fixing’ global finance is the issue of financial secrecy that allows capital to effectively avoid its obligations to the state. Initially, journalists and researchers used the term tax havens referring to countries and jurisdictions that offered low (or zero) tax rates on specified categories of income along with commercial and banking secrecy. Faced with the difficulty of defining tax havens more rigorously, observers have moved on to using the term offshore financial centers (OFCs)—a group of smaller jurisdictions (often associated with small islands in the Caribbean, British Virgin Islands, Cyprus, Isle of Man, etc.) (Cobham et al. 2015). But that terminology still failed to capture the important onshore financial jurisdictions, such as Delaware in the United States, that offer similar or even more lax rules for corporate entities. Therefore, the recent expert discussion relies on a term, secrecy jurisdictions defined as “a jurisdiction that provides facilities that enable people or entities to escape or undermine the laws, rules, and regulations of other jurisdictions elsewhere, using secrecy as a prime tool.” (Cobham et al. 2015, 9). They do that by making special provisions in
company law for non-resident international companies allowing them “to carry out their affairs in secret through the use of these ring-fenced company forms and various exemptions from normal corporate reporting requirements, such as disclosure of beneficial ownership and public reporting of accounts.” (Bracking 2012, p. 617)

The supporters of secrecy jurisdictions usually defend these institutional arrangements on the basis of economic efficiency and long-term economic gain. Firms should be able to shop around for a more beneficial regulatory and institutional environment, and legally pursue tax optimization strategies that, in the end, should increase public gains. Similarly, governments can make their regulation more attractive to corporations; tax competition and preferred treatment can serve as a strategy for attracting mobile capital and promoting growth (Winner 2005, Zodrow 2003). The efficiency argument suggests that when corporations have such tax optimization opportunities, they will be more likely to invest. Furthermore, smaller countries can build their whole economies around financial services. If governments can promote industrialization through Export Processing Zones (EPZ), then why not have such privileged zones for the financial industry sector? (Bracking 2012, 621)

Nonetheless, policy concerns with secrecy jurisdictions began to accumulate starting in the late 1980s, motivated by several overlapping processes and specific events. The inevitable link between financial secrecy and illicit financial flows and money laundering provided one important reason for policy discussions. The creation of the Financial Action Task Force (FATF) in 1989 by the G-7 countries was an institutional response designed to tackle these issues. The developed countries long understood the importance of the integrity of the global financial system and the perils of unregulated financial flows (Sarno et al. 1999). The 9/11 terrorist attack on the United States spurred further policy attention to these issues. It became clear that the financing of terrorist organizations through global financial institutions represents a major threat to US national security interests. The governments doubled their efforts on tackling ‘threat finance’ - an umbrella term that included besides terrorism, money flows related to narcotics, human trafficking, and organized crime, etc. (Sharman 2011, Levi 2010, Cook 2011).

Additionally, the conversation about harmful tax practices that reduce the fiscal base and weaken the public sector began already in the late 1990s with the 1998 OECD report (Bracking 2012, 625). Many development-oriented NGOs such as Oxfam and Christian Aid as well as the Tax Justice Network raised the issue of lost taxes and tax injustice due to secrecy jurisdictions. These problems were shown
to be especially detrimental in the context of developing countries that were in need of infrastructural development and public funds and services for poverty reduction (Ibid. 626). The 2008 financial crisis made the issue of tackling tax avoidance and regulating secrecy jurisdictions even more urgent. These jurisdictions were a crucial element in the chain of factors causing financial crisis (Rixen 2013, Fernandez and Wigger 2015). The OECD and the G-20 forum created to manage the effects of the financial crisis had to commit to an extensive regulatory reform that would, as many observers expected, transform the global financial infrastructure (Helleiner 2014).

Additional pressures to address tax avoidance emerged in developed countries. In the wake of the 2008 crisis, governments had to rely on public funds to bail out their biggest banks, other financial institutions, and, sometimes, whole industries (Blau et al. 2013). In the face of massive government bailouts, non-governmental and societal actors could press even harder for the issues of equity and justice. The non-governmental watchdog organization Tax Justice Network was founded in 2003 to bring attention to tax evasion practices that have become prominent in the corporate sector. Their cause was strengthened after the 2008 crisis. The global rise of populist politics that manifested the growing public discontent with globalization producing lopsided benefits and allowing businesses to undermine public finance and weaken the state was also worrying (Rodrick 2019, Piketty 2014).

2.1 Populist Politics

Contrary to expectations, the reforms undertaken after the 2008 crisis failed to transform the global financial system and resulted in incremental changes rather than a systemic overhaul (Helleiner 2014, Underhill 2014, Rizen 2013). The importance of secrecy jurisdictions has not diminished, although the OECD-promoted Tax Information Exchange Agreements (TIEAs) streamlined the process of international cooperation on tax matters. In 2015, secrecy jurisdictions accounted for 43 percent of global external assets and 47 percent of global foreign direct investment (FDI) (Kubinec 2019).

