By way of introduction...

Is there – to misquote William Shakespeare – something rotten with the state of capitalism? In the wake of the financial crisis, many people seem to think there is. According to a poll commissioned by the BBC World Service of people in 27 countries, only around one in ten believed capitalism works well. In just two of the surveyed countries did that number rise above one in five – 25% in the United States and 21% in Pakistan.

Unhappy as people were, the poll showed little appetite for throwing out capitalism altogether – fewer than one in four supported that notion. But people do want change – reform and regulation that will check capitalism's worst excesses.

That view is shared by many political leaders. In 2009, Germany's Chancellor Angela Merkel and the Netherlands' then-Prime Minister Jan Peter Balkenende argued that "it is clear that over the past few decades, as the financial system has globalised at unprecedented speed, the various systems of rules and of rules and supervision have not kept pace". In the United States, President Barack Obama declared that "we need strong rules of the road to guard against the kind of systemic risks that we've seen". In the United Kingdom, Prime Minister Gordon Brown said that "instead of a globalisation that threatens to become values-free and rules-free, we need a world of shared global rules founded on shared global values".

But what form should those rules and values take? How can we best harness capitalism's power to deliver innovation and satisfy our material needs while minimising its tendency to go off the rails from time to time. This chapter looks at some of the themes that have emerged in reform and regulation since the crisis began, focusing on three main areas:

► Regulating financial markets
► Tackling tax evasion, and
► Creating a “global standard” for ethical behaviour

Why do we need to regulate financial markets?

In ancient Rome, the judge Lucius Cassius was called on to deal with some complex cases. To get to the bottom of things, he was known for asking a simple, single question: Cui bono? Who benefits? Two millennia on, and in a different context, that’s a question that’s being asked of the global financial system.

At one level we all benefit from the financial system. Without institutions like banks, our complex modern economies couldn’t exist: They are at the heart of the payments system, they are safe places to store money, and they bridge the gap between those with money to lend and those needing a loan. Similarly, without share markets, companies would struggle to raise funds; without commodities markets, buyers would lack certainty on future prices of essential goods; without foreign exchange systems, international trade would grind to a halt.
But that's not to say we all benefit from everything financial markets do. For instance, financial markets facilitate speculation – in other words, the buying and selling of assets with the aim of turning a quick profit, rather than holding on to them as a long-term investment. In itself, that's not necessarily bad: Speculation keeps markets ticking over, providing them with much-needed liquidity. But it can have serious downsides if it artificially inflates asset prices. Once formed, such bubbles have a tendency to pop.

In recent decades, speculation has grown hugely on the back of “financial innovations”, such as the collateralised debt-obligations (CDOs) and credit-default swaps (CDSs) we encountered in Chapter 2. Proponents argue that these allow risk to be greatly diversified – in other words, investors don’t need to keep all their risks in one basket. Others are not so sure. Paul Volcker, former chairman of the Federal Reserve, the United States’ central bank, has said he can think of only one financial innovation in recent decades that has benefited society – the ATM.

Advances in technology used by financial markets have also come under scrutiny. For example, computer trading allows shares and financial derivatives to be bought and sold in just 300 microseconds – faster than the blink of an eye. Traders use such systems to take advantage of minuscule shifts in prices on markets. On a single bond or share, for instance, this might be nothing more than a decimal point followed by a string of zeroes and a one. But when it’s combined across an order worth a million or a hundred million dollars it adds up. Cui bono? Proponents say, again, that such approaches increase liquidity in markets. Others are not so sure: “It remains hard to believe that it all adds anything much to the efficiency with which the real economy generates and improves our standard of living,” the Nobel laureate Robert Solow has commented.

Some observers have spoken of a division in the financial system: On the one hand are activities that are necessary and that bring wider economic benefits; on the other is something that some critics say resembles a casino. (Although to be fair to casinos, at least risks there are evenly distributed and can be accurately calculated; that’s not true of financial markets.) Whether or not that metaphor is fair, there does appear to be little doubt that the financial system in its current form is contributing to financial insecurity: Just think of the financial meltdown and a raft of previous incidents, such as the 1997 Asian crisis and the dotcom bubble of the late 1990s. Weakened economies can’t afford another meltdown: New rules are needed.

