

**SMALL STATES AND THE CHALLENGE OF
SOVEREIGNTY: COMMONWEALTH CARIBBEAN
OFFSHORE FINANCIAL CENTERS AND TAX
COMPETITION**

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ABSTRACT

The dynamics of inter-state relations and state sovereignty have been disturbed by late-20th century globalisation. Yet the literature on the international system, globalisation and international political economy gives scant attention to the most vulnerable sovereign entities, the small and micro states. One significant exception has been the Commonwealth, with its many small state members. Another is the area of financial crime, and the role of the offshore financial centre (OFC) within global finance. This thesis analyses the efforts of several small Commonwealth states from the Caribbean to maintain their OFCs in the face of an OECD-directed campaign against tax competition. It demonstrates both the contribution made to economic development by an OFC and the successful assertion of sovereignty achieved by these small states.

The case study focuses on Caribbean OFCs and the OECD campaign against harmful tax competition during 1998 - 2003. First, the argument that tax competition is a global problem is deconstructed. Three main points from the small states' response to the OECD position are explored, along with the OECD's rebuttal. Because the small states are individually at a disadvantage, the thesis provides an exposition of the collective response facilitated by the Commonwealth. The OFC is justified by its material contribution to the small state economy. Specific contributions made to the economies of the Bahamas, Dominica, St. Vincent and the Grenadines and the Cayman Islands are demonstrated. The pivotal impact of U.S. policy on the OECD project and on Caribbean OFCs is explored. Yet while one effect was a decline in the number of registered offshore firms, the quantity of capital transiting the Caribbean increased. This study of small states and offshore finance re-affirms the continued relevance of the sovereign state as an actor in international society, but also illustrates the importance of issue-area and geographical context.

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No man is an island, entire of itself; every man is a piece of the continent, a part of the main.

–John Donne, *Devotions upon Emergent Occasions*,
no. 17 (1624)

This is the point when the author demonstrates the universal truth to those lines. At the start of a project of this size one doesn't think much about the time and effort that is contributed to it by one's family, friends, acquaintances and even strangers. By the time that you reach the end, and are staring at a bound copy of all your efforts, you realise just how valuable the encouragement, support, and spine-stiffing 'you can't quit now' words have been to help you reach the finish line. Along the way many folks provided assistance, in all manners great and small.

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In the end, however, I alone remain responsible for the contents of this thesis and for any errors or mis-statements than may remain buried within.

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Acronyms

ACP	Africa-Caribbean-Pacific
CAP	Common Agricultural Policy
CARICOM	Caribbean Community
CFTAF	Caribbean Financial Action Task Force
CHOGM	Commonwealth Heads of Government Meeting
CMGSS	Commonwealth Ministerial Group on Small States
ECCB	Eastern Caribbean Central Bank
ECCU	Eastern Caribbean Currency Union
EPZ	Export processing zone
EU	European Union
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FTAA	Free Trade Agreement of the Americas
GATS	General Agreement on Trade In Services
GATT	General Agreement on Tariffs and Trade
GNI	Gross National Income
GNP	Gross National Product
HTCI	Harmful Tax Competition Initiative
IBC	International Business Company
IBF	International Banking Facility
IFI	International Financial Institution
IMF	International Monetary Fund
IRS	Internal Revenue Service
ITIO	International Tax and Investment Organisation
LDC	Less Developed Country
LLDC	Lesser Less Developed Country
MERCOSUR	Mercado Común del Sur (Common Market of the South)
MNC	Multinational Corporation
NAM	Non-Aligned Movement
NATO	North Atlantic Treaty Organization
NGO	Non-Governmental Organisation
OECD	Organisation for Economic Co-operation and Development
OECS	Organisation of Eastern Caribbean States
OED	Oxford English Dictionary
OFC	Offshore Financial Institution
PPP	Purchasing Power Parity
SIEDS	Small Island and Enclave Developing States
UN	United Nations
UNCLOS	United Nations Convention on the Law of the Sea
USA PATRIOT Act	Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001
WTO	World Trade Organisation

SOVEREIGNTY, SIZE AND MONEY

One lesson seems clear: that the difficulty of damming money flows in separate countries will require cooperation, achieved with intermittent gains and setbacks, in surveillance of money and capital markets when disturbed, and ultimately in the coordination of monetary and fiscal policies.

– Charles Kindleberger¹

In the closing decade of the twentieth century the end of the Cold War brought with it a flowering of multilateralism that seemed to flourish in a zeitgeist of globalisation.² State interactions were no longer framed in terms of an East-West conflict and consequently, it seemed as if this change opened up a freedom of action on the part of all states, not simply those with significant military or economic power. Freed from the confines of this ideological conflict, the impression developed that every voice would be heard, and every issue discussed, with equal treatment for all in a renewed drive towards the collective benefit of humanity.

As the global community adjusted to the absence of Cold War rivalry, it became increasingly apparent that while it was a new day the same old song continued to play. Only now, it was more often economic power that dominated inter-state relations, rather than military power. The problem remained that small states generally lack economic power as much as they lack military power. Within this global situation resides the research question considered here—how have small states been able to maintain a sense of

¹ Charles P. Kindleberger, *International Capital Movements* (Cambridge: Cambridge University Press, 1987), p. 87.

² A theme that may be found for example in a speech by Madeleine K. Albright, U.S. Ambassador to the United Nations, to the Council on Foreign Relations in Washington, D.C. in January 1995. Madeleine K. Albright, 'The United States and the United Nations: Confrontation or Consensus?' *U.S. Department of State Dispatch* 6, no. 6 (1995). For an analysis of 'globalisation' as the zeitgeist of the 1990s, see Justin Rosenberg, 'Globalization Theory: A Post Mortem', *International Politics* 42, no. 1 (2005).

sovereign independence when confronted by pressures to change that originates from their larger peers? Of particular interest is the variety of ways in which the influences of large states operate behind the guise of multilateral initiatives. These initiatives are often represented to the public under a rubric claiming that, if they succeed, they will create a harmonious environment for the betterment of humanity through multilateral co-operation and by providing global public goods.

Against a backdrop painted with images depicting globalisation debates, a retreating state, and humanitarian interventions, this thesis argues a case for the continued relevance of state sovereignty in an international society of states. Indeed, not only does sovereignty remain relevant, but it may also be that its most jealous guardians are the smallest of states. Whatever the argument made about the decline and evisceration of state sovereignty, the fact remains that the world is composed of states which constrain and construct the lives of those existing within their borders, both actual persons and corporate persons. The essential concern behind the case study analysed below was recognised by Charles Kindleberger twenty years ago—regulatory arbitrage permitted by state sovereignty permits opportunities for some that are detrimental to the welfare of others.

[T]here should be some harmonization of various national laws, making differences in legal approaches unimportant as incentives for movement of capital. Such harmonization is difficult to achieve in a world of sovereign states. It involves ganging up on the Luxembourgs, Liechtensteins, Bahamas and the like to undermine their advantage as tax havens emanating from the sovereign right to set levels of taxation and to protect business dealing within the jurisdiction with laws ensuring secrecy.³

As will be seen, this problem maps on to both the North-South axis of disagreement and a trans-Atlantic axis of disagreement, due in part to differing perceptions of sovereignty, and in particular taxation as an element of *fiscal* sovereignty.

³ Kindleberger, *International Capital Movements*, p. 73.

The argument presented here involves small states and their participation in the international society at the beginning of the twenty-first century. The elements of this account of small state sovereignty are the Organisation for Economic Co-operation and Development (OECD), taxation, and offshore financial centres (OFCs). In using the OECD initiative to eliminate harmful tax competition as a case study, the focus is not on tax competition or the political economy of taxation. Naturally, these matters must be discussed in order to understand the background and premises behind the disagreement that developed between the OECD and a number of small states. Nevertheless, the main point of interest here rests on an effort to overturn the domestic decisions made by sovereign states for their economic development. The changes demanded by the OECD affect decisions that specifically encompass the domestic issue areas of taxation and financial (banking) legislation. This case study is treated therefore as an instance of international intervention, of a peaceful but coercive crusade to impose change within state regulation of finance. Individually and collectively, the small states hosting offshore financial centres have responded to this intervention, as they strive to maintain their sense of sovereign independence while pursuing economic development for the general welfare of their residents.

The justification for this act of international intervention is found in a domestic problem for OECD states involving the collection of taxes due from their own recalcitrant residents. Fiscal sovereignty, as one facet of state sovereignty, anticipates that not only is a society free to choose its preferences about taxation (what to tax, how much tax to apply, etc.), but that it possesses the capability to collect these taxes from the members of that society. Increasing economic links between different tax jurisdictions exacerbate a problem that tax administrations have struggled with since their earliest days—the avoidance and evasion of paying taxes. Consequently, the issue of taxation is considered in sufficient detail in order to understand the domestic motivation that propels an OECD effort to end

a situation that it has characterised as ‘harmful tax competition’. This presentation will include not only the prevalence of competition for revenue amongst tax-collecting jurisdictions, but also the more fundamental question about the right of a state to impose tax.

By way of introduction to the subject, this chapter has been structured so as first to present the context and scope for this research. This is followed by a brief discussion about the emergence of offshore financial centres as a component of the global financial system. The third section introduces several fundamental questions of taxation and the chapter closes with a description of the remainder of the thesis.

What does size have to do with it?

Small states exist on the margins of international relations research in a fashion reflecting the very nature and structure of international society itself. This may be because they are not as ‘sexy’ as powerful states and imperial powers as a research topic. On the other hand, it may result from the fact they lack an indigenous research establishment of sufficient size to aggressively promote a research agenda focused on the interests and issues of the small state. Very often small states are presented as existing on the periphery of the major powers – either as the victims of political action, or as suppliers and consumers of the goods and services produced by major states. This is certainly the situation within much of the research that includes the small states of the Caribbean.

World events in the closing decade of the twentieth century opened different opportunities for the economic potential of the small state to be realised. Whether we identify present circumstances as interdependence (1970s terminology) or globalisation (1990s terminology) the redistribution of production that is facilitated by technology (telecommunications), transportation (containerisation) and labour cost differentials (that may now be extensively utilised by the first two factors) provides a space in the global

economy in which a small state with limited capabilities/capacities may still prosper. The significant point to emphasise is that it is *global*, that opportunity exists beyond the nearest neighbours of the small state to encompass any potential customer and supplier. And global capital flows are the lubricant to this engine of commerce.

Success, however, involves competition, and competition has losers, as well as winners. Moreover, the redistribution of production applies to illegal and illicit goods and services just as much as it does to the legal/licit economy.⁴ If a small state, or the ruling coterie of a small state, is so inclined there are also avenues of profit available from the illegal as well as from legitimate economic endeavours.⁵ The economic subsector considered in the research that follows permits such an opportunity to benefit from the illegal sector, and in several instances this opportunity has been taken, much to the reputational detriment of the financial industry as a whole in these small state economies. Throughout, the case remains that these jurisdictions insist upon an acknowledgement of their *sovereign* status as a participant in the society of states. Even when and where the constraints of a given situation limit the opportunities for independent action, the small state *expects* equal treatment and recognition for their sovereign independence, irrespective of their size, when it impacts/involves their population and economic well-being.

A number of these small jurisdictions exercise influence within the realm of international finance. They operate as nodal points in the web of banks and financial institutions that interlace the world via electronic connections. A reference to any one of

⁴ See for example the work of Carolyn Nordstrom, Carolyn Nordstrom, 'Shadows and Sovereigns', *Theory, Culture & Society* 17, no. 4 (2000); Carolyn Nordstrom, 'ICT and the World of Smuggling', *Bombs and Bandwidth: The Emerging Relationship Between Information Technology and Security*, ed. Robert Latham (New York & London: The New Press, 2003); Carolyn Nordstrom, *Shadows of War : Violence, power, and international profiteering in the twenty-first century* (Berkeley, California and London: University of California Press, 2004).

⁵ For example, the case made against the Seychelles in 1995, when they passed legislation for an economic development act offering citizenship to anyone, with a provision providing immunity from criminal prosecution, if they had an investment greater than \$10 million. Under intense international pressure, the legislation was rescinded. Patrick Glynn, et al., 'The Globalization of Corruption', *Corruption and the Global Economy*, ed. Kimberly Ann Elliot (Washington, D.C.: Institute for International Economics, 1997), pp. 24 - 25.

these jurisdictions is likely to sprinkle the conversations of financial analysts and government regulators, and the specific jurisdiction identified will only differ as a result of one's location or range of interests—the Bahamas, Luxembourg, Vanuatu. Along with these sovereign states are a number of non-self-governing territories that also participate in the offshore financial industry, most prominently the British Overseas Territory of the Cayman Islands. In the discussion that follows 'jurisdiction' will be used when referring to these non-self-governing territories as well as the independent states.

In any discussion of offshore finance, the most frequently mentioned feature is taxation, or rather the general absence of income taxes imposed by these jurisdictions. This feature is widely believed to be the only purpose, function and rationale for the existence of financial institutions in these locations, particularly when combined with banking confidentiality. However, as will be seen, the circumstances behind the emergence and expansion of offshore finance extend beyond mere taxation, and many of these jurisdictions support other offshore services. Nonetheless, it is this particular point of taxation that leads the OECD to conduct a campaign against those jurisdictions it believes are engaging in 'harmful' tax competition. The organisation (and some of its members) is concerned that they are losing *potential* tax revenue because mobile capital has been transferred through institutions located offshore.

To counter this practice, the G-7 member states of the OECD encouraged the organisation to undertake a campaign to change the situation. By preparing a case that portrays the existence of foreign accounts as the point of origin for 'harmful tax competition', they expect to force mobile capital to return to its source. Without the opportunity for tax arbitrage, capital has no reason to travel.⁶ Therefore, it is necessary to

⁶ This perspective does not take into account the other significant reason for capital mobility—return on investment. Even with equivalent taxes, some locations will continue to offer a higher rate of return on investments, and capital will seek that return.

look at the OECD use of the phrase, harmful tax competition, and the intent behind its use. How can competition be considered harmful, particularly since competition, as a principle, is fundamental to the theory and operation of a capitalist economy. The statement reflects reality only if we agree that some harm results from tax competition. The term itself suggests the occurrence of some ‘damage, hurt, or injury’ to a ‘person, party or institution’. In this case, *how* is the harm inflicted, and upon *whom (or what)* is the harm inflicted by tax competition? Is there an alternative approach negating the harm, if it is not possible to change the practice that is perceived as harmful?

At issue is the fact that at the same time that the OECD strives to intervene and change the tax policies of non-member states, they have been unable to resolve this issue internally amongst themselves. The apparent hypocrisy in this circumstance is among the first issues raised by any critique of the merits of the project.

Issues arise not only about the consultation and the determination process, but also about the fact that the international regime being developed is driven and controlled by a group of countries, which are themselves major perpetrators of the ‘offending’ actions.⁷

Moreover, there are differing conclusions about the impact of tax competition upon an economy, which further stokes the debate. One reason is that the economic research on tax competition arrives at different conclusions depending on the starting assumptions as well as economic model employed by the researcher.

A common and simple example of tax competition has been its use to attract business, especially manufacturing facilities. The use of favourable tax policies (tax holidays, preferential rates, special exemptions or deductions, etc.) by a community to attract new enterprises is widely acknowledged, and in many cases encouraged. The specific use of the term ‘community’ is necessary because the competition for a prospective facility may be between two (or more) towns, provinces, regions, or states. Consequently,

any distress over the impact of the favourable tax regime for other jurisdictions may be domestic (national) as often as it is international. For example, the competition for a new Intel chip fabrication plant to be located outside of the United States in the mid-1990s included communities in thirteen different states: Argentina, Brazil, Costa Rica, Chile, China, India, Indonesia, Korea, Mexico, Puerto Rico, Singapore, Taiwan, and Thailand. Narrowed to four states (Brazil, Costa Rica, Chile and Mexico) Intel ultimately selected Costa Rica in 1996. Some of the reasons identified were ‘political and social stability; high quality of life; rule of law and low levels of corruption; relatively high levels of economic freedom, particularly with regards to international trade and capital flows; [and] relatively high levels of education.’⁸ Similar items were noted for a new Intel manufacturing plant to be located within the United States. In that instance, Charles Pawlak (vice president of Intel International and corporate manager of real estate and site selection) stated that ‘Our preference would be to get *no* special concessions; we just want a place that meets our needs. Incentives are only important if there’s a deficiency.’ In this second example, the competition for the new facility was between 10 communities located in Arizona, California, and Oregon.⁹

A study published in 2000 by the Foreign Investment Advisory Service (a joint service of the International Finance Corporation and the World Bank) investigated the use of tax incentives to attract foreign direct investment. In doing so, the authors found,

⁷ Bishnodoat Persaud, ‘OECD Curbs on Offshore Financial Centres: A Major Issue for Small States’, *The Round Table*, no. 359 (2001), p. 204.

⁸ Andrés Rodríguez-Clare, ‘Costa Rica’s Development Strategy based on Human Capital and Technology: how it got there, the impact of Intel, and lessons for other countries’, *Journal of Human Development* 2, no. 2 (2001), p. 316.

⁹ Jack Lyne and Tim Venable, ‘Speed, Growth Drive Intel’s Pick of Arizona for US\$1.3 Billion Plant’, *Site Selection* 39, no. 6 (1994), p. 1009.

Tax incentives neither make up for serious deficiencies in a country's investment environment nor generate the desired externalities. But when other factors—such as infrastructure, transport costs, and political and economic stability—are more or less equal, the taxes in one location *may* have a significant effect on investors' choices. This effect varies, however, depending on the tax instrument used, the characteristics of the multinational company, and the relationship between the tax systems of the home and recipient countries.¹⁰

This conclusion echoes the above quotation from the Intel executive. Consequently, a reader of the FIAS report may conclude there are too many variables affecting the analysis behind the site selection process for one to conclude authoritatively that tax incentives have an influence (or not) on investment decisions. In the case study explored here, the OECD has explicitly excluded foreign direct investment (FDI) from their investigation of harmful tax competition. The authors of the report acknowledged ‘that the distinction between regimes directed at financial and other services on the one hand and at manufacturing and similar activities on the other hand is not always easy to apply.’¹¹ Nonetheless, the variety of conclusions reached about the harm or benefit arising from tax competition in this instance also is present in research on finance capital taxation.¹²

In a frequently cited IMF report, some 69 jurisdictions were identified as providing the home for an offshore financial centre.¹³ The geographic dispersion of these locations dictates the establishment of limits for the research effort. The intersection of this list with membership in the Commonwealth produced a subset of small sovereign states with an offshore business sector. The choice of the Commonwealth Caribbean jurisdictions is in part one of size and the presence of a number of OFCs, and also in part because it brings

¹⁰ Jacques Morisset and Neda Pirnia, *How Tax Policy and Incentives Affect Foreign Direct Investment: A Review*, (Washington, D.C.: The World Bank and International Finance Corporation Foreign Investment Advisory Service, 2000), p. i, Available: www.worldbank.org/research/workingpapers. Emphasis mine.

¹¹ Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD Publications, 1998), paragraph 6, p. 8. However, they indicate the organisation's intention to continue with research into the question of tax competition and FDI in the future.

¹² See for example, John M. Mutti, *Foreign Direct Investment and Tax Competition* (Washington, D.C.: Institute for International Economics, 2003).

in U.S. foreign and economic policy towards the Caribbean (particularly money laundering in this instance). This limitation reflects the legal norms dimension of the ‘offshore’ and related perceptions of taxation (tax competition) and it takes account of the fact that a number of Caribbean states have actively resisted the OECD’s project. Additionally, this research is limited to the period 1998 - 2003. The first OECD report on harmful tax competition was published in 1998, and the position of the United States regarding the project shifted in 2001. Most of the significant events involving the Caribbean small states occurred during this period. Naturally, reference must be made to events prior to 1998 as background for subsequent actions and events, as well as mentioning events that occurred in 2004 in order to demonstrate the progress resulting from the actions taken during the period of analysis. Finally, events beyond the question of tax competition and offshore finance during this period have affected the actions of states and therefore the issues of concern to them. These will be referred to as appropriate, especially with respect to U.S. foreign policy and the initiatives undertaken to deal with money laundering and the financing of terrorism.

Fundamentals of taxation (and tax competition)

The attitudes of individuals and societies about taxes, collecting taxes and paying taxes, have become the moral justification (and in some sense elitist self-righteousness) for the action of states and international organisations as played out in this story of ‘peaceful’ international intervention. In addition, the different conclusions variously reached by economists, politicians, and analysts emanate from their individual initial position on the question of state taxation. These attitudes are fuel for the debate between the OECD and small states over the accusation that offshore finance promotes *harmful* tax competition.

¹³ Luca Errico and Alberto Musalem, *Offshore Banking: An Analysis of Micro- and Macro-Prudential Issues*, Working Paper of the International Monetary Fund, WP/99/5 (Washington, D.C.: International Monetary Fund, 1999), p. 11.

There are two fundamental reasons to collect taxes—to provide benefits to citizens, and to redistribute wealth amongst them. Taxes collected to provide benefits are essentially user fees. They are contributions made by citizens to finance the goods and services received from the government. Taxes collected for the express purpose of redistributing wealth (transfer payments in the form of poor relief, food subsidies and unemployment benefits, etc.) transform the state into some sort of Robin Hood, taking from the rich and giving to the poor.¹⁴

The distinction between redistributive and benefit taxes may not be as clear. One could also argue that at least some redistributive taxes could be understood as benefit taxes in the sense that wealthy individuals pay them for the benefits (e.g., lower crime rates, a better educated workforce) that more egalitarian societies provide.¹⁵

Thus, redistribution in a limited sense finances a more egalitarian society. Yet it might be equally true that an expanding economy that provides increased employment would lead to lower crime rates (crime is no longer necessary to pay for the necessities of life) and a better educated workforce (paid by employers seeking to further expand their successful business). It is on this basis that an argument can be made that excessively taxing the rich is self-defeating for the community at large. Notwithstanding this counter argument, the OECD project is an effort to assure that taxes may be collected from the wealthy residents that have shifted their assets offshore.

The specific challenge to sovereignty explored in this thesis occupies a space within the wider debate about globalisation as a modern/late-twentieth century phenomenon. One frequently identified aspect of globalisation has been the *velocity* of capital mobility, facilitated both by telecommunications technology advancements and the elimination of capital controls. Consequently, one school of thought finds in this set of circumstances a

¹⁴ Alexander W. Cappelen, 'The Moral Rationale for International Fiscal Law', *Ethics and International Affairs* 15, no. 1 (2001), 97.

¹⁵ Ibid. footnote 2, p. 97.

threat to the welfare state, from a perceived ‘race to the bottom’ in corporate tax rates, and taxation more generally, that will eventually lead to reduced state revenues.¹⁶ The reduction in tax receipts would lead to a reduction in welfare provision that will undermine the foundations of the welfare state, particularly as established in continental Europe. These views on capital mobility and tax competition are embedded in the initiative of the OECD to force compliance with a programme to eliminate tax competition between states.

A basic argument of the tax competition (and public choice) literature was published by Charles Tiebout in 1956 under the title ‘A Pure Theory of Local Expenditures’. This article engaged with an earlier work by Paul Samuelson concerning individual preferences for public goods.¹⁷ The hypothesis of Tiebout’s article posits that, *contra* Samuelson, individuals are able to express a preference for public goods. This expression is performed through the act of choosing their place of residence, given that this choice was predicated upon the local availability of public goods. Preference for any specific public good would involve the support of public expenditures to provide it, and therefore a corresponding consent to pay the taxes that provide the public good. This argument was applied to the case of local government taxes and expenditures, in the United States, and relied upon labour force mobility. The fact that labour is somewhat immobile along with the problem of free riding in connection with access to public goods are two of the criticisms raised with this particular argument.¹⁸

The impediment to a cross-border application of Tiebout’s theorem is that labour is fairly immobile given the widespread existence of immigration controls and the general desire of citizens to live in a familiar culture. This situation remains the case even within

¹⁶ Vito Tanzi, *Taxation in an Integrating World* (Washington, D.C.: The Brookings Institution, 1995).

¹⁷ Charles M. Tiebout, ‘A Pure Theory of Local Expenditures’, *The Journal of Political Economy* 64, no. 5 (1956); Paul A. Samuelson, ‘The Pure Theory of Public Expenditure’, *The Review of Economics and Statistics* 36, no. 4 (1954).

¹⁸ For a short discussion of the both Tiebout’s theorem and its criticisms, see John Cullis and Philip Jones, *Public Finance and Public Choice*, 2nd ed. (Oxford: Oxford University Press, 1998), pp. 296 - 300 and their references.

the European Union for EU citizens.¹⁹ Nonetheless, in presenting an idealised situation of consumer choice about local taxation, the Tiebout theory has become a basic part of public choice economics, with respect to tax competition and public expenditures. And in this fashion, it serves as a corollary to Charles Kindleberger's characterisation of capital flight: 'A narrow economic reading might regard the action as a speculative position based on the prospect of currency devaluation. A broader socio-political view would call it a middle-class strike.'²⁰ Just as capital flight may be viewed as a form of middle-class protest against the state and its management of a national economy, the same may be said of tax avoidance on the part of individual citizens. Suffering not from a tyranny of the majority, but rather from the tyranny of a tax-imposing minority in control of the government, these dissenters duck and dodge away from the *impôt*, whether on ethical/moral grounds or simply to resist the confiscation of their wealth by the state. Therefore, even though citizens are disinclined to move, which would clearly establish their preferences for existing or proposed public goods (and thus the level of tax that they felt to be acceptable), they are inclined to move their capital in an effort to reduce their tax contributions. Thus tax avoidance indirectly indicates citizen preferences about their tax contributions to the state. In sum, the difficulty with this theory at the end of the twentieth century is the fact that while residents may express their preference for public goods in their choice of residence, they may now more easily avoid contributing to these public goods. By demonstrating their desire to retain their wealth by choosing to locate their financial assets 'offshore', these residents reproduced the 'free rider' problem described by the OECD as justification for the harmful tax competition project.²¹

¹⁹ Immigration moreover possesses its own version of 'non-tariff' barriers, for example training and education prerequisites (transferral of accreditation) and licensing requirements.

²⁰ Kindleberger, *International Capital Movements*, p. 58.

²¹ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, p. 14.

The structure of offshore finance exists within the nature of international politics, and the traditions of state sovereignty. These traditions include both independence of action over domestic activities, and a proscription against intervening into the domestic activities of *another* sovereign state. It is within these traditions that states are free to design governing structures for banking, finance and taxation which are independent, and therefore potentially different, from those of other sovereign states. Yet, the proscription against intervention has developed exceptions in the past several decades. Stephen Krasner argues that the non-intervention principle of state sovereignty has been substantially porous from the very beginning.²² Nonetheless, the case presented here suggests that the citizens of sovereign states are taught to believe otherwise, and that they strongly resist the interference of others into the domestic affairs of their country. This is a central argument made by Hochstetler, Clark, and Friedman concerning state sovereignty.

Outside of the realm of military power, sovereignty emerges as less central to states' material interests and more central to their asserted social identities than standard arguments over sovereignty suggest.²³

Moreover, having established the widespread understanding that all sovereign states are entitled to equal treatment (as reflected for example in the United Nations system of international organisations) for some states to act otherwise is a problem. As confirmed by K. J. Holsti in his textbook on *International Politics*:

The third rule states simply that however they differ in size, population, location, or military capabilities, all states are equal with respect to legal rights and duties.²⁴

Thus, if there are processes, procedures or activities that would directly impact the lives and welfare of the citizens of a sovereign state, then that state should be involved and its representatives should be participants. In the case of large developed states, this has not

²² See Stephen D. Krasner, *Sovereignty: Organized Hypocrisy* (Princeton: Princeton University Press, 1999).

²³ Kathryn Hochstetler, et al., 'Sovereignty in the Balance: Claims and Bargains at the UN Conferences on the Environment, Human Rights, and Women', *International Studies Quarterly* 44 (2000), p. 592.

been a significant problem as they are frequently the instigators of these activities, and often host the relevant meetings. The participation of small states on the other hand, is hampered by the limited resources (both personnel and finance) available to them in order to participate in the full range of international fora. This resource limitation should not be used, however, to justify their exclusion from those gatherings likely to develop proposals intended to direct a change to their domestic legal or social structures. This is one problem with the OECD's project—small states with OFCs were not included in the process that created the harmful tax competition project that now demands their co-operation and compliance.

Offshore – The financial rather than nautical dimension

In order to limit the extent of discourse surrounding the offshore financial centre, one must appreciate the use, and potential misuse, of the term *offshore* within the context of global finance. Clearly, in the nautical sense the word offshore is meant to describe an entity (ship, rock, or island) located at some distance from the coast of a larger island or mainland (continental) territory. Ronen Palan suggested that for the purposes of politics and domestic regulation, the use of the term might be derived from the pirate radio stations of the 1960s. Radio Caroline, off the coast of the United Kingdom for instance, sought to emulate Radio Luxembourg while at the same time avoiding the national regulation on broadcasting in the UK. This regulatory avoidance was achieved by floating at sea just beyond the territorial limit (3 miles at this point in time) of domestic UK regulations.²⁵ This suggests to a present day reader a sense of the permeability of

²⁴ K. J. Holsti, *International Politics: A Framework for Analysis*, 3rd ed. (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1977), p. 93.

²⁵ Ronen Palan, *The Offshore World: Sovereign Markets, Virtual Places, and Nomad Millionaires* (Ithaca and London: Cornell University Press, 2003), pp. 21 - 23. Palan provided a longer exploration of the term than this, emphasising the lack of

boundaries (territorial borders) and an emergent sense of the globalisation of information (in this instance, rock music and advertising) in a time before we had imagined such developments. Most literature covering offshore finance associates the usage of the term offshore with the emergence of the Eurodollar markets during the economic recovery following World War II. The etymology of offshore provided by the Oxford English Dictionary refers to an article from the 8 May 1948 issue of *The Economist* – ‘The 16 nations will be provided with ‘off-shore’ dollars for buying from Germany.’²⁶

John Gerard Ruggie looked at the condition of territoriality as shaping the discourse in international politics, ‘There has been a remarkable growth in transnational microeconomic links over the past thirty years or so, comprising markets and production facilities that are designated by the awkward term ‘offshore’—as though they existed in some ethereal space waiting to be reconceived by an economic equivalent of relativity theory.’²⁷ He goes on to mention not only the area of finance, but also production and marketing as possessing a ‘global’ nature. The discussion of offshore as a sense of space, or place, drifts into the domain of geography, and the politics of the geographic. In the discipline of geography, and in particular in the pages of cross-disciplinary journals such as *Geopolitics* and *Political Geography*, the politics of place and space are presented in the context of borders, territoriality and globalisation.²⁸

a common definition for its various purposes amongst financial institutions, international telecommunications, and foreign direct investment. For the story of Radio Caroline in particular, see Peter Moore, *Radio Caroline, a history*, 7 Dec 2002, Web pages, Radio Caroline, Available: <http://www.radiocaroline.co.uk/History.htm> [accessed 16 December 2002].