While the developed world has its own opportunities and discontents with financial secrecy laws (mostly related to tax optimization and profit-shifting issues), the emerging economies faced an additional set of issues interlinked with the availability of these special financial zones. The rationale for using offshores on the part of business actors from the developing countries is often linked to weak institutions and uncertain business environments in which they operate. Weak property rights create fears of expropriation. The lack of secure property rights and the absence of independent courts
to resolve business disputes undermine economic activity and investment. In such an environment, asset holders are forced to look for other options enabling them to secure their wealth. They benefit from tax optimization and seek regulatory arbitrage, yet it is not their sole concern.

Policy makers from the emerging economies also have to confront the implications of offshores for domestic corruption. Secrecy jurisdictions allow laundering the illicit funds, thereby becoming ‘enablers’ of corrupt deeds potentially even amplifying such trends (Judah and Sibley 2018, Davidson 2017). Offshore centers, therefore, provide opportunities to both secure assets threatened by ineffective institutions and to combine the benefits from laundering and securing assets that were often obtained with the use of these ineffective institutions.

The domestic institutional effects of global financial secrecy are also present in the world affected by the health pandemic. At the early stages of the pandemic, the focus on saving lives in a state of high uncertainty and lack of reliable information and expertise strained policy makers. Anti-crisis policies and programs have been rolled out in rapid succession targeting specific social groups and vulnerable economic areas. At the recovery stage, even more programs will be needed. The urgency and scale of these interventions make it difficult to monitor and to audit the procurement practices and legitimacy of massive spending. The scarcity of resources and disrupted supplies expose organizations to legal and compliance challenges. Corruption, fraud, and money laundering could thrive in this environment. These issues could be especially acute in emerging economies where we already see cases of corruption linked to pandemic-induced spending. The Organized Crime and Corruption Reporting Project (OCCRP) has recently reported cases of dodgy spending in Romania, Slovenia, and North Macedonia as well as Colombia and the Philippines. Covid-related graft probes are underway in Saudi Arabia and Brazil. The law enforcement agencies in the Russian Federation, where regional governments were made responsible for Covid-related policy making, are also investigating cases of potential Covid-related corruption and fraud. The proceeds from these newly created graft opportunities are likely to end up in offshore accounts, once again reminding the citizens of these countries about the ‘dark side of globalization.’ Such elements of the global financial system that are taken advantage of by corrupt

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https://www.occrp.org/en/daily/12292-philippines-offers-600-for-information-on-corrupt-officials
officials can be seen as facilitators of domestic corruption, as institutions that contribute (if indirectly) to sustaining the demand for corruption in countries with weak institutions.

3. Drivers of Institutional Arbitrage

Economic actors are strategic players who adapt to various institutional settings. In the globalized world, they also could select different institutional environments. In turn, their choices and actions can shape institutions. Many studies view institutions as constraints and the economic actors as passive players who take the rules. Some authors, however, emphasize the active agency of multinational economic actors such as multinational enterprises (MNEs) that can craft strategic responses to the institutional processes that affect them or make the rules (Regner and Edman 2013, 277).

Institutional arbitrage or the opportunity for economic actors to move operations, construct additional legal entities and change the corporate structure to take advantage of rules, regulations and the legal systems that enable greater profits, less taxes and more security is one of the manifestations of the active agency mentioned above.

3.1 Tax Avoidance and Regulatory Arbitrage

The global financial system enables businesses to engage in regulatory arbitrage. Many businesses around the world revert to such arbitrage opportunities to optimize their tax returns. The secrecy jurisdictions—many of them located on the islands of Bermuda, the Cayman Islands, British Virgin Isles, and Cyprus, but also include other countries, such as Switzerland, the Netherlands, Luxembourg, and Singapore, enable such actions by maintaining tax privileges for the offshore companies. According to the Tax Justice Network (TJN), currently, the United States has emerged as the second largest supplier of financial secrecy in the world after Switzerland and followed by the Cayman Islands.7

These financial centers allow MNEs to shift profits from one jurisdiction to another, most commonly via transfer pricing (Eden, 2009). When operating in several countries, firms can choose where they report most of their earnings. Transfer (mis)pricing occurs when firms move the earnings from high to low-tax jurisdiction areas by using incorrect pricing for imports and exports between the company

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7 https://fsi.taxjustice.net/en/introduction/introducing-the-fsi
subsidiaries. Transfer pricing itself is a legal activity, but transfer mispricing is driven by the manipulated prices and is illegal. These activities lead to reduced government claims on corporate cash, thereby improving the shareholder profitability but damaging the public finances. The tax havens with their exceptionally low rates of corporate income taxation, thus promote the growing profit (or capital) share of GDP (Piketty, 2013). The share of corporate profits in the US GDP increased from 5% in 2001 to 11% in 2012, pointing to the growing influence of capital within the economy (Ibid., 2). At the same time, the public sector suffers. According to some estimates, operations through offshore centers reduce US companies’ tax obligations by 20%, which represents a tenfold increase since 1980 (Zucman 2014).

