What is Financial Transparency?

Richard Murphy and Paul Sagar

Purpose of this paper

The Mapping the Faultlines project is based on the contention that the mechanisms that allow illicit financial flows to occur result from a synergistic relationship between the world's secrecy jurisdictions and its secrecy providers (usually accountants, lawyers and bankers) who create the structures that these jurisdictions facilitate. Inherent in the work is an assumption that an alternative is possible: that if there was increased financial transparency it would be much harder to hide illicit financial flows, and that in turn the volume of such flows would decrease.

The Mapping the Faultlines project is not seeking to offer policy solutions to the problems it identifies at this time: these will be offered at a later date. It does, however, seem inappropriate that it address issues of secrecy and the problems it creates unless the alternative of transparency, and the merits it can deliver, is considered.

This paper seeks to do just that, both by exploring the arguments for transparency and what the resulting benefits might be of achieving it, and by describing what transparency would look like if it were to exist. In doing so this paper seeks to do more than describe what is, it seeks to describe what should be. Yet this is not an exercise in determining what ought to be so, based on examples from current best practice: this paper suggests that there is an ideal form of financial transparency to which we should aspire, and sets out what that might be. Without seeking to establish this ideal it is suggested that any eventual policy proposal this work might give rise to will fall short of the goal to which society should aspire.

Assumptions

The argument presented in this paper for financial transparency is motivated by an appeal to justice [1]. This paper uses a relatively straightforward proxy for justice: it assumes that all people stand equal before the law, and should be treated equally by the law. In other words, that the rule of law applies.

This is an assumption made not only within a jurisdiction, but intended to apply beyond and between them. This is not because of an assumption that 'international law' (which is notoriously weak and ambiguous when it exists) governs all jurisdictions. It is because in the

[1] There are numerous concepts of justice: this paper is deliberately avoiding the debate as to which should be considered of greatest significance to this issue by use of a proxy.

modern globalised world, activities undertaken in one jurisdiction will frequently have consequences in another. Yet for equality before the law to apply in the latter, it will frequently be required that its principles are applied in the former, as we shall see.

This assumption is presumed to extend to the important role of the state in ensuring that the property rights of people are upheld.

In making this assumption an implicit further assumption is made, which is that if an individual expects the state to uphold their legitimate right to own property this in turn requires that those people whose rights are protected by the state recognise the right of the state to claim on their property in the form of taxation. This implicit further assumption results from the presumption that if the state can legitimately determine who has and who has not got a property right it can also legitimately, and with the same authority, determine if it in turn has a claim upon property. This assumption is grounded in the truism that a state funded by taxation is a necessary pre-requisite for the upholding of any property rights whatsoever in modern society.

None of these assumptions, it should be noted, challenges the right to privacy of the individual, when they act in a personal capacity and within the requirements of the law. This right to privacy is widely valued, and respected.

The limitations of rights and the assumptions of obligation

All the above being noted, the right to privacy is, like most rights granted in law, a qualified right.

For example, the right to privacy is matched by the individual's obligation to the state: firstly to pay tax in accordance with the laws of the place or places where they locate their economic activities, as well as those where they record them (which may be different) and secondly to act responsibly with regard to any privileges granted to them by that state or those states who have an interest in those transactions giving rise to the tax payments that might be due. One such privilege includes the right to use legal structures affording a benefit to the user which might not be available to an individual acting in their own right; for example access to limited liability through use of incorporated structures and the right to use trusts that alter the laws of property.

It is not suggested that the use of such structures should be curtailed (which may, in any event, be impossible). What is contended is that the privilege these structures bestow carry with them a responsibility to report whether the privilege granted by society has been responsibly managed by those to whom it has been granted. However, that duty to act responsibly can only be demonstrated to have been fulfilled when evidenced. The evidence required is that the existence of the entity, the identity of its beneficial ownership, the true identities of those managing it, its constitution and the accounts which evidence the activity undertaken, must all be placed on public record so that those with legitimate interest[2] in its affairs can determine that it has been properly managed in accordance with the law. This paper suggests that this publicity is the justifiable price to be paid for the advantage that these structures undoubtedly provide to profit-seeking individuals and entities.

