Does Transparency bring Cleanliness?
Offshore Financial Secrecy Reform and Corruption Control

Daniel Haberly, University of Sussex
Alex Cobham, Tax Justice Network
Valentina Gullo, University of Sussex
GI-ACE part of the ongoing Anti-Corruption Evidence (ACE) research programme funded by UK Foreign, Commonwealth & Development Office (FCDO)

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• Three priority areas:
  – Addressing the international architecture that supports corrupt exchanges
  – Promoting integrity systems in the public and private sectors
  – Tackling corruption at sub-national and sectoral levels
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Widespread recognition of the role of “offshore” secrecy jurisdictions in financial crime, including laundering and storage of proceeds of corruption.
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  – *Indications are of some success (albeit partial & uneven) at the level of policy change*
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- Intensifying series of international and national reform initiatives (e.g. coordinated by EU, OECD, FATF, US, UK) aimed at improving financial transparency.
  - *Indications are of some success (albeit partial & uneven) at the level of policy change* 
- **BUT**, limited understanding of actual impact of policy changes on illicit financial activities
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Key Question: *Has greater transparency actually reduced the illicit use of offshore Secrecy Jurisdictions?*
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**Basic approach:** *Time-series panel regression analysis of impact of changing jurisdiction-level policies on “high risk” offshore shell company formation & dissolution by low-income country clients*
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Basic approach: Time-series panel regression analysis of impact of changing jurisdiction-level policies on “high risk” offshore shell company formation & dissolution by low-income country clients

Contribution:
- Informing ongoing “offshore” reform efforts with assessment of existing policy effectiveness
  - Identification of trouble spots (in terms of policy and geography)
Key Question: Has greater transparency actually reduced the illicit use of offshore Secrecy Jurisdictions?

Basic approach: Time-series panel regression analysis of impact of changing jurisdiction-level policies on “high risk” offshore shell company formation & dissolution by low-income country clients

Contribution:
- Informing ongoing “offshore” reform efforts with assessment of existing policy effectiveness
  - Identification of trouble spots (in terms of policy and geography)
- Understanding what factors drive offshore shell company use by low income country actors
Three-part analysis:

  
  • Q: How has the world map of financial secrecy and IFF-regulation changed at the jurisdiction level?
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Panama Papers – Number of Entities Created by Year

The graph shows the number of entities created by year. The number of entities created increased significantly from 1994 to 2002, peaking around 2002. There was a subsequent decline starting around 2004, with a more significant decline in 2010.
Panama Papers – Number of Entities Created by Year

Current TJN Financial Secrecy Index Coverage (from 2009)
Panama Papers – Number of Entities Created by Year

Regulation of Illicit Financial flows (RIFF) dataset (1990-2015)
Regulation of Illicit Financial Flows (RIFF) Coverage

61 jurisdictions – prioritized based on combination of OFC / tax haven lists, TJN evaluations, importance in international financial markets, and importance in ICIJ data

25 years (1990-2015) – based on combination of ICIJ coverage and policy data availability

16 policy variables – defined based on combination of importance and data availability

Additional 4 variables for 2000-2015
HFSD Variables

• Variables (1990-2015):
  – Banking secrecy
  – Bearer shares (ban/immobilization)
  – Suspicious transaction reporting (reporting obligations, whistleblower protections, anti-client tipping-off provisions)
  – Client due diligence procedures (general and political exposed persons)
  – Automatic Exchange of Information
  – Money laundering criminalization (drug & non-drug)
  – Financial intelligence unit establishment
  – Terrorist financial criminalization
  – Shell banks prohibition (establishment and correspondence)
  – Bilateral tax treaties & information exchange agreements

• Additional variables (2000-2015)
  – Trust registration
  – Information exchange and judicial cooperation
  – Beneficial ownership (reporting obligations and record-keeping)
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– Part 2: Understanding the Drivers of Offshore Shell Company Formation by Developing and Transition Economy Clients
  • **Q:** What are the drivers of "high risk" offshore shell company use, potentially linked to corruption-related and other IFFs?
  • **Method:** Panel regression analysis of Panama and Paradise Papers data