Firms associated with secrecy jurisdictions might be driven by reasons other than taxes. Some prefer the institutional environment and more lenient regulations available in these jurisdictions. Durnev et al. (2017) study firms with headquarters in countries with strict legal regimes that rely on subsidiaries in secrecy jurisdictions. One of the findings of this research is that firms linked with these financial centers exhibit lower quality of financial reporting (associated with the regulatory arbitrage and their secrecy policies). These findings are confirmed on the subset of US firms with subsidiaries in secrecy jurisdictions as well (Ben Amar et al. 2019). It appears that beyond tax optimization, a patchy regulatory framework offered by particular jurisdictions is part of the business model used by some firms to circumvent regulatory authorities.

According to the Tax Justice Network, arguably the most significant organization today that promotes financial transparency by mapping, analyzing, and explaining the role of these financial centers, in 2010, the amount of money invested virtually tax-free in secrecy jurisdictions amounted to $21 trillion to $32 trillion. Of that sum, anywhere between $7.3 trillion to $9.3 trillion originated in 139 lower-middle-income countries that had external debt and were borrowing themselves to bankruptcy (Henry 2012).

3.2 Flight from Insecure Property Rights vs. Corruption

While business actors from advanced democratic states might be driven by the opportunities offered by regulatory arbitrage and tax optimization, the institutional environment in the developing and emerging economies often presents different types of problems and opportunities. Business actors from countries with weak institutions might seek out secrecy jurisdictions for different reasons as well.
On the one hand, secrecy jurisdictions enable corrupt officials and businesses from countries with unaccountable power structures to hide their illicitly gotten wealth. On the other hand, business actors operating in weak institutional environments might look towards secrecy jurisdictions to protect their assets from potential expropriation by corrupt state officials or more politically powerful business actors. Therefore, for countries with weak property rights, secrecy jurisdictions provide an alternative institutional venue for protecting their property rights from potential domestic expropriation.

Scholars have introduced several new concepts to describe the phenomena related to these issues and differentiate the ‘offshorization’ motives of firms from advanced economies and those operating in less friendly environments. We discuss them below.

3.4 Investment Round-Tripping

The phenomenon of investment round-tripping is an issue closely interlinked with secrecy jurisdictions. It refers to “the process whereby investors resident in a certain country route their investments into their own economy not directly, i.e., through domestic legal entities, but through foreign intermediary companies that are interposed between them and the target of the investment” (Nougayrede 2015, 4). The intermediary companies – frequently referred to neutrally as holding companies, corporate vehicles, special-purpose vehicles (SPVs), or special purpose entities (SPEs) – are also referred to, often, as shell companies or ‘mailbox’ companies.

Investment round-tripping was first described using the case of China in the 2002 study by the World Bank “Global Development Finance 2002,” noting that between 40% and 50% of FDI to China originated from Hong Kong SAR, China. Another study confirmed these numbers, estimating the round-tripping from Hong Kong SAR, China, to mainland China during 1998-2002 to be in the range of 26.3% and 53.4% (with the middle estimate of 39.9%) (Xiao 2004, 21). A big part of this returning capital might have first left China through export mis-invoicing (or other unaccounted ways) that get recorded, in part, in the balance of payments errors and omissions. These accumulated errors reached 12.1% of GDP in 2001 and represented part of the capital flight from China, with the other part being reflected in the current account surplus (Xiao 2004, 14). This pattern of capital leaving (often as capital flight) as an outward FDI to offshore financial centers and coming back – for profit-making – as foreign capital has been labeled ‘round-tripping.’
Investors use round-tripping for tax optimization and minimization. As described earlier, companies engage in international tax planning by registering their subsidiaries in jurisdictions that provide tax privileges to the offshore companies. These transactions are usually facilitated by banks. Based on Russian business operations, Chernykh and Mityakov (2017) have demonstrated that a higher degree of offshore transactions performed by banks is positively correlated with the tax evasion activities of non-financial companies doing business through these banks.

