



T H E   R E V I E W  
O F

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## The Financial Crisis

Law and Order In the Bahamas

—  
To Resist or not To Resist:  
That is the Question

—  
Blacklisting for Dummies

—  
OECD or Tax Havens:  
Who's at Fault?



**The Institute** is an independent non-political non-profit institute that promotes economic growth, employment and entrepreneurial activity. It believes that this can best be achieved with a free market economy and a society that embraces the rule of law, the right of private property and the values of family, learning, honesty and hard work.

These beliefs lead to the following policy positions:

- For a balanced budget
- For the “rule of the law”
- For the privatization of the public corporations
- For a smaller government and lower taxes
- For an efficient justice system
- Against government management of the labor market
- Against a minimum wage
- Against price controls

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# Law and Order in the Bahamas

The Bahamas is now facing a financial crisis of great severity...a crisis with many facets and dimensions. It may start with actions taken against the banking industry of the Bahamas by the Organization for Economic Cooperation and Development starting January 1, 2001.

In part this problem is not caused by what the Bahamas has done. This part, the "Uncooperative Tax Haven" issue, is a reaction of the OECD countries to their own deficiencies. The next three articles will discuss this issue from different points of view.

However, this article contends that the "money laundering" problem is producing the crisis...and it is in large part the result of the breakdown of "law and order" in the Bahamas. That breakdown can be seen in many ways ranging from the small and barely noticed to the spectacular and shocking such as -

- A proposed labour bill that will make it a crime for a businessman to use modern techniques to determine the identity or truthfulness of an employee
- The apparent failure of the Government to live up to its international agreements
- The rise in crime that so frequently fills the headlines and front pages of the press

The Institute contends that the Government should address not only the specifics of how to deal with the OECD...the

legislation to be enacted...but also the fundamental question of Law and Order.

## *The Rule of Law.*

The Rule of Law is a concept developed in Britain years ago...in fact, at the dawn of the Industrial Revolution. Then the arbitrariness of despotic government gave way to a *de facto* separation of powers, first between lords and king and then between king and parliament. A.V. Dicey noted that "the law became the highest estate to which the king succeeds, for both he and his subjects are ruled by it."

The Rule of Law is a limit on the type of legislation that any government should pass. Ideally this excludes any legislation or regulation designed to benefit a particular group at the expense of others. In such cases the coercive power of the state is used in a discriminatory way.

F. A. Hayek in his 1944 classic, *The Road to Serfdom*, illustrated this point by referring to the obvious extreme case of that period...actions taken by Adolf Hitler were duly authorized by legislation but were later deemed to be crimes against humanity. In one sense they were "legal" but they violated "the kind of general rules known as formal law".

In practice politicians constantly take actions that benefit the electorate and parts thereof in order to secure their own political power. Historically defense of a country's borders against invasion and pillage worked to the benefit of all...as well as the construction of roads, bridges and ports. The Industrial Revolution flourished during a period when the benefactors of the prior authoritarian regimes lost their privileges. For instance, the revocation of the Corn Laws



removed the protection afforded landowners against the importation of lower cost foreign grains. Politicians forever face the temptation to use the power of the state to benefit specific people at the expense of others. This is a constant struggle in a democratic society.

### *Bahamian culture.*

Given the fact that the legal system here is derived from and is still connected to the English system, why does the implementation here not conform to the spirit of English law? In the sequence of crime, detection and punishment, why is punishment in so many cases reluctantly pursued if at all?

The author contends that it is cultural and is the misuse of victimhood and brotherhood. Historically Bahamians have experienced a unique combination of slavery, colonialism, poverty, a small population and isolation. These shape the Bahamian character.

For perspective let us look at John McWhorter's analysis of African-American society, *Losing the Race: Self-Sabotage in Black America* (Free Press, New York, 2000). He describes "Victimhood" as the collective consciousness of past "injustices" that is natural and healthy...if...it leads to rational thought and constructive solutions. It becomes "Victimology" when it simply fosters and nurtures "an unfocused brand of resentment and a sense of alienation." In these instances it is evidenced by –

- An exaggerated sense of separation from others
- A belief that historical factors warrant the application of a different set of moral values

- Support for one's "brother" even when those more widely held values would not warrant such support
- A failure to appreciate and consider the progress that has been made
- Emotional and illogical thinking when problems are framed within a context that literally does not exist any more
- A diminished self-esteem when one is held to a "lesser" set of standards.