To put it another way: the right of others to know is the price paid for the benefit that use of a structure provides to the person who avails themselves of it. It is stressed immediately that this does not violate the right of the individual to privacy: nothing argued here suggests that the individual should forego the right to privacy that the legal systems of many countries provide~~s~~. The requirement to publicise transactions and related matters arises only when use is made of the artificial structures created by law, such as companies, partnerships, trusts, foundations, charities and other entities, all of which might bestow advantage with regard to tax, liability or other matters which the individual cannot enjoy when transacting in their own name. It is that enjoyment which carries with it the obligation to disclose. The obligation arises because of the potential harm that can be incurred by other inhabitants of jurisdictions which allow such structures to exist, but who are denied the correlate body of public information required to ensure that those structures are not being abused.

Considered conversely, the price of non-disclosure should therefore be the cost of foregoing the enjoyment of the advantages of the privileges bestowed. If, say, a company refuses to disclose, then society should refuse to continue to grant it the legal privileges required for its continued operation.

The economic dimension

There are therefore powerful ethical arguments for financial transparency: put most simply, that in allowing individuals and profit-making entities to employ certain structures for their private gain, other members of society have a right to scrutinise and oversee the use of those structures to ensure that they are not being harmed by their abuse.

There are powerful economic arguments as well. Most fundamentally, that data available on public record mitigates the risk of those who trade with limited liability entities, and this produces considerable economic benefits.

Economic theory makes it clear that the perfectly efficient allocation of resources is only possible in very particular circumstances, one of which is the availability of perfect information. That is, of course, impossible to achieve in actuality. Achieving the best possible approximation to perfect information does, however, reduce risk in the market place by increasing certainty which in turn is likely to promote the efficient allocation of resources.

[2] By “legitimate interest” it is typically meant: “the authorities of a jurisdiction wishing to ensure that persons operating within that jurisdiction have complied with the responsibilities which are attendant to the privileges granted by that jurisdiction, in order to safeguard the interests of others who may be harmed, should those privileges be abused”. See below for further explanation.

At this point it is important to note that some argue that perfect information is not needed: for example, economists who promote the efficient market hypothesis (EMH) suggest that prices reflect all known information, and instantly change to reflect new information. In finance this, they say, makes, it impossible to consistently outperform the market by using any information that the market already knows, except through luck. Much of the economic modelling that resulted in the financial crisis that erupted in 2007 was based on this thesis. It is the hypothesis of those who promote the EMH that absence of data does not matter so long as all share in the unavailability of that data.

Whether or not the EMH is correct, the fact is that secrecy jurisdictions ensure that *not* all share in this absence of data equally. Secrecy jurisdictions hide data asymmetrically: some market participants know what is happening, and others do not. Indeed, this is the very purpose of secrecy jurisdictions. Their commercial appeal would be negligible if they hid information from all agents; their purpose is to hide information from some agents on behalf of others. The presence of this deliberate asymmetry (to which economists seem to have turned an intriguingly blind eye, since remarkably few have studied secrecy jurisdictions or commented upon their market impact) makes clear that the EMH, even if theoretically and empirically correct (itself a contentious issue), cannot be used to argue that secrecy jurisdictions are irrelevant.

Whatever the impact, or not, of the EMH, few dispute that high levels of information in a market increase the efficient allocation of resources and promote certainty and stability by allowing agents to make the most well-informed decisions, with the consequence that risk is reduced. Again, though, some attempt to deny the relevance of this point when considering the activities of companies in secrecy jurisdictions on the grounds that few offshore companies actually trade, since most act as intermediate investment managers, and hence conclude that disclosure is not needed by offshore companies. This, however, is a vacuous argument: without full disclosure we do not know which companies are trading and which are not; the fact that *some* offshore companies don't actually trade is effectively meaningless in lieu of disclosure. Hence, disclosure is still required. In addition, all such companies alter the distribution and nature of property rights, enhancing and protecting those ring-fenced within limited liability entities, reducing the liability to tax in most trusts, and as a result diminishing the claim a creditor has when trading with the limited liability entity and the entitlement of government vis-a-vis the trust. This reordering of rights does in itself require that disclosure be made in the interests of accountability for the benefit provided.

Disclosure is required, therefore, to create stable markets, uphold the rule of law (by ensuring that all individuals and entities are complying with the law equally), safeguard people's property and interests from harm by other's abuse of legal entities, and to provide a level playing field in information where discrimination cannot exist between offshore and onshore enmities, thus ensuring that the financial elites capable of employing offshore mechanisms cannot stand above the laws of their own jurisdictions in a way that non-elites cannot.[3]

We thus see the economic and ethical arguments for disclosure interacting. Disclosure increases the availability of information. This leads to more stable markets and increases efficiency of resource allocation. Increased stability and more efficient resource allocation promote the interests of all members of society. Thus, disclosure does not simply allow interested parties to ensure that they are not being harmed by profit-making individuals and entities, it actively promotes the interests of all groups by improving the workings of markets.