In China, the round-tripped FDI could use preferential land rights, tax, and other policies extended by the Chinese government to FDI. By posing as foreign, Chinese businesses could take advantage of their government’s effort to attract foreign capital. Geng Xiao (2004) suggests that Chinese capital went abroad to escape foreign exchange controls and that these patterns held since at least the 1990s. Despite a large size of the re-routed Chinese capital, the returning capital represented only about one-quarter of the overall capital flight from the country (Xiao 2004, 24). Much of the Chinese capital is ‘parked’ overseas. Besides Hong Kong SAR, China, the British Virgin Islands (BVI) is the second largest source of FDI into China, while the Cayman Islands attract 10 times as much investment from China as the United States (Sharman 2012, 317). Even after the Chinese government abolished preferential treatment for foreign investors in 2008, the round-tripping investment dynamic in the country remained. Sharman (2012) argues that these practices are motivated not only by tax avoidance and preferential treatment motives but also by business agents trying to reduce transaction costs by relying on more efficient institutions available in these jurisdictions.

Up to 44% of India’s FDI has been routed through Mauritius, which has emerged as the major source of FDI flows into India. Some estimates indicate that Mauritius and Singapore account for over 50% of FDI flows into India (Gunputh et al., 2017, 36). This high share of FDI was driven by tax optimization benefits enabled by Mauritius’ Double Taxation Agreement (DTAA) with India (Bajpai and Dasgupta 2004). The government addressed this situation in 2016-2017 when it closed this taxation loophole and imposed a 10% capital gains tax on funds routed through Mauritius (Gunputh et al., 2017, 38). Capital inflows from Mauritius dropped three-fold by 2018 following the treaty amendment (Fowler 2019).

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8 This loophole was closed in 2008, when the government abolished such preferential treatment.
Round-tripping became an important practice for Russia’s economy as well. According to Kheyfets (2010, 15), between 70% and 90% of Russian companies formally belong to companies registered in offshore zones. A high correlation of inward and outward investment flows between Russia and such financial hubs as Cyprus and the British Virgin Islands became a distinctive feature of FDI in Russia (UNCTAD 2013, 65). A surprising emergence of the island of Cyprus as the major source of FDI into Russia as well as the central destination for Russia’s outward FDIs is driven by the phenomenon of round-tripping. Cyprus ranked first among the biggest sources of FDI coming to Russia before 2013, and by 2016, the trends returned to pre-crisis levels (i.e., prior to the 2014 sanction regime). As of August 2019, Cyprus is also the most popular jurisdiction to register businesses of Russian origin. According to Russian economic consulting firm Credinform, over 53% of Russian companies with offshores are controlled through Cyprus. Other offshores such as the Seychelles and British Virgin Islands account for 14% and 11%, respectively.

Cyprus is an important offshore not only for Russia. Rabab’ah et al. (2016) conducted a social network analysis relying on the data from the Panama papers and focusing on the Middle East region network. This analysis revealed the United Arab Emirates and Cyprus as the central nodes with the highest degree of connections to other nodes in the network, implying a significant role played by these jurisdictions in financial flows going through the Middle East region.

Other resource-endowed post-Soviet countries such as Kazakhstan show similar patterns of round-tripping investment flows. A study of inward FDI by Dyker (2015, 121) reveals that since 2005 one-third of Kazakhstan’s inward FDI originates in the Netherlands. The author suggests that many Kazakh oil and gas companies, both private and state-owned, round-trip their investments through the Netherlands. A study of round-tripping by the National Bank of Ukraine has estimated that during 2010-2017 over 20% of direct investment flows (around $35.5 billion) were round-tripped (Syvak 2018). As in Russia, Cyprus has emerged as one of the leading originators of FDI investments in Ukraine, specifically, for example, in metallurgy (Saha et al. 2018, 26). Cyprus is also a major destination for outward investments from Ukraine, with Donetsk oblast emerging as a particularly prominent region in Ukraine in terms of these outward flows (Ibid., 35).

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9 “Top-10 of the Russian companies controlled by offshore shareholders,” Credinform, August 2018. [https://credinform.ru/ru-RU/Publications/Article/297e5c6ae17e](https://credinform.ru/ru-RU/Publications/Article/297e5c6ae17e)

10 Ibid.
This brief survey suggests that investment round-tripping is a widespread phenomenon in the context of emerging economies. Business agents in developing countries are often routing their assets through secrecy jurisdictions back into their domestic economies – to take advantage of lower taxation or preferential treatment accorded to foreign investors by governments scrambling for investors, to protect their assets from potential expropriation, to hide the origin and ultimate beneficiary information, especially in cases where the assets might be obtained through illegal means. The secrecy jurisdictions facilitate all those different objectives. Nevertheless, as we discussed in the case of China, only a small portion of the capital outflows from these countries returns through these channels. Financial globalization that was expected to enhance the ability of developing nations to attract capital has resulted in massive capital outflows, especially in countries with a natural resource base.

