

Responding to an “analysis of the efficacy of Tax Justice Network’s methodology in constructing a secrecy index”¹

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The Tax Justice Network has published the Financial Secrecy Index every two years since 2009. In addition to being widely covered in the international media, the index is increasingly [widely cited](#) in academic and policy research. It is used in a number of important broader indices, such as the Center for Global Development’s [Commitment to Development Index](#) and the [Basel Anti-Money Laundering Index](#) published by the International Centre for Asset Recovery. In addition, the index is used for risk analysis by a [range](#) of [private consultancies](#) and at least one [central bank](#).

TJN welcomes critical engagement on its research and policy positions: this helps sharpen our thinking and moves the conversation forwards. We welcome this latest study prepared for [Cayman Finance](#).

The author, Aaron Smallwood of U.Texas-Arlington, identifies four “major problems” with the Financial Secrecy Index (FSI). Of these, three allegations are factually inaccurate or misunderstand the FSI’s aim, while one is a general criticism that would apply to most indices. On balance, we find little substance in the critique. Nonetheless, we wish to encourage further engagement from jurisdictions such as Cayman in regard to their own ranking, or that of others, in the Financial Secrecy Index.

Criticism 1: that the FSI does not control for different variables affecting the size of the financial industry, and so may be “biased against large financial centers” (p.4).

Response: This is to misunderstand the nature and purpose of the index. Causal links between financial secrecy and financial sector size certainly make an interesting research topic, and the FSI data enables precisely such a question to be addressed through time series analysis. But this is not the purpose of the FSI, which has been designed to draw attention to the potential harm that might arise from the lack of transparency and compliance with anti-money laundering standards of economies that provide financial services to non-residents.

¹ <http://www.caymanfinances.com/wp-content/uploads/2014/08/TJNreportFinal.pdf>; 7.10.2014.

² This report has been prepared by TJN staff and partners. Please send any feedback or comments to markus@taxjustice.net.

In this respect it is undoubtedly correct to argue that huge OFCs in major OECD countries like Luxembourg, U.K., U.S.A., which are known to attract illicit flows from across the world, are likely to cause more harm to the global economy than tiny OFCs like Vanuatu. The latter may well have a higher secrecy score than the U.K., for example, but in practice its market share is miniscule compared to the U.K.'s. Dr Smallwood notes that Samoa is the most secretive jurisdiction scored, yet ranks only 76th in FSI 2013. This is because Samoa's share of the global provision of financial services to non-residents is calculated as 0.001%.

To the extent that the FSI aims to take into account not only each jurisdictions' financial secrecy, but the potential of that secrecy to affect other countries, it is perhaps fair to say that it is "biased" against large financial centres. TJN has been explicit in seeking to develop an index that can help move policy towards a level playing field, rather than to continue the bias of subjective list approaches which inevitably singled out smaller, politically less powerful jurisdictions while ignoring some of the major players. We have been explicit about this aim, and do not apologise for our success in influencing international policy discussions which have – for now at least – abandoned such lists in order to aim for inclusion of all major players in ongoing policy processes such as that on multilateral, automatic information exchange.

Under the related 'Criticism 4' below we discuss the relative emphasis on scale and secrecy; but here we might note that despite Dr Smallwood's claim that scale dominates the FSI, the correlation between scale weight and final ranking is only 0.38.

To take a more specific example, the UK, the second biggest player with nearly 20% of global scale weight, sits outside the top 20 of the FSI 2013. And the top twenty secrecy jurisdictions in the 2013 index include a mix of players with a tiny global market share (e.g. Dubai, Labuan, Mauritius), small scale OFCs (e.g. Austria, Bahrain, British Virgin Islands, Jersey, Lebanon, Panama), larger players (e.g. Cayman Islands, Germany, Hong Kong, Japan, Switzerland), and two of the three largest (Luxembourg and USA).

Criticism 2: that TJN made no attempt to determine which of the 15 Key Financial Secrecy Indicators (KFSIs) are most important.

Response: TJN has chosen to apply an equal weight to all 15 KFSIs. Other options, including a weighting process based on independent expert opinion, were considered for the 2009 index and for subsequent indices. A simple enquiry to TJN would have avoided the mistaken claim that: "*TJN has made no attempt to determine which indicators are most important*" (page 10).