It is reasonable to conclude that "Victimology for political gain" is a major factor in the present state of Law and Order in the Bahamas. This is unfortunate.

According to Thomas Sowell (*Conquests and Cultures: An International History*, Basic Books, New York, 1998) the Rule of Law played an important role in why Britain became "the first industrial nation and retained its preeminence for a century. The evolution of the rule of law...not only helped promote the internal economic development of Britain itself, it helped attract to Britain much of the commerce of Europe."

Likewise in the case of the Bahamas today internal economic growth and capital inflows have been and are important... especially in the Global Economy...the only one in which the Bahamas can prosper.

### *The Blacklisting crisis.*

And...with respect to economic growth, culture does matter. This is not just theory without real consequences.

The country's position in international financial markets is threatened by the OECD blacklisting. In fact, the inefficient politicized justice system exacerbated the

country's problems by blocking and frustrating legitimate legal proceedings under international agreements. This evidences a disregard for the Rule of Law.

Some will say that culture just like people won't change. However, the country's abundant legal skills, its Christian tradition and national self-interest could facilitate the kind of appraisal and action that would bring it into line with the spirit of the Rule of Law. This is both necessary and desirable.

### *A critical reply.*

As is its practice, the Institute circulated the above text for comment. It got one response that recognized the article as a "Good piece!" but contended that the country's majority wants "the absolute protection of the criminal". The commentator went on to document this point and suggested the following closing text to the proposed Letter to the Editor:

"We complain about the cost of operations at Bahamasair, Batelco and other governmental bodies. We recognize the stealing and the various scams. However there is no national acceptance on a personal level to stop this bloodletting that has corrupted the whole of Bahamian society.

"Now it seemingly has overflowed into the international arena with the 'blacklisting' of The Bahamas. The average Bahamian should now be aware that what is accepted as everyday life has significant negative consequences that he can justifiably fear. Suddenly 1 plus 2 plus 3 may equal 6."

He added, "I hope it is so!"



# To Resist or Not To Resist: That is the Question

By LENNOX PATON, Counsel and Attorneys-At-Law

The Organization for Economic Cooperation & Development (OECD), in an affront to International law and comity, has declared fiscal war on the Bahamas on behalf of the high tax jurisdictions of the world. The Bahamas has a key decision to make, capitulate and surrender or stand firm and resist. The future of the financial services industry of the Bahamas is at stake.

The primary objective of the OECD is the unfettered disclosure of financial information by financial institutions and professionals in the Bahamas in respect of their customers and clients in order that foreign taxes can be levied on the income and gains realized by such customers and clients.

Is it in the national interest of the Bahamas to capitulate to the OECD and its tax information requirements and procedures?

Before the Bahamas answers this question there should be a thorough and careful analysis in the "sunshine" and not behind closed doors. To date the Government has been very circumspect about releasing any information. It is drafting the legislation with an attorney retained by the Bahamas Financial Services Board (BFSB) and, in fact, has forbidden him to disclose to the BFSB the nature and content of his consultations with the Government. This state of affairs is unacceptable. Under such circumstances how can the BFSB possibly represent its members? It cannot.



The debate needs to be brought out into the open.

Firstly, there is no debate over the requirement of the Bahamas to comply with the recommendations of the Financial Action Task Force (FATF) in respect of anti-money laundering measures. The Bahamas must fully support the FATF and dedicate the necessary resources to fulfil its commitments in this regard. The OECD's tax demands, however, are another matter. We must be careful not to blur the line between the FATF and the OECD and unnecessarily surrender to the OECD's tax demands in the name of satisfying the legitimate requirements of the FATF.