What regulation should aim to achieve

How would a reregulated financial system look? The Financial Stability Board, an international forum for national financial authorities that was created out of a smaller grouping (the Financial Stability Forum) in the wake of the crisis, has set down what it sees as three key objectives:

**Objective 1 – Make financial systems less pro-cyclical:** As Chapter 3 explained, economies usually move in cycles – some growth followed by a slowdown and then some more growth. One way to think of these ups and downs is in terms of a child sitting quietly on a swing, swinging to and fro. But what happens if she’s the adventurous type? Chances are she’ll lean forward as the swing goes up and back as it heads down. She may not know the term, but the child is behaving “pro-cyclically” – she’s amplifying the swing’s oscillation. It’s all good fun – until she falls off.

Something similar has happened in the relationship between financial systems and the real economy. During the good times, banks became ever more willing to lend, often to people who once wouldn’t have had a chance of getting a loan. That helped fuel a bubble in property prices. But when the good times ended, the lending stopped. (As the poet Robert Frost said, “A bank is a place where they lend you an umbrella in fair weather and ask for it back when it begins to rain”). Businesses that were beginning to struggle during the slowdown suddenly faced an extra problem: They couldn’t borrow money. That only increased the risk of failure, so adding to the general economic malaise. Just like the little girl pushing the swing forwards and backwards, the financial system can deepen the natural ups and downs of the economy. As a result, the falls are harder than they might otherwise be.

Revised regulations will aim to dampen this effect. For example, they could work to make it harder for banks to lend in the good times but easier in the tough times. This could be done by
changing banks’ capital requirements. As Chapter 2 explained, in simple terms the amount a bank can lend is restricted by how much capital it has – a bank with a bigger capital buffer can lend more, one with a smaller buffer can lend less. New rules might require banks to build up buffers during an economic upturn, but allow them to fall back to a minimum level when the economy cools.

Objective 2 – Restrict leverage: Leverage, which essentially means borrowing to invest, derives its name from one of the great human discoveries – the lever. To understand how it works, we need to go back to the playground. After the little girl has finished swinging, she runs over to a seesaw (a lever) and sits on one end. Her dad goes to the other end. With just a light push on his end of the seesaw, his little girl at the other end rises effortlessly. That’s the power of leverage – a small effort can give a big result. The idea is the same in economics – you borrow a little money (or a lot) and invest it so smartly that the return easily covers the cost of the original loan and provides you with a handsome bonus.

How does leverage work?

In financial markets, the term “leverage” is used in a couple of different ways. Still, in basic terms leverage always exposes investors to greater risk. “If the bet goes right, the returns are huge; if it goes wrong, the losses are big too,” as the journalist Gillian Tett has written.

Leverage doesn’t operate only in the rarefied world of high finance. Ordinary people use it, too. Imagine two friends, cautious Claire and leveraged Leo. Claire has just inherited $100 000 in her granny’s will, and decides to buy a house for just that amount (as she’s borrowing nothing, her leverage ratio is 0). Leo, not wanting to be left behind, decides he’ll buy the neighbouring house, but he has savings – or capital – of just $10 000. He goes to his bank, explains the situation, and is delighted when they offer him a $90 000 mortgage at an annual interest rate of 5% (giving him a leverage ratio of around 9 to 1).

A year goes by, the property market has boomed, and the two friends decide to cash in on their houses, each now selling for $130 000. On her initial investment of $100 000, Claire has earned an extra $30 000 – a nice bonus of 30%. What about Leo? Out of his $130 000, he has to pay back his $90 000 loan to his bank plus $4 500 to cover a year’s interest payments. Once that’s done, he’s left with $25 500 (plus the $10 000 he started with) – a whopping bonus of 255%.

But what happens if prices fall? Imagine after a year that the houses are selling for only $70 000. The two friends decide to get out of the market as quickly as possible rather than risking further losses. Against her initial investment of $100 000, cautious Claire now has $70 000; in other words, 70% of her capital remains intact. For leveraged Leo, things are much, much worse. At the end of the year, he owes his bank $94 500 for its loan and the interest on it. Selling the house for only $70 000 means he’s still $24 500 short of what he needs, plus he’s wiped out his initial capital. In effect, he’s bankrupt.