4. Financial Secrecy and Corruption

The secrecy and opaqueness offered by secrecy jurisdictions can open doors to corruption. These special financial centers have long promoted legal means enabling businesses to achieve legal separation between the asset-holder and the funds by using anonymous shell companies and various types of ‘consultancy fees’ used as an alibi for fund transfers (Sharman 2010). Such secrecy can be used for hiding money laundering and corruption proceeds as well as proceeds from criminal activities linked to drug and other illegal trade, as well as terrorism financing (Ibid). In high-corruption environments, firms often engage in bribes to state officials to get contracts and preferential treatment. Non-transparent offshore bank accounts and anonymous shell companies become the preferred mechanisms for transferring money across different jurisdictions constituting the supply side of ‘grand corruption’ (Lord and Levi 2017).

Russia is a good case to demonstrate that the reasons for these financial flow patterns go beyond treaty shopping and tax optimization. Ledyaeva et al. (2015) link the issue of onshore corruption, and the reliance on secrecy jurisdictions in their study of the direction of round-trip FDI flows. They analyze firm-level data on the distribution of offshore FDI across Russian regions and find that FDIIs from secrecy jurisdictions are positively associated with the level of corruption in the host region. This relationship is stronger for OFCs with a higher secrecy score. Hence, we conclude that round-trip FDI is strongly motivated by the interplay between onshore corruption and offshore secrecy.
This linkage between corruption, weak institutions, and offshores was also confirmed in a cross-national study of petroleum rents. Andersen et al. (2016) found that petroleum rents originating in countries with weak institutions (mostly autocracies) have a much higher probability of ending up in tax havens than those originating in non-autocracies. The authors suggest that “unanticipated increases in petroleum rents are partly captured by political elites and transferred to private bank accounts in havens, either directly or through sham corporations based in other havens” (Andersen et al. 2016, 28). They find a similar pattern at work in these polities in the face of political instability: elites transfer part of their domestic wealth to tax havens prior to elections and coups d’etat (Ibid.). Besides petroleum rents, offshores enable laundering the proceeds from other types of corruption and illicitly obtained wealth. Another recent study by Andersen et al. (2020) reveals that foreign aid disbursements from the World Bank and the Bank for International Settlements to poor countries coincide with significant increases in the value of bank deposits in secrecy jurisdictions. This study suggests that foreign aid might be diverted by economic and political elites into privately held accounts in jurisdictions that enable anonymity and non-transparency, specifically places like Zurich, a well-known center for private wealth management (Ibid., 3).

The link between political instability and capital flight to secrecy jurisdictions is confirmed by the study of the patterns of financial flows in Ukraine. Earle et al. (2019) reveal that the Ukrainian oligarchs who are better connected politically tend to be more secure about their assets relative to those less connected (or associated with the competing political group). Their perception of the security of their assets is demonstrated by the wealth-hiding patterns: those less politically connected tend to use secrecy jurisdictions to a greater degree than the rest of the oligarchs. Ukraine’s 2004 Orange Revolution that resulted in the competing political group coming to power provided a context approximating a natural experiment that enabled this team of researchers to trace the causal linkages between the degree of political connections and a pattern of reliance on tax havens to hide wealth. This study is an important addition to the literature that goes beyond treating offshores as tax minimization vehicles.

The policy makers’ agenda on secrecy jurisdictions and investment round-tripping is frequently dominated by discussions that emphasize tax avoidance issues and build on concern over public finances and collective welfare. The additional rationale motivating the reliance on these jurisdictions
by business actors in emerging economies complicates the overall agenda by adding an institutional and corruption aspect to it.

Nougayrede (2015), a lawyer who has explored and wrote about a case of Russian oil company Yukos that relied on subsidiaries and trusts registered in Cyprus, the Isle of Man, Jersey, Gibraltar, the British Virgin Islands (BVI) and Guernsey, noted the different interpretations of round-tripping from public and private law perspective. Public law reflects concerns about collective welfare threatened by actions of private actors seeking to escape stricter regulatory and tax obligations. Private law emphasizes that round-tripping “enables investors from emerging markets to exercise their party autonomy and access more sophisticated legal orders, and enables them to claim international property rights protection perceived to be stronger than property rights protection under their domestic laws” (2015, 2). The larger debate about the pros and cons of secrecy jurisdictions for emerging economies focuses either on their role in facilitating corruption and money laundering or on offering more efficient institutions to business agents from countries with weak institutional environments. The frequent reliance of business actors on legal arbitrage outside their home countries when it comes to resolving business disputes supports the idea that corruption and money laundering are not always the main motive behind such institutional outsourcing (Sharafutdinova and Dawisha 2017).