The OECD's demands and objectives are set out in a report titled, "Harmful Tax Competition an Emerging Global Issue" published in 1998. The Bahamas was characterized as a "Tax Haven" and labeled as an "Uncooperative Tax Haven" in the OECD's follow up report in June 2000. The Bahamas has until 31<sup>st</sup> July 2001 to commit to the OECD that it will eliminate its "harmful tax practices" i.e. commit to disclose tax information. Failure to make such a commitment will result in the Bahamas being "Blacklisted" and subject to "Defensive Measures".

The possible "Defensive Measures" are listed in the OECD report as follows:

- To disallow deductions, exemptions, credits, or other allowances related to transactions with Uncooperative Tax Havens or to transactions taking advantage of their harmful tax practices.
- To require comprehensive information reporting rules for transactions involving Uncooperative Tax Havens

or taking advantage of their harmful tax practices, supported by substantial penalties for inaccurate reporting or non-reporting of such transactions.

- For countries that do not have controlled foreign corporation (CFC) or equivalent rules, to consider adopting such rules, and for countries that have such rules, to ensure that they apply in a fashion consistent with the desirability of curbing harmful tax practices.
- To deny any exceptions (e.g. reasonable cause) that may otherwise apply to the application of regular penalties in the case of transactions involving entities organized in Uncooperative Tax Havens or taking advantage of their harmful tax practices.
- To deny the availability for the foreign tax credit or the participation exemption with regard to distributions that are sourced from Uncooperative Tax Havens or to transactions taking advantage of their harmful tax practices.
- To impose withholding taxes on certain payments to residents of Uncooperative Tax Havens.
- To enhance audit and enforcement activities with respect to Uncooperative Tax Havens and transactions taking advantage of their harmful tax practices.
- Not to enter into any comprehensive income tax conventions with Uncooperative Tax Havens, and to consider terminating any such existing conventions unless certain conditions are met.

- To deny deductions and cost recovery, to the extent otherwise allowable, for fees and expenses incurred in establishing or acquiring entities incorporated in Uncooperative Tax Havens.
- To impose “transactional” charges or levies on certain transactions involving Uncooperative Tax Havens.

The OECD is not able unilaterally to impose any or all of the above “Defensive Measures”. Rather each individual member of the OECD will individually have to implement them. The OECD includes Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, UK and USA. The odds of the membership acting in concert are probably very low. In addition, certain member countries, such as Switzerland and Luxembourg, will act in their own self-interest in a manner that will conflict with the objectives of the OECD itself.

Undoubtedly the most important member of the OECD, as far as the Bahamas is concerned, is the USA. For a complex set of reasons, it has unilaterally committed to enter into a Tax Information Exchange Agreement with it. But even here, based upon Senator Army’s letter to Treasury Secretary Summers, there may be little support in the United States Senate for the imposition of any coordinated “Defensive Measures” against, *inter alia*, the Bahamas.

The Bahamas has for many years held the principle of confidentiality sacrosanct. Only last year Bahamian BFSB delegations toured Europe’s capitals extolling the virtues of The Bahamas, especially our position on confidentiality.



Billions of U. S. Dollars have been deposited with Bahamian financial institutions in part because of the Bahamas' policy in this regard. The vast majority of these funds are legitimate. We have an obligation to these persons and we should not callously abandon them. There is no shame in upholding our belief in the right to privacy and confidentiality. The Bahamas stands to gain substantially in the international financial services arena if we champion this cause. We should not support the OECD's bid for Orwellian control over private affairs.

The Government cannot expect the members of the Association of International Banks and Trust Companies (AIBT) to be very vocal since the vast majority of them are foreign institutions requiring work permits to retain their senior management in place. It consequently falls to the local professional community to rally to the cause and demand a role in the determination of policy.

The Government should not act as a monopolist in the decision making process. It would benefit by a more open disclosure of position papers and early drafts to ensure a constructive debate. Hopefully the Government has learnt a lesson in this regard from its recent experience with its Labour Bills. The Government should not risk the spectre of 5,000 middle class Bahamians taking to the streets to protest the potential loss of jobs owing to the country's capitulation to the OECD.