In good times, leverage can be a powerful way to build wealth. But when the economy turns, it can wipe out capital and create huge debts. And that’s what happened to the banks during the financial crisis. For years, they found ways to increase their leverage and invested in complex instruments like mortgage-backed securities. The use of offshore subsidiaries and complex transactions meant this build up of leverage was often not clear on banks’ balance sheets. That meant the scale of banks’ risk-taking wasn’t understood by regulators and investors – and, sometimes, even by bank directors. As mortgage foreclosures spread in the United States and elsewhere, banks’ investments became increasingly questionable. That was bad, but the situation was exacerbated by the scale of their leverage.

Managing risk

That’s why banks’ leverage ratios need to be targeted in new financial regulation. But there also needs to be an intense focus on why banks allowed themselves to build up such huge risks in the first place.
and, more generally, how they manage risk. In theory, banks have all the tools – such as highly complex mathematical models – they needed to do this. In practice, risk management failed. To some extent this was a technical issue – those computer models may have been complex but they weren’t always right. But it was also a human issue. Examples of this are myriad. In many banks, risk managers didn’t – and still don’t – enjoy nearly the same status as high-flying traders, so they were easily overshadowed, ignored and sometimes co-opted by better-paid trading teams keen on pushing the risk envelope. Executive pay was also a factor (see box).

“Testimony by the ex-head of risk at the British bank HBOS ... gives a picture of a bank management with little regard or care for risk management as it pursued its headlong rush into expanding its mortgage business.”

Grant Kirkpatrick, OECD Journal: Financial Market Trends

There were also very serious failures of corporate governance. Directors did not always receive realistic risk assessments, or were not informed of strategic decisions taken by managers regarding risk exposure. Even when they did receive the relevant information, they didn't always understand it. That’s worrying, but it’s also not surprising: Modern financial markets are hugely complex, and there’s a real shortage of people who can fully get to grips with them, not just at the board level but also at the management level. There were also failures to heed warnings. For instance, directors of the failed Northern Rock bank in the United Kingdom admitted reading official reports in early 2007 warning of liquidity risks (in simple terms, this is where a bank doesn’t have the funds to meet immediate demands), but did nothing about them.

Revised regulation will need to impose stricter standards of corporate governance, but that can only go so far. There will also be need to be a real sea change in attitudes and an acceptance by directors both of the seriousness of their task and of their responsibilities to shareholders, creditors and wider society. The former CEO of Unilever, Niall Fitzgerald, who has also served as a bank director, sees the challenge facing directors before the crisis – as well as today – in this way: “The question you have to ask yourselves is: did you know what the institution was doing and the full consequences of what it was doing? Because, if you did, you were complicit with the recklessness. Or if the answer is you didn’t know, then you cannot have been discharging your responsibility as a director of the company properly.”

Objective 3 – Penalise mistakes: It’s one of the ironies of the financial crisis that an era in which banks and financial institutions enjoyed ever greater freedom to regulate themselves ended in massive state intervention. To outsiders looking in, it can seem that financial institutions were happy to push the state away as long as they were making money, but once things turned sour they came running back for help. That hasn’t come cheap for taxpayers: According to OECD estimates, governments have made commitments of over $11 trillion to support troubled banks and financial institutions (note, this represents commitments to cover worst-case scenarios, not actual spending).

Many observers believe this rescue not a one-off result of the recent financial crisis, but rather part of a long-term trend. After centuries in which the banks came to the aid of the state, “for the past two centuries, the tables have progressively turned. The state has instead become the last-resort financier of the banks,” according to a paper co-authored by the Bank of England’s Andrew Haldane. Even though states have repeatedly said “never again,” his paper says that risks from allowing widespread bank defaults is so great that “such a statement lacks credibility. Knowing this, the rational response by market participants is to double their bets. This adds to the cost of future crises. And the larger these costs, the lower the credibility of ‘never again’ announcements. This is a doom loop.”