Since the outset of the research in 2008, and ahead of every subsequent FSI, we have asked world experts on corruption, money laundering and tax evasion for advice on how to improve and weight each category. This widespread consultation has given rise to a range of technical improvements in the choice and design of KFSIs, but – as yet – has not produced any clear claim for differential weighting. Our decision has therefore remained to apply accepted practice in such a situation and stay with the equal weighting assumption.³

Nevertheless, TJN is keeping the issue of weighting under review, and may well adopt an alternative approach to weighting in the future; any specific proposals, including from Dr Smallwood, will be welcomed and considered on their merits.

Criticism 3: that the FSI gives rise to double counting of variables in some KFSIs.

Dr Smallwood cites two examples. First, he claims that KFSI 9, on unilateral double tax avoidance mechanisms, replicates elements of KFSI 13 on bilateral tax treaties.

However, this is based on an erroneous understanding of the complex interaction between international and national tax credit rules. KFSI 13 on the number of bilateral treaties focuses solely on the “information upon request” clause and not on double tax relief offered in the treaty.⁴ The author also mixes up double tax relief through a treaty with unilateral tax relief.⁵

The second instance of alleged double counting involves KFSI 1, on banking secrecy. The author claims we count twice a bank’s legal obligation to store certain financial transaction records for a long period of time. While there are two questions which appear similar, they are not the same. The first question addresses whether financial institutions are required to “maintain, for at least five years, all necessary records on transactions, both domestic and international”. The second question asks

³ For example, the Commitment to Development Index (CDI) from the Center for Global Development weights its indicators equally. A study by [Stapleton & Garrod](#) (*Ecological Economics* 66, 2008) assesses a survey which supported differential weights, and concludes that the CDI should not in fact diverge from equal weights.

⁴ We even explicitly include TIEAs and not only DTAs in this latter indicator, which are wholly unrelated to relief from double taxation.

⁵ To conflate the two and to suggest that both “at least partially capture a jurisdiction’s willingness to provide tax relief” (page 8) is accurate, but irrelevant to the charge of whether KFSIs count or reward a certain behaviour several times. In our view, creating a law for specific scenarios unilaterally on the one hand, and entering into bilateral treaties for specific countries on the other hand, are two separate set of actions (DTAs even have the status of law in some countries) warranting (in themselves, and notwithstanding the previously mentioned fundamental error of confusing information exchange treaties with double tax relief) separate analysis and assessments.

“whether banks are required to maintain records over time, especially of large or unusual transactions”.

There are subtle but important differences between the two questions. The first question, which draws its answers from FATF reviews, applies to data relating to all financial transactions. The second question, which emphasises ‘large or unusual transactions’ that might or might not trigger suspicious transactions reports, draws its answers from the US State Department’s INCSR. Capturing the latter data is clearly important in monitoring the effectiveness of AML processes. The former dataset is also important since it provides a source of information for fulfilling tax information exchange obligations.

We would also note that in empirical research it is widely established that a possible remedy to address potential weaknesses in particular datasets consists in diversification of the sources, as we have done by using FATF and State Department data.⁶

Criticism 4: that the FSI results are “disturbingly sensitive” to some element of the formula combining both secrecy score and scale weight (page 4).

It is correct – but also inevitable – that the relative weighting of the FSI’s two components, secrecy and scale, exerts a major influence on the final ranking. The same of course holds true for any index that combines variables into a single metric. We have sought to balance the two: page 70-72 of our [FSI-Methodology \(here\)](#) explains how the choice of the formula reflects the characteristics of the two series, in order to give both due bearing. Again, we would welcome discussion of alternative, technically valid suggestions.

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The Tax Justice Network values the growing interest in, and use of, the Financial Secrecy Index. As explained here, we do not consider the Cayman Finance critique to raise serious issues for the FSI – but we remain open to constructive discussion of possible improvements in the methodology for ranking jurisdictions according to the wider damage that their lack of transparency may cause.

With global awareness of tax justice issues and the scale of illicit financial flows continuing to grow, it is incumbent upon researchers in the field to collaborate to build the evidence base upon which policymakers can draw.

⁶ To place emphasis on record keeping obligations of banks by including questions on both, a clear 5 year obligation for record keeping, and the requirement to store information on large or unusual transactions, is not double counting.