The tax argument

Markets depend on the existence of property rights. These can only be fairly and consistently enforced through a properly administered legal system. Yet this in turn implies that those who depend upon that legal system for personal gain have a duty to contribute to the upkeep of that legal system, and comply with its requirements. One of these requirements is to comply with the spirit of that law as well as its strict letter. This is a simple consequence of the rule of law in practice: that all are treated equally before the law. If a person or entity relies upon others complying with both the spirit and letter of the law in order to achieve personal gain, it would be inconsistent for the rule of law to require from them compliance with only letter and not spirit. This would violate the requirement that all are treated equally before the law.

Given this, the principles inherent within the concept of tax compliance should be used to determine the necessary standard of financial transparency required for taxation purposes. For this purpose tax compliance is defined as seeking to pay the right amount of tax (but no more) in the right place at the right time where 'right' means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

This definition makes clear, for example, that the practice of recording a transaction in one location when it actually has its economic impact elsewhere, at least without full disclosure being made in both places, cannot be condoned. The implication for the entire offshore / secrecy world contained within this statement is clear: tax compliance challenges the very nature of its trade because, by definition, offshore structures always record transactions in a place where they do not actually occur. That is because the core offering of the offshore / secrecy world is not merely tax advantage but secrecy itself. Without the opacity that secrecy jurisdictions provide then it is highly unlikely that most of their other offerings would

[3] This is assuming that "offshore" and "onshore" could even be properly and categorically identified – which few seem able to agree upon.

be of benefit to the clients of the lawyers, accountants and bankers who work from, but in a very real sense not in, these locations.

This reality is inherent in the definition of a secrecy jurisdiction: they are places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain with that legislation or regulation being designed to undermine the legislation or regulation of another jurisdiction. In addition, secrecy jurisdictions create a deliberate, legally-backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so. It therefore follows that jurisdictions meeting this definition are not transparent, an issue we shall explore below. They are, however, far from alone.

It is, for example, commonplace for a member of the public to be unable to secure the accounts of a corporation in the country in which it is incorporated. Similarly, the use of nominees is so rampant in many secrecy jurisdictions that any other data concerning an entity placed on public record is assumed by those using the data to be of little real meaning since it is highly unlikely to provide any real evidence as to the ownership or control of the limited liability entities with which a person may be trading. Market inefficiency is the inevitable consequence because in the presence of misinformation resulting from opacity resources will be inappropriately invested in the wrong opportunities resulting in sub-optimal returns for society as a whole. By this standard many secrecy jurisdictions are for all practical purposes almost completely opaque.

This is particularly true for tax information exchange purposes as well. A number of the world's jurisdictions have signed a limited number of Tax Information Exchange Agreements (TIEAs). Most are decidedly recent having been signed in anticipation, or in the aftermath, of the London G20 Summit in April 2009. The few that have been in existence for somewhat longer have given rise to very limited real information exchange. For example, based on The Cayman Island's budget[4] for 2008-09, the amount of data to be supplied is anticipated to be very low indeed in proportion to the number of transactions likely to be undertaken: just eighty requests are anticipated by the jurisdiction in a year, despite the Islands being the world's fifth largest banking centre with a significant volume of business flowing from the USA.

There is good reason for this state of affairs. As the standard TIEA makes clear[5], a TIEA request must provide or state:

(a) the identity of the person under examination or investigation;

(b) what information is sought;

4 http://www.taxresearch.org.uk/Blog/2009/01/07/call-that-information-exchange/ accessed 1-6-09

5 http://www.oecd.org/dataoecd/15/43/2082215.pdf accessed 1-6-09

(c) the tax purpose for which it is sought;

(d) the grounds for believing that the information requested is held within the jurisdiction of which the request is made;

(e) to the extent known, the name and address of any person believed to be in possession of the requested information.