Nouriel Roubini, a high-profile economics professor and consultant, and others have described this as “a system where profits are privatized and ... losses socialized” – in other words, in the good times bankers get to keep their winnings, in the bad times taxpayers pick up the tab. Clearly, such a situation raises serious questions of social equity and justice. But even aside from these, the crisis has underlined the role of what’s called “moral hazard” – in other words, unless people pay the price of their mistakes there’s no incentive for them not to go on making those mistakes.
Are bankers overpaid?

When the chief executive of Royal Bank of Scotland, Stephen Hester, appeared before a parliamentary committee in London in early 2010, he had an embarrassing admission to make about his pay package (worth potentially about $15 million over three years): “If you ask my mother and father about my pay they’d say it was too high …”.

The compensation paid to bankers is one of the great running sores of the financial crisis. There’s no doubt that it can be eye-popping – think of the estimated $100 million given to Charles Prince when he quit Citibank or the estimated $161 million for Stan O’Neal when he stepped down from Merrill Lynch. But what’s more relevant in terms of financial regulation is not the absolute size of pay packages but how they’re structured and how that shapes employees’ behaviour.

Typically, fixed salary forms only a small part of a financial high-flyer’s compensation; for examples, studies suggest that in 2006 it accounted for only about a quarter of CEO income in European banks and as little as 6% in the U.S. The rest usually comes in performance-based cash bonuses, stocks and stock options (which give the holder the right to buy shares in the future at a specified price).

How can these shape behaviour? Take bonuses. Typically, these are based on how well a bank has been doing over the past six or 12 months. As a result, they may encourage bankers to worry more about short-term profits than long-term stability. They can also encourage greater risk-taking. Think of a trader whose bonus is based on the profits he generates from his trades: There’s no limit to the top end of his bonus, while the bottom end is limited to zero, in other words no bonus and no deduction from his baseline salary. The bigger the profit he makes the bigger the bonus, but the penalty for a loss – no matter how big it is – remains at zero (although he may well lose his job). In this case, the trader wins if his gambles succeed, but it’s the bank and its shareholders who pay if he racks up losses.

A number of approaches to remaking executive compensation have been proposed. The details vary, but several ideas recur. For example, compensation shouldn’t encourage employees to take risks that exceed the bank’s overall risk appetite. It should also work in a way that lines up employees’ interests with the longer-term concerns of shareholders. It should reflect the wider performance of the business, not just the individual’s. And it should never reward employees in the short term for risks that may only play themselves out over the long term.

One problem for governments is that banks have become increasingly vulnerable to failure but allowing them to collapse has become increasingly dangerous. As we’ve seen, in recent decades many banks have effectively become two businesses in one: a “traditional” bank, taking in deposits and offering loans; and a much more risk-prone investment bank, dealing in securities. In many cases, such banks are now regarded as “too big to fail”. This is not really a reflection on their size but more on their nature, and the risk that their collapse could lead to a systemic failure in the banking system (some people prefer their term “too complex to fail”).

“A bank ‘too big to fail’ might be defined as referring to a bank that has grown in a manner that its failure would have systemic implications”.


This risk exists for two main reasons. Firstly, banks generally rely on fairly small amounts of capital. For traditional banks this is usually tolerable; even during a downturn they can usually cover their losses (and if not, depositors are insured up to significant amounts in most countries, so a bank failure should not threaten the financial system as a whole). But, as we saw in the previous section, for investment-style banks leveraging can greatly amplify losses. When these two different types of banks live under the same roof, losses on the investment side can threaten the traditional side.
Secondly, trading in securities and derivatives typically enmeshes an investment bank in a vast web of obligations with other financial entities – banks, insurers, hedge funds and so on. Just as happened during the financial crisis, the failure of any one of these can send a chill throughout the entire system.

**Let banks fail**

If financial regulation is to become more effective, it needs to reduce moral hazard. In other words, banks and other financial institutions need to be allowed to fail – but without bringing down the entire banking system. A number of approaches have been proposed that might allow that to happen. For instance, systemically important banks might be required to produce a “living will” that would set out how they could be safely dismantled in the event of failure. Proponents argue this would force banks to clarify their legal structures and separate out their various activities. Another approach would involve legislation along the lines of the 1933 Glass-Steagall Act in the United States, which in effect created two classes of banks, commercial and investment. Its repeal in 1999 is seen by many as a contributing factor in the run up to the financial crisis.