– Part 3: Understanding the Impacts of Financial Secrecy Reform
  • **Q:** What effects are IFF-regulatory and secrecy reforms having on "high risk" offshore shell company use?
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Overall RIFF Composite Regulatory Score

Scored based on factor analysis of 10 (of 16) indicators selected to minimize missing data; first factor explains 87% of total variance in 10 indicators

Includes bearer shares ban/immobilization, suspicious transaction whistleblower protections, suspicious transaction reporting obligations, client tip-off restrictions, automatic exchange of information, client due diligence (general), PEP enhanced due diligence, ML criminalization drugs, ML criminalization other, financial intelligence unit)
Overall Regulation (factor analysis-scored)

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The ICIJ leaked datasets of shell company formation (Offshore Leaks, Panama Papers, Paradise Papers)

100Ks of companies formed by clients in hundreds of countries over several decades

Significant advantages over existing data sources to construct a DV in time series panel analysis of offshore shell company formation
(very rough) estimate % of all offshore companies* by jurisdiction covered in ICIJ leaked datasets

(ca. 290,000 entities w. useful data)

- Niue: 99%
- Bermuda: 63%
- Samoa: 53%
- Seychelles: 47%
- British Anguilla: 44%
- BVI: 19%
- Cook Islands: 18%
- Cayman Islands: 15%
- Bahamas: 14%
- Panama: 13%

*totals from Palan, Murphy, & Chavagneux 2010 & Bermuda Company Laws & Regulations Handbook 2012
Panama Papers coverage versus Orbis coverage by jurisdiction (% of companies)

Offshore Leaks coverage versus Orbis coverage by jurisdiction (% of companies)

Paradise Papers coverage versus Orbis coverage by jurisdiction (% of companies)

Combined Offshore Leaks & Panama Papers coverage versus Orbis coverage

Relationship of jurisdiction-level coverage of ICIJ databases with jurisdiction-level coverage of Orbis
Percent of all shell companies in Panama and Paradise papers belonging to identified politically exposed persons (PEPs)

Source: International Consortium for Investigative Journalists
Geographic Structure of Shell Companies Linked to Politically Exposed Persons in the Panama and Paradise Papers

Source: International Consortium of Investigative Journalists
Created by Daniel Haberly, 2020
ICIJ Data Coverage of Illicit Global Wealth Chains

Shell Company Incorporation Jurisdiction

Shell Company Address Jurisdiction (typically intermediary admin. site)

Intermediary home jurisdiction

Client Jurisdiction
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Part 2 goals and methods

• **Methodology:** Worldwide time series panel regression analysis of shell company formation determinants by developing and transition economy-based officers (“clients”), from 1991-2015
  – Exploratory analysis with emphasis on sensitivity analysis and robustness checks
Independent Variables

• Two groups of independent variables:
  – Institutional & political (rule of law, private property rights, state ownership, & changes in all of these, plus regime change / political instability)
  – Economic and financial (external debt, foreign aid, IMF crisis assistance, natural resource rents, GDP growth, PPP GDP per/cap relative to USA)
Results 2.1: Cross-sectional (international) analysis of long-term shell co. use propensity

- What are the general characteristics of developing & transition economies associated with higher shell co-use intensity? (long-term international comparative)
Results 2.1: Cross-sectional (international) analysis of long-term shell co. use propensity

• What are the general characteristics of developing & transition economies associated with higher shell co use intensity? (long-term international comparative)

  1) Offshore company formation is highest in the countries that can least afford it
Cross-sectional determinants of long-term shell co. formation intensity % GDP
All developing and transition economies (1991-2015)

Summary of multi-model sensitivity analysis (based on different samples & factor combos)

Long-term determinants of intl. (officer country) variation in shell company formation (relative to. GDP)
(percent of models where variable had a significantly negative / positive effect) - all developing & transition
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- political instability
- GDP growth
- low growth / unstable (fac3)
- resource rents
- property & legal institutions
- state ownership
- liberal / low rents (fac2)
- external debt
- PPP GDP/cap rel. to USA
- aid dependence
- aid/debt/poverty (fac1)