4.1 Legal Arbitrage in Commercial Litigation

Access to a more sophisticated legal environment is yet another important driver of round-tripping and the use of secrecy jurisdictions. Business actors need reliable and independent courts to resolve disputes. Such institutions are not always readily available in their home countries. Globalization created a market in legal services that many internationalizing firms rely upon. Companies can “shop” for different legal systems and pick one based on their preferences about the costs and effectiveness. Nougayrede (2014, 386) refers to these practices as ‘legal outsourcing’ that can involve the creation and use of foreign companies as trading entities or holding companies to transfer asset ownership and the use of foreign laws for contracts with clauses stipulating dispute resolution in specific legal systems outside their home countries. For example, the English law of contract became a preferred legal system for many international businesses in Eastern Europe and Central Asia. Meanwhile, the London Court of International Arbitration (LCIA), the London Commercial Court (LCC, a division of the High Court) and the Arbitration Institute of the Stockholm Chamber of Commerce have become the popular destinations used by businesses from Russia and the wider post-Soviet region for dispute
resolution (Nougayrede 2014, 16). The International Court of Arbitration headquartered in Paris and arbitration courts in Geneva, New York, and other financial centers have also seen an increase in litigants from Russia.11

Globalized commercial litigation is part of institutional arbitrage trends that could be investigated from the perspective of institutional interdependencies. On the one hand, such legal outsourcing is rational behavior for business actors who seek out more advanced and impartial legal mechanisms to develop their businesses and protect their proceeds. The providers of these services can refer to the law as a public good that could be rendered by foreign lawmakers and courts.

However, the approach that privileges the autonomy of business actors to engage in institutional arbitrage ignores the political economy of development. The ‘imported’ or ‘outsourced’ laws, while resolving the short-term problems of asset-holders, fail to promote long-term development and can harm the home environment (Nougayrede 2014). If foreign laws and foreign courts become substitutes for domestic institutions, wealthy and powerful actors face lower incentives to lobby for the institutional development within their own countries, locking developing countries in a “trap of low-quality institutions wherein no political coalition can form to support institutional improvement” (Ibid., 437; Sharafutdinova and Dawisha 2017).

In short, the availability of impartial courts for litigating business disputes in London and other global cities represents an important institutional resource that business actors from various institutional environments can make use of. At the same time, following Albert Hirshmann’s ‘exit, voice and loyalty’ argument, any exit opportunity works by suppressing or substituting the potential associated with ‘voice.’ In real life, this means that global business actors who can ‘outsource’ legal services might worry less about the absence of impartial and effective legal systems and courts in their own countries.

5. Lifting the Veil of Secrecy: The Evolution of Policy and Regulation

The multilateral efforts of fighting tax evasion and money laundering date back to the 1990s and even earlier. The Financial Action Task Force (FATF) was created in 1989 by the G7 to deal with money

laundering issues (Hampton and Christensen 2002). FATF developed a comprehensive framework of recommendations to combat money laundering and terrorism financing and established a process of mutual evaluations (peer review) of technical compliance with FATF recommendations and the effectiveness of measures adopted by specific countries. Based on these evaluations, FATF compiles lists of jurisdictions “under increased monitoring” that are actively working on addressing ‘strategic deficiencies’ in their regulatory regimes (this list is sometimes referred to as the ‘grey list’). A list of high-risk countries, at the moment, includes the Islamic Republic of Iran and the Democratic People’s Republic of Korea.

An issue of beneficial ownership of entities has emerged as a particularly important concern for countries around the world. The ease of creating empty (shell) corporate vehicles and integrating them into complex corporate chains that cross different countries and continents is the main mechanism for hiding real ownership. FATF issued recommendations in 2019, and the United States, the United Kingdom, and the EU countries are adopting their own rules for identifying and disclosing beneficial owners. Many countries have introduced the registries of beneficial owners (with each company expected to provide up-to-date information about the company’s beneficial owners). Following the implementation of the fifth EU Anti-Money Laundering Directive, the EU member states are expected to make these registries publicly available. The secrecy jurisdictions such as the BVI, Bermudas, and the Cayman Islands, are taking beneficial ownership issues very seriously as well. Some have introduced penalties for breaching the rules governing beneficial ownership disclosures.

The global initiatives to improve information exchange between national tax authorities at first met with heated debates and concerns about jeopardized banking confidentiality, especially in countries that depended on banking secrecy (such as Switzerland and Austria). The 2008 financial crisis raised the stakes for the governments advancing the cause of improved financial transparency. The post-crisis regulatory shift was driven by the OECD and the G20. Main initiatives originated in the countries most interested in the legitimacy and sustainability of the global financial architecture: the

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14 On the progress of implementation, see “Patchy Progress.”