A proposal from the OECD calls for the operations of individual banks to be grouped under what’s called a “non-operating holding company”. This parent company would be able to raise capital in the stock market and invest it – transparently – in the bank’s affiliates, which would be separate entities in legal terms. Because they would all be part of the same group, the affiliates could cut costs by sharing in areas like computing, technology systems and backroom operations. But their separateness would insulate each affiliate from a failure in the group. In the event of a crisis, the parent wouldn’t be allowed to shift capital from one affiliate to the other – for instance from its commercial banking arm to its investment arm. If the investment arm failed, it could die without bringing down the entire bank. Such failures should become rarer in such a system, however. Separating out the bank’s various capital pools means investors would know the real financial strength of each affiliate, and could thus make a more accurate risk assessment.

**What’s happening in banking regulation?**

Around the world governments are pursuing various approaches to bank regulation: New and proposed rules and guidelines have come also from intergovernmental organisations such as the Bank for International Settlements, the Financial Stability Board and the OECD, which has produced a framework for financial regulation. There isn’t the space here to explore all these in detail, but a few general themes have emerged:

► Improve transparency: Banks’ exposure to risk (both on and off their balance sheets) should be made much clearer, as should their relationship to offshore and special-purpose entities.
► Increase surveillance: Central banks and other regulators should improve oversight of banks and financial institutions, and develop better early warning systems.
► Revise capital and liquidity rules: Banks should have a stronger capital base, and should have greater reserves of liquidity – i.e. resources that can be called on to meet short-term financing needs.
► Strengthen risk management and corporate governance: Risk managers should be given more responsibilities and greater influence over management. Directors should be knowledgeable independent and should, as one OECD report suggests, maintain a “‘healthy scepticism’ in their assessment of the bank’s strategies, policies and processes”.
► Fix executive pay: Bankers’ compensation should encourage them to favour long-term growth and stability over riskier short-term profits.
► End “too big to fail”: Banks or parts of banks that fail need to be able to go out of business without damaging the entire financial system.
This list just scratches the surface of what is being done and what needs to be done. For instance, it doesn’t include proposals for a central “clearing house” for trades in derivative financial products, such as credit-default swaps, which would aim to increase transparency. Nor does it deal with how consumers could be protected in the financial maze – are specialised agencies needed, for example, and could improved financial education help people to better understand the risks and benefits of investments such as mortgages?

There’s also a very important international element to financial regulation: After all, the biggest banks today are, almost by definition, global banks. This poses special challenges for national regulation, and underlines the usefulness of an international approach that’s consistent and comprehensive. This would reduce the possibility of banks exploiting quirks and loopholes in national regulations to gain advantage. But it should also lead them to concentrate more resources on core business like deposit-taking and lending and to develop effective approaches to risk management and corporate governance.

**What’s being done to tackle tax evasion?**

Mention tax havens and you may well think of some sunny island where taxes are non-existent and most companies are just a brass plate in a lawyer’s office. Or, as The Economist puts it – with tongue only slightly in cheek – “a country or designated zone that has low or no taxes, or highly secretive banks, and often a warm climate and sandy beaches, which make it attractive to foreigners bent on tax avoidance or even tax evasion.”

Whether these places will remain quite so “attractive” in the future is unclear. One of the side-effects of the crisis has been a fresh determination by governments to call time on tax evasion. At the G20 meeting in London in April 2009, leaders pledged “to take action against non-cooperative jurisdictions, including tax havens,” and declared that “the era of banking secrecy is over”.

In some ways this new willingness might seem surprising: While the role of tax havens in causing the crisis remains a matter for debate, their existence did at least facilitate banks’ reckless appetite for risk. Equally, the existence of tax havens, and the problems they create, have been well known for many years: As far back as 1998, the OECD set out a definition of the characteristics of tax havens, and followed this two years later with a list of jurisdictions it judged fitted that bill.