The reason for the low number of information requests becomes obvious immediately. An example helps illustrate this. By definition there is considerable secrecy within secrecy jurisdictions about trusts of all sorts. It is also exceptionally difficult to determine from readily available sources the ownership and control of companies in such locations whilst many also have official banking secrecy laws that are also designed to disguise ownership and control. In that case the chance of linking an asset, such as a bank account that is owned by a company which is in turn controlled by a trust with a person under investigation in another jurisdiction who may or may not be settler and / or beneficiary of the whole arrangement is remote in the extreme. The existence of TIEAs is immaterial in such a case: without a 'smoking gun' to trigger an enquiry under the Tax Information Exchange Agreement the reality is that such an agreement has no practical value.

Putting these pieces together, we see the following. Tax compliance is both indicative of, and necessary for, the proper upholding of the rule of law: when agents are tax non-compliant they attempt to exempt themselves from the rule of law, by definition, because they attempt to ensure that the law does not apply equally to them in their tax payments. Secrecy jurisdictions, by their deliberate legislative opacity, at the very least obscure the ability to determine whether tax compliance is being undertaken or not (as well as, in many cases, facilitating tax non-compliance as well). Furthermore, TIEAs are inadequate mechanisms for redressing this problem.

The transparency issue

These considerations indicate the first of several key issues that need to be addressed with regard to transparency. This is that creating the legal form of transparency, that might be evidenced for example by signing Tax Information Exchange Agreement, is not enough. Having this legal form of transparency is almost meaningless when the reality is that sufficient obstacles to transparency are left in place to ensure that the substance of exchange is not happening, as the budgeted number of exchanges in Cayman suggest is likely in that jurisdiction. Transparency, for the sake of the argument made here, is not a noun that suggests a structure for communication has been created: transparency as defined in this paper is a verb suggesting that communication of data is actually taking place. The evidence is that current initiatives are not delivering the verb, they are only delivering the noun.

Secondly, transparency is a broad-based issue. It does not apply only with regard to a very limited range of financial crimes such as money laundering and terrorist financing, important as it is in those cases. The Cayman Islands, for example, persist in arguing that transparency relates only to financial crime i.e. illicit financial activities. But in actuality transparency is a condition that relates to the smooth operation of markets generally, as noted above with regards to information availability, stability and resource efficiency. Furthermore, and in reply to Cayman, markets which give rise to transactions which may be licit or illicit require transparency in order for it to be possible to determine which transactions are licit or illicit in the first place. It is nonsensical to claim that financial transparency need only be applied to one class of transactions deemed "illicit" because it is *transparency itself* which allows one to determine the illicit or licit status of a transaction. Cayman's view of transparency, which is shared by many other secrecy jurisdictions, puts the cart before the horse.

Given these facts, transparency means that a jurisdiction has a duty to ensure that the consequences of the structures it facilitates (which because they are 'offshore' in the 'secrecy world' do by definition arise in other jurisdictions) are reported in the locations where those consequences arise. This is simply to mitigate the risk that financial crime, including tax evasion, might occur in that or those places. Unless this happens the definition of transparency being employed is too narrow, because the 'transparency' offered is insufficient to identify illicit from licit activity, which is at last part of the point of the exercise and the only one secrecy jurisdiction's recognise.

Thirdly, and perhaps most importantly, given the definition of tax compliance noted above, what happens offshore must be tax avoidance. This is because by definition secrecy jurisdictions provide tax and regulatory privileges to those who do not conduct active business affairs within their own jurisdiction whilst allowing such affairs to be recorded in their domain even though they occur elsewhere. Hence, if one of the privileges provided by using a secrecy jurisdiction is to pay tax in that place (payment being somewhat notional of course if the tax is charged at zero per cent) this is, presumably, a only benefit because tax is not being paid (in full) in the jurisdiction where the actual economic activity takes place (or else, why locate offshore?). Hence the tax due onshore is being avoided, by definition.

This suggests that the difference between the substance and form of transactions is absolutely central to offshore, because offshore provides the form of transactions but their substance comes from 'elsewhere'[6]. In that case unless the secrecy jurisdiction takes care to ensure that the transactions it facilitates are disclosed in the location where they actually have impact, as well as in its own domain, any concept of transparency it creates is meaningless: those who would need to know about the transactions would not have the means to do so unless the secrecy jurisdiction ensured this disclosure was made. There is, however, little evidence that secrecy jurisdictions take this implication of genuine transparency seriously.

[6] By 'elsewhere' is meant: "An unknown place in which it is assumed, but not proven, that a transaction undertaken by an entity registered in a secrecy jurisdiction is regulated." This is a technical term in the tax lexicon.