²⁶ *OED online*, 2nd edition (1989), 2002, Web pages, Oxford University Press, Available: <http://athens.oed.com/> [accessed 16 December 2002].

²⁷ John Gerard Ruggie, ‘Territoriality and Beyond: Problematizing Modernity in International Relations’, *International Organization* 47, no. 1 (1993), p. 141. Note this observation preceded the widespread availability of the Internet, and the subsequent general usage of the term ‘virtual’.

²⁸ See for example, M. Coleman, ‘Thinking about the World Bank’s ‘accordion’ geography of financial globalization’, *Political Geography* 21 (2002); Alan C. Hudson, ‘Placing trust, trusting place: on the social construction of offshore financial centres’, *Political Geography* 17, no. 8 (1998); Susan M. Roberts, ‘Small Place, Big Money: The Cayman Islands and the International Financial System’, *Economic Geography* 71, no. 3 (1995).

The logical (and natural) counterpoint to offshore is *onshore*.²⁹ Within the constraints of financial markets, this term is used to refer to those institutions and agencies that exist within the regulated domains of sovereign states. Specifically, it is often used to designate the institutions and agencies regulated by the large, developed sovereign states, and represents a counterpoint to the situation believed to exist in an offshore financial centre. At the same time, however, these OFCs also exist within regulated sovereign states, simply ones that chose a path of minimum regulation on those aspects that encourage and support their (offshore) business environment. In the main, they strive to meet the capital adequacy ratios mandated by the Basle Concordat and other international supervisory requirements.³⁰ Consequently, in this conception the use of onshore in opposition to offshore creates an irregular (if not Ruggie's 'ethereal') landscape of financial institutions and regulation, containing offshore entities located at sea and surrounding the several landmasses of onshore regulation (United States, Europe/EU, Japan, India, Australia/New Zealand, etc.)³¹

Placing offshore and onshore onto a virtual map depicting such a landscape produces most of the visualisation behind the use of these terms. Yet it leaves to be described a number of jurisdictions that include small territories of the United Kingdom – the non-self-governing territories. These territories exist in a semi-independent, semi-autonomous condition that, while not sovereign statehood, nonetheless permits them the

²⁹ However, if the text does not involve offshore in any circumstance, then the use of the term onshore (to describe for example, the nature of banking regulation in Germany) is completely absent. Consequently, onshore does not appear to exist in the absence of the offshore.

³⁰ See Working Group on Offshore Financial Centres, *Report of the Working Group on Offshore Centres*, (Financial Stability Forum, 2000), Available: http://www.fsforum.org/publications/publication_23_31.html [accessed 17 March 2003]; Monetary and Exchange Affairs and Statistics Departments, *Offshore Financial Center Program*, A Progress Report, (Washington, D.C.: International Monetary Fund, 2002), Available: <http://www.imf.org/external/np/mae/osshore/2002/eng/032802.htm> [Accessed 19 July 2002].

³¹ Here I follow the lead of Alan Hudson, who described his preference for the term 'regulatory landscapes' as opposed to 'regulatory spaces' because this served 'to emphasize: their unevenness and dynamism; the interconnection of regulatory environments; and the fact that landscapes and the actors within them are mutually constitutive rather than regulatory space being a backdrop which actors do not themselves shape.' Alan Hudson, 'Offshorenness, globalization and sovereignty: a postmodern geo-political economy?' *Transactions of the Institute of British Geographers* 25, no. 3 (2000).

space in which to establish domestic legislation on taxation and financial regulation nominally independent of the government of the United Kingdom. Thus the Channel Islands, Gibraltar, the Cayman Islands, etc. possess a strong geographical/political/legal connection to the onshore state, yet at the same time have a space in which to reproduce characteristics of an offshore state, given that these territories host ‘offshore’ financial centres. The extent to which this situation was a factor in the debate over sovereignty for Gibraltar is not readily apparent, but Gibraltar provides financial services that fall within the broad concerns of both the EU and OECD concerning tax harmonisation and tax competition.³²

Thus, nautical terms of physical geography have been captured for use in political geography and political economy. And perhaps in the minds of some, when visualising this regulatory landscape of onshore and offshore finance, they have introduced, or painted in, the presence of liquidity pipelines, which serve to convey the financial flows from one domain to the other—pipelines which are not metered, and thus not contributing (via *appropriate* taxes) towards the maintenance of the state institutions that provide the peaceful environment constructing this landscape and its infrastructure. It is in this sense, of the existence of unmetered financial flows, that accusations are generated that the OFCs are free riders on global public goods.

Financial Services in an Offshore Landscape

Since 1960, improvements and new technologies in the area of telecommunications (satellites, a global infrastructure of high-speed, large bandwidth fibre optic cabling,

³² Concerning the circumstances of Gibraltar see Joe Garcia, ‘The Rock Gets Rolled: A Letter from Gibraltar’, *The National Interest*, no. 69 (2002). In connection with the Harmful Tax Competition Initiative’s 2001 Progress Report, Caroline Doggart wrote that ‘Spain managed to throw a last-minute spanner into the works. It threatened to veto the new agreement unless Gibraltar was treated as a preferential tax regime under UK authority, instead of an independent fiscal jurisdiction, as had been planned.’ Caroline Doggart, *Tax havens and their uses*, Research Report, 10th ed. (London: Economist Intelligence Unit, 2002), p. 154. For an extended discussion of OFCs in the UK Dependent Territories, see Mark P. Hampton, *The Offshore Interface: Tax Havens in the Global Economy* (London: Macmillan Press Ltd, 1996).

miniaturisation of electronics, and finally, the Internet) have dramatically changed the operation of financial services. Dedicated, secure telecommunication networks have been created, which now allow immense quantities of near-instantaneous commercial/financial transactions to occur globally, 24/7.³³ This technology has facilitated an immense growth in the financial services industry globally (for the Eurodollar market alone, with a size of \$11 billion in 1964, it grew to \$1 trillion in 1984 and stood at \$3 trillion in the early 1990s).³⁴ This growth included the sizeable expansion of the offshore sector.

While this has been treated as a consequence of the latest wave of globalisation, the role of this aspect of global communications technology/networks is merely several factors greater than the pre-existing structure that supported inter-state finance. A more fundamental impact on global markets occurred as a result of the web of telegraph cables spread throughout the world during the second half of the 19th century. Telegraphic connections between London and Paris increased opportunities for financiers at both the London Stock Exchange and the Bourse in Paris. The extension of these links via submarine cables that connected Europe to North America, the Caribbean and beyond, further expanded business as more current information became available than was previously the case. For example, when the General Council of Martinique contracted with the local telegraph company for a regular news dispatch, current wholesale prices from European and American markets were specifically requested. “The French islands

³³ For a discussion of the impact of information technology on international relations, see Geoffrey Herrera, ‘The politics of bandwidth: international political implications of a global digital information network’, *Review of International Studies* 28, no. 1 (2002).

³⁴ Adam Baines, ‘Capital mobility and European financial and monetary integration: a structural analysis’, *Review of International Studies* 28, no. 2 (2002), 344, citing Ron Martin, “Stateless Monies, Global Financial Integration and National Economic Autonomy: The End of Geography?” in S. Corbridge, R. Martin and N. Thrift (eds.), *Money, Power and Space* (Oxford: Blackwell, 1994).

needed this information, especially wholesale prices, in order to compete in the cut-throat sugar business.³⁵

Indeed, Bill Maurer developed an argument which found the origin of offshore finance to be an ‘unintended consequence’ of the trans-Atlantic connections between Europe, the United States, and the Caribbean. He reached this conclusion after observing the overlap between the location of Caribbean financial centres and the telegraph/telecommunication nodes of Cable and Wireless in the Caribbean.³⁶ Early telegraph links were progressively upgraded as new technologies emerged, first as telephone trunk lines and later fibre optic cables. Consequently, when financial firms looked to establish branches and subsidiaries beyond onshore regulation, these locations already possessed the capability to satisfy their communication requirements. Decisions made in the 19th century resulted a hundred years later in the growth of offshore finance—in these specific locations, and not elsewhere. However, as will be discussed in more detail later, there are a number of other factors leading to the location of an offshore financial centre at a particular place, beyond the presence of these nodal points.

A Common Legal Tradition

Another reason to focus on Commonwealth small states with regard to issues of offshore finance is their common legal system. The existence and operation of the offshore realm has a strong association with the British legal tradition. Most jurisdictions outside of Europe with some history as a financial haven possess a legal system based on British (English) common law. This includes most Caribbean and Pacific OFCs, in

³⁵ Daniel R. Headrick, *The Invisible Weapon: Telecommunications and International Politics, 1851 - 1945* (New York: Oxford University Press, 1991), pp. 54 - 56.

³⁶ Bill Maurer, ‘Islands in the Net: Rewiring Technological and Financial Circuits in the ‘Offshore’ Caribbean’, *Comparative Studies in Society and History* 43, no. 3 (2001), p. 469.

addition to the unique relationships maintained by the Channel Islands and the Isle of Man with the United Kingdom.³⁷

In a broad sense, the legal space that is occupied by offshore business exists within a fundamental difference between the English and Continental legal systems. The difference lies within the foundations of each legal system—for the continental legal tradition *explicitly* identifies what is permitted, whereas the English legal tradition *explicitly* identifies what is *not* permitted. Thus, an action is banned in the continental tradition, unless the law has expressly permitted it. Conversely, any action not specifically identified as an illegal action is permissible in the English tradition, until such a time as it has been defined as illegal by legislation.³⁸ This underlying legal tradition appears to be embedded within cultural perceptions of the law, and expectations as to what is considered either legitimate or illegitimate. The legal structures of society shape the conduct of citizens in a variety of ways, both large and small and particularly with entrepreneurial business developments.³⁹

As a consequence of European colonialism, European legal traditions were promulgated around the globe. The English Common Law foundation for Caribbean legal systems was described by Rose-Marie Antoine in her textbook *Commonwealth Caribbean Law and Legal Systems*. ‘The term common law tradition, although originating in England and founded on English law, speaks to all the English-speaking countries and the geographical

³⁷ Additionally, I have been reminded that many of these same jurisdictions were also havens for piracy and privateering more than two hundred years ago. But that is another story, even though it has prompted such headlines as ‘Pirates of the Caribbean’ in the financial press. Carl Mortished, *Pirates of the Caribbean refuse to play ball on tax havens*, 11 February 2004, Web page, Times Online, Available: <http://business.timesonline.co.uk/article/0,,8210-996741,00.html> [accessed 26 March 2004].

³⁸ Palan, *The Offshore World*, p. 29. The distinction has been described also as one between ‘soft-law’ (because the rules reflect the results of court decisions) and ‘hard-law’ (because the law is codified by legislation). Rose-Marie Belle Antoine, *Commonwealth Caribbean Law and Legal Systems* (London: Cavendish Publishing Limited, 1999), pp. 29, 31.

³⁹ In economics and finance this has been a topic of particular interest for Andrei Shleifer and his colleagues, see for example Rafael La Porta, et al., ‘Legal Determinants of External Finance’, *The Journal of Finance* LII, no. 3 (1997); Rafael La Porta, et al., ‘Law and Finance’, *Journal of Political Economy* 106, no. 6 (1998); Edward L. Glaeser and Andrei Shleifer, ‘Legal origins’, *Quarterly Journal of Economics* CXVII, no. 4 (2002).

area known as the Commonwealth.⁴⁰ The subsequent development of the practice of offshore finance may be understood then as an absence of any *explicit* prohibition of these financial practices. As noted in the discussion on the origins of the Eurodollar market below, ‘offshore’ transactions first appeared in the City of London via a discrete and explicit separation of resident and non-resident deposits of foreign currencies. The British financial system was ‘effectively compartmentalized’ between domestic deposits in pounds sterling subject to domestic regulations, and foreign deposits in all other currencies (though primarily dollars) which were unregulated.⁴¹ This position on banking regulation intersected with earlier British case law concerning corporate taxation. As noted by Sol Picciotto, court cases, which bounded the definition of corporate residence, led to an ‘anomaly that a company incorporated in the UK would not be liable to UK taxes if controlled from abroad.’⁴² This led to an additional opportunity where firms could incorporate a subsidiary in the UK, which they then ‘controlled’ from abroad and through which they routed business activity. This technique for structuring the multinational corporation would result in avoiding British taxes on business transactions, along with any tax that would have been imposed by the parent corporation’s state of residence.⁴³ Taken together, these two features of the law facilitate lawful tax minimisation by corporations through offshore subsidiaries and operating through a form of regulatory arbitrage.⁴⁴

⁴⁰ Antoine, *Commonwealth Caribbean Law and Legal Systems*, p. 29. She further notes that ‘the common law tradition describes the substantive and procedural legal rules, techniques, and institutions which evolved from the early courts of law in England after the Norman conquest.’

⁴¹ Gary Burn, ‘The state, the City and the Euromarkets’, *Review of International Political Economy* 6, no. 2 (1999), p. 226.

⁴² Sol Picciotto, ‘Offshore: The State as Legal Fiction’, *Offshore Finance Centres and Tax Havens: The Rise of Global Capital*, eds. Mark P. Hampton and Jason P. Abbott (London: Macmillan Press Ltd., 1999), p. 49.

⁴³ Picciotto identified several specific legal cases that established the precedent in the footnotes accompanying his discussion.

⁴⁴ This practice helps to explain the substantial number of international business companies registered in such places as the Cayman Islands (68,078 in 2003) and the Bahamas (16,604 in 2003). See below, Appendix A – Caribbean Offshore Financial Centre Data.

An appreciation of the history and development of this legal tradition within the Commonwealth provides an understanding of the nature and origins of offshore finance. These differences have been recognised for some time and were highlighted within internal British government documents concerning the establishment of the New Hebrides (Vanuatu) financial centre. In a letter from the Treasury to the Inland Revenue in August 1974, the author noted the fact that ‘legal provisions for controlling New Hebrides financial operators and for guaranteeing their secrecy derive exclusively from English law...’⁴⁵ This distinction influences the perception of various actors concerning the legitimacy of offshore finance. These perceptions of legitimacy are further aggravated by the fact that ‘because in some countries, to seek to frustrate the intention of the law is already a breach of an express legal principle.’⁴⁶ One conclusion from this line of thought is that some commentators do not recognise the actions of the OECD as an explicit attack upon state sovereignty because they view the conduct of offshore finance (and those using these services) as intrinsically illegal. For example, the rapporteur for a European conference concerning corruption described such a viewpoint when presenting ‘The nexus between corruption and offshore financial centres: an introduction’.

If it is not correct to state that offshore financial centres exist because of a corrupted environment ..., it should be assumed that there is an indirect link between grand corruption and offshore.⁴⁷

Therefore, from this legal-cultural perspective, one could argue that the state itself has engaged in illegitimate conduct by legislating and promoting offshore finance and is

⁴⁵ United Kingdom. Public Record Office, ‘Investment Industry in New Hebrides’, (London: 1974), vol. FCO 32/1101, folio 67. These communications were involved in the development of a letter (dated 30 August 1974) from the British Prime Minister in reply to a letter from the Australian Prime Minister (23 July 1974) expressing the concerns of Australian Revenue authorities with their residents’ use of New Hebrides as a ‘tax haven’.

⁴⁶ Jeffrey Waincymer, ‘The Australian Tax Avoidance Experience and Responses: A Critical Review’, *Tax Avoidance and the Rule of Law*, ed. Graeme S. Cooper (Amsterdam: IBFD Publications BV in co-operation with the Australian Tax Research Foundation, 1997), p. 251.

⁴⁷ Ernesto U. Savona, ‘The nexus between corruption and offshore financial centres: an introduction’ (paper presented at the Programme of action against corruption, 4th European Conference on services specialised in the fight against corruption, Limassol (Cyprus), 20 - 22 October 1999), p. 14.

therefore a ‘financial pirate’. Some of the proponents of ‘international standards’ argue against this unacceptable conduct as one that is ‘shunned’ by law-abiding states.⁴⁸ This fosters a tension within the differences facilitated by state sovereignty between the jurisdictions (and their representatives) from these differing legal traditions.⁴⁹

A central premise of this research is the fact that the ‘offshore world’ is an integral aspect of the states system. There is, however, the fact that ‘offshore’ jurisdictions manipulate the institutional structure of sovereignty and create, as Palan argues, sovereignty as a marketable commodity for governments. Through the juridical implementation of sovereignty, the right and ability to create laws defining the structure of finance and regulation within the state container, small states have used their sovereignty as a commodity in pursuit of economic development. This commodity (in the form of tax administration) produces the contested ground upon which this case study examines the nature of sovereignty as enacted by its smallest practitioners. This viewpoint is contested by those who argue from the standpoint that a global public good supersedes the sovereignty (and sovereign choices) of any individual state.⁵⁰ Such an argument supports the OECD position by presenting transparency and information exchange between and amongst participants in the international financial system as welfare enhancing. Consequently, transparency and information exchange represent elements of a larger structure supporting international financial stability, a goal that is regarded as a global

⁴⁸ Seiichi Kondo, *Ending Tax Haven Abuse*, 2002, PDF file, OECD, Available: <http://www.oecd.org/pdf/M00028000/M00028566.pdf> [accessed 20 April 2002].

⁴⁹ This issue has been noted by a French lawyer in a text on money laundering, ‘Il est certain d’autre part que le droit anglo-saxon permet l’utilisation de mécanismes, d’outils et de procédés favorisant l’évasion fiscale et plus spécifiquement la dissimulation de l’identité des ayants droit, propriétaires ou bénéficiaires des fond.’ Olivier Jerez, *Le blanchiment de l’argent*, 2e ed. (Paris: Revue Banque Edition, 2003), p, 99.

⁵⁰ Cecilia Albin, ‘Negotiating international cooperation: global public goods and fairness’, *Review of International Studies* 29, no. 3 (2003). For a consideration of tax competition from this perspective, see Kjetil Bjorvatn and Guttorm Schjelderup, ‘Tax Competition and International Public Goods’, *International Tax and Public Finance* 9 (2002). And with regard to anti-money laundering initiatives, see Eleni Tsingou, ‘Targeting Money Laundering: Global Approach or Diffusion of Authority?’ *New Threats and New Actors in International Security*, ed. Elke Krahnmann (Houndmills, Basingstoke: Palgrave Macmillan, 2005).

public good.⁵¹ By identifying their project as one that supports global welfare, the OECD is emphasising that they have the best interests of all states in mind, and not simply the interests of their members.

The examination of this question of small states defending their sovereign independence intersects with several other debates within the discipline of international relations. First, this demonstration of the continued sovereign capability of the small members of the international society reinforces the argument that, notwithstanding the views of some proponents of globalisation, states continue to matter. Contrasting this aspect of sovereign statehood as independence of action is the increasing semi-formal re-regulation of international finance through the promulgation of international standards and best practices that have been created by select groups with the intention that they will be implemented within all national systems.⁵² This aspect extends beyond the OECD to include the Financial Action Task Force on money laundering, and a variety of cross-national professional organisations for the insurance industry, stock exchanges and other sectors of the financial services industry.

Structure of the thesis

Just as Charles Kindleberger recognised the core question, so too he understood the essential hurdle facing the solution to the question: ‘Harmonization, whether in complete or in optimal deregulation, however the latter may be defined, means of course a loss of national sovereignty for the harmonizing countries.’⁵³ Conceding sovereignty is not

⁵¹ Stephany Griffith-Jones, ‘International Financial Stability and Market Efficiency as a Global Public Good’, *Providing Global Public Goods: Managing Globalization*, ed. Ronald U. Mendoza (Oxford: Oxford University Press for The United Nations Development Programme, 2003). See also John Eatwell and Lance Taylor, *Global Finance at Risk: The Case for International Regulation* (Cambridge: Polity Press, 2000).

⁵² Rodney Bruce Hall and Thomas J. Biersteker, eds., *The Emergence of Private Authority in Global Governance* (Cambridge: Cambridge University Press, 2002); A. Claire Cutler, *Private Power and Global Authority: Transnational Merchant Law in the Global Political Economy* (Cambridge: Cambridge University Press, 2003).

⁵³ Kindleberger, *International Capital Movements*, p. 73.

something states, large or small, are readily willing to undertake. To control their tax structure (fiscal sovereignty) is to control many (if not all) aspects of their domestic economy. Issues of national culture, preferred approaches to social welfare, and income re-distribution are merely items at the top of the list impacted by tax harmonisation. Because of the obvious difficulty in achieving global tax harmonisation, the OECD appears on the surface to be approaching this problem by forcing small non-member states to undergo changes that are in the best interests of OECD members with its representation as a global problem and the resolution as a global public good.

The tax competition project has been constructed as global in scope and execution. To analyse it in its entirety would be a formidable task too large for a PhD thesis. Consequently, this thesis is limited to a specific consideration of several Caribbean jurisdictions that are associated with the Commonwealth. This approach provides for an evaluation of a number of factors that influenced the evolution of the OECD project, and the efforts of small states to resist it. As already suggested, the common legal tradition of most Commonwealth members is fundamental to the regulatory structures of offshore finance. In support of these small states the Commonwealth Secretariat provides assistance in a number of areas, including the development of model laws, guidance for economic development, and as a collective voice within international fora against the OECD position on tax competition. Caribbean small states exist within the immediate shadow of the United States and their experience with the American tax administration demonstrates aspects of the U.S. policy position for the tax competition project not obvious within official statements. Together these attributes compose the limits of the case study used here.

The structure of the remainder of this thesis is as follows: the next chapter reflects upon the nature of state sovereignty, covering the traditional representations of sovereignty, as well as elements of more recent debates suggesting the end of sovereignty.

This discussion is accompanied by a presentation of small states—what is meant here by ‘small’, the historical incidence of small states, and the succession of small states that accompanied decolonisation.

The third chapter expands upon the issues introduced above—the global landscape of financial flows and the presence of competition amongst jurisdictions for tax revenue. A history of offshore activity as originating with efforts to keep wealth safe from predation is sketched, accompanied by the application of offshore finance for economic development in small states. This is followed by an analysis of taxation in and by states, with particular reference to the public choice contention that competition amongst tax-collecting jurisdictions is a benefit for the citizens of those jurisdictions.

On this foundation, the research moves in chapter 4 to an analysis of the OECD’s project to define harmful tax competition and the methods with which to counter the problem as they have identified it. The historical example of American Prohibition provides an analogy to a critical aspect of the OECD project—the essential need for the co-operation of all states with the goals and objectives established by the OECD. An examination of the OECD reports on harmful tax competition produces an outline of the structure within which they foresee concerned states taking measures to eliminate tax competition.

Following the OECD perspective of our global condition, chapter 5 presents the small states’ critique of that viewpoint. There are three major criticisms offered against the harmful tax competition project. Each of these critiques are presented, and then followed with the replies offered by OECD representatives. The implication of the project for non-self-governing territories is briefly explored within the context of this critique. In addition, the danger implicit in the sanctions considered for use against non-co-operative jurisdictions is offered by a short reflection on a similar action—the Financial Action Task

Force (FATF) 'blacklisting' of the Philippines as part of its campaign against international money laundering.

The critique provided by small states encompasses their individual action. Mindful of the frequent recommendation that small states should participate within the wider collective activity of international organisations, chapter 6 presents the contributions of the Commonwealth in this case study. Various efforts undertaken by the Commonwealth and the Commonwealth Secretariat demonstrate not only the organisation's extensive support for small states, but also recognises the broad presence of small states within the organisation. Closing the chapter is a consideration of the collective action taken by some of these jurisdictions outside of the Commonwealth (as an intergovernmental organisation). A non-governmental international organisation was established in 2001 affording a wider membership for affected jurisdictions, and specifically providing a location where the non-self-governing territories with offshore financial centres were equal participants.

A discussion of several specific small Caribbean states with offshore financial centres is presented in chapter 7. The chapter opens with an assessment of research quantifying the scope and magnitude of the economic, social and environmental vulnerability experienced by small states as a consequence of their size and location. It then focuses on the role played by the offshore financial services industry within the economies of four representative Caribbean jurisdictions. The vulnerability of this particular industry has been significantly increased by the OECD project. The chapter then considers the status of the Caribbean OFCs as components of the global financial system and the flow of global capital through these locations. It questions the influence of the OECD harmful tax competition project upon these global flows. Reference data for this analysis is contained in the appendices that follow chapter 9.

The United States has a very specific influence upon the question of tax competition and this is presented in chapter 8, which looks at American policy, and how it shifted after the inauguration of a new presidential administration in January 2001. Money laundering is discussed in more detail, because it is an activity that is frequently conflated with tax competition and its criminalisation has been part of U.S. attempts to counter drug trafficking as a supply-side solution to drug addiction in society. The domestic origins of the anti-money laundering policy led to American foreign economic policy and the creation of an intergovernmental organisation to pursue money laundering. American foreign economic policy with respect to the OECD harmful tax competition project has been subjected to domestic influence as well, and that aspect is discussed in the chapter. Finally, it is necessary to address the repercussions of the 11 September 2001 terrorist attacks for this research, which not only include trans-national financial transactions, but also have engendered an environment when any and all policy actions are now framed in terms of how they advance the war on terror. The magnification of surveillance in democratic Western society as a component of this war on terror can only be hinted at here. Yet the expectations for the implementation of comparable surveillance measures within small jurisdictions will strain their already overburdened governmental structures.⁵⁴

Following a summary of the main points from the preceding chapters, the Conclusions chapter returns to the core question of state sovereignty for small states today. *Fiscal* sovereignty is the specific factor threatened by the larger states (represented by the OECD) in the case study, yet by their very nature, offshore financial centres exist within a larger global financial network. Consequently, retaining any semblance of independent action requires the tacit, if not explicit, co-operation of onshore finance—*ipso*, the co-operation of the large(r) states. It is ultimately the OECD's goal to limit and control such

⁵⁴ See for example Ken Ross, 'Globalization, Governance and Guns: Some reflections on the South Pacific in the 1990s', *The Round Table*, no. 372 (2003).

co-operation, unless it operates within the constraints determined by the harmful tax competition project. The final chapter closes with suggestions for the future prospects of the 'offshore' as a conceptualisation of state sovereignty for small states and their position within international society.

A SMALL, SOVEREIGN, STATE

Martin Wight points out that “it would be impossible to have a society of sovereign states unless each state, while claiming sovereignty for itself, recognized that every other state had the right to claim and enjoy its own sovereignty as well.”

– John Gerard Ruggie¹

In order to create a firm definition of the small state, a number of relevant factors have been identified by a variety of authors. The most fundamental factor was size, commonly applied to territory, population, or the domestic economy of the state. Additional factors have included military capability or manufacturing capacity, but they are heavily influenced by the first three listed. These common factors of territory, population and economy (combined with the serendipitous impact of resource endowment) influence all the other metrics that may be proposed to rank order sovereign states. Size, as the determinant for categorising states, will be explored in depth later in this chapter.

Sovereignty, as a feature of a state amongst the community of states, has come to be used as a development tool by small states. One analysis of this strategy suggests that the fundamental factor is the ability to establish municipal law within a defined and bounded territory.

¹ John Gerard Ruggie, ‘Territoriality and Beyond: Problematizing Modernity in International Relations’, *International Organization* 47, no. 1 (1993), p. 162. Ruggie is citing Martin Wight, *Systems of States*, ed. Hedley Bull (London: Leicester University Press, 1977), p. 135.

First, there is a shared perception that a sovereign right to write the law—whether at the municipal, state, or national level—combined with a competitive system can be used as a competitive asset. In other words, a link between a competitive system of jurisdictions and the potential for the commercialized use of the right to write the law is well recognized.²

For Palan, the small state ‘sold’ its sovereignty when choosing to establish an offshore financial centre. In effect, the small state used its sovereign status to pursue a comparative economic advantage to offset the other limited capabilities that accompany its small size. The use of this strategy may be an approach to counter the loss or decline of a comparative advantage for some other commodity. The benefits from hosting an offshore financial centre include increased employment in the service sector, which can increase the education and training prospects for citizens, and revenue from associated fees and taxes. Thus state sovereignty has been used to provide the means to increase and enhance the domestic economy of the small state.³

However one may view this use of state sovereignty, it is necessary first to understand what is meant by the term. A number of concepts of sovereignty are presented in the second section of this chapter. Before looking at this topic, the first section presents a short historical account of the emergence of small states in modern international society. This historical perspective outlines the situation prior to World War II, and then the period of decolonisation that followed the conflict. After looking at the more general concepts of sovereignty, the discussion focuses on what the concept means for the new states. The third section tackles the issue of the definition used for ‘small’ in this research effort on small state sovereignty.

² Ronen Palan, ‘Tax Havens and the Commercialization of State Sovereignty’, *International Organization* 56, no. 1 (2002), p. 159.

³ Godfrey Baldacchino, ‘Jurisdictional Self-reliance for Small Island Territories: Considering the Partition of Cyprus’, *The Round Table*, no. 365 (2002).

