

Out of Sight

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I have the [following article in the latest edition of the London Review of Books](#):

In his budget last month George Osborne announced that if in the future a UK company runs its internal banking arrangements through a tax haven subsidiary it will benefit from a special tax rate of just 5.75 per cent of the resulting profits. The rate is exceptionally low: the same activity undertaken in the UK is taxed at 23 per cent. It is a change that will delight corporate tax avoiders everywhere: the UK will now condone the use of tax havens in locations such as the Cayman Islands, Jersey and the Isle of Man. It is expected that by 2016 more than one sixth of corporation tax will come from such offshore activities.

No one has yet offered a definition of 'tax haven' on which we can all agree. The IMF, the OECD and the other main agencies tend to adopt the language they think acceptable to their own constituency. The term 'tax haven' is too obviously value laden, as the French equivalent, paradis fiscal, makes clear. 'Offshore', too, conjures images of island paradises, when some of the locations involved — Liechtenstein, for example — are landlocked. 'International financial centre', a creation of the financial services industry, seems designed solely to give an air of respectability. There are four primary uses for 'tax haven' locations. First, they are used by those wishing to avoid or evade their obligation to pay tax. Tax avoidance is legal, but contrary to the spirit of taxation law, while tax evasion is always illegal, involving the non-disclosure of a source of income to an authority that has a legal right to know about it.

Second, they are used to hide criminal activities from view. That criminal activity might be tax evasion itself, but might also be money-laundering or crimes generating cash that needs to be laundered — theft, fraud, corruption, insider dealing, piracy, financing of terrorism, drug trafficking, human trafficking, counterfeiting, bribery and extortion.

Third, they are used by those who want their activities to be anonymous, even if they are entirely legitimate. Some people wish to hide their wealth from their spouses, for example; others might want to conduct trade which, though legitimate, might risk their reputation.

Fourth, they are used by those seeking somewhere cheaper to do business; in these locations they can usually avoid the costly obligation to comply with regulations that would apply onshore. The need for anonymity is common to all these activities, which take place in what one might call the 'secrecy world'. Secrecy is a property right like any other. To create and protect it requires the rule of law. Governments that choose to create laws allowing it to exist must have status as international jurisdictions (though not necessarily as countries, as the British Crown Dependencies demonstrate). Since no jurisdiction willingly undermines its own laws, the secrecy so created can be used only by people residing outside its own domain. The regulations created by these 'secrecy jurisdictions' are designed to undermine the legislation or regulations of another jurisdiction. To facilitate matters, a legally backed veil of secrecy ensures that those making use of them cannot be identified as doing so.

Secrecy jurisdictions raise revenue by collecting fees from registering companies. They may also charge fees for regulating the financial services industry located in their domain, and collect tax on the personal earnings of anyone working in that industry. In some locations, such as Jersey, taxes on the profits of banks comprise a significant part of the state's revenue and the financial services industry accounts for half of GDP.

All this is possible because secrecy jurisdictions create the structures that the financial services industry sells access to. Typical among these are tax haven companies. These are extremely secretive: no information about them is made available on any public register, and very often the local tax authorities know nothing about them either. Yet even that level of secrecy tends to be insufficient for those engaged in offshore activities. The tax haven companies are almost invariably owned by trusts, which are also registered offshore and are run by the local financial services industry through specialist companies. The trusts are completely anonymous: there is no record of them on any public register; they are not taxed locally and local tax authorities know nothing about them. The person creating them is not identified in the trust documentation, which never specifies who the beneficiaries are. An offshore company owned by an offshore trust presents an almost impenetrable barrier to inquiry, equivalent to the banking secrecy offered in a country like Switzerland, not least to law enforcement agencies and tax authorities around the world — hence the reputation offshore has for assisting crime.

The bankers, lawyers and accountants who operate from these jurisdictions provide 'secrecy services' to their clients. These 'secrecy providers' may call themselves 'offshore finance centres' or 'international finance centres', but that is misleading. Secrecy is what they are selling.

The customers for secrecy services will never be found in the jurisdiction in which their provider is located. They are always located 'elsewhere' — that is, outside the secrecy jurisdiction's domain. 'Elsewhere' is, in many ways, a more appropriate term than 'offshore'. It allows secrecy jurisdictions, secrecy providers and their customers to

maintain the claim that they are conducting legitimate, well-regulated activities, because the substance of the transactions arranged by secrecy providers always takes place 'elsewhere'. Regulatory compliance within the secrecy jurisdiction is, as a result, easy to engineer, because nothing happens there, but transactions undertaken 'elsewhere' will also escape regulation in the jurisdiction where the activity is actually taking place. That of course is the intention.

Secrecy jurisdictions argue that because the transactions take place 'elsewhere', they are not taxable within the secrecy jurisdiction: such places choose not to tax transactions happening outside their domain. They then insist that declaring these transactions is the responsibility of their clients. That way the secrecy providers are able to argue that they are fully tax compliant. We might think of this domain, in which the real transactions arranged by real secrecy providers take place, as the 'secrecy space'. It is always 'elsewhere', and in that sense does not exist, but the willingness of secrecy providers, their clients, governments and authorities to behave as if it did creates the libertarian dream of an ungoverned domain for the making of unregulated profit. The truth is that multinational corporations do not really have offshore operations: they simply record some transactions in the secrecy space. George Osborne's corporation tax reforms give the clearest possible indication that the Treasury has accepted the legitimacy of the secrecy space.

Osborne's changes will inevitably result in a loss of tax revenue to the UK. Serious as that is, there will be other consequences too. The UK is actively encouraging companies to conduct transactions in the secrecy world, but who will regulate the resulting trade? Just as important, what are the implications for governance when a government and major corporations condone the use of a space that exists only as a legal fabrication? How can we even estimate, still less do anything about the associated risks?

Unaccountably, professional economists have almost entirely ignored the issue of tax havens. The few academics who have examined them argue that tax havens are beneficial. And yet, it is obvious that by denying access to information, they are an aberration in neoclassical economic theory, bound to result in the misallocation of resources in a market system. To some in the market — individuals as well as corporations — tax havens are, needless to say, of enormous benefit. Those who have access to them will, given the prices charged, be those with access to significant wealth. They reduce their effective tax rates by cloaking their tax avoidance and tax evasions in secrecy; their capital increases exponentially quicker than others' as a result; this fact is hidden from view and, therefore, does not attract comment. No wonder they continue to survive. The question is: who is paying the price?