15 [https://www.internationalinvestment.net/news/4016539/cayman-islands-fine-breaches-beneficial-ownership](https://www.internationalinvestment.net/news/4016539/cayman-islands-fine-breaches-beneficial-ownership)
United States, the United Kingdom, Switzerland, and the European Union countries. These initiatives emphasized the need for banks and other financial intermediaries to collect better information on their clients and promote tax sharing across different jurisdictions (Sharman 2017). The intergovernmental efforts were supported by the work of transnational NGOs such as the aforementioned Tax Justice Network, the Washington DC-based thinktank Global Financial Integrity founded in 2006 to measure and study illegal financial flows, and other organizations such as the OCCRP and Global Witness committed to global corruption investigation and exposure. After a concerted effort by the OECD and the G20, most states today have agreed to cooperate with foreign information requests on tax-related matters.

The public debate about financial secrecy has been significantly catalyzed by data leaks from such offshore financial zones as Panama, The Bahamas, and other secrecy jurisdictions. The infamous Panama papers involving millions of documents exposed in 2016 (with an additional leak in 2018) implicated political and economic elites, including heads of states around the world. Other leaks, such as the Paradise papers, also involved millions of documents connecting specific names to offshore companies. These data leaks enabled a scholarly exploration of the effects of such public exposure on firm value quantifying (if indirectly) the economic value of secrecy. Donovan et al. (2019) identified 338 publicly listed firms with links to corporate vehicles in secrecy jurisdictions. Their findings suggest that such connections to secrecy jurisdictions are used both to create firm value and to expropriate corporate funds. When firms rely on secret corporate vehicles to avoid taxes, and as a means to bribe state officials to win business, they add value. This conclusion is also supported by an earlier study of companies involved in Luxembourg Leaks (Hueseckenh et al., 2016). However, this study suggested that secret corporate vehicles aid insiders to divert corporate funds (Ibid., 4142-4143). The public exposure of secret accounts and entities in offshore zones has affected the shareholder value of these firms. Following the data leaks, firms connected to the leak have experienced about a 1% drop in firm value relative to other firms (Ibid., 4120).16

The inter-governmental regulatory activities aimed at improving the integrity of the global financial system have been developing for a few decades now. But what about their effectiveness? Some recent

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16 Note that a different study arrives at a bit different conclusions with regard to the effect of the exposure on capital structure and taxation level. See Li and Ma 2019.
studies of the effects of regulatory shifts and innovations aimed at greater financial transparency have raised skepticism in this regard. Evaluating anti-money laundering (AML) rules based on a cost-benefit analysis framework suggested that this was “the world’s least effective policy experiment” (Pol 2020). The study finds that the impact of AML policy has been inconsequential, while the compliance costs have been high and rising. Sharman (2017) argued that the effects of regulatory shifts on financial transparency are frequently unintended. His study explored the impact of new regulations using the specific cases of Liechtenstein, the Seychelles, and Australia. Sharman argued that, instead of dismantling illicit wealth chains, the new rules might either create new business opportunities for other jurisdictions or transform the global wealth chains making them more intricate and interconnected.

These critical policy assessments suggest ‘structural design problems’ and a failure to engage with the fundamental factors underpinning policy making in this field. These assumptions include, for example, a belief that making financial institutions to perform complex tasks based on international standards improves the integrity of the global financial system. Engagement with diverse perspectives might be necessary to overcome the loop of policy failures followed by solutions that do ‘more of the same’ (Pol 2020, 89). Below we suggest some observations from the institutional theory that could be used to refresh and modify the policy-making paradigm guiding the design of the global financial system and the efforts to improve financial transparency.

6. Institutions as a Cause or an Outcome: The Need for a New Paradigm of Institutional Evolution

The reigning policy paradigm in the sphere of regulating global finance focuses on institutions – rules and regulations that are expected to shift the behavior of business agents. This is not surprising given the well-developed literature on the importance of institutions for controlling corruption. Knowledge accumulation on how and why institutions matter has been ongoing since at least the 1970s and especially intensively since the 1990s when the institutional economics has been enriched by the works of Williamson, North, Greif, Ostrom, etc. In this paradigm, the business agents themselves are treated as rule-takers, as actors that adjust to the institutional environment. Institutions are seen as constraints on actions and business agents as passive followers of these constraints.
This vision appears to be too limited for the current environment. It does not account for businesses’ active agency in overcoming constraints in various creative ways (that leads to often unintended outcomes of policies predicated on this assumption, as illustrated earlier). Scholars of international business behavior and comparative political economy have long noted the disconnect between institutional theory and international business research (Jackson and Deeg 2008a). Jackson and Deeg (2008a, 2008b) called for a more dynamic view of institutional evolution and change that incorporates the actions of business actors. These actions are important both in terms of the evolving domestic and international institutions. The institutional arbitrage opportunities seen and realized by business actors on the global scale have implications for both spheres – domestic and international. The exploration of such transnational institutional interdependencies and how foreign institutions and structures might shape the evolution of domestic institutions – through direct and indirect mechanisms – is a recent concern (Farrel and Newman 2014).