But in recent years, a number of things have happened to make the position of tax havens increasingly untenable. In early 2008, police in Germany used data taken from a bank in Lichtenstein to investigate wealthy Germans suspected of using bank accounts in the tiny European principality to evade taxes. Chancellor Angela Merkel described the scale of the tax evasion as “beyond what I could have imagined”. The following year, the United States Justice Department secured an agreement with the Swiss bank UBS to turn over the names of around 250 of its clients suspected of failing to pay U.S. taxes.

Incidents such as these highlighted the need for tax jurisdictions to be able to request information from each other in order to ensure taxes are paid. In the wake of the crisis, this has become an even bigger issue. Governments in many countries have run up big debts while trying to keep financial markets and the wider economy afloat. At the same time, declining economic activity has been eating into their tax take: Falling demand means lower profits for companies, and thus lower corporate taxes, while rising unemployment means fewer workers to pay income taxes. That’s another reason why governments are increasingly determined to ensure that the taxes they are owed are paid in full.
At a time when governments around the world need tax revenues to address the global economic crisis, countering international tax evasion is more important than ever.

What are tax havens?

So, what exactly is a tax haven? For a historical perspective, it’s interesting to look at the 1998 definition from the OECD, which set out four defining characteristics:

- No, or very low, taxes on income: In other words, income that would typically be taxed in most places – such as salaries, profits or earnings from rents – is not taxed or barely taxed.
- Insufficient exchange of information: Authorities in other jurisdictions are unable to find out if their own citizens are stashing money in the haven.
- Lack of transparency: Are tax rules and information clear and accessible to all.
- No substantial activities: A company or individual has a legal – but not a real – presence. For example, a sneaker manufacturer may be registered in the haven, but it’s not making or distributing its sneakers from there.

Today, to a very large extent, just two of those factors – exchange of information and transparency – have come to be seen as the real issue with tax havens and, indeed, with tax jurisdictions generally. This might seem surprising considering the popular association between tax havens and low taxes. However, it’s important to understand that the basic concern for the international community with tax havens is less how they treat their own taxpayers and more how they relate to other tax jurisdictions.

What is a “tax jurisdiction”?

Tax rules vary between countries, but they can vary also within countries. In many cases, a geographical region or zone that has separate tax arrangements, or control over them (even if it’s not itself a separate country), can be regarded as a distinct tax jurisdiction.

So, if a tax haven levies no or low taxes on its own taxpayers, that’s pretty much its own business, as long as it treats locals and foreigners similarly. But if a haven admits funds from taxpayers in another jurisdiction, and then refuses to respond to requests for information about those funds, then it becomes everyone’s business.

And everyone really does mean everyone: Much of the work that governments do – from building roads to providing healthcare – is paid for by taxpayers. When individuals and businesses are able to evade paying the taxes they are legally required to pay, it means higher tax bills for everyone else. In poorer countries, the cost of tax evasion is even starker, and can be measured in terms of lack of development and lost lives. According to estimates, developing countries lose to tax havens three times what they get in aid from developed countries. “If taxes on assets hidden by tax dodgers were collected in their owners’ jurisdictions,” says OECD Secretary-General Angel Gurría, “billions of dollars could become available for financing development.”

What has changed?

G20 leaders have said they’re determined to act on tax evasion, but what’s changed in reality? Perhaps the biggest change is the number of tax jurisdictions who are now making and implementing commitments to exchange information with other jurisdictions. Much of this has happened through the OECD Global Forum on Transparency and Exchange of Information, a body linked to the OECD but with a much broader membership – almost 90 jurisdictions (as of late 2009), including pretty much all the world’s major financial centres.
What does exchange of information involve? Crucially, tax jurisdictions must ensure they collect reliable and relevant information, and make it available when asked to. They also cannot invoke their own bank secrecy laws or domestic tax interests as a defence for turning down such requests.