Unless the Bahamas maintains a comparative advantage over financial centres such as London, financial institutions will not have a rational reason to maintain or establish operations in the Bahamas. We cannot compete on the same playing field as London, New York, Toronto,



**Zurich, Geneva, Singapore or Hong Kong. We must have an advantage and at present those advantages are confidentiality and the lack of complex, onerous regulation. We are in danger of losing both.**

If the Bahamas stands firm and does not capitulate to the OECD, it will be "blacklisted" in August 2001. As stated above we may be subject to one or more "Defensive Measures". There is no guarantee that such sanctions will be implemented in a concerted manner by the OECD membership or at all. Further, it is not a foregone conclusion that any such sanctions will have a deleterious effect on the Bahamas. However, in the event any such sanctions do cause serious harm the option will always be open for the Bahamas to capitulate to the OECD and make the demanded "Scheduled Commitment" thereby having the sanctions lifted and being removed from the "Uncooperative" list and placed on the "Cooperative" list.

The Bahamas has a history of being cautious and such caution is certainly merited now. In the future, resistance to the OECD may well be a badge of honour. The case for immediate capitulation to the OECD is not compelling.

Let the debate begin!

# Blacklisting for Dummies

For the last 5 months our town meetings, local press, talk radio and TV have been inundated with the "Blacklisting of the Bahamas" story. Everyone seems to have his or her own ideas on the issues:

- Retailers see a drying up of consumer spending;
- Clerical workers see their careers coming to an end;
- Taxi drivers see an end to tourism because they think it's really driven by the banking industry; and
- Even the bad guys (the criminals, their lawyers, and the corrupt police and politicians) are getting concerned.

In an attempt to bring the issues into a meaningful focus we cornered a friend of ours who manages one of the more respected private banks in Nassau. Private bankers are known for their discretion in everything, so we will simply refer to our banking buddy as "PB" (Private Banker). Here is the gist of our conversation.

**IEF:** We're thinking of writing a thin book called "Blacklisting for Dummies" and wondered if you would help.

**PB:** Sure. "Alphabet Soup" could be a good title as well.

**IEF:** How so?

**PB:** Just list the attacks being made on the International Financial Centres: OECD, FSR, FATF, IMF, FINCEN and QJ/QI

**IEF:** But there must be some fire where you see smoke. We

hear it's all about money laundering and drugs.

**PB:** Sometimes it is very easy to reduce what appear to be complex socio-economic issues into simple easy to understand theories. I'll give you some examples:

- Asked how he got re-elected, President Clinton said, "It's the economy, stupid!"
- In 2000 soon to become President, Governor Bush said, "It's the personality, stupid!"
- What's Blacklisting all about? "It's competition, stupid!"

**IEF:** Then what is all this talk about money laundering?

**PB:** Being in favour of money laundering is like being against motherhood or favouring war. How can you argue against it? Do you remember that great exchange between Derek and Clive (Peter Cook and Dudley Moore)"?

Derek: I was against it, you know.

Clive: Against what?

Derek: The Second World War.

Clive: Well, I think everyone was against the Second World War!

Derek: Yes, but I wrote a Letter!

**IEF:** So you're saying that under the guise of putting an end to money laundering, the real agenda is to stamp out competitors?

**PB:** Exactly. Let's have another bowl of Alphabet Soup.

What is the OECD? It's not a body corporate or any other judicial body. It's a club made up of 29 countries, each of which, to a greater or lesser degree, imposes a combination of

income, sales, capital gains, inheritance, value added and departure taxes in addition to import and export duties to run their fiscal houses.

**The OECD Club is terrified by --**

- Countries like the Bahamas that seem to be able to run their fiscal house on only import duties, property and turn over taxes
- Foreign exchange trading that has gone from billions of dollars daily in the 1970s to trillions today (How do they find the "tax evasion" needle in that haystack?)
- The Internet that gives everyone the ability to buy, trade and invest on a global basis by pressing "Enter" on their PC, and
- The September 2000 start-up of allegedly the world's first 24-hour Internet offshore bank that targets expatriates.

**That's why you've got very paranoid bureaucrats running in circles.**

I'm not saying that money laundering isn't evil or that it doesn't happen. I'm saying the taxing countries intend to put countries like the Bahamas out of business because they don't like the competition. They see their tax base eroding because business is finding better places to grow. More money is laundered through New York banks on a daily basis than exists in the Bahamas.