Historical perspective

Small States prior to World War II

To consider the small state as a topic for research, the first question one encounters is to define it—what is a *small* state? To approach this question the researcher must determine the parameter(s) of size to be applied and the methodological approach to be used. In a 1976 article, Niels Amstrup presented a wide survey of the literature that contained an historical perspective often missing from other surveys. Amstrup wrote that, ‘it seems relevant to indicate that this problem [of the role of small states in the international system] has a long tradition of political thinking in Europe.’⁴ In particular, he identified two German dissertations from the early 1920s, and several earlier references to small states in German and French political writing. Amstrup listed six approaches which have been used to distinguish the small state, and concluded that this leads to the elusiveness of the concept of a ‘small state’.⁵ More interestingly, he also concluded from his research that there was ‘an astonishing lack of cumulation in these contributions. So, nearly all studies since the end of the 1950s have ignored the earlier studies made in Europe, in particular in Switzerland.’ This led him to observe that ‘[s]tated in the extreme one could say that it seems easier to develop one’s own view on small states than comparing it with other and earlier views.’⁶

Within the context of the international system in the first half of the twentieth century, it is only natural to find that the focus of the literature rested on European small states. Amstrup found that most of this literature positioned small European states as

⁴ Niels Amstrup, ‘The Perennial Problem of Small States: A Survey of Research Efforts’, *Cooperation and Conflict* XI, no. 3 (1976), p. 163. See also Otmar Höll, ‘Introduction: Towards a Broadening of the Small States Perspective’, *Small States in Europe and Dependence*, ed. Otmar Höll, The Laxenburg Papers, No. 6 (Wien: Wilhelm Braümüller, 1983), p. 14.

⁵ His bibliography contained 55 works, and Amstrup indicated that he had excluded those studies written on specific individual states.

⁶ Amstrup, ‘The Perennial Problem of Small States: A Survey of Research Efforts’, p. 178.

buffers between the European powers. It was in this role that small states were used as the justification and rationale for the military conflict begun in 1914. When he presented the Fiftieth Anniversary Lecture of the School of Slavonic and East European Studies in 1965, Gunnar Heckscher referred back to the Inaugural Lecture of the School of Slavonic Studies in London. That earlier lecture, presented in 1915 by Thomas G. Masaryk (at the time Lecturer in Slavonic History at the School, and later President of Czechoslovakia, 1918 - 1935), was titled 'The Problem of Small Nations in the European Crisis'. Heckscher in particular referred to a point Masaryk made concerning sovereignty.

On the other hand, when talking about 'democratic internationalism', Masaryk was already pointing to another solution. He admitted also—and this, it has to be remembered, was rather sensational at the time—that 'sovereignty', meaning complete independence of other states and nations, was becoming an unrealistic concept. It is doubtful whether he would have been prepared to make the same admission later on when he was President of Czechoslovakia. But today it seems obvious to almost everybody that at least the economic and cultural interdependence of nations, and in fact also the political interdependence of states, are growing apace. One of the encouraging trends in postwar [World War II] development, especially although not exclusively in Europe, is that this fact is becoming accepted and that practical conclusions are being drawn from it.⁷

With fifty years of hindsight providing guidance, this view of *relative* sovereignty appears to anticipate an increase in *European* interdependence.

While Masaryk's remarks may now seem prescient, given our knowledge of the European Union and its eastward expansion in 2004, troubled times lay between Masaryk's vision in 1915 and the establishment of even the initial roots of the European Union (EU) in the 1950s. The peace settlement for World War I created a number of new states in

⁷ Gunnar Heckscher, 'The Role of Small Nations --Today and Tomorrow', *Fiftieth Anniversary Lecture of the School of Slavonic and East European Studies of the University of London, given on 19 October 1965* (London: University of London, The Athlone Press, 1966), pp. 10 - 11. Heckscher was the Swedish Ambassador to India, and formerly Professor of Political Science at Stockholm University. In his lecture, Masaryk said, 'It is a matter of course that there are different degrees and forms of independence. Sovereignty is relative, for the economic and cultural interdependency of all nations is growing. ... Europe is getting more and more federalized and organized.' Thomas G. Masaryk, 'The Problem of Small Nations in the European Crisis', *reprint of the Inaugural Lecture of the School of Slavonic Studies at King's College, University of London, given on 19 October 1915* (London: University of London, The Athlone Press, 1966).

Central Europe, including Czechoslovakia, while at the same time sowing the seeds for World War II. Writing in late 1941 Sidney Dark, a journalist, baldly stated –

The small weak state is an international nuisance. It is generally misgoverned. It is nearly always jealous of its neighbours. It has in the past lived in a constant state of fear of losing its independence, and this fear has been the greatest asset of the aggressor.⁸

He most likely was reflecting upon the events of the previous two decades and of the small states created in the aftermath of World War I. Dark later wrote, “The “real need and just demands” of the small nations can only be met if they become parts of larger nations, effective political unions justified by geographical position, economic interests and racial affinity.”⁹ This statement foreshadows later debates about the ‘viability’ of some colonies to become independent states. In addition, this view is in keeping with a broader belief that ‘bigger is better’.

Soon after the publication of Dark’s commentary, Sir J. A. R. Marriott wrote a rebuttal to it in his text, *Federalism and the Problem of the Small State*.

‘The small weak State is an international nuisance.’ That contention has lately been advanced by a writer of repute. Nor is it novel. But it is directly opposed to the argument of this Essay, which has been based on the assumption that the survival of the smaller Nation-States is essential to civilization.¹⁰

As suggested by his title, the solution to ‘the Problem of the Small State’ was to create a Federal State in which the small nation would be a component member. Marriott

⁸ Sidney Dark, ‘Minorities’, *A Christian Basis for the Post-War World: A Commentary on the Ten Peace Points*, ed. A. E. Baker (London: Student Christian Movement Press, 1942), p. 51. This collection of essays was published to promote the ten peace points identified in a letter from the leaders of the Churches of England. That letter was in reply to the publication of five peace points by Pope Pius XII.

⁹ Ibid. The reference to ‘real need and just demands’ was to the fourth point made by Pope Pius XII—‘If a better European settlement is to be reached there is one point in particular which should receive special attention: it is the real needs and the just demands of nations and populations, and of racial minorities. ...’ There was no indication, however, that the Pope was limiting his concerns to small states, or even to Europe. A. E. Baker, ed., *A Christian Basis for the Post-War World: A Commentary on the Ten Peace Points* (London: Student Christian Movement Press, 1942), pp. 14 - 15.

¹⁰ Sir J. A. R. Marriott, *Federalism and the Problem of the Small State* (London: George Allen & Unwin Ltd, 1943), p. 99. Marriott developed an historical argument for his belief that small states were essential to civilization. He considered Greek city-states (in particular Athens), the Roman Republic, and Italian Renaissance city-states; and then discussed the development of federal states during the past two centuries, including Australia, Canada, Switzerland and the United States.

suggested that a federal state, similar perhaps to Switzerland, could be established for the Balkans (or amongst the states along the banks of the Danube and Rhine rivers). Thus, while he disagreed with Dark about the nuisance factor presented by the small state, Marriott arrived at a conclusion remarkably similar to Dark. A conclusion that small independent states *should* be combined into larger political entities. Both Marriott and Masaryk foresaw a movement towards unification, but it was a vision centred on Europe. There was no suggestion amongst these authors of the forthcoming disintegration of colonial empires and the subsequent emergence of new states.

The Path to Independence

After the Second World War, decolonisation and the actions of an increasing number of the new members in the United Nations' General Assembly encouraged the creation of many new, often small, states. The problem for the transition from colony to state encompassed the capacity and viability of the colony to exist as an independent state. In general, political viability was seen as possessing the capacity for self-government. For the larger colonial territories, steps may already have been slowly underway to develop the capacity for self-government. In the case of the British colonial empire, independence also anticipated membership in the Commonwealth of Nations.

For the smaller territories, however, it was more than just the capacity for self-government that was considered. For them, viability was also framed in economic terms, that is, as a capacity to be, or become, economically self-sufficient. In the case of the British colonial empire, the intra-governmental debate in London (as found in a government report of 1957) suggested some territories were 'of no material value and could not hope to maintain themselves with a stable administration if the British left.'¹¹

¹¹ W. David McIntyre, 'The Admission of Small States to the Commonwealth', *The Journal of Imperial and Commonwealth History* 24, no. 2 (1996), 259 - 260. This article is the product of research in government archives, drawing on the

This report reiterated the concerns raised in 1951, in an earlier report of the ‘Committee of Enquiry into Constitutional Development in the Smaller Colonial Territories’,

To hand over unrestricted control in internal affairs in small territories where the bulk of the populations is economically weak and politically immature might, in practice, involve the abandonment of the people to the dictation of a dominant group which would be free to indulge in tyranny and corruption without let or hindrances.¹²

This may be read as a prediction of the situation that would occur in some instances, and subsequently came to be described as ‘failed states’.

Several factors led to a change of opinion about the question of economic viability, and resulted in the independence of territories earlier seen (and categorised) as ‘not viable’. One was the growing clamour for self-determination, particularly as expressed in/by the United Nations. Another was the example provided by the independence of a number of former colonies, for instance India, Pakistan, and Ghana. There was also an increasing recognition of the cost accumulating to the metropole state (in this case Britain) necessary to maintain these dependent territories. Combined, these factors led to a re-evaluation of maintaining colonies in the capitals of the metropolitan states, particularly as their relative status (and economic capacity) changed in the post-war years.¹³

Independence and self-determination

With respect to self-determination, it must be acknowledged that the literature on self-determination is both extensive and diverse. While lengthy exploration of it is beyond the scope of this thesis, a number of points should be highlighted because of the intimate

working papers of British government officials and provides valuable insight to the thought behind the debate on independence and viability.

¹² Ibid., p. 253. The quotation is from the Committee’s August 1951 report. The Committee was established by the Colonial Secretary to prepare the report for submission to the Cabinet (see Ibid., p. 251).

¹³ For the documentation of British governmental action in more detail involving decolonisation and the growth of the Commonwealth, see in particular documents 46 - 49 and 561 as contained in Ronald Hyam and Wm Roger Louis, eds., *The Conservative Government and the End of Empire, 1957 - 1964* (London: The Stationery Office, 2000). See also Ronald Hyam, ed., *The Labour government and the end of empire, 1945 - 1951* (London: The Stationery Office, 1992) for the earlier, immediate post-war period.

relationship many feel to exist between self-determination and sovereignty. To begin with, the argument for the self-determination of nations predates World War I, when it concerned the status of ethnic groups residing within the Austro-Hungarian and Ottoman Empires. The independence of Greece in 1830 is one example of the struggle for self-determination in the 19th century. Woodrow Wilson championed the issue at the Versailles Peace conference, which included the participation of both Thomas G. Masaryk (successfully for the self-determination of Czechoslovakia) and Ho Chi Minh (unsuccessfully for the self-determination of French Indochina).¹⁴ Nonetheless, the post-war revision of state boundaries in Europe did not necessarily follow patterns of ethnic settlement, and resulted in ethnic ‘minorities’ within the bounds of the (new) states. While the rights of minorities were defined in the peace treaties, this did not completely settle the issue; these were the seeds sown for renewed conflict in Europe, when the ‘protection’ (or assimilation) of a minority was used as the rationale and justification for further aggression.¹⁵

The language of self-determination used at the Peace Conferences after World War I concentrated on the structure of the losing states and their colonies. This was the problem Ho Chi Minh encountered when his petition for the independence of French Indo-China was denied. The status of the colonial territories of the victor nations was not open to negotiation. The conclusion of World War II twenty-five years later did not initially bring about a significant change either. It would require a normative change, as ‘colonialism came to be considered fundamentally wrong.’¹⁶ And, as was already suggested,

¹⁴ See Sophie Quinn-Judge, *Ho Chi Minh: the Missing Years, 1919 - 1941* (London: C. Hurst & Company, 2003), pp. 11 - 29.

¹⁵ Note also the continuation of these conflicts in the 1990s in Eastern and South-eastern Europe and the Transcaucasus. See Jennifer Jackson Preece, ‘Minority rights in Europe: from Westphalia to Helsinki’, *Review of International Studies* 23 (1997).

¹⁶ Georg Sørensen, *Changes in Statehood: The Transformation of International Relations* (London and New York: Palgrave, 2001), p. 57.

the increased relative cost of maintaining colonies, particularly in the financial circumstances of post-war Europe, helped to concentrate minds in the metropolises. In fact,

By the mid-1950s the Treasury was alarmed at the mounting costs of colonial development for the British Exchequer, not least because many British territories, such as the small Caribbean and Pacific islands, could generate only negligible resources in return for extensive grants-in-aid.¹⁷

Part of this normative change was encouraged by the Afro-Asian conference in Bandung, Indonesia in 1955, which issued a declaration emphasising the principles of sovereignty and self-determination, and rejecting colonialism.¹⁸ Increasing pressure on the issue in the UN General Assembly resulted five years later in ‘The Declaration on the granting of independence to colonial countries and peoples’.¹⁹ Note however, that this Declaration applied *solely* to ‘colonial’ peoples. Again, the scope of internationally legitimated self-determination had been constrained. The Declaration has been rejected as justification for separatist movements on the part of ‘peoples’ who were not subject to European colonisation, for instance the Basques and the Kurds.²⁰ On this aspect of self-determination, the UN Resolution denounces ‘any attempt aimed at the partial or total disruption of the national unity and the territorial integrity of a country.’²¹

In essence, the actions of the United Nations remained consistent with its legacy from the League of Nations.

¹⁷ Nicholas J. White, *Decolonisation: the British Experience Since 1945* (London: Longman, 1999), p. 27. White goes on to note that ‘As early as June 1952 one Treasury official commented that “the whole conception of Commonwealth development as the solution to our difficulties is becoming something of a castle in the air.”’ (Citing a Letter from Flett, Treasury to Melville, Colonial Office, dated 30 June 1952 and contained in A. N. Porter and A. J. Stockwell, *British Imperial Policy and Decolonization, 1938-64*, 2 volumes (London: Macmillan, 1987-9) vol. 2, pp. 176-7.)

¹⁸ Sørensen, *Changes in Statehood*, p. 58; Öyvind Österud, ‘The narrow gate: entry to the club of sovereign states’, *Review of International Studies* 23 (1997), p. 177.

¹⁹ UN General Assembly Resolution 1514, 14 December 1960. Note that membership of the General Assembly had shifted since 1945, almost doubling in size. In 1960 members now included such former colonies as Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Côte d’Ivoire, Democratic Republic of the Congo, Gabon, Ghana, Madagascar, Mali, Niger, Nigeria, Senegal, Somalia, Sri Lanka, and Togo. See Department of Public Information Information Technology Section, *Growth in United Nations Membership, 1945-2002*, 2002, United Nations, Available: www.un.org/Overview/growth.htm [accessed 1 November 2002].

²⁰ See Robert H. Jackson, *Quasi-states: Sovereignty, International Relations and the Third World* (Cambridge: Cambridge University Press, 1990), pp. 76 - 78. For more on separatist groups see the web site, *Unrepresented Nations and Peoples Organisation*, <http://www.unpo.org/> [accessed 1 November 2002].

Here is a close parallel to the scenario for Central Europe after imperial dissolution during World War I: empires should be broken up, but the successor nation-states should be preserved intact, irrespective of the national complexity they might contain.²²

The territorial boundaries established to delimit colonies were transformed into state boundaries, without further consideration of the ethnic/minority composition of the resulting state. This follows an established principle of international law known by the Latin term, *uti possidetis*. The principle emerged in conjunction with the conversion of Spanish colonies in the New World into new states in the early nineteenth century. It established the precedence that colonial administrative boundaries become state borders at the time of independence.²³ For the African colonies, this approach was further enshrined in the Charter of the Organization of African Unity (OAU), which reads in part,

Principles – Article III

The Member States, in pursuit of the purposes stated in Article II, solemnly affirm and declare their adherence to the following principles:

The sovereign equality of all Member States.

Non-interference in the internal affairs of States.

Respect for the sovereignty and territorial integrity of each State and for its inalienable right to independent existence.²⁴

²¹ UN General Assembly Resolution 1514, 14 December 1960.

²² Österud, 'The narrow gate', p. 179. See also, Sørensen, *Changes in Statehood*, p. 59.

²³ Steven R. Ratner, 'Drawing a Better Line: *Uti Possidetis* and the Borders of New States', *American Journal of International Law* 90, no. 4 (1996). The same occurred with district borders during the disintegration of Yugoslavia and the Soviet Union.

²⁴ Organization of African Unity, *Charter & Rules of Procedure* (Addis Ababa, Ethiopia: Organization of African Unity, n.d.). 'Done in the City of Addis Ababa, Ethiopia, 25th day of May 1963.' The Charter is included in Gino J. Naldi, ed., *Documents of the Organization of African Unity* (London: Mansell Publishing Limited, 1992), pp. 3 - 10. The OAU has remade itself into the African Union, 'loosely modelled on the European Union and will have the right to intervene in the affairs of its member states, in cases of genocide and war crimes.' *Huge challenge for African Union*, Monday, 8 July, 15:54 GMT 16:54 UK 2002, Web page, BBC News, Available: <http://news.bbc.co.uk/1/hi/world/africa/2115410.stm> [accessed 14 November 2002]. For more on the African Union, see <http://www.africa-union.org/en/home.asp> [accessed 14 November 2002].

Concepts of sovereignty

There exists an extensive literature on the topic of 'sovereignty' within international relations, international law, and political science. The concept, definition, and even the word itself have been challenged since at least the sixteenth century.²⁵ The debate on the nature and validity of the concept has been re-invigorated since the end of the Cold War with the evolving development and use of humanitarian intervention. The condition of sovereignty has also been questioned in light of globalisation, with some authors suggesting not only that the sovereign state may be in decline, but also that the very concept of sovereignty has become redundant.²⁶ Before addressing concerns for the continued relevance of state sovereignty, the concept as used here should first be defined.

Defining the Sovereign State

The Montevideo Convention on Rights and Duties of States (1933) defined the state in its first article as a 'person' in international law possessing four qualifications. These qualifications are: a defined territory, a permanent population, a government, and the capacity to conduct relations with other states. For international law scholars however, the Montevideo Convention is an inter-American convention and it only applies to its limited number of signatories.²⁷ This convention for international law established the

²⁵ F. H. Hinsley, *Power and the Pursuit of Peace: Theory and Practice in the History of Relations between States* (Cambridge: Cambridge University Press, 1963), especially chapter 1.

²⁶ For example, see: Daniele Archibugi, 'Demos and Cosmopolis', *New Left Review* Second series, no. 13 (Jan/Feb 2002); Philip G. Cerny, 'Globalization and the changing logic of collective action', *International Organization* 49, no. 4 (1995); Peter Evans, 'The Eclipse of the State? Reflections on Stateness in an Era of Globalization', *World Politics* 50, no. 1 (1997); David Held and Anthony McGrew, 'The End of the Old Order? Globalization and the Prospects for World Order', *Review of International Studies* 24, no. 5 (1998); Paul Hirst, 'The global economy -- myths and realities', *International Affairs* 73, no. 3 (1997); Michael Mann, 'Has globalization ended the rise and rise of the nation-state?' *Review of International Political Economy* 4, no. 3 (1997); Martin Wolf, 'Will Technology and Global Capital Markets Change the Scope of Government?' *Cato Journal* 21, no. 1 (2001).

²⁷ James Crawford, 'Islands as Sovereign Nations', *International and Comparative Law Quarterly* 38 (1989), p.280. Crawford prefaced his reference to the Montevideo Convention by declaring, 'Despite its importance, or perhaps because of it, statehood has never been authoritatively defined in an international decision or instrument.' However, *The Penguin Dictionary of International Relations* suggested that the Montevideo Convention was 'widely regarded as the classic legal definition'. Graham Evans and Jeffrey Newnham, *The Penguin Dictionary of International Relations* (London: Penguin Books, 1998), pp. 512 - 513.

bounds for a political community, which is to be identified as a state. This political community is sovereign with respect to the territories it occupies. As F. H. Hinsley stated when laying the foundation for his study of sovereignty

...the idea of sovereignty was the idea that there is a final and absolute political authority in the political community; and everything that needs to be added to complete the definition is added if this statement is continued in the following words: “*and no final and absolute authority exists elsewhere.*”²⁸

Therefore, the sovereign state is a political community exercising control over a piece of territory. This condition must be recognised and acknowledged by similar political communities. With this peer recognition comes the acknowledgement that the territory is a juridical equal able to enter into agreements with other states and to have representatives participate in various international organisations. This approach accords power to the existing members of the international community of states, and serves as a control mechanism to limit the participation of aspiring members to the community. Clear examples of the use of this power include the denial of recognition to the Soviet government in Russia following the October Revolution until 1934 by the United States; and the continued recognition of the government in Taiwan as the sovereign representative for China, instead of the Mainland government, until the 1970s by a number of Western states, including most prominently the United States.²⁹

There is also a strong aspect to sovereignty that is necessarily *socially constructed*. The construction of sovereignty is tied to the perception (self-recognition) of a group of people as a nation.³⁰ And, as a nation, they have identified some bounded territory in which they

²⁸ F. H. Hinsley, *Sovereignty*, 2nd ed. (Cambridge: Cambridge University Press, 1986), p. 26. Emphasis in the original.

²⁹ Stephen D. Krasner, *Sovereignty: Organized Hypocrisy* (Princeton: Princeton University Press, 1999), pp. 14 - 20. For a discussion of the Taiwan case, and its position as a state in the Westphalian sense, but not in the international legal sense see Robert A. Madsen, ‘The Struggle for Sovereignty Between China and Taiwan’, *Problematic Sovereignty: Contested Rules and Political Possibilities*, ed. Stephen D. Krasner (New York: Columbia University Press, 2001).

³⁰ Here I tread on unstable ground, with no desire to enter into the discourses of nationalism, self-determination or the ‘right’ to sovereign recognition by any group seeking such (see the previously identified web site, <http://www.unpo.org/>, for a selection of the claimants). But, suffice it to say, at this point I desire to identify a collectivity separate from its mutually constituted perception as a ‘state’. In order to accomplish this, I have elected to use the word *nation*, acknowledging in this context the basis of the European development of the state, very often as a

wish to exercise self-determination. For well-established states, this construction is reinforced by a history (or perhaps a mythology) as a nation-state, which then provides a rationalisation and justification to the claims for existence as a society.³¹ Similarly, for groups possessing a history as a nation, yet lacking status as a state and desiring self-determination, it fuels the desire for independence from the existing political entity of which the territory claimed presently is a part, in order to form a new political entity (or to join with an another, already existent political entity established by members of the same group). Using nation, state and nation-state interchangeably in the English-language literature in order to identify this sovereign political entity only serves to further confuse the issue. However, the focus of the group (nation) is on the territory from which the sovereign state emerges. Gaining recognition for them hinges on the possession of territory, and to a (sometimes variable) extent, exercising control over this territory.³²

Acquisition of sovereignty at this point provides the social recognition of the state—and the rights and responsibilities attendant to this recognition—by the international community. The state is sufficiently autonomous to seek a position amongst other states, while able to conduct internal affairs as desired without external interference. This ideal, or imagined, perspective of sovereignty may not function within the international system in precisely this fashion, as discussed by Stephen Krasner in *Sovereignty: Organized Hypocrisy*. It is however, the image or perception resident in the minds of the leadership within the state that counts, and this image influences the actions they take both in relation to other states, and internally with the populace. For as noted by Krasner,

‘nation-state’. For a wider discussion of sovereignty and nationalism, see James Mayall, ‘Sovereignty, Nationalism, and Self-determination’, *Political Studies* XLVII (1999).

³¹ Consider the argument made by Consuelo Cruz that political identity must be understood as a product of collective memory, constructed and defined intersubjectively by the group/nation in Consuelo Cruz, ‘Identity and Persuasion: How Nations Remember Their Pasts and Make Their Futures’, *World Politics* 52 (April 2000).

³² On this point see, Alexander B. Murphy, ‘National Claims to Territory in the Modern State System: Geographical Considerations’, *Geopolitics* 7, no. 2 (2002).

‘Rulers, not states...make choices about policies, rules, and institutions.’³³ This includes recognition of other political entities as a sovereign state, as well as acting to maintain their rights and status as a sovereign state.

Accompanying the status of recognition as a sovereign state, is the perception of the rights associated with that status. A list of such rights would include:

Control of the passage of people, goods, and services through territorial borders

Monopoly of the means of violence

Authority to enter into agreements with other states

In constructing a definition of sovereignty, we need to ask whether these rights are divisible, i.e. – can a state give up the right (say) to control the passage of individuals across its border with a neighbouring state, and remain sovereign? The experience of the European states that have signed the Schengen Agreement suggests the answer is yes. They have conceded this control mechanism to the outer borders of the group of member states, accepting that individuals go through passport control upon first entry to the Schengen group of states. Once admitted, individuals have free right of passage, without further passport and immigration control, amongst the member states. Nonetheless, the member states feel/perceive that they remain sovereign.³⁴ This view of sovereign rights was described by Michael Fowler and Julie Bunck as the Basket Approach to sovereignty, ‘...a basket of attributes and corresponding rights and duties. While every state has a basket, the contents are by no means the same.’³⁵ Sovereignty is thus relative, and elements of these rights are freely ceded in the process of negotiation. States are therefore willing to relinquish some aspect of their freedom to choose a course of action in exchange for some

³³ Krasner, *Sovereignty: Organized Hypocrisy*, p. 7.

³⁴ Task-Force on the “Intergovernmental Conference”, ‘No. 27, Briefing on the Intergovernmental Conference and the Schengen Convention’, trans. Hubert Schroif, first update ed. (Luxembourg and Bruxelles: European Parliament, 1996); Antje Wiener, *‘European’ Citizenship Practice: Building Institutions of a Non-State* (Boulder: Westview Press, 1998), see specifically Chapter 10, ‘A Space Without Frontiers? - Border Politics’.

benefit. For example, in order to receive loan support from the International Monetary Fund (IMF), a state accepts the financial controls and guidance of the IMF, because the loan is expected to benefit the state—the populace and territory—in order to achieve a greater good in the form of an improved local economy. The key aspect of this perspective of sovereignty is that it is a product of willing cooperation and negotiation, and that should circumstances change the right in question could be reclaimed (at least theoretically). In presenting this approach to sovereignty, Fowler and Bunck quoted Hans Blix comparing sovereignty to property rights,

As ownership is described as a bundle of rights, sovereignty may perhaps be described as a bundle of competences. There is no inherent reason against the voluntary acceptance of limitations upon the freedom of action in one field or in several fields, upon one or more of the competences in the bundle. Of course, such limitations do reduce the freedom of action of the state and thereby nibble at the sovereignty—as the concept is defined here. Most of that freedom will remain, however.³⁶

This conception of sovereignty, particularly with reference to competences, is a foundation for the operation of the European Union.

The alternate approach is to treat sovereignty as a unitary value, ‘a monolith, like a chunk of stone’. In this Chunk Approach to sovereignty, a state either is, or is not, sovereign; just as a woman cannot be half pregnant, a state cannot be 75% sovereign. In this tradition, all sovereign states are equal, in what Krasner and others identify as international legal sovereignty. Therefore, sovereignty is based upon reciprocity amongst states, with similar rights and duties. A state is also party to a collection of treaties and conventions, which further refine the conduct of a state relative to its rights and duties, and which may lead to a relative imbalance amongst states’ rights.³⁷

³⁵ Michael Ross Fowler and Julie Marie Bunck, *Law, Power, and the Sovereign State: The Evolution and Application of the Concept of Sovereignty* (University Park, Pennsylvania: The Pennsylvania University Press, 1995), p. 70ff.

³⁶ Hans Blix, *Sovereignty, Aggression, and Neutrality* (Stockholm: Almqvist & Wiksell, 1970), p. 10, as cited in *Ibid.*, p. 71.

³⁷ *Ibid.*, p. 64ff.

Sovereignty for Small States

Many small states, and most especially those considered here, are relatively new and consequently concerned about perceptions of sovereignty. Thus for a new state, the construction of a social identity as a 'state' (no less than as a 'nation') is also relatively new. As already mentioned and widely noted in the literature on post-colonial states, self-determination, and nationalism, many new states are not homogenous territories, in part because of *uti possidetis*. These former colonies came to sovereign status with pre-existing internal problems of nationalism and self-determination (along with secessionist and recidivist demands). The partition of the Subcontinent into India and Pakistan for example, did not resolve such problems there, as East Pakistan became Bangladesh in 1971, and the Kashmir province remains a flashpoint between India and Pakistan. Another residual effect of decolonisation has been the condition known as the failed state or quasi-state. For Robert Jackson, 'Sovereign states are legally but not necessarily physically insular and today most of them are economically dependent or interdependent.'³⁸ He takes the chunk approach to viewing sovereignty, which is challenged by the situation present in a large number of states. Jackson described the consequences of this situation as a proliferation of quasi-states. Quasi-states are political entities possessing international recognition as a state (possessing territory and conducting relations with other states) but without effective control of the internal affairs of their territory. 'Their governments are often deficient in the political will, institutional authority, and organized power to protect human rights or provide socio-economic welfare.'³⁹

This viewpoint may be further advanced by the suggestion that the continued existence of quasi-states is at the same time a social construct of the international system. Their status as *sovereign states* has been constructed by the rest of the international

³⁸ Jackson, *Quasi-states*, p. 33.

community, which insists on dealing with a unitary actor. This unitary actor is the territory and population previously defined as a state, even if the situation is contested domestically. It is not so much a matter of *degrees* of statehood, as simply one of continuing to treat the territory *as a state*. Various external organisations (IGOs, NGOs, etc.) maintain their expectations for modes of governance and organisational structure, and continue to act as if they exist to represent this notional state. Consequently, these territories continue to perform as states internationally even when they are unable to function as a state domestically.⁴⁰

The concept of sovereignty is integral to political organisation, and thus to the perceptions of the society which forms that political organisation. The essence then of sovereignty may be characterised as the collective concept resident in the collective social/communal mind.⁴¹ These shared public perceptions, as reflected in the images displayed by the media, academic writing, and the public comment of political leaders, all serve to refine and reproduce the definition of sovereignty, thereby influencing the actions of the state, through the conduct of its government. This condition is recognised by small states, which may be particularly sensitive to the actions that reinforce their self-perception of sovereign independence. At the same time, these societies are sensitive to external forces that undermine their self-perception.

An example of the latter situation may be found in the negotiations for 'shiprider' agreements between the United States and a number of Caribbean states in the 1990s. As described by Holger Henke, the difficulty in concluding these negotiations arose from differing perceptions about state sovereignty. The shiprider agreements would permit

³⁹ Ibid., p. 21.