The potential linkage between secrecy jurisdictions and corruption in developing countries has been discussed long ago. Hampton (1996) suggested in 1996 that “the offshore interface may contribute to political decay by intensifying anomalous or corrupt relationships between government and business.” He relied on the anecdotal data citing Vietnam and Taiwan, China, as cases that support his propositions (Ibid., 85). Recent studies by Andersen et al. (2012, 2020) discussed earlier also bring attention to secrecy jurisdictions’ role in facilitating domestic corruption. However, in the discussion above, we have also demonstrated that businesses rely on secrecy jurisdictions to lower their transaction costs and as a mechanism for protecting their property rights from potential expropriations. If these choices that benefit business agents mean the continuation of ineffective and corrupt practices at home, then perhaps we need to think about a new form of corporate social responsibility for business actors from weak institutional environments.

The field of Corporate Social Responsibility (CSR) has been long in development in the West and has recently continued its journey beyond the developed countries (Carriga and Mele 2004; Mehra 2006; Jamali 2014). Hart and Zingales (2017) argue about the need to integrate social objectives as a normatively desirable objective of a corporation (in addition to profit maximization). Corporate shareholders have social priorities, and those should be pursued in the context of the corporation, using corporate means, according to this thinking. An example of environmentally ‘clean’ or ‘dirty’ strategies with variable expected profits that could be adopted by corporate management was a case in point.
The main source of difference between the two strategies, Hart and Zingales (2017) argued, was in the sense of shareholders’ responsibility for the social cost.

Recent studies have found that firm internationalization in the developed world is positively associated with the firm’s CSR rating (Attig et al., 2016). There are also studies in the context of emerging economies that link firms’ integration into global financial infrastructure to better corporate transparency (Gans-Morse 2017). Based on these findings, further development of the CSR agenda in the emerging economies might be a promising path for thinking about institutional development in these countries as well.

The anti-corruption agenda in developing countries might rely on and make good use of business agency rather than discount its potency. It would integrate the notion of business responsibility for improving the quality of domestic institutions and discuss mechanisms for exercising such responsibility, whether through business lobbying organizations, business-government forums, or other means. Policy makers should support greater involvement of domestic business actors in various forms of lobbying for more efficient institutions as well as private-public collaborations in which businesses could set examples of efficiency and good governance.

At the moment, no systematic studies measure the impact of the choices of business actors to rely on offshores and foreign courts on domestic legal and regulatory environments. We also need to learn more about various factors that shape the propensity of businesses to exercise social responsibility and institutional advocacy in emerging economies. Recent scholarship on property rights institutions in Russia, for example, suggests that companies do care about their reputations and can exercise their agency to increase the legitimacy of their property rights and thereby shape social norms in the country (Frye 2017). The continuation of this line of research and exploration of strategies and mechanisms that businesses can rely upon to improve the domestic institutional environment will help to promote this policy agenda.

7. Conclusion

Financial secrecy has been an intrinsic element of the global financial system for a long time. It has been increasingly scrutinized over the last two decades as a source of harmful tax competition that
enables businesses to avoid paying taxes in their home countries. Critics have also noted that secrecy lowers the cost of economic crimes and theft, thereby facilitating corruption, especially in countries with weak institutions. At the same time, there is a growing realization that institutional and regulatory arbitrage available through the global financial system enables firms from emerging economies to take advantage of better institutions in foreign jurisdictions to compensate for institutional deficiencies in their home jurisdictions. Secrecy jurisdictions help businesses protect their property rights.

As we have demonstrated above, many of the studies of business actors investing in secrecy jurisdictions from emerging economies are case-specific. The academic field is still at the stage of accumulating country-centered data on key differences of the drivers and the effects of financial secrecy in different parts of the world. These studies reveal that a country’s state of economic development, wealth, and institutional quality matters. Less developed countries with weak institutions tend to lose much-needed capital through capital flight. Secrecy jurisdictions often become the accumulation points for the capital outflowing from a country and, under favorable conditions, partially returning back.

Most scholars who write about secrecy jurisdictions take a view of business actors as ‘institution-takers,’ emphasizing their adaptational patterns to the existing institutional environment. Analysis that focuses on business actors’ agency and responsibility, and develops a dynamic framework of interrelations between business actions and institutions (domestic and global) is still rare (especially in the international business literature). We see an opportunity to think creatively about corporate social responsibility (CSR) in the context of emerging economies. As CSR ideas are integrated into the emerging economies, it is imperative to think about how emerging businesses that integrate into and take advantage of global economic and financial institutions can work on promoting more effective institutions domestically. Integrating the domestic institutional agenda in the CSR strategies by powerful business actors arguably presents a more constructive path towards addressing the ‘dark side of globalization’ than measures driven by protectionism and financial nationalism.
References


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