**IEF:** So what goes on at the OECD club?

**PB:** They say they are all about transparency yet they meet in secret -- go figure!



**IEF:** And the FATF?

**PB:** A subset of the OECD. Their agenda is KYC, Know Your Customer - one more bit for the soup. The FATF is concerned that Bahamian banks do not know their customers. I can't speak for all sectors of the financial community but I sure know who my customers are - don't you? Doesn't every legitimate businessperson?

**IEF:** What is the Bahamas doing about these attacks?

**PB:** Careful reflection on each criticism and, where warranted, the Government is passing remedial legislation or increasing regulation so that the Bahamas will be recognized as having the best practices of international financial centres around the world.

**IEF:** Could the Bahamas lose its competitive advantage?

**PB:** There may be a perceived short-term loss of competitive advantage, but in the long term the Bahamas may be able to maintain and even strengthen its position as a premier International Financial Centre.

Let me give you another example. In the 1970s small economical Japanese cars invaded the U.S. market and the U.S. automobile manufacturers were threatened. With the help of the Government they negotiated quantitative limits on such imports. The Japanese then opened assembly plants in the U.S. for their high volume models and continued to import the other lower volume ones. They adapted and remain a dominant force.

IEF: Are you saying the threats of the OECD and the FATF to impose sanctions by July 2001 is unfair?

PB: What is unfair is that for whatever historic reason, people living in OECD countries have chosen to have part of their asset base outside of where they live. The OECD countries see erosion of their respective tax base because their citizens choose to remove their assets to other jurisdictions. Essentially the OECD is trying to make their problem our problem.

Let me give you another example:

The average tax rates in the US, UK and Canada are around 40% whereas in Europe they go over 60%. In the US, UK and Canada residents are quite serious about paying their taxes – you have over 80% participation. In Europe you have about 50% participation. Some describe European tax evasion as a “sport”. Others see it as “asset protection”.

IEF: Will sanctions such as refusing to process wire transfers work?

PB: Probably, but Bill Gates is working on the software to get around the issue!

## OECD or Tax Havens: Who's at Fault?

The following is an edited version of "Harmful Tax Practices?", an article by David N. Laband in the October 2000 issue of *Ideas on Liberty* magazine. It is published with permission of the Foundation for Economic Education, Irvington, New York.

### *The OECD story.*

The Organization for Economic Cooperation and Development...is demonizing tax havens around the world. Consider this statement: "harmful tax practices may exist when regimes are tailored to erode the tax base of other countries. This can occur when tax regimes attract investment or savings originating elsewhere and when they facilitate the avoidance of other countries' taxes."...Evidently, the OECD has a problem with tax competition: "If nothing is done, governments may increasingly be forced to engage in competitive tax bidding to attract or retain mobile activities. That 'race to the bottom', where location and financing decisions become primarily tax driven, will mean that capital and financial flows will be distorted and it will become more difficult to achieve fair competition for real economic activities."

Furthermore, the OECD warns that tax havens make collecting taxes on "mobile activities" difficult—creating serious consequences: "If spending is not reduced to make up for this revenue loss there is a real risk that taxes on labour, consumption and non-mobile activities will need to be increased. This shift will make tax systems less equitable and, by narrowing the tax base, will introduce further distortions. By

increasing non-wage labour costs, it may also have a negative impact on employment...The potential impact of these developments is significant."

### ***Capital Flight -- the solution not the problem.***

Sounds bad, huh? Well, it is bad. Only the real problem is that the OECD is trying to kill a tried-and-true cure for the underlying problem of high taxes. Throughout recorded history, when taxes, social or religious policies or other political conditions have become onerous, freedom-loving individuals have either fought to overthrow the oppression or fled to other locations where they were not so oppressed. Like the Pilgrims who fled religious persecution in England in favor of America, the oppressed vote with their feet. This clearly is welfare enhancing for the formerly oppressed individuals, although likely welfare-reducing for the former oppressors.