⁴⁰ Georg Sørensen, 'Rethinking Sovereignty and Development', *Journal of International Relations and Development* 2, no. 4 (1999), 397 - 399.

search and seizure actions by U.S. Coast Guard vessels inside the territorial limits of Caribbean states as part of the war on drugs. Without these agreements, potential law enforcement actions would be a violation of territorial sovereignty. For Henke this controversy demonstrated that the United States lacked an ‘understanding and appreciation of the value and significance which ex-colonial societies, like the Caribbean countries, assign to their independence and right of self-determination.’⁴² This conclusion was echoed by other authors concerning U.S.-Caribbean state relations over the ‘war on drugs’. Moreover, some of the ‘negotiation’ tactics used by the United States to reach a resolution on the shiprider agreements demonstrate this disregard for Caribbean perceptions of sovereignty. For example, when Jamaica expressed its reluctance to signing the initial agreement proposed by the U.S., subsequent discussions included the threat that Jamaica could be ‘decertified’ as a result of the lack of co-operation in the war on drugs.⁴³

The sensitivity of small states, particularly the ex-colonial societies discussed by Henke, to sovereign independence while ultimately acquiescing to the demands of larger states (as was the case with the shiprider agreements) raises another point about concepts of liberty, and of sovereignty. In a lecture to the British Academy, Quentin Skinner suggested that in addition to positive and negative liberty, as explicated by Isaiah Berlin, there is a third concept of liberty. Essentially, when subject to the capricious rule of a sovereign the individual will constrain their actions, not because of any actual interference or threat of interference in their lives by the ruler, but because they are dependent upon the goodwill of the ruler. Thus, it is ‘by the mere knowledge that we are living in dependence

⁴¹ Such a ‘collective concept’ has been refined into the term ‘meme’ and a field of study known as ‘memetics.’ For one view of this phenomenon of the transfer of a cultural practice or idea from one mind to another, see Susan Blackmore, *The Meme Machine* (Oxford: Oxford University Press, 1999).

⁴² Holgar Henke, ‘Drugs in the Caribbean: The “Shiprider” Controversy and the Question of Sovereignty’, *European Review of Latin American and Caribbean Studies*, no. 64 (1998), p. 42.

⁴³ Trevor Munroe, ‘Cooperation and Conflict in the US-Caribbean Drug Connection’, *The Political Economy of Drugs in the Caribbean*, ed. Ivelaw L. Griffith (Houndmills, Basingstoke: Macmillan Press Ltd, 2000), p. 196. This matter of

on the goodwill of others' that our liberty to act as we would desire is thereby constrained.⁴⁴ This third concept of liberty aptly describes the position of the small state in international society, since their decisions and actions reside within such a space, one that is created by their awareness that they are dependent upon the goodwill of larger states.⁴⁵

Variety in Definition – What is ‘small’?

With this understanding of sovereignty, it is now necessary to identify what is meant by a *small* state within the specific context of this research. A variety of approaches have been used to define a small state and this question challenges any attempt to conduct a comparative study of small states. Robert Keohane made this critique of the literature in 1969, in a review article focused on the alliance aspects of small state foreign policy. He provided a definition for a small state that was frequently cited when examining the security concerns of small states—‘*a small power is a state whose leaders consider that it can never, acting alone or in a small group, make a significant impact on the system.*’⁴⁶ Another statement in ‘Lilliputians’ Dilemmas’ has not, however, been quoted as often. It reflects Keohane’s assessment of international relations research more generally.

decertification would lead to a loss of U.S. foreign aid and a U.S. veto on any loans and loan guarantees by international financial institutions.

⁴⁴ Quentin Skinner, ‘A Third Concept of Liberty’, *Proceedings of the British Academy* 117 (2002), p. 247.

⁴⁵ This circumstance for small states was noted by Adam Watson, *The Limits of Independence: Relations between States in the Modern World* (London: Routledge, 1997), pp. 123 - 124.

⁴⁶ Robert O. Keohane, ‘Lilliputians’ Dilemmas: Small States in International Politics’, Rev. of *Alliances and the Third World*, by George Liska; *Alliances and American Foreign Policy*, by Robert E. Osgood; *Alliances and Small Powers*, by Robert L. Rothstein; and *The Inequality of States*, by David Vital, *International Organization* 23, no. 2 (1969), p. 296. Emphasis in the original. His complete definition for the spectrum of statehood began – ‘I therefore suggest the following definition with the caveat that in all cases statesmen’s attitudes must have considerable basis in reality. *A Great Power is a state whose leaders consider that it can, alone, exercise a large, perhaps decisive, impact on the international system; a secondary power is a state whose leaders consider that alone it can exercise some impact, although never in itself decisive, on that system; a middle power is a state whose leaders consider that it cannot act alone effectively but may be able to have systemic impact in a small group or through an international institution; ...*’

This author's view is that precise analytical definitions are more likely than arbitrary or intuitive delineations to point out conceptually significant differences between categories of states and therefore to facilitate behavioral comparison.⁴⁷

This challenge was posed to researchers working with the often nebulous category of 'the small state'. Keohane was criticising the approach taken to establish a definitive category, and then the effort necessary to defend it, in the texts he reviewed.

An attempt to produce the precise analytical definition desired by Keohane was made by Maurice East in 1973. In 'Size and Foreign Policy Behavior: A Test of Two Models', East approached the task quantitatively, using data from the CREON Project.⁴⁸ Specifically he used '4,448 foreign policy events initiated by 32 nation-states during randomly selected quarters of each of the years in the decade 1959-1968.'⁴⁹ Using previous statistical analysis performed on the data set, East established his boundary to determine the small state as one with a population of less than 23.7 million people. He also segregated the data set into developed and developing states, based upon a boundary value for gross national product (GNP) per capita of \$401. His analysis rested, however, on a somewhat ambiguous statement.

Although the data at hand do give reason for believing that there are profound and significant differences in the behavior patterns of large and small states, such a belief cannot be sustained without considerably more research on foreign policy decision-making procedures in small and developing states.⁵⁰

Later research, which perhaps might be categorised as anecdotal by quantitative methodologies, tended to bear out the fact that there were differences in the foreign policy behaviours of small states, vis-à-vis those of large states.⁵¹ Such differences will reflect the

⁴⁷ Ibid. p. 294.

⁴⁸ Comparative Research on the Events of Nations (CREON) Project. The summary report has been converted to PDF format and is available at <http://www.sc.edu/ardc/icpsr/pdf/cbs5205.pdf> [accessed 12 June 2003].

⁴⁹ Maurice A. East, 'Size and Foreign Policy Behavior: A Test of Two Models', *World Politics* 25, no. 4 (1973), p. 561.

⁵⁰ Ibid., p. 576.

⁵¹ See for example Baldur Thorhallsson, *The Role of Small States in the European Union* (Aldershot: Ashgate, 2000); Michael Leifer, *Singapore's Foreign Policy: Coping with Vulnerability* (London: Routledge, 2000); Peter J. Boyce, *Foreign Affairs for New*

limited capacities and resources available to small and developing states to engage in any significant foreign policy activity beyond their immediate neighbourhood. In this fashion the contributors to *Small States in World Politics: Explaining Foreign Policy Behaviour* started from a concept of the small state based on perceptions, 'if a state's people and institutions generally perceive themselves to be small, or if other state's peoples and institutions perceive that state as small, it shall be so considered.'⁵²

In contrast to the work of East, the Commonwealth has built a body of literature using a definition of the small state based on a much smaller population limit. The Commonwealth has provided a forum and a voice for the small state since the early 1980s. A wider awareness of the issues that concerned small states was accomplished with the publication of *Vulnerability: Small States in the Global Society* in 1985.⁵³ This research on small states was revisited in 1997, with a study that broadened the analysis to include the environment and the evolving nature of the global economy following the end of the Cold War. In *A Future for Small States*, the authors defined a small state as one possessing a population of 1.5 million or below.⁵⁴ This updated the earlier definition from one million and reflects the global population increases between 1983 and 1995. In 1997, this cut-off point identified 49 states with a population of 1.5 million or less. Of these states, 28 were members of the Commonwealth, and 42 were considered part of the developing world.⁵⁵

This limit of 1.5 million has been used in other research as the criterion to determine the small state, while some authors continued to use alternate limits, namely the

States: Some Questions of Credentials (St. Lucia, Queensland: University of Queensland Press, 1977); Milan Jazbec, *The Diplomacies of New Small States: The case of Slovenia with some comparison from the Baltics* (Aldershot: Ashgate Publishing Ltd, 2001).

⁵² Jeanne A. K. Hey, 'Introducing Small State Foreign Policy', *Small States in World Politics: Explaining Foreign Policy Behavior*, ed. Jeanne A. K. Hey (Boulder and London: Lynne Rienner Publishers, 2003), p. 3.

⁵³ Commonwealth Secretariat, *Vulnerability: Small States in the Global Society* (London: Commonwealth Secretariat, 1985).

⁵⁴ Commonwealth Advisory Group, *A Future for Small States: Overcoming Vulnerability* (London: Commonwealth Secretariat, 1997), p. 9.

earlier value of one million, or even three million, or five million.⁵⁶ The identification of a population limit is necessarily dependent upon when the research was conducted (which affects the availability of population data). Moreover, there are always concerns with the accuracy and currency of population data. Nevertheless, for the purposes of discussion here, accuracy within 100,000 people was deemed sufficient, and population data from the United Nations has generally been used.⁵⁷

Population size serves as a simple, easily measured criterion for identifying the small state. The authors of *A Future for Small States* emphasised this fact when explaining their definition and recognised that ‘any definition is therefore to some degree arbitrary.’ Given this, two further considerations must be kept in mind when establishing a definition for the small state. ‘First, economists have demonstrated that for small countries a high correlation exists between population and other measures of economic size....’ Second, the concept of size is relative, and our perceptions of *smallness* have changed with the passage of time, particularly as the number of small states increased following the end of World War Two.⁵⁸

The economics research referred to (but not cited) in *A Future for Small States* may be that of Peter J. Lloyd and R. M. Sundrum, and Bimal Jalan in the edited collection

⁵⁵ Commonwealth Secretariat, *Vulnerability: Small States in the Global Society*, p. 9. See below, Tables 2-2 through 2-5 for specific data.

⁵⁶ Also using 1.5 million was Frank B. Rampersad, ‘Coping with Globalization: A Suggested Policy Package for Small Countries’, *The Annals of The American Academy of Political and Social Science*, no. 570 (2000). Using a figure of 1 million were: William Easterly and Aart Kraay, ‘Small States, Small Problems? Income, Growth, and Volatility in Small States’, *World Development* 28, no. 11 (2000); Colin G. Clarke and Anthony Payne, *Politics, security and development in small states* (London: Allen & Unwin, 1987). Using a figure of 3 million were: H. Armstong, et al., ‘A Comparison of the Economic Performance of Different Micro-states, and Between Micro-states and Larger Countries’, *World Development* 26, no. 4 (1998), Available: www.elsevier.com/locate/worlddev. Using the figure of 5 million were: Ken Ross, ‘Power in Numbers’, *The World Today* 57, no. 5 (2001); Stanley D. Brunn and Charles D. Cottle, ‘Small States and Cyberboosterism’, *The Geographical Review* 87, no. 2 (1997); Frane Adam, ‘Developmental Options and Strategies of Small Countries’, *Journal of International Relations and Development* 1, no. 3 - 4 (1998).

⁵⁷ Department of Economic and Social Affairs Population Division, United Nations, *World Population Prospects: The 2000 Revision, Highlights, Draft*, 28 February 2001, Web site with data files, Available: www.un.org/esa/population/unpop.htm [accessed 2 March 2002].

⁵⁸ Commonwealth Advisory Group, *A Future for Small States*, p. 8.

Problems and Policies in Small Economies.⁵⁹ In the chapter 'Classification of Economies by Size', Bimal Jalan calculated a 'country size index' giving equal weighting to population, arable area, and GNP for each of 111 countries. Jalan's approach was to treat each of these three variables as a factor to produce a combined index of size. This approach permitted comparison amongst states. A state was classified as small if it fell below the cut-off point for any one of the three measures. Using data from 1977, Jalan found 59 states met his broad criteria (population less than 5 million; territory less than 25,000 km²; gross national product (GNP) less than \$3 billion). Within this set, he identified the existence of a distinct subset of 21 states which could be categorised as 'micro states' (population less than 400,000; territory less than 2,500 km²; GNP less than \$500 million).⁶⁰

In 'Characteristics of Small Economies' Lloyd and Sundrum built upon the work of Jalan. They found that 'it may be sufficient from a statistical point of view to classify countries by population size alone, the diversity in the other measures of size being averaged out in the process.' This judgement derived from looking at Jalan's research, noting that for the smallest of the less developed countries (LDCs; as determined by the territory and GNP size factors), they were mainly states with less than 5 million people. Lloyd and Sundrum also preferred the approach of using population as the measure for state size because 'it has the advantage from an economic point of view that it relates to the human resource constraint on economic growth.' They developed their approach in more

⁵⁹ Bimal Jalan, ed., *Problems and Policies in Small Economies* (London: Croom Helm, 1982).

⁶⁰ Bimal Jalan, 'Classification of Economies by Size', *Problems and Policies in Small Economies*, ed. Bimal Jalan (London: Croom Helm, 1982). Authors use 'microstate' and 'ministate' with no greater precision than that reflected in the use of the term small state. For example, John Connell defined a microstate as one with a population less than 1 million. And in 'A Comparison of the Economic Performance of Different Micro-states, and Between Micro-states and Larger Countries' Armstrong, et al. set the top limit at 3 million for their study; this delimiter was identified after noting the difficulty with collecting economic data to use as a delimiter. And, as a final example, Bartmann used microstate interchangeably with small state, without ever specifying the size parameters of the states under analysis. His tables however included Gambia (1.2 million) and Gabon (1.3 million) at the top in terms of population size. John Connell, *Sovereignty & Survival: Island Microstates in the Third World*, Research Monograph, No. 3 (Department of Geography, University of Sydney, 1988); Armstrong, et al., 'A Comparison of the Economic Performance of Different Micro-states'; Barry Bartmann, 'Meeting the Needs of Microstate Security', *The Round Table*, no. 365 (2002).

detail, seeking to understand what characteristics could be predicted from size and the impact size would have on the viability of a small developing economy.⁶¹

This research on small states has stood the passage of time, cited for example as the basis for the definition and sample selection used in Atkins, Mazzi and Easter, *A Commonwealth Vulnerability Index for Developing Countries*. In explaining the sample selection for their study, Atkins, et al. acknowledged that alternative approaches to defining and selecting small states existed. They pointed out that the approach taken was in conjunction with the use of population as the determining factor in the 1997 Commonwealth report, *A Future for Small States*. In addition, they referred to Jalan's earlier work, summarising their approach by stating – 'Hence, population can justifiably be used as a proxy for economic size—and ease of data availability provides further justification.'⁶²

The varying approaches taken to define a small state result in a use of different adjectives to qualify the state. Where some texts used the word 'small', others used 'mini' or 'micro'. Several tables categorising small states by population are provided below (pages 69 - 72). These tables break down the roster of states by population size, the first lists those states with less than 5 million people, the second less than 1.5 million, and the third less than 500,000. The fourth table lists all remaining states with populations less than 100,000 as of the 2000 UN Population Report. The final table identifies the non-self-governing territories with population data reported by the United Nations.

One conclusion that we may reach from this review of the pertinent literature is that 'size is relative'. Relative then to the purposes of this thesis, it will continue with the usage of 'small' to indicate a state possessing a population less than 1.5 million. Following

⁶¹ Peter J. Lloyd and R. M. Sundrum, 'Characteristics of Small Economies', *Problems and Policies in Small Economies*, ed. Bimal Jalan (London: Croom Helm, 1982), p. 22.

⁶² Jonathan P. Atkins, et al., *A Commonwealth Vulnerability Index for Developing Countries: The Position of Small States* (London: Commonwealth Secretariat, 2000), p. 4, footnote 1. This approach was also used to characterise small states on the Commonwealth Web site, see Commonwealth Secretariat, *About Commonwealth Small States*, 2003, Web page,

from this discussion, it is reasonable to use this boundary point to determine a small state and follows the lead of the Commonwealth Secretariat. To further discriminate amongst states and establish yet more discrete categories, such as mini or micro is not necessary.

Remnants of Empire

As already mentioned, the question initially raised after World War II concerning the transition of colonies to sovereign states was one of capacity and viability. As the pace and pressure of decolonisation increased, these concerns became less critical to the process. The question was no longer ‘can this territory survive as an independent state’, but rather ‘why is this territory not yet independent?’ The pressure came in particular from the United Nations’ General Assembly Fourth Committee (Special Political and Decolonization), as well as from the citizens/residents of the territories involved. This is not to suggest however that the urge for an independent sovereign status was universal amongst the residents of these territories. Nor does it mean that there are no colonies left in the international system of states. While the descriptive name applied to them may have changed over time, to British Overseas Territory or the French Département d’Outremer for example, these jurisdictions have remained ‘non-self-governing territories’ in the language of the General Assembly.⁶³

Reviewing this list of territories, the reader will recognise the presence of many as locations for offshore financial centres.⁶⁴ This fact introduces an additional dynamic to the debate on harmful tax competition, as the *administering state* becomes a participant in efforts to constrain offshore financial centres. Furthermore, the administering state may have

Commonwealth Secretariat, Available: http://www.commonwealthsmallstates.org/small_states.html [accessed 28 April 2003].

⁶³ ‘General Assembly Commemorates 40th Anniversary of Decolonization Declaration, Declares 2001 - 2010 Second Decade for Elimination of Colonialism’, *Press Release GA/9844* (New York: United Nations, 8 Nov 2000).

⁶⁴ See also Table 3-1, Jurisdictions with offshore financial centres.

competing and conflicting interests within the debate on taxation, as in the case of the United Kingdom, which is a member of the European Union, a member of the Commonwealth, and the administering state for a number of jurisdictions. However, the emphasis here is on those jurisdictions possessing sovereign status, and treated as sovereign states within the international system.

The issue of decolonization and sovereignty has not been explored in depth. As listed in Table 2-5, a number of non-self-governing territories have, for one reason or another chosen *not* to become sovereign states. The Second Decade for the Elimination of Colonialism was decreed as 2001 - 2010, and the discourse on this goal implies that self-determination requires independent, sovereign status.⁶⁵ At a meeting of the Special Committee on Decolonization in 1999, the representative from the United States Virgin Islands felt a statement made by an expert from the Cayman Islands illustrated a 'lack of information and understanding about international law and the meaning of self-determination'. Previously, the Cayman Islands' electorate voted against independence. This was an act of self-determination, but it was not felt to be a sufficient reason to remove it from the list of colonies encouraged to seek independence. 'It could just be noted that the Cayman Islands were not ready.'⁶⁶ The tone of the exchange suggested that a non-self-governing territory is free to choose, as long as the choice is for independence. It implies that nothing other than independence is an acceptable situation for a non-self-governing territory. One problem is that this could result in creating yet another quasi-state. For a territory unable to support itself as an independent political entity (as suggested in this instance by the expert from the Cayman Islands, who stated that the islands 'did not have

⁶⁵ 'General Assembly Commemorates 40th Anniversary of Decolonization Declaration, Declares 2001 - 2010 Second Decade for Elimination of Colonialism'. However, as already mentioned, the discourse on self-determination is extensive, and to a large extent contested, given the constraints imposed in determining what is, and is not, legitimate grounds for self-determination.

⁶⁶ 'Offshore Banking in Island Non-Self-Governing Territories Discussed in Special Committee on Decolonization', *Press Release GA/COL/3004* (New York: United Nations, 28 May 1999).

any natural resource or any products, let alone self-sufficiency') would nonetheless be treated as a sovereign state.

Historically challenged to exist amongst their larger neighbours, small states have been a part of political science/international relations research for over a century. Within the context of this research work, sovereignty for these small states is as much a social construct, as it is a matter of structural control over a territory and population. To limit this research to those territories with less than 1.5 million residents serves to highlight the constraints imposed by limited human resources, along with the size of the domestic economy. These factors influence the decision-making process, with the result in a number of cases of a decision to establish and maintain an offshore financial centre, and now to defend this sovereign choice against the efforts of the OECD.

Table 2-1 – Small States by Population, 1.5 to 5 million

Country or area*	Total population in thousands, 2000
Nicaragua	5 071
Kyrgyzstan	4 921
Jordan	4 913
<i>Papua New Guinea</i>	4 809
Turkmenistan	4 737
Croatia	4 654
Togo	4 527
Norway	4 469
<i>Sierra Leone</i>	4 405
Republic of Moldova	4 295
Costa Rica	4 024
<i>Singapore</i>	4 018
Bosnia and Herzegovina	3 977
Ireland	3 803
Armenia	3 787
<i>New Zealand</i>	3 778
Central African Republic	3 717
Lithuania	3 696
Eritrea	3 659
Lebanon	3 496
Uruguay	3 337
Occupied Palestinian Territory	3 191
Albania	3 134
Congo	3 018
Liberia	2 913
Panama	2 856
Mauritania	2 665
United Arab Emirates	2 606
<i>Jamaica</i>	2 576
Oman	2 538
Mongolia	2 533
Latvia	2 421
Bhutan	2 085
<i>Lesotho</i>	2 035
TFYR Macedonia ^a	2 034
Slovenia	1 988
Kuwait	1 914
<i>Namibia</i>	1 757
<i>Botswana</i>	1 541

Source: United Nations Population Division, 2000.

Note: Commonwealth member states are italicised.

^a The former Yugoslav Republic of Macedonia.

* This was the United Nations' terminology; they qualify this phrase in the report with the statement – "The designations employed in this report and the material presented in it do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries. The term "country" as used in the text of this report also refers, as appropriate, to territories or areas." (p. ii)

Table 2-2 – Small States by Population, 500,000 to 1.5 million

Country or area*	Total population in thousands, 2000
Estonia	1 393
<i>The Gambia</i>	1 303
<i>Trinidad and Tobago</i>	1 294
Gabon	1 230
Guinea-Bissau	1 199
<i>Mauritius</i> ^b	1 161
<i>Swaziland</i>	925
<i>Fiji Islands</i>	814
<i>Cyprus</i>	784
<i>Guyana</i>	761
East Timor	737
Comoros	706
Bahrain	640
Djibouti	632
Qatar	565

Source: United Nations Population Division, 2000.

Note: Commonwealth member states are italicised.

^b Including Agalega, Rodrigues and St. Brandon.

* See the note with Table 2-1 – Small States by Population, 1.5 to 5 million

Table 2-3 – Small States by Population, 100,000 to 500,000

Country or area*	Total population in thousands, 2000
Equatorial Guinea	457
<i>Solomon Islands</i>	447
Luxembourg	437
Cape Verde	427
Suriname	417
<i>Malta</i>	390
<i>Brunei Darussalam</i>	328
<i>The Bahamas</i>	304
<i>Maldives</i>	291
Iceland	279
<i>Barbados</i>	267
<i>Belize</i>	226
<i>Vanuatu</i>	197
<i>Samoa</i>	159
<i>Saint Lucia</i>	148
Sao Tomé and Príncipe	138
Micronesia (Fed. States of)	123
<i>Saint Vincent and Grenadines</i>	113

Source: United Nations Population Division, 2000.

Note: Commonwealth member states are italicised.

^cAs of December 20th 1999, Macao became a Special Administrative Region (SAR) of China.

* See the note with Table 2-1 – Small States by Population, 1.5 to 5 million

Table 2-4 – Small States by Population, less than 100,000

Country or area*	Total population in thousands, 2000
<i>Tonga</i>	99
<i>Grenada</i>	94
Andorra	86
<i>Kiribati</i>	83
<i>Seychelles</i>	80
<i>Dominica</i>	71
<i>Antigua and Barbuda</i>	65
Marshall Islands	51
<i>Saint Kitts and Nevis</i>	38
Monaco	33
Liechtenstein	33
San Marino	27
Palau	19
<i>Nauru</i>	12
<i>Tuvalu</i>	10
Holy See (Vatican City State)	1

Source: United Nations Population Division, 2000.

Note: Commonwealth member states are italicised.

* See the note with Table 2-1 – Small States by Population, 1.5 to 5 million

Table 2-5 – Non-self-governing territories by Population

Country or area*	Total population in thousands, 2000
Reunion	721
China, Macao SAR ^c	444
Guadeloupe	428
Martinique	383
French Polynesia	233
New Caledonia	215
Netherlands Antilles	215
French Guiana	165
Guam	155
<i>Channel Islands</i>	144
United States Virgin Islands	121
Aruba	101
<i>Isle of Man</i>	75
Northern Mariana Islands	73
American Samoa	68
<i>Bermuda</i>	63
Greenland	56
Faeroe Islands	46
<i>Cayman Islands</i>	38
<i>Gibraltar</i>	27
<i>British Virgin Islands</i>	24
Cook Islands	20
<i>Turks and Caicos Islands</i>	17
Wallis and Futuna Islands	14
<i>Anguilla</i>	11
Saint Pierre and Miquelon	7
<i>Saint Helena</i> ^d	6
<i>Montserrat</i>	4
<i>Falkland Islands (Malvinas)</i>	2
Niue	2
Tokelau	1
<i>Pitcairn</i> ^e	0

Source: United Nations Population Division, 2000 and CIA Factbook, 2002.

Note: British dependent territories are italicised. The Christmas Islands, Cocos (Keeling) Islands and Norfolk Island were included in the population figures for Australia by the United Nations.

^d Including Ascension and Tristan da Cunha.

^e The population of Pitcairn was 68 in 2000.

* See the note with Table 2-1 – Small States by Population, 1.5 to 5 million

OFFSHORE FINANCIAL CENTRES AND TAXATION

Behind seemingly technical issues of trade or international money lurk significant political issues that profoundly influence the power, independence, and well-being of individual states.

– Robert Gilpin¹

This chapter considers the nature of offshore financial centres within the context of global finance at the time of the OECD's Harmful Tax Competition Initiative. Global capital (in the form of a variety of financial instruments and their derivations) may be deterritorialised in space as some have suggested; nonetheless, the institutions and individuals that own, manage, or manipulate these funds remain rooted in a bounded territory – with rules, regulations, and weather.² The OECD is attempting to impose rules and regulations on one specific factor of the global financial system, the deposits of mobile capital it portrays as mobile only to avoid taxes. By characterising the offshore financial centres (OFCs) as a source of *global harm*, because they facilitate the efforts of individuals and firms to avoid taxation, the OECD has represented OFCs as detrimental to global well being. Furthermore, the territories that host an OFC are portrayed as free riders on global public goods.³ The small states (and non-self-governing territories) that host offshore

¹ Robert Gilpin, *The Political Economy of International Relations* (Princeton: Princeton University Press, 1987), p. 24.

² Consider for example, Sharon Corkill Cobb, 'Global Finance and the Growth of Offshore Financial Centers: The Manx Experience', *Geoforum* 29, no. 1 (1998); Jack L. Goldsmith, 'The Internet and the Abiding Significance of Territorial Sovereignty', *Indiana Journal of Global Legal Studies* 5, no. 2 (1998).

³ Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD Publications, 1998), p. 15. See also Kjetil Bjorvatn and Guttorm Schjelderup, 'Tax Competition and International Public Goods', *International Tax and Public Finance* 9 (2002); Percy S. Mistry, 'Trends in International Financial System Regulation and Supervision', *International Financial Services Sectors in Small Vulnerable Economies: Challenges and Prospects*, ed. Andreas Antoniou, Commonwealth Economic Paper Series (London: Commonwealth Secretariat, 2004).

financial centres contest these claims and suggest that they provide a valuable and beneficial service to global finance. This service at the same time provides economic development opportunities for these small economies. These are economies that in many cases have been limited historically to tourism and/or single-crop agriculture as a major source of income and employment. One may quickly appreciate the potential that exists for the highly charged and emotional discussion, which could and did take place, between the proponents of global harm versus local economic development.

To understand the nature of this debate, it is important to understand the underlying contentions. The term offshore was introduced in the first chapter for its usage in the context of global finance, along with its nautical origins. In the next section, a short history of the nature of this financial landscape is provided. It serves to preface a discussion of the emergence of offshore finance as a path for economic development. A consequence of offshore finance is the opportunity it provides for tax arbitrage. The second section addresses the implications of this opportunity with a discussion of taxation for modern states, and the concept of fiscal sovereignty. Fiscal sovereignty is a fundamental aspect for the operations of a government in the sovereign state, because this permits the government to determine whether or not to tax, and if so, what and how much to tax. The collection of tax revenue and the subsequent use of this revenue are fundamental questions of preference within the society forming a sovereign state. Consequently, fiscal sovereignty is a crucial subject in the debate surrounding tax competition.

Small State Development within the Terrain of Global Finance

Suggestions for a history of the *offshore* financial system

The use of safe havens to protect assets from confiscation or appropriation has a long, if not distinguished history. Without a doubt, it has existed for as long as there have

been valuable, yet portable, goods (gold, gems, shells, or rare bird feathers). A hoard of silver and gold objects found in Suffolk in 1992 was probably concealed with these intentions in mind.

The latest of the coin issues in the hoard establishes that its burial took place some time after AD 407/8. This was the period when Roman rule was breaking down in Britain, and the Hoxne hoard might be related to these events. The careful burial of this treasure probably means that the owner intended to come back and recover it later, but for whatever reason was unable to do so.⁴

The more modern variant for protecting assets has been identified as originating with capital flight from France to Switzerland at the time of the French Revolution. However, at the end of the 18th century the Swiss had already been protecting French wealth from the Royal tax collector for over a hundred years.⁵ Over time, this service evolved into secret Swiss bank accounts, with their widely recognised reputation as a safe place to hide money. However, we should keep in mind that confidential banking might be justified by more than a need to protect it from expropriation by the state or its representatives. In a panel discussion held in 1998 at the United Nations titled ‘Attacking the Profits of Crime: Drugs, Money and Laundering’, Ian Williams (Vice-President of the United Nations Correspondents’ Association) reminded the participants that

⁴ *The Hoxne Hoard*, 2000, Web page, The British Museum, Available: [http://www.thebritishmuseum.ac.uk/compass/ixbin/hixclient.exe?_IXDB_=compass&_IXFIRST_=1&_IXMAXHITS_=1&_IXSPFX_=graphical/full/&\\$_with+all_unique_id_index+is+\\$_ENC112752&submit-button=summary](http://www.thebritishmuseum.ac.uk/compass/ixbin/hixclient.exe?_IXDB_=compass&_IXFIRST_=1&_IXMAXHITS_=1&_IXSPFX_=graphical/full/&$_with+all_unique_id_index+is+$_ENC112752&submit-button=summary) [accessed 14 March 2003].