This is not least because the form of transparency that many jurisdictions appear to endorse is a fallacious one that facilitates tax and other regulatory avoidance: the process of getting round the law whilst claiming that the law only applies to specified activities, but simultaneously denying the means of *identifying* whether the activities actually being undertaken fall into the category of those specified as illicit by law.

It is worth noting that the argument 'what is lawful is appropriate' – which is an endorsement of compliance with the form of but not the substance within the law - no longer holds true with the public or much political opinion (if it ever did). The 2009 British expenses scandal is proof positive of this. The vast majority of Members of Parliament implicated had stayed within the letter of the Parliamentary rules, but were perceived as having (grossly) subverted their spirit. The crushing public disapproval which resulted is highly indicative. There is demand for that substance to be complied with now in matters of offshore and financial secrecy. That the demand is not higher may be due principally to ordinary people being largely ignorant as to the massive scale and extent of offshore abuse, much of which operates by adhering to laws only in letter and not spirit.

The above considerations taken in sum obviously lead us to require a description of what financial transparency means in the context of ensuring laws are being adhered to in both spirit and letter, that allows the identification of illicit versus licit transactions, and avoids the error of placing the cart before the horse. It should be noted, however, that a description is all that can be provided: *defining* financial transparency is a task that has defeated too many for it to be attempted here.

Describing financial transparency

The description of financial transparency which meets the above requirements is a four stage process. Financial transparency thus understood requires that:

1. The true identity, beneficial ownership and real management of any person or entity that might enter into a transaction must be ascertainable by all those who might transact with that person or entity. This requires that:
   a. all natural persons who undertake a trade record that fact on public record;
   b. all legal entities and other structures created by law, whether trading or not, must place on freely accessible public record full details of:
      i. their beneficial ownership,
      ii. management, and
      iii. constitution;

2. All legal entities and other structures created by law with the legal right to enter into transactions must record their capacity to do so by placing their full and unabridged accounts, prepared in accordance with agreed international standards so that they show the substance as well as the form of the transactions they undertake, on freely accessible public record in all jurisdictions in which they transacted during the period to which those accounts relate;

3. The regulatory authorities of any state can secure in timely fashion information on any transaction they believe to have been undertaken within their domain, always provided that they can give reasonable cause for doing so. They should in addition expect the assistance of any other state when pursuing reasonable enquiries with regard to a transaction without having to prove that wrong-doing has occurred;

4. Exceptions to international cooperation on financial transparency should only be allowed in individual cases when it is expected with reasonable probability that the security of a natural person would be prejudiced as a consequence of disclosure being made.

There are some important points to note about this description. First, the notion of criminality has little to do with it. Secondly, the range of laws to be complied with is wide and relates to civil as well as criminal matters. Third, disclosure of the substance of transactions would necessarily require that full disclosure be made in those places where the impact of offshore transactions arises.

Substance also requires beneficial rather than legal owners to be disclosed. This is because legal ownership structures can be used to disguise the ultimate beneficiary of a transaction (or set of transactions), and thus make it impossible to determine whether the transactions are properly considered licit or illicit in nature. Furthermore 'other structures' extends disclosure requirements to trusts, foundations, charities and other arrangements, for the same reasons, and because it is only natural persons transacting in their own name who have a right to privacy with regard to commercial issues under this definition.[7]

In all others cases, including partnerships, the claim of others requires that disclosure be made.

None of this, of course, compromises the right to privacy of the individual: no one is obliged to use a legal entity, trust, partnership or any other structure. All are choices provided for in law, but none are obligatory. But, in the case of real risk arising, protection is available. Conversely, in the case of real *abuse* arising, those who are harmed by that abuse should have recourse to correcting or preventing it.

This standard of financial transparency is an ideal. No state reaches this standard at present. But that is not the issue of significance for this paper: what is apparent is that there is a move in the direction of enhanced financial transparency throughout the world. Yet at present few jurisdictions, authorities or commentators appear to have much understanding

[7] This is because, as established above, interested public parties may legitimately seek information about profit-seeking individuals and entities which employ privileged financial structures, because those privileged structures have the potential to be used in a way that harms the interests of those interested public parties.

what transparency term might mean, how different concepts of transparency may exist and differ, and what transparency understood in differing senses might entail.

This paper has offered a vision of what financial transparency should be. In doing so it seeks to set a trajectory of travel for those working in this area, which therefore includes the governments of every sovereign nation state in existence.