What it doesn’t involve is automatic release of information. Some critics have suggested it should, but such an approach has real problems: For one thing, it would generate huge amounts of data, which many tax jurisdictions would struggle to manage. Also, it would raise questions over privacy. Despite their bad press, tax havens are used legitimately and legally by many businesses and individuals. For example, trust funds may be based in a zero-tax jurisdiction in order to simplify tax arrangements for family members living all over the world. As long as no laws are broken, beneficiaries of such funds will argue that they have a reasonable right to keep their financial affairs private. Indeed, taxpayers’ rights, including the right to confidentiality, form part of the rules covering exchange of information. Jurisdictions seeking information also won’t be able to launch “fishing expeditions” – demanding huge swathes of information in the hope that some of it might be useful – but will only be able to request information that’s “foreseeably relevant”.

To be a member of the Global Forum, jurisdictions must commit to internationally agreed tax standards, which include activities like exchange of information, and to “peer review”, a process that begins in 2010 and that requires tax jurisdictions to open themselves up to inspection by other jurisdictions. Failure to pass the test could potentially leave them open to sanctions from other governments (neither the Global Forum nor the OECD has the authority to impose penalties).

Black, white and grey …

Throughout 2009, there was much talk in the media of OECD tax “blacklists,” “greylists” and even “whitelists”. While never formally endorsed, these terms did reflect a process that was going on whereby the OECD issued “progress reports” naming tax jurisdictions that were seen as not having made sufficient commitments to the necessary standards. The process is complicated, but in simple terms a test was set that required jurisdictions to show their commitment to the international agreement on exchanging tax information by agreeing a minimum number of exchange-of-information agreements with other jurisdictions. There has been some criticism of this process, with allegations that some tax havens are accumulating the required number of agreements by simply signing deals with other havens. However, it’s important to note this is only the first stage of the process – processes such as peer review will now become a real test of whether tax jurisdictions are living up to their commitments.

But the threat of sanctions is likely to be outweighed by the sheer momentum for reform that has built up over the past few years, says Andrew Auerbach, an OECD tax expert. “It used to be that transparency was seen as a competitive disadvantage,” he says. “Now it’s seen as an advantage. Jurisdictions want to be seen to – and to actually adhere to – the standards because competitively it’s seen as disastrous not to. Because the G20 is focusing on this and wants actions, businesses and individuals are saying, ‘You know, if I’m in that place that’s not adhering to the standards, I’m just asking for trouble’.”

Can we agree global ethical standards?

The crisis has thrown up many questions, not the least of which concerns the “values” of the global economy. “In our view,” Angela Merkel and Jan Peter Balkenende wrote in 2009, “it is […] indispensable that market forces are not only checked through regulations and oversight, but also by a robust global framework of common values that sets clear limits to excessive and irresponsible action.”

Chancellor Merkel’s stance on these issues is worth noting: She has been a determined advocate of a “Global Charter for Sustainable Economic Activity” – an idea aimed at promoting a better balance
between market forces and the societies they serve, so ensuring a “stable, socially balanced and sustainable development of the global economy”.

The proposed Charter would cover a wide range of issues, including economic stability, employment and social policies, and the environment. The aim would be to build an international consensus behind “a collection of overarching principles linking economic liberty with accountability and responsibility as the basic cornerstones of economic activity.” These ideas have also been echoed by the G20, which in September 2009 adopted “Core Values for Sustainable Economic Activity” including “those of propriety, integrity, and transparency”.

The Lecce Framework

The final shape of any Global Charter remains to be seen, but it’s likely to include a number of different strands. One of these may be the so-called “Lecce Framework,” a set of guidelines and frameworks drawing on existing agreements created by bodies like the OECD. These sort of agreements are often referred to as “soft law,” which means they don’t carry fixed sanctions, such as fines and penalties, but are instead “policed” by processes such as peer review, where governments examine each other’s performance in specific areas. In some cases, soft law can become “hard,” such as when a country uses international guidelines as the basis for creating binding legislation or regulations.

What does soft law cover? As well as tax evasion, which was discussed in the previous section, here are a couple of examples of areas that some OECD guidelines and agreements address:

Bribery and corruption: Few forces are more corrosive in societies and economies than bribery and corruption. They destroy people’s trust in leaders, distort competition and push resources into the wrong areas – for instance, corrupt officials may favour big-ticket projects like dams and power stations, which offer a greater potential for kickbacks, rather than more useful projects like schools and hospitals.