⁵ Nicolas Faith, *Safety in Numbers: The Mysterious World of Swiss Banking* (London: Hamish Hamilton, 1982), pp. 19 - 22.

There is another underlying presumption here which disturbs me considerably, and this is of the legitimacy and morality of Governments. I would like to suggest that, for example, if I had been Jewish or a dissident German in 1938, some of the things proposed to counter money laundering might have stopped me getting money out of Germany via any form of banking, because it would have been illegal. There are many currency transfers which are legitimate and moral, but possibly illegal. As a journalist, I myself and colleagues have been involved in getting money through to journalists who are writing under repressive regimes: there are also dissident groups across the world which have been financed by illegal currency transfers.⁶

The French Revolution, Fascist Germany, and economic collapse in Argentina are all examples of periods of capital flight, when individuals sought to protect their financial assets. In the strained and tense environment following 11 September 2001, and the subsequent passage in the United States of the USA PATRIOT Act, the challenge for civil liberty and resistance to repressive regimes has become more difficult. Only now rather than block the flow of capital with the claim that one is engaged in drug trafficking or laundering the proceeds of illegal drug sales the accusation will be that one is a terrorist, or engaged in the financing of terrorism.⁷

Another factor reflected in the origins of offshore financial centres is the desire by depositors to avoid regulation. As noted in an IMF Background Paper on ‘Offshore Financial Centers’,

⁶ Ian Hamilton Fazey, *Attacking the Profits of Crime: Drugs, Money and Laundering: A Panel Discussion*, Transcript, 1998, Web page, Available: <http://www.imolin.org/ungapanl.htm> [accessed 20 April 2002]. The Blum Report is – Jack A. Blum, et al., *Financial Havens, Banking Secrecy and Money Laundering*, 1998, Web page, United Nations Office for Drug Control and Crime Prevention, Available: <http://www.imolin.org/finhaeng.htm> [accessed 20 April 2002]. Charles Kindleberger expressed a similar concern—‘But the same laws that are needed in a few difficult cases are harmful when they are taken advantage of en masse to undermine the sovereignty of the countries from which the money comes, and especially when they protect the gains of criminals, scofflaws, and spivs.’ Charles P. Kindleberger, *International Capital Movements* (Cambridge: Cambridge University Press, 1987), p. 73.

⁷ The implications of the USA PATRIOT (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism) Act of 2001 for financial transactions are discussed in more detail below, in chapter 8. An easily read presentation of the methods used to launder money may be found in R. Thomas Naylor, *Wages of Crime: Black Markets, Illegal Finance, and the Underworld Economy* (Ithaca and London: Cornell University Press, 2002). See in particular, chapter 4, ‘Treasure Island: Offshore Havens, Bank Secrecy, and Money Laundering’.

The maintenance of historic and distortionary regulations on the financial sectors of industrial countries during the 1960s and 1970s was a major contributing factor to the growth of offshore banking and the proliferation of OFCs.⁸

The Eurodollar market developed in the 1960s as a market for U.S. dollars, deposited and loaned by banking institutions outside of the United States, and thus outside the oversight and supervision of U.S. banking regulations. By operating outside of 'all national banking systems', Gary Burn felt the Eurodollar market had become 'a true *offshore* market'.⁹ Eurodollars became Eurocurrency (any currency deposited and lent onward outside the issuing state) and then banks developed additional financial instruments, and created the Eurobond market. This nomenclature has unfortunately become confusing since the common currency of the EU has been named the 'Euro', but that is a small matter in the larger picture of offshore financial centres.¹⁰ Similarly, the activities of the financial institutions in the City of London, 'when dealing in non-resident deposits and credits of non-resident currencies' were not subject to the regulations of the United Kingdom's domestic financial market. Thus, the City of London became an offshore financial centre, though this could also be categorised as 'on-the-shore' given that resident deposits in sterling, held by the same institutions, are subject to domestic regulation.¹¹ The success of British banks in the Eurodollar market attracted competition from American banks, which established branches in the City, again beyond U.S. banking regulation and supervision.

The success of an increasing number of institutions and locations specialising in the Euromarkets was quickly recognised. An IMF Senior Tax Administration Analyst

⁸ Monetary and Exchange Affairs Department, *Offshore Financial Centers*, 23 June 2000, Web page - IMF Background Paper, Available: <http://www.imf.org/external/np/mae/oshore/2000/eng/back.htm> [accessed 17 July 2002].

⁹ Gary Burn, 'The state, the City and the Euromarkets', *Review of International Political Economy* 6, no. 2 (1999), p. 230. Emphasis in the original.

¹⁰ On the topic of the usage of 'Euro' see Mervyn K. Lewis, 'International Banking and Offshore Finance: London and the Major Centres', *Offshore Finance Centres and Tax Havens: The Rise of Global Capital*, eds. Mark P. Hampton and Jason P. Abbott (London: Macmillan Press Ltd., 1999), p. 112.

¹¹ Burn, 'The state, the City and the Euromarkets', pp. 235 - 237.

emphasised in 1976 the fact that the offshore financial centres were enabled by the conduct of high-tax states.

These and other mechanisms may be likened to escape valves left in their tax systems by high-tax countries, in order to grant taxpayers relief from the pressures of taxation. As long as these provisions remain in effect, high-tax countries cannot place all the blame on tax havens for the losses of revenue they suffer.¹²

Recognising this fact led to changes in the regulation of onshore financial institutions in order for domestic institutions to compete internationally. Among the first changes to occur was the establishment of the New York International Banking Facility (IBF) in December 1980. As an alternative to fighting the offshore phenomena throughout the later 1970s, the U.S. Treasury Department approved the creation of this offshore space, within their onshore regulatory control.¹³ Another change to emerge during the 1980s involved the supervision of offshore banks. The collapse of international banks structured through holding companies located in another state highlighted a need to clarify and refine national responsibilities in the area of international banking supervision.¹⁴ This led to the revision of the Basle Concordat, and the creation of the Offshore Group of Banking Supervisors.¹⁵ A third factor affecting the operation and continued development of OFCs, in particular those located in the Caribbean, has been the campaign against money laundering in conjunction with the 'War on Drugs' and, since 2001, to combat terrorist financing. The impact of these international efforts for the operation of Caribbean financial institutions is discussed below in chapter 7.

¹² Milka Casanegra de Jantscher, 'Tax havens explained', *Finance and Development* 13, no. 1 (1976), pp. 32 - 33.

¹³ Leonard Seabrooke, *US Power in International Finance: The Victory of Dividends* (Basingstoke: Palgrave, 2001), p. 111; Ronen Palan, 'The emergence of an offshore economy', *Futures* 30, no. 1 (1998), p. 68.

¹⁴ The first was the Banco Ambrosiano in 1982, followed by the Bank of Credit and Commerce International (BCCI) in 1991. See Caroline Doggart, *Tax havens and their uses*, Research Report, 10th ed. (London: Economist Intelligence Unit, 2002), pp. 77 - 78.

¹⁵ Ibid; Cobb, 'Global Finance and the Growth of Offshore Financial Centers', p. 13. For more on the Offshore Group of Banking Supervisors, see <www.ogbs.net>.

Offshore Financial Centres as Development

In conjunction with the development of the Eurodollar market the offshore financial centre came to be seen as one approach to economic development, and thus economic security, for small states. Small jurisdictions have considered financial services as an economic development strategy since the 1960s.¹⁶ This strategy for economic development began in the Caribbean with the Cayman Islands in 1967, while at the same time they chose to remain a British colony.¹⁷ In the Pacific, the first offshore financial centre was established on Norfolk Island in 1966.¹⁸ When the finance centre in Port Vila, New Hebrides, was established, some of the reasons offered were that it did not occupy a lot of land, did not pollute, and did not compete with local businesses. On this point, Hampton cites an 'official British view' from the New Hebrides (after independence, Vanuatu).¹⁹ At the time, Officials from the British Residency sought advice on the regulated development of a 'tax haven' from the already existing British tax havens in Bermuda, the Bahamas and the Cayman Islands.²⁰

It soon becomes clear upon reading the internal correspondence between the various departments of the British government during this period that there are two main viewpoints about the creation of tax havens in the dependent territories. On the one side are those in offices such as the Inland Revenue and the Treasury who are concerned with

¹⁶ See for example United Kingdom. Public Record Office, 'Proposals for Establishment of a Financial Centre in Malta', (London: 1963), vol. CO 926/1862.

¹⁷ United Kingdom. Public Record Office, 'Tax Havens in Cayman Islands', (London: 1973), vol. FCO 44/861; Susan M. Roberts, 'Small Place, Big Money: The Cayman Islands and the International Financial System', *Economic Geography* 71, no. 3 (1995), p. 240.

¹⁸ Anthony van Fossen, 'Norfolk Island and Its Tax Haven', *Australian Journal of Politics and History* 48, no. 2 (2002). In describing Norfolk Island's status vis à vis Australia, van Fossen wrote, 'The question of Norfolk Island's evolving political relationship to Australia remains not only substantially unresolved, but has become more complex and conflictual in recent years.' (p. 211)

¹⁹ Mark P. Hampton, 'Treasure Islands or Fool's Gold: Can and Should Small Island Economies Copy Jersey?' *World Development* 22, no. 2 (1994), p. 242. See also Terry Dwyer, "'Harmful" tax competition and the future of offshore financial centres, such as Vanuatu', *Pacific Economic Bulletin* 15, no. 1 (2000).

²⁰ United Kingdom. Public Record Office, 'Tax Havens and Tax Concessions in the West Indies', (London: 1970), vol. FCO 44/356.

the financial consequences for the United Kingdom itself from the existence of tax havens. And on the other side are those officials that find the establishment of a tax haven to offer economic benefits for the small dependent territory, as well as the potential to reduce the requirement for and dependence upon aid from London. Very often the staff of the Foreign and Commonwealth Office represented this latter group, whether located in London or in the dependent territories themselves.²¹

Bishnodoat Persaud reiterated the attractive environmental and economic features of an OFC in 2001:

Offshore financial services have become a significant part of the economy of many small states. These activities generate a substantial amount of license fees which belie the notion of a no tax situation. They also generate employment involving secretarial, administrative, accounting, information technology and professional skills.²²

These features, in conjunction with the revenue from licensing fees, help to explain the efforts taken by small states to defend and maintain the status quo. The actual circumstances during 1998 - 2003 for several Caribbean jurisdictions are discussed in chapter 7.

The development and success of offshore financial centres in small states depended upon the nature of the international economic structure established after World War Two by the Bretton Woods Agreement. This structure permitted variations between states in banking regulation, capital controls, interest rate ceilings and the effective rate of

²¹ See variously United Kingdom. Public Record Office, 'Tax haven proposals in the Caribbean', (London: 1967 - 1969), vol. OD 28/311; United Kingdom. Public Record Office, 'Tax havens', (London: 1967 - 1969), vol. IR 40/16743; United Kingdom. Public Record Office, 'Review of problems arising from the existence of tax havens', (London: 1970), vol. FCO 44/360.

²² Bishnodoat Persaud, 'OECD Curbs on Offshore Financial Centres: A Major Issue for Small States', *The Round Table*, no. 359 (2001), p. 209. See also Commonwealth Advisory Group, *A Future for Small States: Overcoming Vulnerability* (London: Commonwealth Secretariat, 1997), paragraph 5.15 (p. 35).

taxation.²³ The circumstances of post-war recovery and the burgeoning Cold War conflict fostered the development of the Eurodollar market, and subsequently a growing recognition of the arbitrage possibilities in international finance. Business opportunities developed for financial institutions outside of the major, regulated financial markets, leading to the creation of offshore financial centres of varying quality (in terms of local regulation, control and oversight).²⁴

At the same time, there have been periodic warnings for the difficulties that faced offshore financial centres. An evaluation of offshore banking in 1979 suggested that 'it seems possible, indeed probable, that there is little unsatisfied demand for new offshore centers'.²⁵ A few years later the author of a study on offshore banking in the Bahamas observed that 'recent international developments ... appear to threaten the future survival of offshore banking centres'.²⁶ While global financial markets liberalised throughout the 1980s, the offshore financial sector continued to grow. In his analysis of the OFC as an economic development strategy in 1994, Mark Hampton concluded that while a state might be successful in establishing a new OFC, that success was dependent upon satisfying a niche in the marketplace. He cautioned that 'hosting an OFC is clearly not a panacea for SIE [small island economy] development'.²⁷

Accommodating the Offshore Financial Centre

As already noted, the end of the Bretton Woods regime, and financial crises in the 1980s and 1990s led to the creation of various multilateral financial organisations. These

²³ John B. Goodman and Louis W. Pauly, 'The Obsolescence of Capital Controls? Economic Management in an Age of Global Markets', *World Politics* 46, no. 1 (1993), pp. 52 - 60.

²⁴ Carlene Y. Francis, 'The Offshore Banking Sector in the Bahamas', *Social and Economic Studies* 34, no. 4 (1985); Mark P. Hampton, *The Offshore Interface: Tax Havens in the Global Economy* (London: Macmillan Press Ltd, 1996).

²⁵ Ian McCarthy, 'Offshore banking centers: benefits and costs', *Finance and Development* 16, no. 4 (1979), p. 48.

²⁶ Francis, 'The Offshore Banking Sector in the Bahamas', p. 91.

²⁷ Hampton, 'Treasure Islands or Fool's Gold', p. 248.

organisations were tasked with establishing international financial standards, providing for international banking supervision, and co-ordinating efforts to counter the criminal mis-use of the international financial system. At the same time, national governments were reducing aspects of their financial regulation in an effort to become competitive internationally.²⁸ Furthermore in the 1990s the growth and dispersion of telecommunications technologies facilitated and eased the growth of extraterritorial financial services. 'By allowing a more footloose location of service activities, the Internet and the spread of e-commerce make for a greater mobility in international business. This is adding to the opportunities available to OFCs.'²⁹ In addition, as discovered by the government of Canada in 2003, these same telecommunication technologies have expanded opportunities for individuals to shift capital offshore.³⁰

There are several features of the offshore financial centre touted as both the reason for their success, and the reason that they are a problem for the international community. This includes limited regulation and oversight, banking secrecy and the ease with which a business company may be incorporated, but the most prevalent feature identified is taxation. Offshore financial centres attract business because of their low effective rate of taxation, as compared to developed states (onshore). Business enterprises from a multitude of industries find it beneficial to have their finances shifted, and conducted, *offshore*.³¹ However, while individual firms and individual citizens found this opportunity to

²⁸ See Ronen Palan, et al., *State Strategies in the Global Political Economy*, Revised ed. (London and New York: Pinter, 1999), Chapter 1.

²⁹ Persaud, 'OECD Curbs on Offshore Financial Centres', p. 206.

³⁰ 'Canadians invested \$44.6-billion in tax haven countries in 2001, almost a tenfold increase from \$4.5-billion in 1988, according to a slide presentation made by federal tax officials to Elinor Caplan, Minister of National Revenue.' Karen Howlett and Paul Waldie, 'Lure of tax havens proving irresistible', *Globe and Mail* (Toronto), 9 June 2003, Available: <http://www.globeandmail.com/servlet/story/RTGAM.20030609.wxtax0609/BNStory/Business/> [accessed 16 June 2003].

³¹ In part this reflects the increased financialisation of large firms. For example, consider the situation of Microsoft, which at the end of 2001 reported they had \$38.2 billion in cash, and generated a further \$1 billion a month. As noted in a magazine article, 'One of the key roles of corporate management is to wisely reinvest whatever money the business generates to fuel ever-increasing profits. And with \$40 billion to deploy, Microsoft is now arguably as much an

reduce their tax burden a benefit, the states that believe their tax revenue base has been reduced by such action find it detrimental. A number of developed states are pursuing ways to reduce these tax revenue losses, and to recover what has already been lost.

One approach is to identify states (or sub-state jurisdictions) as ‘tax havens’ and to treat the financial accounts located in them differently. An early use of such a list was by Germany in 1972 and a number of states since then have produced similar lists.³² Anyone with an account in one of the identified locations was automatically suspected of tax evasion, or at least of contravening anti-avoidance tax laws. Their tax return form would often be subjected to scrutiny and very often, they would lose tax law benefits (tax credits and/or deductions) as a countermeasure to the suspected effort to avoid paying taxes. However, this approach was insufficient, as an individual could simply travel to the tax haven, establish an account, place funds into it, and then forget to report its existence to their home state tax collection authorities. With self-reporting tax collection methods, and without a means to discover the existence of these foreign accounts, the situation was of mounting concern to a number of developed states. The concern has developed into an effort for collective action to change the situation and make it possible to discover the existence of these foreign accounts.

Attempts to organise a collective response through the OECD have been made since at least 1977.³³ A meeting of OECD ministers in 1996 directed the OECD’s Committee on Fiscal Affairs to ‘develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for

investment firm as a software maker. (In fact, its cash stake is larger than the combined assets of the 9 biggest venture-capital firms in the U.S., larger than all but four of the country’s equity mutual funds.)’ Jim Frederick, *Microsoft’s \$40 billion bet*, 12 April 2002, Web page, money.cnn.com, Available: http://money.cnn.com/2002/04/12/pf/agenda_msft/ [accessed 21 June 2003].

³² Doggart, *Tax havens and their uses*, 10th ed., pp. 11 - 16. See Table 3-1 Jurisdictions with offshore financial centres for the list used in this research.

³³ Richard A. Gordon, *Tax Havens and Their Use by United States Taxpayers - An Overview* (Washington, D.C.: United States Government Printing Office, 1981), p. 31.

national tax bases, and report back in 1998.³⁴ By the 1990s, the overall phenomenon of globalisation was identified as exacerbating the problem. The following statement emerged from the meeting in 1996 of the G7 Heads of State.

Finally, globalisation is creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, carrying risks of distorting trade and investment and could lead to the erosion of national tax bases.³⁵

The resulting OECD report, *Harmful Tax Competition: An Emerging Global Issue*, presented the OECD's case for eliminating this competition.

The financial figures used to support the case for the OECD focused on their belief in the presence of untaxed income located in offshore financial centres. In 1977, for the states providing locational data to the Bank of International Settlements, bank assets located in offshore institutions amounted to \$5,078 million. By 1987 this had grown to \$692,002 million in reported assets, and by 1997 to \$1,429,453 million.³⁶ A number of OECD member states believed that some significant amount of tax revenue was lost because of the offshore location of assets. Consider in this context the experience of one high-tax European state. When Germany reintroduced a withholding tax on interest in 1992, some DM100bn (\$66bn) was thought to have fled the country, more than half of which was deposited in Luxembourg subsidiaries of German banks.³⁷ This was not a new

³⁴ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, p. 7.

³⁵ Ibid.

³⁶ In 2002 the reported assets located in offshore centres was \$1,567,970 million. These figures reflect those jurisdictions identified as offshore centres by the Bank of International Settlements (Aruba, Bahamas, Bahrain, Barbados, Bermuda, Cayman Islands, Guernsey, Hong Kong SAR, Isle of Man, Jersey, Lebanon, Macao SAR, Mauritius, Netherlands Antilles, Panama, Singapore, Vanuatu, West Indies UK). See Appendix B, Bank for International Settlements Data. This data is discussed with relevance to the Caribbean in chapter 7.

³⁷ Caroline Doggart, *Tax havens and their uses*, Research Report, 9th ed. (London: Economist Intelligence Unit, 1997), p. 58; Philipp Genschel and Thomas Plümper, 'Regulatory competition and international co-operation', *Journal of European Public Policy* 4, no. 4 (1997), pp. 632 - 633. Other tax law changes were underway in Germany at this time, affecting corporate taxation. See Genschel and Plümper for the impact of German corporate investment in Ireland, and the changes made to close what Germany perceived to be a loophole in its tax law (which served to help fuel Ireland's economic recovery and boom in the early to mid 1990s). In April 2003, a fourth major German bank was fined for 'systematically helping its customers avoid the composite tax on interest earnings introduced in the early 1990s by shipping untaxed earnings to tax havens abroad.' Elise Kissling, *Deutsche fined for tax evasion*, 4 April 2003, Web page,

experience for Germany. In 1987, a similar withholding tax (of 10%) on domestic interest income had been established, to begin in 1989. This was seen as a causal factor for a subsequent massive outflow of investment from domestic German government bonds, and a significant factor in the overall increase of German capital exports in 1988 ('almost four times as high as in 1987').³⁸ It is worth noting, as IMF research has found, that 'for every one percentage point increase in industrialised countries' top corporate tax rates capital inflows to offshore centres rose by 5% in general and by 19% for Caribbean centres.'³⁹

While there may be consensus as to the potential impact on state revenue resulting from capital flows exiting the territorial boundaries and regulation of the state, more generally there are disagreements over the nature and structure of capital taxation. The next section will explore these issues about taxation. Then the discussion turns to taxation as a matter of fiscal independence, and as a component of state sovereignty.

Taxation in the Modern State

The economic literature covering taxation, tax policy co-ordination and tax rate harmonisation frequently utilises mathematical or game theoretic models. Generally absent, however, is the application of these models to 'real world' circumstances or testing against empirical data.⁴⁰ In some cases, the representative two-state model is modified, from presenting two symmetrical states to presenting two differently sized states, or

Frankfurter Allgemeine Zeitung, Available: <http://www.faz.com/IN/INtemplates/eFAZ/archive.asp?doc={F2D69A1C-187A-47D8-B85F-40313674DECC}&width=800&height=572&agt=explorer&ver=4&svr=4> [accessed 13 April 2003].

³⁸ Helmut Schlesinger, 'Capital Outflow and Taxation -- The Case of the Federal Republic of Germany', *Reforming Capital Income Taxation*, ed. Horst Siebert (Tübingen: J.C.B. Mohr (Paul Siebeck), 1990), p. 105.

³⁹ Deggart, *Tax havens and their uses*, 10th ed. Deggart refers to *International Monetary Fund Country Report* No. 01/3, Table 5.

⁴⁰ See James Andreoni, et al, 'Tax Compliance', *Journal of Economic Literature* 36, no. 2 (1998), pp. 850 - 852.

introducing a third, non-participating state (a.k.a. – a tax haven) to the model.⁴¹ Nevertheless, use of empirical data to demonstrate these models within the messy domain of inter-state politics is limited.⁴² Research by a number of authors, including Eggert, Fuest and Huber, Perroni and Scharf, and Huizinga and Nielsen, contain equations that suggest the potential results deriving from tax co-ordination amongst states (the EU Tax Harmonisation Directive as one example), but it offers no suggestion over the taxpayer action likely to result from such co-ordination efforts.⁴³

Fortunately, the essence of ‘real world’ taxpayer conduct has been captured elsewhere and in particular by the literature on tax avoidance/tax compliance.⁴⁴ Broadly speaking, there is ‘tax avoidance’ and ‘tax evasion’ – the first term describes those transactions which are within the letter of the law, even to the point of using unintended legislative loopholes. The second item, tax evasion, is of greater concern as it involves transactions that are intended to escape legal tax obligations via fraudulent means.⁴⁵

⁴¹ Harry Huizinga and Soren Bo Nielsen, ‘Withholding taxes or information exchange: the taxation of international interest flows’, *Journal of Public Economics* 87, no. 1 (2002); John Douglas Wilson, ‘Tax competition with interregional differences in factor endowments’, *Regional Science and Urban Economics* 21, no. 3 (1991).

⁴² An example which used OECD panel data to address a question of tax competition relative to globalisation was Lucas Bretschger and Frank Hettich, ‘Globalisation, capital mobility and tax competition: theory and evidence for OECD countries’, *European Journal of Political Economy* 18, no. 4 (2002).

⁴³ Wolfgang Eggert, ‘Capital tax competition with socially wasteful government consumption’, *European Journal of Political Economy* 17, no. 3 (2001); Clemens Fuest and Bernd Huber, ‘Why is there so little tax coordination? The role of majority voting and international tax evasion’, *Regional Science and Urban Economics* 31, no. 2-3 (2001); Carlo Perroni and Kimberley A. Scharf, ‘Tiebout with Politics: Capital Tax Competition and Constitutional Choices’, *Review of Economic Studies* 68 (2001); Harry Huizinga and Soren Bo Nielsen, ‘The coordination of capital income and profit taxation with cross-ownership of firms’, *Regional Science and Urban Economics* 32, no. 1 (2002). However tax-payer activity was suggested by Lorz when analysing the effects of tax competition for interest group lobbying; and also by Sørensen when he analysed the impact of tax co-ordination relative to income (re)distribution. See Oliver Lorz, ‘Capital mobility, tax competition, and lobbying for redistributive capital taxation’, *European Journal of Political Economy* 14, no. 2 (1998); Peter Birch Sørensen, ‘The case for international tax co-ordination reconsidered’, *Economics Policy* 15, no. 31 (2000).

⁴⁴ For a review of the tax compliance literature see Andreoni, et al., ‘Tax Compliance’.

⁴⁵ See Gordon, *Tax Havens and Their Use by United States Taxpayers - An Overview*, pp. 60 - 61. This basic determination of two aspects, avoidance and evasion, was further refined by Ramon Jeffery, who concluded that the problem possessed three aspects, evasion, avoidance, and mitigation.

Tax evasion is the intention to evade an existing tax liability, which often involves an element of criminality or fraud, such as the failure to disclose income. The *unacceptable* reduction of one’s tax liability by ordering one’s affairs in a particular way constitutes *tax avoidance*, while the *acceptable* reduction of such liability constitutes *tax mitigation*. In both the domestic and international contexts, the seemingly intractable difficulty is that of distinguishing between acceptable and unacceptable transactions where there are beneficial tax consequences for a taxpayer; that is, in differentiating between tax mitigation and tax avoidance. Ramon J.

Furthermore, the treatment of tax evasion, and thus its criminalisation, varies from country to country. Notably, in Switzerland tax avoidance/evasion has not been a crime, whereas in other jurisdictions it is, to a greater or lesser extent.⁴⁶

In the legal literature, frequent reference is made to precedent establishing court cases. Statements made by judges concerning the conduct and action of taxpayers have particular cogency. For the United States, Vanistendael cited Judge Learned Hand (*Gregory versus Helvering*, 1934) – ‘Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.’ From the British judicial record comes *Commissioners of Inland Revenue versus Duke of Westminster* (1936), in which the judges wrote – ‘Such behaviour is perfectly legal, because most countries recognise the right of the taxpayer to arrange his affairs in such a way as to pay less tax.’⁴⁷ A broad assessment of the situation found that taxpayers simply

Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation* (The Hague: Kluwer Law International, 1999), p. 98, emphasis in original.

However, I find this to be semantic hair-splitting, as attempting to determine (much less agree on) the difference between acceptable and unacceptable would be as effective as attempting to determine the state of mind of the taxpayer when they made a particular decision which had tax consequences in order to determine that it was *illegal* tax avoidance. This approach is in keeping however with the increasing enactment by states of *anti-avoidance* laws in their on-going efforts to collect and keep tax revenue. Moreover, the attempt by the judiciary (or to convince the judiciary) of the validity of such anti-avoidance legislation appears to be an effort to actively interpret not only the legislation, but also the legislators’ intent (state of mind) to increase revenue collection and reduce *abusive* tax avoidance activity.

⁴⁶ Nevertheless, the OECD continues in its campaign to convince Switzerland to establish tax fraud as a crime. See for example Andrew Parker, ‘OECD tax plan faces collapse’, *The Financial Times* (London), 10 October 2003. For further discussions on this topic see Organisation for Economic Co-operation and Development, *Improving Access to Bank Information For Tax Purposes: The 2003 Progress Report* (Paris: OECD Publications, 2003), pp. 9 - 11, Available: <http://www.oecd.org/dataoecd/5/0/14943184.pdf> [accessed 27 September 2004]; J. J. B. Skinner, ed., *Tax Avoidance, Tax Evasion* (London: International Bar Association, in co-operation with Sweet & Maxwell Ltd, 1982); Graeme S. Cooper, ed., *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD Publications BV in co-operation with the Australian Tax Research Foundation, 1997).

⁴⁷ Frans Vanistendael, ‘Judicial Interpretation and the Role of Anti-Abuse Provisions in Tax Law’, *Tax Avoidance and the Rule of Law*, ed. Graeme S. Cooper (Amsterdam: IBFD Publications BV in co-operation with the Australian Tax Research Foundation, 1997), p. 132. The author also identified court cases from Australia (*Jacques versus Federal Commissioner of Taxation*, 1924) and Belgium (*Judgement of June 6, 1961, Cour de Cassation*).

...behave in such an idiosyncratic manner in tax matters. As Wheatcroft puts it, 'when dealing with other areas of law citizens tend to stick to well-trodden paths; with tax law, they seek new ones.'⁴⁸

The legal approval of tax minimisation would certainly stimulate government (legislative) action to find any means and measures necessary to enhance revenue collection. Consequently, the trend in the past several decades has been in the other direction, with states enacting anti-avoidance laws. These laws are particularly difficult to enforce, however, as they attempt to assess the 'state of mind' of the taxpayer at the time the suspect activity occurred. This is necessary in order to determine if the *intent* was to *avoid* paying tax.

This view of tax avoidance seeks to define it by reference to a state of mind although the state of mind might be presumed from identifiable external criteria such as the form in which the taxpayer organised the transaction.⁴⁹

Thus, absent concrete, indisputable evidence of tax evasion, but believing the intent was to avoid paying tax, in an *unacceptable* fashion, the tax administration attempts to demonstrate the evidence is sufficient to *imply* an intent to avoid.

Once questions arise as what and how the Revenue authority is told of a person's state of mind the boundaries between legitimate avoidance and concealment amounting to evasion become increasingly difficult [sic] to detect.⁵⁰

There is also the perception to be found in the literature that 'Given that tax evasion is so widespread, it is unlikely that information will be provided directly by taxpayers and full information thus requires the participation of foreign authorities.'⁵¹

⁴⁸ Graeme S. Cooper, 'Conflicts, Challenges and Choices -- The Rule of Law and Anti-Avoidance Rules', *Tax Avoidance and the Rule of Law*, ed. Graeme S. Cooper (Amsterdam: IBFD Publications BV in co-operation with the Australian Tax Research Foundation, 1997), p. 17. He quoted GSA Wheatcroft, 'The Interpretation of Taxation Laws with Special Reference to Form and Substance' (1965) vol *La Cahiers de Droit Fiscal* 7.

⁴⁹ *Ibid.*, p. 28.