Group of highly correlated independent variables
Factor (dimension) capturing their shared variation
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- Aid dependent, highly indebted poor countries (factor 1)
  - neg triple agreement
  - neg 1% sig
  - neg 5% sig

- pos triple agreement
- pos 1% sig
- pos 5% sig

- Group of highly correlated independent variables

Factor (dimension) capturing their shared variation
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-100% -80% -60% -40% -20% 0%

political instability
GDP growth
low growth / unstable (fac3)
resource rents
property & legal institutions
state ownership
liberal / low rents (fac2)
external debt
PPP GDP/cap rel. to USA
aid dependence
aid/debt/poverty (fac1)

Foreign aid dependence
Aid dependent, highly indebted poor countries (factor 1)

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(percent of models where variable had a significantly negative / positive effect) - all developing & transition economies

- GDP Growth
- Political instability
- Foreign aid dependence
- Aid dependent, highly indebted poor countries (factor 1)
- Low GDP growth & politically unstable countries (factor 3)

Group of highly correlated independent variables
Factor (dimension) capturing their shared variation
Composite Map of Panama and Paradise Papers Offshore Shell Company Formation Intensity, in relation to GDP, 1990-2015

*Standardized officer country fixed effects coefficients estimated in fixed effects-terms only (officer-country, service provider-incorporation jurisdiction, service-provider time) panel regression model of annual Appleby & Mossack Fonseca offshore company formation events as a % of officer country GDP

**Country omitted due to insufficient observations or offshore intermediary status
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  1) Offshore company formation is highest in the countries that can least afford it
  2) Offshore company formation is lower in relation to GDP in mineral rent-dependent than in non-mineral rent dependent economies—GDP composition effects
Results 2.2: Time Series Determinants of Shell Company Formation

- What are the causal mechanics of shell company formation, including “high risk” formation, by developing and transition economy clients?
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- What are the causal mechanics of shell company formation, including “high risk” formation, by developing and transition economy clients?
  1) Offshore company formation in developing countries is linked to financial cycles in developed countries
Worldwide developing & transition economy client offshore company formation & performance of key asset markets

Value as a percent of 1991-2014 average

- MF & Appleby average (developing country)
- MF total formation (developing)
- Appleby total formation (developing)
- US stock & UK real estate (OECD)
- US stock prices (OECD)
- UK real estate (OECD)
Worldwide developing & transition economy client offshore company formation & performance of key asset markets

Value as a percent of 1991-2014 average

R2 of relationship: 0.92
Year-on-year ratio change in worldwide developing and transition economy client formation & performance of key asset markets

R² of relationship: 0.40

- YOY change in US stock & UK real estate index (ratio)
- YOY change in MF & Appleby shell company formation (ratio)
Year-on-year ratio change in worldwide developing and transition economy client formation & performance of key asset markets

R2 of relationship: 0.40
Higher than the combined explanatory power of all country-level variables

- YOY change in US stock & UK real estate index (ratio)
- YOY change in MF & Appleby shell company formation (ratio)
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- What are the causal mechanics of shell company formation, including “high risk” formation, by developing and transition economy clients?
  1) Offshore company formation in developing countries is linked to financial cycles in developed countries
  2) “High risk” external foreign currency inflows that pass directly into the hands of the state are recycled back outwards via offshore company formation
Summary of multi-model sensitivity analysis (based on different samples)
Determinants of Shell Company Formation in Panama and Paradise Papers, 1991-2015: Countries with no History of Communist Rule

Summary of multi-model sensitivity analysis (based on different samples)

Countries with no communist history (time series shell co formation determinants)

- Foreign aid & devt. assistance
- IMF crisis assistance
- Mineral rents

- L1 aid chg.
- L1 foreign aid
- L1 external debt chg.
- External debt chg.
- L1 IMF crisis lend
- IMF crisis lend
- L1 res. rent chg.
- Res. rent chg.
- L1 resource rents
- Regime change
- L1 regime change
- L1 deterior. legal & prop.
- Deterior. legal & prop.
- L1 improv. legal & prop.
- Improv. legal & prop.
- L1 property & legal inst.
- L1 nationalization
- L1 privatization
- Nationalization
- Privatization
- L1 state ownership
- L1 GDP grow chg.
- GDP grow chg.
- L1 GDP grow
- L1 PPP GDP/cap
- Serial dependence