A number of international agreements seek to tackle these issues, including the United Nations Convention against Corruption and the OECD Anti-Bribery Convention. Some OECD soft laws have gone on to become hard law – for example, a recommendation in the mid-1990s that bribes paid to foreign officials should not be tax-deductible is now embedded in the tax laws of many countries.

Business behaviour: As we saw earlier in this chapter, the crisis helped expose some serious shortcomings in corporate governance, with procedures often failing to safeguard against excessive risk taking in financial companies.

“When they were put to a test, corporate governance routines did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies…”

Grant Kirkpatrick, Financial Market Trends (2009)

To work effectively, corporate governance needs to deal both the rights and the responsibilities of a company’s management, its board, shareholders, employees, clients and others. Structures, responsibilities and procedures need to be clearly set out, and information needs to disclosed in a way that’s timely, accurate and transparent. These issues are addressed in a number of OECD agreements, including the OECD Principles of Corporate Governance and the OECD Guidelines for Multinational Enterprises.

Building bricks

Revised versions of such agreements may well form the “bricks” of the more overarching approach championed by Chancellor Merkel and other leaders. Just as the crisis revealed failures in how banks and businesses operate, it also highlighted areas in regulation – from legally binding rules to soft law – that need to be updated. That process will form a key task in designing a Lecce Framework.
That's likely to be a challenging process. Quite simply, governments don’t always see eye to eye on how best to regulate the global economy, whether through binding laws or soft law. Anglophone countries, such as the United States and United Kingdom, have tended to favour a lighter regulatory hand; continental European countries, such as Germany and France, have often leaned towards a more hands-on approach. Equally, some countries are uncomfortable with the idea of subjecting lucrative industries like financial services to international regulations that they fear could limit their ability to compete globally.

**Carrots or sticks?**

There is also the question of whether frameworks and guidelines that are not accompanied by real sanctions have sufficient “teeth” to be effective. Individual countries tend to regard national sovereignty as paramount in most areas, so governments are usually slow to sign up to legally binding agreements. The result, as we’ve seen, is that global governance often takes the form of soft law.

Such approaches have benefits and drawbacks. On the one hand, where there are no real sanctions, especially on businesses, there may be a risk that global standards exist in name only. “Most [intergovernmental organisations] are designed to discipline signatory governments by moral suasion or in some cases, sanctions, but not corporations which remain completely unregulated at the global level,” Kimon Valaskakis, a former Canadian ambassador to the OECD and president of the New School of Athens, has argued. “As a result, the ‘guidelines’ and ‘frameworks’ end up having the same status as New Year Resolutions, such as quitting smoking or losing weight. Most of them are just not kept.”

On the other hand, as OECD Secretary-General Angel Gurría has pointed out, processes without sanctions “are easier to join. People don’t need to dot every ‘I’ and cross every ‘T’ if they aren’t worried about getting whacked by sanctions.” Clearly, the more governments and businesses that sign up to international agreements, the greater the potential for setting global standards.

Sanctions – the “stick” in the carrot and stick – are also not the only way to change behaviour. Incentives can be effective, too: For example, countries that sign up to non-binding international agreements may receive more favourable treatment in areas like trade and investment from other signatories. At the corporate level, too, incentives – “carrots” – can play an important role in shaping behaviour. For instance, tax systems can make it more attractive for managers to receive bonuses in the form of long-term stock holdings rather than in cash, which may steer them towards seeking long-term profitability rather than quick returns.

**Questioning the future**

The crisis has revealed shortcomings in our understanding of the global economy. That’s why there’s been so much talk about the need for new rules and regulations. But, in its own way, the crisis has also helped to change the global economy, adding hugely to many countries’ national debt, for instance. In some ways, nothing will ever be quite the same again. So what will be the long-term impact of the crisis? In the next, and last, chapter of this book, we look at some of the ways in which the crisis will continue to shape the global economy and how we think about it.

**References**


The views expressed in this draft chapter are those of the author and do not necessarily reflect the views of the OECD or its member countries.