⁵⁰ Malcolm Gammie, 'Tax Avoidance and the Rule of Law: A perspective from the United Kingdom', *Tax Avoidance and the Rule of Law*, ed. Graeme S. Cooper (Amsterdam: IBFD Publications BV in co-operation with the Australian Tax Research Foundation, 1997), pp. 201 - 202.

⁵¹ Philippe Bacchetta and María Paz Espinosa, 'Information sharing and tax competition among governments', *Journal of International Economics* 39, no. 1-2 (1995), p. 104. Bacchetta and Espinosa tempered their position a little in a later paper, '...tax avoidance is widespread.' Philippe Bacchetta and María Paz Espinosa, 'Exchange-of-Information Clauses in International Tax Treaties', *International Tax and Public Finance* 7 (2000), p. 275.

Because of the very nature of tax avoidance and tax evasion, an accurate assessment of the extent and prevalence of these activities continues to be difficult.⁵² However, the statement may also reflect perceptions held by policy-makers, and may therefore serve to motivate their drive for information exchange on the part of national tax collection administrations. Certainly this assumption is embedded in the OECD's project on harmful tax competition.

This obtuse circumstance has not prevented attempts to gauge the size of the tax evasion problem. In *Justifying Taxes*, Agustín Menéndez used estimates of the size of the 'shadow' (or underground) economy to extrapolate the extent of tax evasion in Europe. Nonetheless, 'the increase of the shadow economy has not reduced the money collected through taxes, but it has led to the placement of a heavier tax burden on the official economy.'⁵³ The logic of this statement is similar to the concern with 'lost' tax revenue on income located in OFCs. Yet, following this logic, if the growth of the shadow economy has not reduced the amount of revenue collected by the state, then it has not in turn placed a heavier tax burden on the open economy. Should the shadow economy disappear overnight, it would not affect the tax revenue collected, and the government would continue to operate as before. What this means is that the shadow economy has reduced *growth* in tax revenue. In response to the level of taxation, the population has restricted the Leviathan state, not through tax competition, but by displacing economic activity to the untaxed realm.⁵⁴ The tax burden on the open economy has perforce held steady, while 'the

⁵² Hines commented on this issue, 'Very little is known about the determinants or magnitude of international tax evasion, since the self-reported data that serve as the basis of analysis not surprisingly reveal nothing about it.' James R. Hines, Jr., 'Lessons from Behavioral Responses to International Taxation', *National Tax Journal* LII (1999), pp. 313 - 314.

⁵³ Agustín José Menéndez, *Justifying Taxes: Some Elements for a General Theory of Democratic Tax Law* (Dordrecht: Kluwer Academic Publishers, 2001), p. 107. Similar efforts are made with respect to determining the size of the money laundering problem. See John Walker, 'How Big is Global Money Laundering?' *Journal of Money Laundering Control* 3, no. 1 (1999).

⁵⁴ The concept of the *Leviathan* state, as used in the economics literature concerning taxation is explored in the next section of this chapter.

total tax yield, measured in terms relative to the total size of the economy, has not decreased.⁵⁵ Menéndez provided an illustration for tax evasion reflecting the situation—

For example, in Italy and Spain, the average income of a liberal professional is lower or slightly higher than that of an unqualified employee, according to their income report. That goes against common experience and any serious estimation, pointing to considerable and widespread tax fraud.⁵⁶

If the analogy from this discussion of the shadow economy holds for offshore financial centres, then attempts to force ‘delinquent’ capital presently located offshore to return to the high-tax onshore jurisdiction might not mean an increase in tax revenue collections. It could instead result in reduced savings and investment. If the tax owed on an investment exceeds the rate of return (adjusted for inflation), citizens are just as likely to spend as they may be to save their disposable income.⁵⁷ The ‘rational’ citizen, as a representative taxpayer, will explore other opportunities in order to benefit themselves. So they might move into the underground economy, increase their rate of consumption, or simply reduce their income (why work harder to earn more money only to then transfer it to the state via taxes?).⁵⁸

Among the thoughts influencing taxpayer conduct is the role of the state and its use of the collected tax revenue. Consequently, the perceptions held by citizens concerning the value and benefit from the use of their tax contribution would influence their support for, and acquiescence in, taxation. This development is reflected in statements such as ‘harmful tax competition diminishes global welfare and undermines

⁵⁵ Menéndez, *Justifying Taxes*, p. 108.

⁵⁶ *Ibid.*, footnote 73 on p. 107.

⁵⁷ See for example the remarks in Richard W. Rahn, ‘Economic murder-suicide’, *The Washington Times* 12 June 2003, Available: <http://www.washtimes.com/commentary/20030611-093247-4381r.htm> [accessed 16 June 2003].

⁵⁸ This point was also made by Barry Bracewell-Milnes, *Tax Avoidance and Evasion: The Individual and Society*, 2nd Impression ed. (Upminster, United Kingdom: Panopticum Press, 1980), p. 87. ‘The taxpayer can avoid tax by shifting either the tax itself or the pattern of his activities.’

taxpayer confidence in the integrity of tax systems.⁵⁹ The growth of the shadow economy as presented in Menéndez between 1960 and 1994 is very suggestive. The citizens of these OECD countries have essentially ‘voted with their feet’ by taking measures to avoid paying taxes.⁶⁰ As Menéndez described the situation, ‘Firstly the lack of satisfaction with tax systems has tended to be expressed through the private act of evading taxes and less so through a public criticism of the tax model.’⁶¹ It is this accumulation of individual actions by the citizens of a state that leads the government to pursue methods to maintain existing levels of tax revenue collection. The purpose for this discussion of tax compliance and the underground economy is to emphasise the domestic basis of taxation. The problem presented by offshore financial centres to other states is that they are an opportunity for citizens to relocate savings and investment outside the territorial boundaries of the state. It is this problem that leads the OECD to frame the OFC as detrimental to global well being.⁶² Nonetheless, there is research suggesting that tax compliance is not a rational choice, given the level of deterrence measures implemented within OECD states to force compliance. The analysis of Lars Feld and Bruno Frey attribute the level of tax compliance to ‘tax morale’, the willingness of taxpayers to pay their taxes, rather than as a response to the threat of prosecution.⁶³ For their research work, tax morale is a product of the relationship between the taxpayer and the tax administration within a state’s legal and constitutional structure. Thus, when it is widely recognised as a good relationship (taxpayers are treated respectfully) tax compliance is higher. When the situation is one of

⁵⁹ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, p. 8.

⁶⁰ See Table 1 - Size of the Shadow Economy, in Menéndez, *Justifying Taxes*, p. 108.

⁶¹ Ibid.

⁶² Two Norwegian economists reached a different conclusion. In their paper they demonstrate ‘that international spillovers from public goods reduce tax competition. In fact, in the case of purely international public goods, there will be no tax competition at all. Underprovision of public goods will however prevail due to the free-rider problem.’ Bjorvatn and Schjelderup, ‘Tax Competition and International Public Goods’, p. 119.

⁶³ Lars P. Feld and Bruno S. Frey, *Deterrence and Morale in Taxation: An Empirical Analysis*, CESifo Working Paper No. 760, (Munich: Ifo Institute for Economic Research, 2002), Available: <http://www.CESifo.de> [accessed 19 August 2004].

low tax morale and the relationship between taxpayer and tax administration is adversarial, tax evasion is more prevalent.⁶⁴

Leviathan State or Benevolent State?

Economists typically depict the state as one of two ideal types. This approach fits very well with the frequent use of game theory to model the decision-making process. The first view of the state was as a Leviathan, ‘intrinsically untrustworthy revenue-maximisers’. Accompanying this view is the perception that tax competition serves as a constraint ‘on the intrinsic pressures towards excessively high tax rates implied by policy-makers’ pursuit of their own interests.’ The opposite view, without the simple Hobbesian label, presents the state as a benevolent maximiser of citizens’ welfare. For a benevolent maximiser state, tax competition produces inefficient outcomes, which detract from its ability to provide public goods. In other words, competition prevents the state from increasing taxes in order to fund additional public goods.⁶⁵ The tension inherent between these ideal types is implicit in questions focusing on government policy-making, government efficiency, and the extent and depth of government presence in society.⁶⁶ The conclusions reached by Jeremy Edwards and Michael Keen found circumstances where the government was at neither extreme (neither revenue-maximiser nor benevolent-maximiser), yet tax coordination between states could still result in benefits for the representative citizen. The results depended upon the two factors of ‘income effect’ and ‘relative price’ and could just as easily cause a welfare loss for the representative citizen as it could produce a benefit.⁶⁷

⁶⁴ Lars P. Feld and Bruno S. Frey, *Trust Breeds Trust: How Taxpayers Are Treated*, Working Paper No. 98, (Zurich: Institute for Empirical Research in Economics, 2002), Available: <http://www.iew.unizh.ch/wp/> [accessed 19 August 2004].

⁶⁵ While a ‘benevolent maximiser’ state is not necessarily also a ‘welfare’ state, the challenge to increase (or even to maintain) tax revenue in the face of tax competition confronts the welfare state more urgently. See Vito Tanzi, ‘Globalization and the Future of Social Protection’, *Scottish Journal of Political Economy* 49, no. 1 (2002).

⁶⁶ Jeremy Edwards and Michael Keen, ‘Tax competition and Leviathan’, *European Economic Review* 40 (1996), pp. 114 - 115. See also the earlier article by Geoffrey Brennan and James M. Buchanan, ‘Towards A Tax Constitution For Leviathan’, *Journal of Public Economics* 8 (1977).

⁶⁷ Edwards and Keen, ‘Tax competition and Leviathan’, pp. 130 - 131.

Nonetheless, these extreme depictions of state government are often used by authors to frame their work on taxation and tax competition.

The relative social demand for public goods (and thus tax revenue) has also been framed in terms of ‘fairness and redistribution’.⁶⁸ Perceptions of fairness, and of the need for both benefit taxation and redistributive taxation, shape public attitudes about tax competition and influence policy-makers. As summarised by Alberto Alesina and George-Marios Angeletos, individuals possess some innate desire for what they consider a ‘fair’ outcome. Yet, the perception of ‘widespread tax evasion’ seems at odds with this assertion. Do individual desires to minimise tax payment (as reflected by efforts for tax avoidance) overcome this desire for fairness? Writing about *The Shadomy World of Tax Evasion, Capital Flight and Fraud*, Ingo Walter suggested that it does.

And the growing complexity of tax codes and their use for a broad range of political purposes other than raising revenue has added further to the impression of unfairness, gradually undermining tax morality and stimulating the search for escape even among otherwise law-abiding people.⁶⁹

For Walter this taxpayer perception of unfairness may be directed at the imposition of taxes, or it may be focused on how the tax revenue is used. Nonetheless, given a perception that the state was not achieving a fair outcome, citizens were ‘opting out’. In order to counteract this tendency, opportunities to ‘opt out’ must be reduced. The approach taken by the OECD is an attempt to reduce, if not eliminate, tax competition in a belief that this will reduce tax avoidance and restore ‘lost’ tax revenue.

⁶⁸ Alberto Alesina and George-Marios Angeletos, *Fairness and Redistribution: U.S. versus Europe*, Working Paper, No. 9502 (Cambridge, MA: National Bureau of Economic Research, 2003), Available: <http://www.nber.org/papers/w9502>. There is a more fundamental question present in Alesina and Angeletos’ paper concerning perceptions of state social welfare support. These perceptions about the level of need and quantity of state welfare provision obviously have a direct impact on levels of taxation. For this latter question on social preferences, see also Alberto Alesina, et al., ‘Why Doesn’t the United States Have a European-Style Welfare State?’ *Brookings Papers on Economic Activity*, no. 2 (2001). For a discussion of the incorporation of morals and social aspects in economic research, see the review article by Andreoni, et al., ‘Tax Compliance’.

⁶⁹ Ingo Walter, *Secret Money: The Shadomy World of Tax Evasion, Capital Flight and Fraud*, 2nd ed. (London: Unwin Hyman Ltd, 1989), p. 79.

In an intuitive sense, it is a bit presumptuous to think that the representative or notional taxpayer is concerned beyond local issues. The representative taxpayer may find a direct connection exists between local taxes and local public goods (schools, roads, the community centre) and probably perceives a connection between provincial taxes and provincial public goods (provincial universities, provincial highways, provincial welfare benefits). However, the connection between national taxes and national public goods (defence, highway maintenance, national parks, etc.) becomes more tenuous. The *representative* taxpayer is very likely unconcerned with the international because there is little perceived direct impact on their life.⁷⁰

The argument that tax competition reduces public welfare is not conclusively established. The authors of a survey of economic and public finance literature reviewed studies supporting both sides of the topic, and analysed their arguments. Günther Schulze and Heinrich Ursprung found that '[i]t appears that the final judgement on the welfare effects of increased tax competition depends critically on how one views government behaviour.'⁷¹ While concluding that empirical evidence 'does not appear to have given rise to any significant retrenchment of the welfare state, it cannot be rejected out of hand that the tax *structure* may have been influenced by the globalisation process...' as the decline and convergence of corporate tax rates between states appear to suggest.⁷² But they also point out that the corporate income tax base, and the revenue collected from it, is small when compared with those of the income and value added taxes of developed states. Therefore, Schulze and Ursprung have also concluded that the ability of states to maintain existing welfare programs will only be seriously affected should 'the income and value

⁷⁰ Menéndez, *Justifying Taxes*, pp. 106 - 115. Consider on this point, the level of public interest and public support to be found for the institution of a 'Tobin' tax on international financial transactions.

⁷¹ Günther G. Schulze and Heinrich W. Ursprung, 'Globalisation of the Economy and the Nation State', *The World Economy* 22, no. 3 (1999), p. 311.

⁷² *Ibid.* p. 346. Emphasis in the original.

added tax bases become significantly more mobile in the future course of global market integration.⁷³ Moreover, one might add, it is this concern that is behind EU efforts for tax harmonisation in Europe—cross-border shopping (taking advantage of lower VAT) and the existence of capital collecting interest in foreign bank accounts, untaxed—could seriously erode the national and collective tax bases.

Taken together, the arguments of Menéndez, Feld and Frey, and Alesina and Angeletos support the contention of the OECD that taxpayer confidence has been undermined. But it is not tax competition itself which undermines the confidence (and thus the tax morale) of the representative taxpayer. Instead, it is the response of the state to the presence of competition. While there has been an increase in the size of the underground economy (as shown by Menéndez), taxpayers desire or seek a fair outcome. Consequently, if they trust the tax administration they pay taxes. The study of Feld and Frey concludes that participation in the democratic process fosters support for the tax administration. ‘In such systems of direct democracy, taxpayers know that the public services they consume are worth the taxes they pay. Taxpayers therefore feel obliged to pay their taxes honestly.’⁷⁴ It is not the existence of yet another way to evade taxes (such as an OFC) that undermines tax morale. It is the relationship between taxpayers and the tax administration that affects taxpayer confidence. As Feld and Frey wrote, ‘trust breeds trust’.

A Sovereign Right to Tax?

When reading the debates over international tax harmonisation, one often encounters the statement that states have a sovereign right both to tax, and to determine

⁷³ Ibid.

⁷⁴ Feld and Frey, *Trust Breeds Trust: How Taxpayers Are Treated*, p. 6.

the amount of tax. The point frequently made by opponents of tax harmonisation emphasises the sovereign independence of the state on matters of taxation.

A country's right to levy taxes is a fundamental aspect of its sovereignty. Without the power to tax, a government would be unable to redistribute resources among its citizens and provide public goods. The question of how tax rights should be distributed is therefore one of the oldest and most important problems of tax theory.⁷⁵

This perspective takes us a step beyond the discussion of state sovereignty already presented. Moreover, it addresses the question of how the state is to achieve self-sufficiency. A similar perspective is present in the tax harmonisation debate within the European Union.

Another holistic approach, much favoured in the European discussion as well as by economists focusing on world-wide allocative efficiency as the most relevant international tax policy objective, is some form of imposed harmonization or uniformity. At one level, this implies international tax police again, or cession of national sovereignty.⁷⁶

The redistributive aspect of tax revenue, between wealthy and poor, is an element of these debates domestically as well as internationally. These debates engage with the question over the preferences held in a given society for public goods and the allocation of state revenue.

A contrasting perspective from small developing states also concerns the question of fiscal sovereignty. To answer the question—who has the right to tax? — Rosemarie Antoine approaches it as a matter of jurisdiction, in the legal sense of the word. Can a state claim the right to tax entities (or individuals) located outside their territorial boundaries? The answer involves the difference between the ‘origination’ approach and the ‘residence’ approach used to establish a tax liability. With the origination approach, income is taxed in the territory in which it originates (also known as the territorial approach or principle of

⁷⁵ Alexander W. Cappelen, ‘The Moral Rationale for International Fiscal Law’, *Ethics and International Affairs* 15, no. 1 (2001), p. 97.

territoriality). Under the residence approach, the income is taxed by that territory wherein the citizen (or firm) resides (also known as the domicile approach). Developed states frequently take the residence approach for corporate income tax, with the consequence that tax collection has in effect become an extra-territorial application of domestic law. Antoine states that this method is contested by developing states, asserting that ‘they, and not the country of original residence, have the right to tax.’⁷⁷ It is essentially an infringement on their sovereignty, from this perspective of taxation.

Accompanying the distinction between origination and residence in taxing income is the state’s approach for determining the extent of income subject to taxation. For the individual, there are two approaches, one based upon the individual’s place of residence (territorial) and the second based upon the individual’s citizenship (worldwide). It is a question of jurisdiction, ‘In Britain, the Inland Revenue is not very interested in the colour of your passport—its primary concerns are with residence, ordinary residence, and domicile.’⁷⁸ This produces a potential for complex income tax submissions, and promotes the development of an entire sub-discipline within law and finance for tax consultation in the United Kingdom.⁷⁹ For citizens of the United States on the other hand, they are obligated to report their worldwide income, from all sources to include non-U.S. employment and non-U.S. investment and savings. This holds even if they are not resident

⁷⁶ Richard M. Bird and J. Scott Wilkie, ‘Source- vs. residence-based taxation in the European Union: the wrong question?’ *Taxing Capital Income in the European Union: Issues and Options for Reform*, ed. Sijbren Cnossen (Oxford: Oxford University Press, 2000), pp. 100 - 101.

⁷⁷ Rosemarie Antoine, ‘The Offshore Financial Services Sector: Legal Policy Issues on the Path to Development: A Legal Defence’, *Journal of Eastern Caribbean Studies* 26, no. 4 (2001), p. 11. A similar position was stated by the Panamanian Foreign Minister to the International Bar Association Conference in 2002. Jose Miguel Aleman, *Panama and the OECD on International Tax Cooperation: Presenting the case of a Real Economy*, 2002, Web page, Available: <http://www.freedomandprosperity.org/Papers/aleman/aleman.shtml> [accessed 11 March 2003].

⁷⁸ J. A. Kay and M. A. King, *The British Tax System*, 5th ed. (Oxford: Oxford University Press, 1990), p. 204. As explained by Kay and King, residence is the state where one lived in a particular tax year; ordinary residence is the state where one usually lives; and domicile is the state with which one ‘has the strongest associations’. While for many of us these are all the same, there are a number of UK citizens where it is not the case, thus the benefit of offshore banking.

⁷⁹ Moreover, according to *The Yearbook of the Offshore Finance Industry* – ‘The rules governing resident and non-resident status [for expatriate Britons] are nowhere set out clearly in law, and are open to interpretation.’ Iain Yule, *Offshore 96: The Yearbook of the Offshore Finance Industry* (London: Charterhouse Communications, Ltd., 1996), p. 14.

in the United States. This is because the U.S. maintains a worldwide tax administration, based on citizenship, and laws exist to increase the difficulties experienced by renouncing citizenship for presumed reasons of tax minimisation. Tax deductions and credits are available to reduce the impact of double taxation in most states' tax structure. Nevertheless, under worldwide-based tax laws *all* income is considered. To forget to declare the interest income from an account in the Cayman Islands is tax evasion, not avoidance, for a U.S. citizen.

For the United Kingdom, with a territorial-based tax administration, it is not so clear-cut. It becomes a question of its remittance basis. In this instance, the possession of an offshore account is a form of potential tax avoidance. The citizen may not be obligated to declare the income, until it is repatriated (remitted) into the United Kingdom. If the income is utilized, e.g., consumed while on holiday abroad, it is tax avoidance, but is it tax evasion? This is open to some debate as the question of intentionality is raised.⁸⁰ However, if the same citizen walks up to the automated teller machine (ATM) around the corner from their home, and withdraws money from their offshore account, the transaction should now be accountable to the state's tax administration, to whatever extent it was earned income.

The use of an ATM to access funds however may be effectively anonymous. Because the tax administration doesn't know about the transaction, and presently has no method to isolate the transaction, it is known only to the account holder, the financial transaction system, and the institution maintaining the account.⁸¹ The transaction may not *be* anonymous, but it does fly under the radar of the anti-money laundering regime's

⁸⁰ As a starting point, on this see David Collison and John Tiley, *Simon's Tiley and Collison UK Tax Guide 2003-04*, 21 ed. (London: LexisNexus UK, 2003), pp. 1197 - 1203. Naturally, as with all discussions of individual income tax, this comes with the standard disclaimer to consult with one's tax professional on one's individual circumstances.

⁸¹ This circumstance is subject to change as the technology to track ATM use is developed. For an early indication of efforts in this area see Michelle Gilchrist, *Tax haven crackdown*, 24 February 2004, Web page, *The Australian*, Available:

suspicious activity reports (SARs), based on transaction size. The amount one is permitted to draw from an ATM on a daily basis is significantly less than the transaction size that would trigger a SAR (this amount depends on the jurisdiction, in the U.S. it is \$10,000 and in the UK it is £10,000).⁸²

The treatment of corporations is far more complex. Firms are the predominant rationale behind double taxation treaties, firms conduct individual negotiations with local officials before making significant new investment, and firms are treated to a variety of tax credits/deductions.⁸³ Moreover, firms may engage in transfer pricing, a problem that increasingly becomes problematic for tax administrators as international trade becomes more a matter of intra-firm trade. The multinational firm is able to manipulate pricing between divisions or subsidiaries located in different states, effectively transferring taxable income, and deductible business expenses, to the benefit of the firm. Tax treaties include provisions to tackle transfer pricing, but to deal with the problem effectively requires co-ordination between the affected states' tax administrators.⁸⁴ Another tactic used by multinational corporations (MNCs) has been to establish a holding company in a location offering preferential treatment for the firm's tax status. The holding company 'owns' patents or other intellectual property that it then 'licenses' to subsidiaries (likely including

http://www.theaustralian.news.com.au/common/story_page/0,5744,8773087%255E601,00.html [accessed 26 March 2004].

⁸² For my perspective on the intersection of the OECD harmful tax competition project, electronic access to financial institutions, and individual efforts to avoid tax, see William Vlcek, 'The OECD and Offshore Financial Centres: Rearguard Action Against Globalisation?' *Global Change, Peace and Security* 16, no. 3 (2004).

⁸³ For a recent summary of U.S. tax rules see the report prepared for the U.S. Senate Committee on Finance, Joint Committee on Taxation, *The U.S. International Tax: Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations*, (JCX-67-03) (3 July 2003), Available: <http://www.house.gov/jct/x-67-03.pdf> [accessed 5 December 2003].

⁸⁴ Johan Deprez, 'International tax policy: recent changes and dynamics under globalization', *Journal of Post Keynesian Economics* 25, no. 3 (2003); Edward M. Graham, *Global Corporations and National Governments* (Washington, D.C.: Institute for International Economics, 1996).

the original firm) located in less tax-friendly locations. This also effectively transfers the MNC's global income and profits to the low tax jurisdiction.⁸⁵

Sovereignty also has been identified as hindering the achievement of an 'efficient allocation of revenue between countries inuring to the benefit of taxpayers'.⁸⁶ The author of *The Impact of State Sovereignty on Global Trade and International Taxation* contends that state sovereignty no longer serves the needs of the political community and its citizens. Instead, sovereignty is preventing the co-ordination activities required to eliminate international tax distortions.

In the light of international economic integration it is no longer sufficient just to look at the equity considerations which arise between taxpayers. It is now essential also to look at the equitable relativities between nations: inter-nations equity. This requires that the worldwide tax base be fairly shared between nations.⁸⁷

To achieve this goal requires the co-operation of all states, which must cede their sovereign right to set, collect and distribute tax revenue to a global authority.

The essential problem, as identified by this text, is 'State reluctance to enact international norms for fear of losing "sovereignty"'.⁸⁸ The solution to this problem is found in the extraterritorial enforcement of municipal (state) law. Ramon Jeffery suggested that while a state's enforcement jurisdiction may be limited by territorial boundaries, its legislative jurisdiction is not limited by those boundaries.⁸⁹ Therefore, Jeffery argued that

⁸⁵ While this approach reduces tax obligations to a state, it does increase the value of the firm to its owners/share holders (who are presumably taxed in some jurisdiction). This also intersects with the question of fairness and redistribution, as it benefits the few (owners/share holders) without redistribution of income to the many (public or public goods). Though if it is a publicly traded firm, it is possible those shareholders include mutual funds and pension plans, increasing the number of citizens that compose the 'few'. Furthermore, in a fashion similar to individuals renouncing citizenship, firms may undertake a 'corporate inversion', in which the firm 'sells' itself to an offshore affiliate for the purpose of transferring corporate residence (citizenship) in order to reduce its corporate taxes. This strategy became a political issue in the U.S. in 2002, initiated after the announcement by Stanley Works of its intention to 'relocate' to Bermuda. Elaine Walker, 'Proposed U.S. legislation may close Bermuda loophole', *The Miami Herald* 1 July 2002, Available: <http://www.miami.com/mld/miamiherald/business/3568010.htm> [Accessed 10 July 2002].

⁸⁶ Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation*.

⁸⁷ *Ibid.*, p. 11.

⁸⁸ *Ibid.*, p. 37.

⁸⁹ At issue is the legality of enforcement beyond the borders of the state in which the law has been enacted, particularly when in this case tax evasion is not consistently considered a crime in all jurisdictions. Nevertheless, Jeffery felt that "To

the refusal of one state to enforce the tax laws of another state merely facilitates and promotes tax evasion. His contention was that 'world-wide economic integration' has fundamentally changed the situation for international relations and international law. Globalisation therefore justifies, or at least legitimates, the extraterritorial enforcement of a state's laws.

[I]t no longer follows that one State, by exercising its prerogative power in the territory of another, is necessarily challenging that other State's sovereignty. The reason for this is that the basis of the enforcing State's economic power is no longer circumscribed by territorial boundaries.⁹⁰

The objective is to give up all notions of state sovereignty (at least for economic matters) in order to remove all barriers to tax collection, and further, to establish a global tax regime in order to create an equitable global society.

State sovereignty also includes the fact that no state is obligated to act as the tax collection agent for another sovereign state. Bilateral agreements are intended to overcome this difficulty, while not expecting a state to enforce the laws of another state within its sovereign jurisdiction. The inability of a state to request and collect financial data concerning any accounts held by its citizens in an offshore jurisdiction without a prior information exchange agreement obstructs the capability of the state to pursue tax evasion, much less impose tax. However, the existence of a bilateral agreement does not assure information exchange, as the agreements often require mutual recognition of possible criminal conduct by the account owner, for example the accusation of money laundering. Tax avoidance or evasion in one state may not satisfy the mutual recognition requirement, as that activity may not be similarly defined in the second state.⁹¹ Part of the objective of the OECD project is to resolve these difficulties.

say that enforcement jurisdiction is the prime regulator in international law is to confuse theory with practice. Just because a law cannot in practice be enforced does not in any way relate to its legality or otherwise.' (p. 117)

⁹⁰ Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation*, pp. 123 - 124.

⁹¹ Edwin van der Bruggen, 'State Responsibility under Customary International Law in Matters of Taxation and Tax Competition', *Intertax* 29, no. 4 (2001).

In exploring offshore financial centres and taxation, the intention has been to place them within a context of small state economic development. In turn, economic development within global finance, and the burgeoning nature of globalisation, impacts the sovereignty of small states. In particular it impacts the space in which small states are allowed fiscal sovereignty. At the same time, the different approaches used for taxation discussed here require fiscal sovereignty amongst states in order to continue to function. These differences are fundamental to retaining the ability to choose, and thus to enable each state to pursue and achieve the goals and aspirations for social welfare and the distribution of public goods desired by its citizens. It appears hypocritical on the part of developed states to retain the freedom of choice concerning taxation for themselves, while insisting that other states must forego similar sovereign choices. Thus, we now turn to the efforts of the OECD to eliminate what it has determined to be 'harmful' tax competition as a result of the choices made by sovereign states.

Table 3-1 – Jurisdictions with offshore financial centres

Africa	Asia and Pacific	Europe	Middle East	Western Hemisphere
<i>Djibouti</i>	Australia	Austria	<i>Bahrain</i>	<i>Anguilla</i>
Liberia	<i>Cook Islands</i>	<i>Andorra</i>	Dubai	<i>Antigua and Barbuda</i>
<i>Mauritius</i>	<i>Guam</i>	Campione	Israel	<i>Aruba</i>
<i>Seychelles</i>	Hong Kong	<i>Cyprus</i>	Kuwait	<i>Bahamas</i>
Tangier	Japan ^a	<i>Gibraltar</i>	Lebanon	<i>Barbados</i>
	<i>Macao</i>	<i>Guernsey</i>	Oman	<i>Belize</i>
	Malaysia ^b	Hungary		<i>Bermuda</i>
	<i>Marianas</i>	Ireland ^c		<i>British Virgin Islands</i>
	<i>Marshall Islands</i>	<i>Sark and Isle of Man</i>		<i>Cayman Islands</i>
	<i>Micronesia</i>	<i>Jersey</i>		Costa Rica
	<i>Nauru</i>	<i>Liechtenstein</i>		<i>Dominica</i>
	<i>Niue</i>	<i>Luxembourg</i>		<i>Grenada</i>
	Philippines	<i>Malta</i>		<i>Montserrat</i>
	Singapore ^c	Madeira		<i>Netherlands Antilles</i>
	Thailand ^d	<i>Monaco</i>		Panama
	<i>Vanuatu</i>	Netherlands		Puerto Rico
	<i>Western Samoa</i>	Russia		<i>St. Kitts and Nevis</i>
		Switzerland		<i>St. Lucia</i>
		United Kingdom ^f		<i>St. Vincent and the Grenadines</i>
				<i>Turks and Caicos</i>
				United States ^g
				Uruguay

Source: Luca Errico and Alberto Musalem, *Offshore Banking: An Analysis of Micro- and Macro-Prudential Issues*, Working Paper of the International Monetary Fund, WP/99/5 (Washington, D.C.: International Monetary Fund, 1999), p. 11

Note: Those states or non-self-governing territories with a population less than 1.5 million have been italicized.