**On net, it almost certainly is the case that voting with the feet enhances social welfare; otherwise the oppressors would have been willing and able to strike a bargain with the oppressed to induce them not to leave.**

Corporate raiders specialize in taking over mismanaged companies and finding better management. The raider is not the cause of the acquired company's problems; he is an entrepreneur who helps cure the underlying problem of mismanagement. Similarly, capital flight away from political mismanagement serves the same purpose. Whether the political mismanagement takes the form of direct seizure through high taxes or onerous regulation, capital flight sends an unmistakable message that individuals are oppressed. Labour flight serves the same purpose. The point is that the problem



does not originate in the country where the owners of labor and capital settle; it originates rather in the country from which the owners of labor and capital fled.

Indeed, if the discussion were focused on the large-scale movement of politically or ethnically oppressed refugees from Rwanda to Uganda or from Kosovo to Montenegro, there likely would be strong agreement within OECD. The real problems lay in Rwanda and Kosovo, not in the safe havens of Uganda or Montenegro. The seeking of a safe haven is symptomatic of underlying pathology in the home country; it is not the pathology itself.

### *The plight of the immobile.*

Not everyone who is oppressed can or will move. A variety of factors may make an individual immobile, despite political, religious, social or other oppression. The factors causing immobility include family or social reasons, not easily transferable labor skills, immobile physical capital and religious beliefs. It hardly seems efficient to preclude those who are well and able to move on the grounds that there are others (the immobile) who are unable or unwilling to do so.

Yet that is exactly what the OECD argues for: "There is no reason why taxpayers that do not or cannot take advantage of harmful tax practices should have to pay the taxes avoided by those who have easy access to tax havens and harmful preferential tax regimes." This position reflects only one possibility and one that likely misses the mark by a wide margin.

The policy dilemma is as follows:

- If the geographically immobile is able to use the power of the state to force everyone...including those that have fled...to pay taxes to fund projects valued highly only by them, then total welfare is reduced. The state and the immobile have successfully exploited the mobile.
- If, however, those left behind pay the taxes avoided by those who have fled, total welfare is increased. The mobile group is not exploited.

### *The capital flight message.*

Back to the issue of causation: the problem here is not tax havens and not mobile capital. Tax havens do not create mobile capital. Rather, mobile capital (just like mobile labor) continuously seeks a better place to live.

The real problem is high taxes and oppression. High taxes reduce the return to owners of capital and labor. The owners of both react predictably: by reducing the amount of capital and labor they supply. They do so either by converting their immobile capital to mobile capital and leaving the area entirely in favor of a location where the returns are higher, or by refusing to work (or to put their capital to work). Either way, the impact of high taxes is welfare reducing. By implication then, the impact of tax havens is unmistakably welfare enhancing. The more capital (or labor) that flees to tax havens, the stronger the message sent to the politicians that taxes are too high. This is information that political leaders need to have in order to make fully informed decisions about tax policy.

The OECD policy initiative does not promote welfare (although it claims to, of course). Rather, it is a mechanism designed to protect members of the OECD cartel.

**“If personal freedom is the basic institution of the free society,**

**then the principles of private property and freedom of contract must be the vital instruments of the free society,**

**for personal freedom cannot even be conceived outside the environment provided by property and contract rights.”**

Sylvester Petro

## *Highlights*

The Bahamas is now facing a financial crisis of great severity...a crisis with many facets and dimensions. It may start with actions taken against the banking industry of the Bahamas by the OECD starting January 1, 2001.

"Now [the acceptance of criminal behaviour] seemingly has overflowed into the international arena with the 'blacklisting' of The Bahamas. The average Bahamian should now be aware that what is accepted as everyday life has significant negative consequences that he can justifiably fear. Suddenly 1 plus 2 plus 3 may equal 6."

Unless the Bahamas maintains a comparative advantage over financial centres such as London, financial institutions will not have a rational reason to maintain or establish operations in the Bahamas. We cannot compete on the same playing field as London, New York, Toronto, Zurich, Geneva, Singapore or Hong Kong. We must have an advantage and at present those advantages are confidentiality and the lack of complex, onerous regulation. We are in danger of losing both.

On net, it almost certainly is the case that voting with the feet [capital flight] enhances social welfare...The seeking of a safe haven is symptomatic of underlying pathology in the home country; it is not the pathology itself.

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