- Blue horizontal lines indicate statistical significance at different levels:
  - Blue: 5% significance
  - Purple: 1% significance
  - Black: Triple agreement

- Red horizontal lines indicate non-significance.
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Summary of multi-model sensitivity analysis (based on different samples)

Countries with no communist history (time series shell co formation determinants)

- Foreign aid & devt. assistance
- IMF crisis assistance
- Mineral rents (indirectly mediated via state sector)
- State ownership

- External Debt (indirectly mediated via state sector)
Summary of multi-model sensitivity analysis (based on different samples)

Countries with no communist history (time series shell co formation determinants)

- External Debt (indirectly mediated via state sector)
- IMF crisis assistance
- Mineral rents (indirectly mediated via state sector)
- State ownership

No general country-specific business cycle impact

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  3) Political regime change events cause formation to fall
Summary of multi-model sensitivity analysis (based on different samples)

Regime change event

All middle and low-income countries (time series shell co formation determinants)
Results 2.2: Time Series Determinants of Shell Company Formation

- What are the causal mechanics of shell company formation, including “high risk” formation, by developing and transition economy clients?
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4) Liberalizing structural reforms generate increased offshore company formation (socialist history dependent)
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percent of models in which a variable is statistically significant (sensitivity analysis based on co. formation threshold and data leak)

Summary of multi-model sensitivity analysis (different samples)

One dimensional economic institutional representation ("liberalism")

Multidimensional liberalization (process) (privatization & law & property rights)

Multidimensional liberalism (condition) (privatization & law & property rights)

Countries with communist history (time series shell co formation determinants)
Countries with no communist history (time series shell co formation determinants)
Countries with no communist history (time series shell co formation determinants)

Summary of multi-model sensitivity analysis (based on different samples)

Two dimensional economic institutional representation (state ownership & Law/property rights)

Legal and private property
Institutional strengthening

State ownership level

Effects appear to be entangled with mineral rent & debt recycling, & external debt crises

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5) Most of these effects are also corruption dependent!
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1) Offshore company formation in developing countries is linked to financial cycles in developed countries

2) “High risk” external foreign currency inflows that pass directly into the hands of the state are recycled back outwards via offshore company formation – **stronger in less corr. countries**!

3) Political regime change events cause formation to fall

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3) Political regime change events cause formation to fall

4) Liberalizing structural reforms generate increased offshore co. formation 3&4 only visible in high-corr. and socialist countries!

5) Most of these effects are also corruption dependent!
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  • Method: Joint panel regression analysis of RIFF indicators and Panama and Paradise Papers data (in progress) -> preliminary findings
Impacts of Financial Secrecy Reform (preliminary)

• What effects are IFF-regulatory and secrecy reforms, at the intermediary jurisdiction level, having on “high risk” offshore shell company use?
Impacts of Financial Secrecy Reform (preliminary)

- What effects are IFF-regulatory and secrecy reforms, at the intermediary jurisdiction level, having on “high risk” offshore shell company use?
  1) Reforms on paper are being implemented in practice
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Scored based on factor analysis of 10 (of 16) indicators selected to minimize missing data; first factor explains 87% of total variance in 10 indicators

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Global Shell Games Service Provider Compliance Scores

http://www.globalshellgames.com/results--maps.html

Source: Findley, M. G., Nielson, D. L., Sharman. 2014. Global Shell Games (online data mapper)
Relationship between 2010 RIFF composite regulatory scores, and Global Shell Games service provider compliance scores
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Conclusions and Implications

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  - Corroborating lines of evidence of real reform in many (albeit not all) offshore jurisdictions at both the formal level of regulation itself, and the level of observed service provider practice
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  – (Taxation!)
Thank You!

Daniel Haberly, d.haberly@sussex.ac.uk
Alex Cobham, alex@taxjustice.net
Valentina Gullo, v.gullo@sussex.ac.uk