^aJapanese offshore market (JOM).

^bLabuan.

^cAsian currency units (ACUs).

^dBangkok international banking facility (IBF).

^eDublin.

^fLondon.

^gU.S. international banking facilities are located in New York, Miami, Chicago, and Los Angeles–San Francisco.

THE OECD CASE FOR HARMFUL TAX COMPETITION

He will place a tax on the air you breathe and on the bread you eat; he will give you a legislation which is as legitimate as it is unjust and instead of reasons, he'll give you laws. These will grow in the course of time, until you no longer exist for yourselves but for others.

– Franz Grillparzer, *Libussa*, Act 2 (1872)

Sovereignty, and the sovereign right to tax (or not) rests within the structure of the state. This state-centric perspective may be subject to criticism for ignoring other, non-state, influences on the lives of citizens.¹ However, the situation prevails that it is the state, with its attendant structures, which remains concerned with the well being of its residents and citizens. Whether that concern involves a minority or a majority, nevertheless revenue is required to satisfy expectations for political goods. State revenue is generally collected via either tariffs or taxes, yet the scale and extent of this collection may be manipulated to achieve a variety of purposes beyond simply government operations. This manipulation may be intended to attract new or additional sources of non-tax or indirect revenue to the state. These efforts lead observers to characterise the result as a ‘competitive’ state, for the government strives to enhance the political goods available to its citizens, while competing with other states (who also seek to enhance their public’s welfare).² Among the political goods pursued are jobs (or full employment), improved infrastructure, improved

¹ As discussed in the previous chapter, this is the argument made by Jeffery concerning the impact of globalisation. As will be seen below, the OECD identifies globalisation as a concern with respect to taxation as well.

² Ronen Palan, et al., *State Strategies in the Global Political Economy*, Revised ed. (London and New York: Pinter, 1999). In addition, see more generally the work of Susan Strange and Philip Cerny.

educational opportunities, and additional business opportunities ancillary to the investment attracted to the state.³

One arena for competition amongst states that has emerged over the past few decades concerns the taxation of individuals and firms. The competitive nature of the rate of taxation and the items subject to tax has been stimulated by the growth and pervasiveness of modern transportation and communication. Consequently, individuals and firms are no longer constrained by the physical geography of their resident (home) state. This further stimulates the competition, to a point where it has been characterised as 'harmful' by some observers. One might argue however, that it is only the losers in this competition which complain—that it is 'unfair', that the playing field is not level, and that consequently the competitive situation causes harm. The situation is described as one where the tax policy variance amongst states has skewed investment decisions. This in turn denies some states tax revenue, as well as providing a motivation and avenue for capital flight (whether or not it is to avoid expropriation or simply to seek higher returns on investment).

International co-operation is required in order to resolve this competition between states collectively. However, different domestic needs could influence the level of co-operation forthcoming from the involved states. The next section describes an example that may provide some insight into the potential success of the harmful tax competition initiative. The American experience with the Prohibition against the manufacture and sale of alcohol emphasises the importance of co-operation amongst neighbouring states in order for the project to succeed. After presenting a picture of the challenges facing a global tax harmonisation effort, the chapter presents a brief background to the OECD

³ Jacques Morisset and Neda Pirnia, *How Tax Policy and Incentives Affect Foreign Direct Investment: A Review*, (Washington, D.C.: The World Bank and International Finance Corporation Foreign Investment Advisory Service, December 2000), Available: www.worldbank.org/research/workingpapers; Charles Oman, *Policy Competition for Foreign Direct Investment: A*

project. This sets the scene for a more detailed examination of the project objectives within a context of state sovereignty. The documents published to explain and promote the harmful tax competition initiative are analysed. The examination is composed of subsections describing the OECD case against tax competition. The definition developed by the OECD for 'harmful' tax competition, and the tactics the OECD proposed to counter this harmful tax competition are both outlined. The next subsection explores the phrase frequently used to identify the goal of the OECD initiative. This goal is 'to level the playing field' and required the creation of a special working group to establish a common definition of the phrase. The discussion in this chapter on the harmful tax competition project concludes by briefly presenting some of the dissenting views offered by OECD member states concerning the project.

A Cautionary Tale – American Prohibition

In the United States, tax evasion is seen most famously as the charge used to arrest and convict Al Capone, infamous Chicago mobster of the Prohibition Era.⁴ Here we might wish to pause for a moment and consider the unintended consequences of righteous actions intended to promote a better society. In response to the calamities induced by the excessive consumption of alcohol, well-meaning individuals and organisations had sought for years to prohibit the sale of all alcoholic beverages within the United States. In time (and for a time) they succeeded, for with the passage of the 18th constitutional amendment

Study of Competition among Governments to Attract FDI (Paris: Development Centre of the Organisation for Economic Co-operation and Development, 2000).

⁴ See *The Untouchables* (1987) and similar movies of the recent past which have kept this popular image of the circumstances in the public imagination. For more exciting tales of capital flight, tax avoidance, tax evasion, corruption and illegal finance see R. T. Naylor, *Hot Money and the Politics of Debt*, 2nd ed. (Montreal: Black Rose Books, 1994).

... the manufacture, sale, or transportation of intoxicating liquors within, the importation thereof into, or the exportation thereof from the United States and all territory subject to the jurisdiction thereof for beverage purposes is hereby prohibited.⁵

In the subsequent unrelated general economic boom of the next decade, the results of Prohibition included making scofflaws of a significant portion of the population, substantially wiping out an extensive (formerly legal) industry in brewing and distilling alcoholic beverages, and establishing an environment leading to the growth of organised crime centred around the production, distribution, and sale of this illegal substance.⁶ (Not to forget, the cost to local, state and federal governments of enforcing the law, combined with the loss of revenue from the taxes and duties formerly collected on alcoholic beverages). Similar to Prohibition, the challenge for the OECD with the harmful tax competition project is not with the capacity to pursue individual tax evasion cases, but in effect to change an environment which facilitates tax avoidance and evasion. This requires collective state co-operation and action.

There were two significant difficulties with implementing Prohibition in the United States: the emergence and growth of illegal distilling and brewing operations within the U.S.; and the role of neighbouring jurisdictions from which alcohol could be smuggled (Canada, Mexico, the Caribbean). With reference to tax avoidance and evasion, the presence of a cash-only shadow economy is comparable to the illegal still, or home-brewed beer. Collecting taxes from cash-in-hand transactions in this underground economy has

⁵ Section 1, 'Prohibition of Intoxicating Liquors' Eighteenth Amendment to the Constitution of the United States of America, available at <http://www.access.gpo.gov/congress/senate/constitution/con029.pdf> [accessed 27 January 2003]. This amendment passed Congress in 1917, and was ratified by three-quarters of the states by 1919. The Volstead Act enforced the 18th Amendment, and was in effect from 16 January 1920. The Prohibition Amendment to the Michigan State Constitution passed two years earlier, in 1916. See Philip P. Mason, *RumRunning and the Roaring Twenties: Prohibition on the Michigan-Ontario Waterway* (Detroit: Wayne State University Press, 1995), p. 1.

⁶ See Larry Engelmann, *Intemperance: The Lost War Against Liquor* (New York: The Free Press, 1979), pp. 142 - 147. NB: scofflaw - One who treats the law with contempt, esp. a person who avoids various kinds of not easily enforceable laws. The OED Online reports the term came from a Prohibition Era contest to identify a word to be used to characterise the 'lawless drinker.' More than simply the patrons that frequented the blind pigs and speakeasies (the underground illegal bars that arose in response to consumer demand) this group also included the pharmacists who sold various potions of high alcohol content—for medicinal purposes only.

been a challenge to tax authorities since the origination of taxation, but it remains fundamentally a domestic activity between individuals. The accrual of untaxed income offshore however suggests the situation presented by the smuggling of Canadian whiskey across the Detroit River during the Prohibition. Successful efforts to stop the smuggling required the co-operation of Canadian authorities. This co-operation was undertaken with a recognition that Canadian businesses generated significant revenue from the manufacture and sale of alcohol that later found its way across the border into the U.S. Similar to the OECD's efforts with non-co-operative states, the U.S. sought the co-operation and co-ordination of state authorities in Canada and Mexico to interdict the smuggling activities before the alcohol got to the border. Yet, these same authorities understood the financial benefit they gained from an activity characterised by some as a purely American problem. This perception arose from the fact that it was only in the United States that the manufacture and possession of alcohol was illegal. Consequently, the nature of co-operation was mixed.⁷ Similarly, some OFCs believe tax avoidance to be a problem for the home state of their customers; they are conducting a financial services business and not a tax revenue reporting and collection agency.⁸

The story of the Harmful Tax Competition Initiative

It can be suggested that the roots of the OECD project sprouted from the European Union's Tax Harmonisation campaign.⁹ From this vantage point, the issue was

⁷ Ibid.

⁸ Palan identified American Prohibition as the instigator for the Panamanian shipping registry (that offshore sector for flags of convenience). In order to continue serving alcohol on board, two American flagged passenger ships transferred their flags to Panama. Ronen Palan, *The Offshore World: Sovereign Markets, Virtual Places, and Nomad Millionaires* (Ithaca and London: Cornell University Press, 2003), p. 52.

⁹ Philipp Genschel and Thomas Plümper, 'Regulatory competition and international co-operation', *Journal of European Public Policy* 4, no. 4 (1997); Philipp Genschel, 'Globalization, Tax Competition, and the Welfare State', *Politics and Society* 30, no. 2 (2002); Ronald M. Sanders, 'The Fight Against Fiscal Colonialism: The OECD and Small Jurisdictions', *The Round Table*, no. 365 (2002). However this may simply be a Euro-centric view of the OECD. A Pacific perspective suggests otherwise – 'It is therefore not surprising that Japan, the most rapidly ageing OECD country, instigated the OECD work against tax havens and tax competition in 1995.' Terry Dwyer, 'Information exchange and global economic

not so much a problem of tax avoidance by corporations, as much as it was tax avoidance and tax evasion by countless anonymous individual citizens. Any figures reported for the size and magnitude of extraterritorial wealth are perforce estimates, and thus they should be considered with some scepticism. In particular we should be alert to any pre-existing assumptions embedded in the estimates. Further, it is difficult to segregate the accounts of individuals from accounts possessed by corporate business entities (which could actually mask and conceal an individual).¹⁰ The veracity of figures presented for offshore wealth could be compared with those suggested for money laundering, ‘Figures of \$300 billion to \$500 billion for international flows are banded [sic] around and become “facts by repetition,” but there is very little evidence to justify them.’¹¹ For example, in June 2000 Oxfam UK reported ‘recent estimates’ that there were between \$6 - 7 trillion in offshore financial centres, and that between \$3 - 4 trillion of this sum ‘consists of savings held abroad by wealthy individuals’.¹² The report goes on to calculate that this results in a tax revenue loss of ‘at least US\$50 billion a year’. In testimony offered to the United States Senate, Permanent Subcommittee on Investigations, in July 2001, the District Attorney for Manhattan declared ‘Deposits of U.S. dollars in the Cayman Islands have been increasing by about \$120 billion a year; according to the Federal Reserve Bank of New York, there are

regulation--for whose benefit?’ (paper presented at the fourth meeting of the International Tax and Investment Organization (ITIO), Port Vila, Vanuatu, 4-6 February 2002), p. 1, Available: <http://www.itio.org/documents/TDwyerPaper.pdf> [accessed 7 October 2002].

¹⁰ On this point see the OECD report on the use of corporate vehicles for illicit purposes, Organisation for Economic Co-operation and Development, *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes* (Paris: OECD Publications, 2001), Available: <http://www1.oecd.org/publications/e-book/2101131e.pdf> [accessed 20 August 2002]. There was also a U.S. Senate investigation into the use of American corporations by Russian entities, see General Accounting Office, *Suspicious Banking Activities: Possible Money Laundering by U.S. Corporations Formed for Russian Entities*, (Washington, D.C.: General Accounting Office, 2000), Available: http://www.access.gpo.gov/su_docs/aces/aces160.shtml [accessed 24 September 2002].

¹¹ Michael Levi, ‘Money laundering and its regulation’, *Annals of the American Academy of Political and Social Science*, no. 582 (2002), p. 184.

¹² Oxfam, *Tax Havens: Releasing the Hidden Billions for Poverty Eradication*, June 2000, Oxfam GB Policy Paper, Oxfam GB, Available: <http://www.oxfam.org.uk/policy/papers/taxhvn/tax3.htm> [accessed 20 April 2002], p. 7. For an analysis of their calculations (which develops an argument that they are inflated as a result of the assumptions made in the analysis), see Daniel J. Mitchell, *Oxfam’s Shoddy Attack on Low-Tax Jurisdictions*, August 2001, PDF file, *Prosperitas* (Vol I,

now more than \$800 billion U.S. dollars on deposit in Grand Cayman.¹³ And an article published in *The Nation* in June 2001 quoted a financial consulting firm's 'World Wealth Report' – 'According to Merrill Lynch & Gemini Consulting's 'World Wealth Report,' one-third of the wealth of the world's high net-worth individuals, or nearly \$6 trillion, may be held offshore. Offshore havens also hold an estimated 31 percent of the profits of US multinationals.'¹⁴

As noted by Caroline Doggart (amongst a number of authors), success within the EU (and Europe more broadly, as it requires the co-operation of Switzerland, not a member state of the EU) on tax harmonisation would only serve to push funds further offshore – to financial centres not covered by that EU directive. Some of the unintended consequences in Europe's successful movement towards tax harmonisation may be the proposals in places such as Namibia to establish an offshore financial centre and in Iceland to create a low-tax regime for international trading companies.¹⁵ It is possible that these initiatives were in anticipation of a flow of savings and investment accounts away from the taxation to be imposed by the EU Tax Harmonisation Directive.

Recognising the potential for just such a situation to develop during their long struggle to achieve consensus on tax harmonisation *within* the EU, EU member states within the OECD initiated a complementary effort to be imposed globally, the Harmful

Issue I), A Publication of the Center for Freedom and Prosperity Foundation, Available: <http://www.freedomandprosperity.org/Papers/oxfam/oxfam.shtml> [accessed 4 April 2002].

¹³ Committee on Governmental Affairs, *Testimony of Robert M. Morgenthau before the United States Senate, Permanent Subcommittee on Investigations*, 18 July 2001, published by U.S. Senate, Available: http://www.senate.gov/~gov_affairs/071801_psimorgenthau.htm [accessed 22 July 2002]. There was nothing to suggest however in this testimony from the Manhattan District Attorney just how much of this amount he believed were deposits by U.S. citizens or corporations, versus how much belonged to non-citizens seeking the security of deposits in a hard currency.

¹⁴ Lucy Komisar, 'After dirty air, dirty money', *The Nation*, 18 June 2001, Available: <http://www.thenation.com/doc.mhtml?i=20010618&s=komisar> [accessed 3 March 2003].

¹⁵ Paul Styger, et al., 'Offshore Finance in Southern Africa', *Offshore Finance Centres and Tax Havens: The Rise of Global Capital*, eds. Mark P. Hampton and Jason P. Abbott (London: Macmillan Press Ltd., 1999), pp. 240 - 247. This OFC was intended to operate with a companion EPZ, and provide financial services in southern Africa. For Iceland see, Caroline Doggart, *Tax havens and their uses*, Research Report, 10th ed. (London: Economist Intelligence Unit, 2002), 10th ed., p. 41.

Tax Competition Initiative, in 1996. Turning to the communiqué of the 1996 G7 Summit in Lyon, the initiative received an approving nod.

We strongly urge the OECD to vigorously pursue its work in this field, aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices.¹⁶

This however was somewhat self-serving, as the members of the G7 (with the exception of Japan) are also founding members of the OECD. The G7 declaration was in effect a case of patting one's self on the back, nonetheless this high level acknowledgement underscores the level of support amongst the major developed states for this OECD project. The next section opens the examination of the harmful tax competition debate, starting from the OECD perspective.

An Emerging Global Problem?

The initial document published by the OECD for the project was titled *Harmful Tax Competition: An Emerging Global Issue*. Immediately, starting with the very cover of the report, the OECD has established this to be a 'global' concern, using an image of a globe in the cover artwork. The message to be received is that 'we' (the OECD) were tackling this issue, on 'our' own initiative, for the betterment of all. In the introduction of this report, the authors stated that it

...is intended to develop a better understanding of how tax havens and harmful preferential tax regimes, collectively referred to as harmful tax practices, affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally. *Such harmful tax competition diminishes global welfare and undermines taxpayer confidence in the integrity of tax systems.*¹⁷

The subsequent paragraph then stated that the report covered both member and non-member states and their dependencies. It was important to be clear that not only was the

¹⁶ Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD Publications, 1998), paragraph 2, p. 7.

problem global, but the analysis and attendant recommendations were also global in nature. However, the report refrains from addressing the issues of foreign direct investment (FDI) and consumption taxes. It focused solely on ‘general income tax systems, as well as those taxes levied on certain types of income.’¹⁸ The totality of the work contained in this report ‘needs to be seen in the context of the OECD’s role in a world where the pace of globalisation is accelerating.’¹⁹ One might also read in this statement, that because the pace was accelerating, it was getting beyond OECD control, and therefore it needed to be reined in.

The report continued by acknowledging the fact mentioned earlier, that ‘Work on harmful tax competition has also been carried out in the European Union (EU).’ Consequently, while the authors found the efforts of the EU and OECD to be ‘broadly compatible’ they also found the ‘scope and operation of the two to differ.’²⁰ The success of the EU effort requires global co-operation, most explicitly from the United States, Switzerland and the other states identified in the Directive on the Taxation of Savings.²¹

¹⁷ Ibid., paragraph 4, p. 8. Emphasis mine. The report was the product of the ‘Special Sessions on Tax Competition’ created by the OECD Committee on Fiscal Affairs. See Ibid., p. 7.

¹⁸ Ibid., paragraph 7, p. 8. Rajiv Biswas, a Senior Economist in the Commonwealth Secretariat has suggested that the OECD ‘ring-fenced’ out of the definition of harmful economic practices such things as agricultural subsidies (for instance the Common Agricultural Policy of the European Union). Rajiv Biswas, ‘The Outlook for the Global Offshore Financial Services Industry’, *International Capital Markets, Quarterly Review* 21, no. 2/3 (2001). The absence of FDI however may not be critical, as discussed in chapter 1 some research suggests that tax competition among states and sub-state entities for FDI has limited influence on business decisions. Much more important to businesses are matters of infrastructure, local workforce education and skills, political environment, etc. (a decision-making approach which has also been self-reported by major multinational corporations). See Oman, *Policy Competition for Foreign Direct Investment*.

¹⁹ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, paragraph 8, p. 8.

²⁰ Ibid., paragraphs 17 and 18, p. 11.

²¹ Council of Economics and Finance Ministers, *Results of Council of Economics and Finance Ministers, Brussels, 21st January 2003-Taxation*, 22 January 2003, Press release, Press release, Available: http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=MEMO/03/13|0|RAPID&lg=EN&display= [accessed 22 February 2003]. The complete list of ‘certain third countries on the application of equivalent measures’ to be coordinated contained: United States, Switzerland, Liechtenstein, Monaco, Andorra and San Marino. The Council also expects that ‘the relevant dependent or associated territories (the Channel Islands, Isle of Man, and the dependent or associated territories in the Caribbean)’ belonging to the Member States (United Kingdom and Netherlands) apply the same measures. The non-Caribbean dependency of Bermuda apparently was forgotten, or mis-located, if only for a brief period. See Mairi Mallon, ‘Island exempt from EU tax agreement’, *The Royal Gazette* (Hamilton, Bermuda), 5 June 2003, Available: <http://www.theroyalgazette.com/apps/pbcs.dll/article?AID=/20030605/BUSINESS/106050052> [accessed 29 July 2003]; Roger Crombie, ‘Bermuda’s EU tax exemption may not last long’, *The Royal Gazette* (Hamilton, Bermuda), 27

Without the establishment and enforcement of a global effort to exchange tax related information, EU citizens may continue to find locations to invest capital and avoid tax, even if perhaps less convenient and more distant. This suggests the construction of an analogy, that what the blind pigs were to the American Prohibition (a place to get illegal alcohol), the tax havens would be to the global financial system (a place to accumulate capital without suffering from taxation). Subsequently, in the 2000 progress report on the status of the project, section IV addressed the importance of ‘Involving Non-Member Economies’. It is important to involve these non-member states, otherwise there is the concern that there would be ‘a shift of the targeted activities to economies outside the OECD area, giving them an *unwarranted* competitive advantage and limiting the effectiveness of the whole exercise.’²² The point was raised in this progress report in part because non-member states were not involved in the initial work undertaken by the OECD.

Establishing the Case against Competition

In the first chapter of the report – ‘Tax Competition: A Global Phenomenon’ – the emphasis was upon the argument that ‘The accelerating process of globalisation of trade and investment has fundamentally changed the relationship among domestic tax systems.’²³ One may read this as a ‘hyperglobalist’ statement—the situation was new, mobility of capital was new, and while this ‘globalisation has had a positive effect on the development of tax systems [it] had the negative effects of opening up new ways by which companies

June 2003, Available: <http://www.theroyalgazette.com/apps/pbcs.dll/article?AID=/20030627/BUSINESS/106270051> [accessed 10 July 2003].

²² Organisation for Economic Co-operation and Development, *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices* (Paris: OECD Publications, 2000), paragraph 29, p. 22. Emphasis mine.

²³ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, paragraph 21, p. 13.

and individuals can minimise and *avoid* taxes...²⁴ In keeping with some of the critique of this perspective on globalisation, I would suggest otherwise. The ways were not new, and the means of minimising and avoiding taxes were not necessarily new, only technologically more advanced. Looking at the history behind the development of global finance and tax havens, one finds that corporate domicile and capital flight were aspects of the financial landscape prior to this latest wave of internationalisation. As already noted, Switzerland has been used to protect individual wealth from confiscation in unsettled times since the 17th century. Corporate case law concerning taxation (and in a sense the inter-state transfer of corporate profits) in the United Kingdom date from 1876.²⁵ At a time when London was recognised as the world financial centre and global financial hegemon, this suggests that corporations (both joint-stock and individuals) have found spaces in the financial regulatory landscape for at least the last 130 years (and likely much longer) to avoid taxation.²⁶

Nonetheless, *Harmful Tax Competition* starts from the premise that the situation is ‘new’. Individuals that utilise the services of tax havens, and the tax haven jurisdictions themselves, are characterised as ‘free riders’ –individuals because they benefit from public spending but don’t contribute towards public goods; and the tax havens (and their residents) were broadly characterised as free riders on the ‘general public goods created by the non-haven country.’²⁷ The OECD report acknowledged the complexity of the issues involved in taxation, and the use of tax laws by many states to encourage and facilitate development and investment. The report also recognised the paucity of data available to

²⁴ Ibid., paragraph 23, p. 14. Emphasis mine, recall the definition of avoidance—minimising tax owed, *within the letter of the law*. This observation generally follows the hyperglobalist thesis as sketched out in David Held, et al., *Global Transformations: Politics, Economics and Culture* (Stanford, California: Stanford University Press, 1999), pp. 3 - 5.

²⁵ Sol Picciotto, ‘Offshore: The State as Legal Fiction’, *Offshore Finance Centres and Tax Havens: The Rise of Global Capital*, eds. Mark P. Hampton and Jason P. Abbott (London: Macmillan Press Ltd., 1999), footnote 5, p. 73.

²⁶ For the historical perspective, see for example Paul Langley, *World Financial Orders: An Historical International Political Economy* (London and New York: Routledge, 2002).

perform ‘a detailed comparative analysis of the economic and revenue effects involving low-tax jurisdictions.’ Nonetheless, its authors found that ‘the available data do suggest that the current use of tax havens is large, and that participation in such schemes is expanding at an exponential rate.’²⁸ The figure provided in the report is that

...foreign direct investment by G7 countries in a number of jurisdictions in the Caribbean and in the South Pacific island states, which are generally considered to be low-tax jurisdictions, increased more than five-fold over the period 1985-1994, to more than \$200 billion, a rate of increase well in excess of the growth of total outbound Foreign Direct Investment.²⁹

Let us pause for a moment and consider this example—first, as already noted, FDI itself was explicitly excluded from this report, yet it was necessary to use FDI data to support the argument, presumably due to a lack of more relevant data. The absence of detailed figures to support this statement is also interesting in that another OECD publication provides data identifying ‘direct investment abroad (outflows)’ for the G-7 states in 1994 as US\$ 188 billion (out of an OECD total of US\$ 248 billion).³⁰ However, it is quite likely that the capital flows identified in the OECD report were simply transiting the offshore centres onward as FDI in other locations.³¹ The facilities offered by OFCs have been utilised extensively in this manner and certainly, there are limited investment opportunities in these low-tax jurisdictions themselves.

One method for using a low tax jurisdiction with FDI involves leasing equipment. This can be a more profitable strategy than owning the same equipment at that location, given the proper treatment of capital depreciation rules in the home state tax regulations.

²⁷ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, paragraph 24 - 25, pp. 14 - 15.

²⁸ *Ibid.*, paragraph 35, p. 17.

²⁹ *Ibid.*

³⁰ Organisation for Economic Co-operation and Development, *International Investment Perspectives* (Paris: OECD Publications, 2004), p. 32.

³¹ This aspect of offshore finance is explored in more detail for several Caribbean jurisdictions below in Chapter 7.

The technique was to lease the equipment from an intermediate company, located in a low-tax jurisdiction, for use in a third state. The lessor collected payments in a low-tax jurisdiction, while the parent company located in the high-tax jurisdiction claimed deductions on the business expense for leasing the equipment. In addition, the intermediate firm might have been able to claim capital depreciation deductions on the equipment that it owned. If all of these firms were in the same corporate structure, all monies stayed within the family, as it were.³² Furthermore, this strategy may serve to limit exposure to the risk of expropriation or nationalisation of a firm's capital equipment. Captive insurance companies, similarly located in low-tax jurisdictions, also facilitate the management of risk. While the captive company insured the risks of the owning firm, it collected its premiums (and thus profits) in a low-tax jurisdiction. At the same time, the parent firm benefited from the deduction on insurance premiums available in some high-tax jurisdictions. Again, the monies remained within the corporate family.³³

Reports appeared in the Australian media in early 2003 (and echoed by the media in Bermuda) concerning large capital outflows passing through 'tax havens'. The reports dramatically stated that 'According to figures compiled by the federal government's financial intelligence agency, Austrac, \$5.01billion flowed out of Australia to 41 OECD-designated tax havens in the June 2002 financial year, and \$3.56billion flowed back in.' This was accompanied by a statement from the opposition party's (Labor) assistant treasury spokesman,

³² Doggart, *Tax havens and their uses*, 10th ed., pp. 72 - 73.

³³ *Ibid.*, pp. 87 - 88. Doggart identified the U.S. and UK as having deductions for corporate insurance premiums. However, this was something the U.S. was also aggressively seeking to eliminate as a tax avoidance method. Captive insurance firms are not limited to corporations. Cooperative groups of U.S. medical doctors also use them for malpractice insurance, a high-cost, high-risk aspect to practising medicine in a very litigious society.

‘This isn’t just high-wealth individuals or big companies’, Mr Cox said. ‘Certainly hundreds of millions, probably billions of dollars in Australian tax are being lost each year.’³⁴

However, the reply offered by the Australian Taxation Office reflects the complexity of the issue, and again the problem with collecting relevant data.

‘The \$5 billion refers to the amount of funds identified as transferred to haven countries, it does not refer to the amount of tax avoided or evaded’, Mr Fitzpatrick [First assistant commissioner] said yesterday.

‘It says nothing about the profit derived from those funds, the tax payable on those profits, tax that is payable in Australia or tax that has actually been paid in Australia.

‘Not all tax-haven use is offensive. For example, Bermuda provides special regimes for shipping and insurance.’³⁵

As this Australian example illustrates, the authors of *Harmful Tax Competition* were justified in their concern over the lack of relevant, applicable data. The lack of data is in part a result of the complexities of the tax code. It is because of this problem that the OECD continued ‘to attach importance to collecting additional data on developments in tax havens and in the use of preferential tax regimes.’³⁶ At the same time, they recognised that ‘there are no particular reasons why any two countries should have the same level and structure of taxation.’ Most issues of taxation are domestic and reflect social preferences, however, there are increased spillover effects due to globalisation. ‘Countries should remain free to design their own tax systems as long as they abide by internationally accepted standards in doing so.’ These efforts by the OECD are intended, in part, to

³⁴ Morgan Mellish, ‘ATO under pressure on tax havens’, *Australian Financial Review* (Sydney), 6 January 2003, p. 1, Available: http://newsstore.f2.com.au/apps/viewDocument.ac?pb=all_ffx&sid=23034202&docID=FIN030106S4JLR13TI4U&rm=200&dt=selectRange&sy=nstore&dr=3months&st=nw&rc=10&ss=F2&clsPage=1&so=relevance&kw=tax-haven%20&sf=article&cwv=true [accessed 1 February 2003]. Bermuda was highlighted in this report, as the destination of ‘more than \$2.5billion’ from Australia. For a perspective on the issue from the media in Bermuda, see Becky Ausenda, ‘Bermuda – a magnet for Australian tax dollars’, *The Royal Gazette* (Hamilton, Bermuda), 7 January 2003, Available: www.theroyalgazette.com [accessed 19 January 2003].

³⁵ Fiona Buffini, ‘ATO talks tough on tax havens’, *Australian Financial Review* (Sydney), 7 January 2003, p. 3, Available: http://newsstore.f2.com.au/apps/viewDocument.ac?pb=all_ffx&sid=23034184&docID=FIN030107D144N340KEE&rm=200&dt=selectRange&sy=nstore&dr=3months&st=nw&rc=10&ss=F2&clsPage=1&so=relevance&kw=tax-haven%20&sf=article&cwv=true [accessed 1 February 2003].

provide OECD-acceptable international standards.³⁷ But, if taxation is a domestic concern for the sovereign state, why is there a need for *internationally* acceptable standards? If we agree that a need exists for international standards, is it valid that they be created by a select group of states? This is not the technique used by the International Standards Organisation (ISO) to provide standards in other areas of commerce and business. There a group of experts (either national or international) prepares a draft standard that is then submitted for review, comment and vote (with or without comments). Each national standards agency has the document reviewed by national experts, and then it submits its *one* vote. The ISO however is not a club with membership restrictions limiting it to select states like the OECD.³⁸

Creating a Definition of the Harmful Competitor

In the second chapter of the report, ‘Factors to Identify Tax Havens and Harmful Preferential Tax Regimes’, are the criteria used to determine and discriminate between tax haven states and non-tax haven states. Within this determination exists a further subset of states, those non-tax haven states with preferential tax regimes. There are a number of problems posed by these criteria. First, the definition of a ‘tax haven’ was self-referential within the text (amongst paragraphs 42, 43, 44, and 47). Second, the terms tax evasion and tax avoidance were conflated, while the issue of money laundering has been introduced—because if access to information for tax purposes (transparency) was constrained, ‘it facilitates tax evasion and money laundering’.³⁹ Finally, there is the effort made to distinguish between a tax haven, and a preferential tax regime. Each of these problems will

³⁶ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, paragraph 35, p. 17.

³⁷ *Ibid.*, paragraph 26, p. 15.

³⁸ For more information on the ISO and its process for developing standards, see <<http://www.iso.org/iso/en/aboutiso/introduction/index.html>>

³⁹ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, paragraphs 53 and 54, p. 24.

be discussed in more detail, as they were pivotal to the aims of the project, and to the criticisms made about the OECD initiative.

First, the authors found that it was possible to distinguish ‘three broad categories of situations’ where the tax imposed in one state on a ‘geographically mobile activity’ would be different (lower) than that imposed by another state for the same income. The first category established was the state as tax haven, and therefore with ‘no or only nominal tax on that income.’ The second category was a situation in which, while the state ‘collects significant revenues from tax imposed on income at the individual or corporate level’, the source of this particular income received preferential treatment so as ‘to be subject to low or no taxation’. Finally, the third category was simply that the first state ‘collects significant revenues from tax imposed on income at the individual or corporate level’ but the rate of tax imposed was less than the second state.⁴⁰ The value of the adjective ‘significant’ was not quantified, presumably because it was obvious, and thus recognisable in the eyes of the beholder. However, what is considered a significant level of taxation by a U.S. citizen may be viewed as a low level of taxation by an UK citizen. Michael Keen described this particular distinction in discussing five specific differences between the U.S. and UK tax systems in 1997.⁴¹

The text of *Harmful Tax Competition* referred internally back to a previous paragraph, and acknowledged that ‘globalisation has had a positive effect on the development of tax systems’; thus this third category would be beyond the scope of the report.⁴²

⁴⁰ Ibid., paragraph 40, pp. 19 - 20.

⁴¹ Michael Keen, ‘Peculiar institutions: a British perspective on tax policy in the United States’, *Fiscal studies* 18, no. 4 (1997). This article was also published as Michael Keen, ‘Peculiar institutions: a British perspective on tax policy in the United States’, *National Tax Journal* 1, no. 4 (1997).

⁴² This could change if the supposition is confirmed that mobile capital will still escape from high-tax jurisdictions for lower-tax jurisdictions with sufficient power to avoid reporting the income gained by the citizens of the high-tax jurisdictions. In 2002, the U.S. fell into this category of state.

It is not intended to explicitly or implicitly suggest that there is some general minimum effective rate of tax to be imposed on income below which a country would be considered to be engaging in harmful tax competition.⁴³

So the first category identified that a tax haven is a tax haven, the second category identified tax-collecting states that provide preferential treatment for mobile capital, and the third category recognised the distinction between and amongst sovereign states to establish their own levels of taxation.

It appears then, that sovereign states are permitted fiscal sovereignty to establish rates of tax imposed on income, so long as there is a tax imposed and there is no preferential treatment of non-residents in its imposition. Yet this perception contradicts the sentence, quoted above, that the report 'is not intended to' establish some minimum expected level of taxation. Globalisation has introduced acceptable competition amongst those states which impose taxes, and this has 'thereby [minimized] tax induced distortions'.⁴⁴ Nevertheless, a perception also exists suggesting that those states imposing little or no tax induced a 'race to the bottom'.⁴⁵ Surely, this anticipates an expectation of some minimum level of taxation upon individual and corporate income. And if this level has not been met, if the state was not collecting those 'significant revenues' from individual and corporate income, then it qualified as a tax haven, by the definition promoted in this report.

This brings us back to the question, what is a tax haven? First, while the authors acknowledged 'the concept of a "tax haven" does not have a precise technical meaning' they nevertheless found it possible to discriminate between states which fell into the first

⁴³ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, paragraph 41, p. 20.

⁴⁴ Ibid.

⁴⁵ Ibid., paragraph 43, p. 20. There is a literature concerning the 'race to the bottom' thesis in both economics and regulation (environmental regulation in particular). John Hobson has argued that in the case of taxation it should more accurately be described as a 'race to the middle'. See John M. Hobson, 'Disappearing taxes or the "race to the middle"? Fiscal policy in the OECD', *States in the Global Economy: Bringing Domestic Institutions Back In*, ed. Linda Weiss (Cambridge: Cambridge University Press, 2003).

category (tax havens) from the states which fell into the second category (preferential regimes).⁴⁶ The discriminating characteristic was between minimal taxation, and the preferential treatment of a specific source of income. For the authors of this report—‘the absence of tax or a low effective tax rate on the relevant income is the starting point of any evaluation.’⁴⁷ After this declarative point in the report, the text proceeded to explore the factors used to determine if a state qualified as a tax haven, or possessed a preferential tax regime.

Chief among the determining factors identified was the level of transparency, a particularly popular term in the vocabulary of globalisation. In this report transparency is seen as hampered by the existence of legislative, legal or administrative provisions preventing an ‘effective exchange of information’.⁴⁸ Transparency is not simply co-operating in the exchange of information, it is also the elimination of secret tax agreements and legal barriers to the disclosure of beneficial ownership. The lack of transparency is depicted as also preventing an exchange of information for other ‘tax-related’ financial matters such as money laundering. Here again, the concern is really with laws permitting banking confidentiality. It is important to note that the report at this point spoke of ‘criminal tax fraud’. This phrase has different (or non-existent) meanings within different state legal systems. Consider for example the analysis arranged by the OECD on ‘Access for Tax Authorities to Information Gathered by Anti-Money Laundering Authorities’. The analysis was conducted on data provided by OECD *member* states and found that there were significant differences in the exchange of information even permitted within the

⁴⁶ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, paragraph 42, p. 20.

⁴⁷ However, Jersey, the other Channel Islands and many other low-tax or no-tax jurisdictions have stuck to tax systems installed up to 60 years ago. These systems were not designed to lure foreign investors and tax avoiders but to raise sufficient revenue for domestic public expenditure needs.’ Doggart, *Tax havens and their uses*, p. 6. Thus, low domestic requirements resulted in low domestic tax collection receipts, and again, it is a matter of social preferences.

⁴⁸ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, paragraph 53, p. 24.

individual legal systems of the survey respondents for this specific criminal activity.⁴⁹ The results indicate that significant challenges hinder the way forward for states to achieve the level of transparency desired. To accomplish the crossflow of data desired between law enforcement and revenue collecting authorities will require legislative action on the part of many states. Any efforts to write or rewrite laws will attract input from a variety of domestic pressure/interest groups that both support and oppose these efforts. Just one of the reasons is the matter of individual privacy, an issue that is much debated in developed states inundated with computer-based data collection.⁵⁰ A lack of both transparency and the effective exchange of information are two of the four key factors used to identify a particular jurisdiction as a tax haven.

The other two factors were ‘no or nominal taxes’ and ‘no substantial activities’. As already noted, the factor concerned with the level of taxation was identified as ‘a necessary condition for the identification of a tax haven.’ Moreover, if the jurisdiction was ‘perceived to offer itself as a place where non-residents can escape tax in their country of residence’ then this may be a sufficient condition.⁵¹ The desire for ‘substantial’ activities was deemed important because otherwise it appeared the jurisdiction was merely ‘attempting to attract investment and transactions that are purely tax driven.’ Substantial activities might include for example full-time employees and offices, however, the report conceded that determining if ‘an activity is substantial can be difficult.’⁵² In response to criticisms related

⁴⁹ Organisation for Economic Co-operation and Development, *Access for Tax Authorities to Information Gathered by Anti-Money Laundering Authorities*, Country Practices, (Paris: OECD, 2002), Available: <http://www.oecd.org/pdf/M00036000/M00036918.pdf> [accessed 8 December 2002].

⁵⁰ For one perspective addressing the personal privacy aspect of the harmful tax competition project, see Terence Dwyer and Deborah Dwyer, ‘Transparency versus Privacy: Reflections on OECD Concepts of Harmful Tax Competition’, *International Capital Markets, Quarterly Review* 21, no. 2/3 (2001). And for differences between the EU and the U.S. on exchanging electronic data, see Stephen J. Kobrin, ‘Safe harbours are hard to find: the trans-Atlantic data privacy dispute, territorial jurisdiction and global governance’, *Review of International Studies* 30, no. 1 (2004).

⁵¹ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, paragraph 52, p. 23.

⁵² *Ibid.*, paragraph 55, p. 24.

to this problem, the substantial activity factor was reassessed, and it was dropped as an evaluation criterion with the 2001 Progress Report.⁵³

So one might conclude a jurisdiction was a tax haven if one perceived it offered an escape from taxation. Depicted in this fashion, the tax competition proposition appeared flexible enough to be applied to any jurisdiction one may desire, small state or large state, as long as you were sufficiently perceptive. For example, in 2002 the United States did not tax the income activities of non-resident non-citizens (no or nominal taxes), or report the possession of such accounts to the country of residence of these individuals (lack of effective exchange of information).⁵⁴ In this fashion the United States is a tax haven—for non-resident aliens. Yet this last point, the fact that this situation applies only to non-resident aliens, is a discriminating factor between the tax haven and the preferential tax regime; the U.S. does collect ‘significant revenues’ from individual and corporate income taxes. As a result, the U.S. should be identified as possessing a preferential tax regime rather than as a tax haven, yet neither identification was made in the OECD reports.⁵⁵

Similar in nature to the tax haven, the preferential tax regime is the second category where there are differences amongst states in the tax imposed on mobile capital. Three of the four key factors are identical with the tax haven category. These factors are no or low effective tax rates, lack of transparency, and the lack of effective exchange of information. The difference was the fourth factor, ‘no substantial activities’ had been replaced with the

⁵³ Organisation for Economic Co-operation and Development, *The OECD’s Project on Harmful Tax Practices: The 2001 Progress Report* (Paris: OECD Publications, 2001), p. 10.

⁵⁴ Marshall J. Langer, ‘New EU, U.K., and U.S. Reporting Rules on Bank Deposit Interest Paid to Nonresidents’, *Tax Notes International*, 28 January 2002, Available: <http://www.freedomandprosperity.org/langer2.pdf> [accessed 3 April 2003]. The sole exception made is for the accounts of Canadian citizens.

⁵⁵ The assertion here that the United States possesses a preferential tax regime for the deposits of non-resident aliens is mine. The only U.S. preferential tax regime identified in the OECD reports was the Foreign Sales Corporation. See Organisation for Economic Co-operation and Development, *Towards Global Tax Co-operation*, p. 14; Organisation for Economic Co-operation and Development, *The OECD’s Project on Harmful Tax Practices: The 2004 Progress Report* (Paris: OECD Publications, 2004), p. 9.

‘ring fencing’ of tax regimes.⁵⁶ The concept of ‘ring fencing’ got to the heart of the matter, and was the aspect that made the tax regime in question preferential. As defined in the report, ring fencing was the situation where the regime was restricted to non-residents; or those who benefited from the regime were ‘explicitly or implicitly denied access to domestic markets’. Since residents were excluded from the preferential regime, it was clearly intended to attract mobile capital seeking to avoid the taxation of the country of origin. And this approach ‘effectively protects the sponsoring country from the harmful effects of its own incentive regime’ while it caused harm to foreign tax bases.⁵⁷ In addition to mobile capital, the description of a preferential tax regime could be applied to other areas of taxation excluded from this report, for instance the tax-free export-processing zone. But in the case of preferential tax regimes, the report did not limit itself to these four key factors (as it did with the definition of a tax haven).

The additional factors, which may be used to identify a preferential tax regime, occupied the remainder of the chapter in *Harmful Tax Competition*. The chapter then concluded with several questions for use in ‘assessing the economic effects of a preferential tax regime in terms of its potential harmfulness.’ Recall that the second category identified jurisdictions which ‘collect significant revenues’ from income taxes, with the exception of this preferential regime. The list of remaining factors comprises a roll-up of all remaining elements that could identify those jurisdictions where a citizen from a high-tax OECD state might have an account and avoid excessive taxation on their income. These factors were: an artificial definition of the tax base, failure to adhere to international transfer pricing principles, foreign source income exempted from the residence’s country tax (the territorial taxation system used in the UK for example), negotiable tax rate or tax base (as famously used by Switzerland for Elizabeth Taylor, as one amongst a collection of celebrity

⁵⁶ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, box 2, p. 27.

personalities over the years⁵⁸), existence of secrecy provisions, access to a wide network of tax treaties, regimes which were promoted as tax minimisation vehicles, and places where the regime encouraged purely tax-driven operations or arrangements.⁵⁹

Taking action against the competition

Having determined that harmful tax competition exists, that it is a global problem, and having suggested how to identify the sources, it only remained for the report to propose the methods for use in ‘Counteracting Harmful Tax Competition’. This is the title of Chapter 3 of *Harmful Tax Competition*, the first paragraph of which reads,

Governments cannot stand back while their tax bases are eroded through the actions of countries which offer taxpayers ways to exploit tax havens and preferential regimes to reduce the tax that would otherwise be payable to them.⁶⁰

It is a situation wherein individual states are attempting to protect their tax base, but feel that international co-ordinated action is necessary, because ‘the activities which are the main focus of this report are highly mobile.’⁶¹ More accurately, because the income they are seeking to impose a tax upon is highly mobile, only international co-operation can monitor or control it.

To achieve this international co-ordination, action is necessary from the major regional finance centres (Frankfurt, Paris, Hong Kong, Chicago), as well as the global finance centres (New York, London, Tokyo), if the project is to succeed. A leak anywhere in the global financial system, that allows an offshore financial centre under sanctions to transfer funds into the system, will negate the efforts of the OECD project. Any space in which one may place untaxed income and continue to have access to it provides a tax

⁵⁷ Ibid., paragraph 62, pp. 26, 28.

⁵⁸ Ronen Palan, ‘Tax Havens and the Commercialization of State Sovereignty’, *International Organization* 56, no. 1 (2002), pp. 157 - 158. Palan cites Robert Z. Aliber, *The International Money Game*, 2nd ed. London: MacMillan, 1976, p. 182.

⁵⁹ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, paragraphs 68 - 79, pp. 30 - 34.

⁶⁰ Ibid., paragraph 85, p. 37.

haven alternative for any so inclined. Therefore, the OECD is not only relying on the participation of state governments, but also the co-operation of the major multinational financial firms with branches, subsidiaries, partners and affiliates resident in the OFCs (implicitly anticipated via state regulation and enforcement). To achieve this level of participation, it appears the OECD is also implicitly going to depend upon a specific and widely recognised feature of the successful financial centre, the value of its reputation and the consequential fragility of a reputation. We need only consider the circumstances surrounding one historical case to demonstrate this feature for an offshore financial centre. On the Isle of Man, a 'lax regulating regime enabled a series of business failures to [occur] in the early 1980s in particular, [sic] the devastating crash of the Savings and Investment Bank Limited (SIB) in 1982'.⁶² This affected the reputation of the financial centre, and resulted in a loss of confidence in the remaining financial institutions on the island. There was also the cost of dealing with various legal actions and of compensating depositors in the failed institution.⁶³ The implementation of new legislation increased regulatory oversight and supervision. However, it has taken years for the Manx financial services industry to recover from this one failed bank.

The OECD report divided its Recommendations for countering harmful competition into three categories. These categories collected together recommendations concerning domestic legislation, tax treaties, and the 'intensification of international co-operation'.⁶⁴ The Recommendations of specific interest for this research project were all under this latter category of international co-operation, viz.: the establishment of 'a Forum to implement the Guidelines and other Recommendations of this Report' (#15); the

⁶¹ Ibid., paragraph 90, p. 38.

⁶² Sharon Corkill Cobb, 'Global Finance and the Growth of Offshore Financial Centers: The Manx Experience', *Geoforum* 29, no. 1 (1998), p. 16.

⁶³ Mark Solly, *Government and Law in the Isle of Man* (Castletown, Isle of Man: Parallel Books, 1994), p. 90.

⁶⁴ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, paragraph 92, p. 39.

production of a list of tax havens (#16); and a recommendation that states with particular links to tax haven jurisdictions ensure these links do not promote harmful tax competition (#17). Thus the intention was to create the mechanism through which to force the uncooperative jurisdictions, which would be ‘named and shamed’ on the official OECD list of tax havens, to become co-operative. Finally, those states possessing colonial vestiges were expected to use their ‘particular links’ to eliminate harmful tax competition from these non-self-governing jurisdictions.

In Pursuit of the ‘Level Playing Field’

In conjunction with describing tax competition as a source of global harm, the supporters of the harmful tax competition project identified as their goal the creation of a ‘level playing field.’⁶⁵ This sports analogy is consistent with a view of an international system composed of competing states. Such a conception also reinforces a belief in a limited tax base from which to draw state revenue. Therefore, one state’s loss is another state’s gain. In order to maintain their existing tax base, high tax states are pursuing a campaign to ‘level the playing field’ upon which high tax states competed against the low or no tax states.⁶⁶

Because its usage is so prevalent in the documents analysed here it is necessary to consider the application of the term to global finance. A usage suggested by small states was that all states ‘must be subject to the same rules for any given activity.’⁶⁷ This viewpoint was contradicted by the solution reached in February 2003 for *EU* tax

⁶⁵ The usage of this phrase is extensive and present from the first report. The use of the phrase continued in the 2000 progress report, Organisation for Economic Co-operation and Development, *Towards Global Tax Co-operation*. And again in the progress report for 2001, Organisation for Economic Co-operation and Development, *The OECD’s Project on Harmful Tax Practices (2001)*. Consequently, it has been widely used by commentators of the OECD’s Harmful Tax Competition project.

⁶⁶ See Palan, et al., *State Strategies in the Global Political Economy*, Chapter 2.

⁶⁷ Stikeman Elliott, *Towards A Level Playing Field: Regulating Corporate Vehicles in Cross-Border Transactions*, (International Tax and Investment Organisation and The Society of Trust and Estate Practitioners, 2002), p. xi, Available: <http://www.step.org/showarticle.pl?id=363&n=&toparticle=363> [accessed 7 October 2002].

harmonisation, which did not advance the project for a *global* level playing field in taxation. It is a contention that results from the differential treatment accorded three EU member states on the matter of information exchange.⁶⁸ As already discussed, the exchange of information was an important element of the OECD's plan for removing harmful tax competition. The OECD's Global Forum on Taxation organised a meeting in October 2003 'to discuss the issue of a global level playing field in the area of transparency and information exchanged in tax matters.'⁶⁹ The participants recognised that the desired level playing field did not yet exist. So they designated a Sub-Group to develop proposals for action leading to the achievement of a global level playing field. The concept they developed was that it 'is fundamentally about fairness'.⁷⁰ Therefore, the global level playing field for the exchange of information 'serves as a goal'.⁷¹

As with the OECD's stated objective for the tax competition project as a whole, this definition does not involve a level playing field for competition in tax rates. Rather, it addresses the means by which the OECD would overcome the obstacles of fiscal sovereignty and banking confidentiality for collecting tax on residents' foreign accounts. As a matter of fairness amongst states the level playing field involves tax regime transparency and the exchange of tax-related financial information. In this fashion, the existence of a difference in tax rates becomes immaterial as a factor in international finance. With the establishment of the information exchange regime, states would have the

⁶⁸ Austria, Belgium and Luxembourg would initially implement a *transitional* withholding tax, and would only implement automatic exchange of information when two conditions have been met. First, the EU had an agreement with 'Switzerland, Liechtenstein, San Marino, Monaco and Andorra to exchange of information upon request as defined in the OECD Agreement on Exchange of Information on Tax Matters.' And second, 'if and when the Council agrees by unanimity that the US is committed to exchange of information upon request as defined in the 2002 OECD Agreement for the purposes of the [Taxation of Savings] Directive.' Matthew Levitt, 'Stemming the Flow of Terrorist Financing: Practical and Conceptual Challenges', *The Fletcher Forum of World Affairs Journal* 27, no. 1 (2003).

⁶⁹ Global Forum on Taxation, *A Process for Achieving a Global Level Playing Field*, (Organisation for Economic Co-operation and Development, 2004), p. 2, Available: <http://www.oecd.org/dataoecd/13/0/31967501.pdf> [accessed 12 June 2004].

⁷⁰ Ibid.

⁷¹ Ibid., p. 3.

information required to collect taxes from their residents at domestic rates, no matter where the income was earned. In effect, this will supersede all existing territorial tax administrations by assessing all tax obligations against globally earned income, as opposed to income earned within the jurisdiction of the taxpayer's state of residence. The objective accomplished by this definition is to overcome the barrier created by principles of state sovereignty as noted in the last chapter. The concept of the level playing field is focused upon the discrete factors of transparency and information exchange in tax matters. This definition serves as the goal for the committed participants of the OECD project.⁷²

One could argue that efforts to create a level playing field are not intended to redress an imbalance, but instead are intended to establish common rules of play. If all participants are following the same global rules for 'acceptable' conduct, than competition (where it exists) will be 'fair'. To use a sports analogy is to allude to a sports event, whether football, rugby, baseball, or cricket. Yet even in sports competitions, the fact that the playing field is level, does not guarantee that the competition is equitable or 'fair'. Consider the status for example of Manchester United and the New York Yankees as representative professional sports franchises. Both are well-funded organisations able to use their economic position to maintain their dominance by acquiring the best available players. They are analogous to the large states, competing against less well-endowed smaller organisations. Consequently, they possess an economic advantage that has translated into a competitive advantage that overwhelms the level circumstances of their playing field. Extending this analogy to the OECD states suggests that forcing a global level playing field, in whatever market sector, provides them with a competitive advantage to maintain their market position and to continue to dominate the economic efforts of smaller states.

⁷² Ibid., pp. 2 - 3.

As will be seen in the next section, these circumstances worry the smaller members of the OECD just as much as they worry the non-member small states.

An Immanent Critique from OECD abstentions

Support for this project is not unanimous among the member states of the OECD. Annex II of *Harmful Tax Competition* contains the statements by OECD members Luxembourg and Switzerland outlining their concerns.⁷³ In its statement, Luxembourg acknowledged its participation in both the OECD and EU activities on taxation. However it felt this report presented ‘a partial and imbalanced approach’ that did not satisfy the group’s mandate. It was particularly concerned with ‘the Report’s implicit belief that bank secrecy is necessarily a source of harmful tax competition.’ Consequently, ‘Luxembourg shall not be bound by the Report nor by the Recommendations to counteract harmful tax competition.’⁷⁴

In reaching a similar conclusion regarding the report, Switzerland also raised its concern that it did not take into account the non-tax factors involved in economic competitiveness. Similarly, Switzerland noted the point made earlier, that the Report acknowledges that states possess fiscal sovereignty, while at the same time it uses lower tax levels as a criterion for identifying harmful regimes. On this point, the conclusion reached by Swiss officials was that ‘this results in unacceptable protection of countries with high levels of taxation, which is, moreover, contrary to the economic philosophy of the OECD.’⁷⁵

The progress report in 2000, *Towards Global Tax Co-operation*, mentioned in its footnotes that the 1998 report was approved with abstentions from Luxembourg and Switzerland. Belgium and Portugal would join them in abstaining from the 2001 progress

⁷³ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, pp. 73 -78.

⁷⁴ *Ibid.*, pp. 74-75.

report.⁷⁶ This later report contained a footnote in which Luxembourg and Switzerland ‘recalled’ their earlier abstention to the 1998 report. Luxembourg regretted ‘that the 2001 progress report is further away from the goal of combating harmful tax competition with respect to the location of economic activities.’ In addition, Switzerland noted that its earlier abstention applied to any subsequent work.⁷⁷ As states with substantial financial services industries, Luxembourg, Switzerland and Belgium would experience an economic impact similar to the small, non-OECD member states hosting OFCs. However, as members of the OECD, they are on the inside and may participate in the discussions on harmful tax competition. The small states on the outside find their participation is limited to the ‘Global Forum’ where they can neither schedule meetings nor strongly influence the agenda.⁷⁸

Conclusions

Hopefully it has become clear from this analysis of the OECD reports on harmful tax competition that the OECD is approaching this issue with a limited conception of fiscal sovereignty. That is, a conception that demands a significant level of state revenue will originate from taxes and one that anticipates the existence of internationally accepted standards for designing the necessary tax administration. At the same time, there are significant differences among OECD member states in the construction of their tax systems, specifically in the allocation of tax rates to individual income, corporate income,

⁷⁵ Ibid., p. 77.

⁷⁶ In the case of Belgium this position is a change from an earlier approach to tax competition. Genschel and Plümper describe Belgium’s efforts to limit tax competition in the early 1990s, first through the IMF, ‘arguing that tax competition was a truly global problem.’ When that initiative failed to gain purchase, Belgium turned to the European Community to pursue the goal to limit tax competition. Genschel and Plümper, ‘Regulatory competition and international co-operation’, p. 632.

⁷⁷ Organisation for Economic Co-operation and Development, *The OECD’s Project on Harmful Tax Practices (2001)*, page 4, footnote 1.

⁷⁸ See for example *OECD responds to call for a global forum*, 12 February 2003, Web page, Antigua Sun, Available: <http://www.caribbeanads.com/antiguasun/fullstory.cfm?NewsID=10760> [accessed 19 March 2003].

capital income, consumption, and sin (i.e. – tobacco, alcohol and fossil fuels). Within these are various measures intended to encourage certain businesses while discouraging other activities (e.g. – measures promoting family-owned farms and measures to discourage smoking). A state's tax code reflects the social preferences of its society for the construction and distribution of public goods.

The argument developed by the OECD that competition is harmful is clearly built upon the idea that the state is a benevolent maximiser of public welfare. As such, economic analysis starting from this premise supports the initiative, while analysis premised on the viewpoint that the state is a *Leviathan* contests the OECD project. At the same time, the question of taxation and the provision of public goods has become abstracted from the free market ideology promoted by a number of OECD states in other venues, such as trade in goods and services. In general then, one's opinion of the project against harmful tax competition reflects the basic understanding held of the role of the state in society, and the extent of taxation required to satisfy that role. In this fashion, the argument that globalisation has changed the nature of global economic exchange is really an argument that the capability of the state has been diminished. That argument contends that globalisation has reduced the ability of the state to manage its national economy including the control of capital and the extraction of taxes.

The specific criticisms made against the OECD's harmful tax competition initiative, largely by smaller states, are not framed against the perceived loss of state control over the domestic economy. Rather they are concerned with matters of state sovereignty (independence and non-intervention), equitable treatment (for members and non-members alike), and the origination of the project within a club limited to already developed states. These criticisms, followed by various statements made by OECD representatives to rebut them, are presented in the next chapter.

A VOICE OF THEIR OWN – SMALL STATES REPLY

For the citizen of many smaller, poorer, weaker states, however, the international secretariats look more like enemies, instruments of a new kind of collective colonialism devoted to the preservation of the capitalist system and the hierarchies of power represented in it, even at considerable cost to their material welfare, the dignity and sometimes even the survival of individual men, women and children in a neo-colonial society.

– Susan Strange¹

In February 2003, an article in the *Nassau Guardian* identified the European Union's latest efforts towards tax harmonisation as contrary to the OECD goal of a global 'level playing field' for taxation. The reporter identified three jurisdictions (Panama, Antigua and the Cayman Islands) that had immediately registered their criticism of the EU Directive on the Taxation of Savings with either the EU or the OECD. They were protesting the preferential treatment accorded some EU member states as part of the resolution accomplished finally to put in place the Savings Directive.² The OECD also expressed a concern at the potential impact the directive could have on their harmful tax competition initiative.

Donald Johnston, OECD Secretary General, wrote privately to the heads of EU Governments in January [2003] saying Europe had endangered a global drive to crack down on criminal tax cheats, by excusing three member states from exchange of information.³

¹ Susan Strange, *The Retreat of the State: The Diffusion of Power in the World Economy* (Cambridge: Cambridge University Press, 1996), p. 93.

² John K. F. Delaney, 'Uneven Ground: The unlevel playing field for the world's financial centres', *The Nassau Guardian* (Bahamas), 12 February 2003, Available: <http://www.thenassauguardian.com/business/277002592126656.php> [accessed 16 February 2003]. 'Panama and Antigua wrote the OECD protesting the preferential treatment accorded by Europe to some of their own [and the] Cayman [Islands] wrote the European Commission.'

³ Becky Ausenda, 'EU tax directive signed', *Royal Gazette* (Hamilton, Bermuda), March 11 2003, Available: <http://www.theroyalgazette.com/apps/pbcs.dll/artikkel?Avis=RG&Dato=20030311&Kategori=BUSINESS&Lopenr=103110055&Ref=AR> [accessed 20 March 2003].

These events highlight the status of the project in early 2003, four years after the publication of the initial report. In particular it demonstrates a heightened awareness on the part of residents in the targeted small states of the potential impact of these external events on their lives. In the previous chapter, the main elements of the OECD project on harmful tax competition were outlined. This chapter discusses the reaction of small states to the coercive nature of this project. In the first section is a discussion of their main points of criticism—that it challenges state sovereignty, that the OECD is not appropriate as a site for global governance, and that the treatment of non-co-operative jurisdictions must be equitable. This is followed in the second section with elements of the OECD rebuttal to these criticisms. The final section provides a summary of the debate between the opponents and proponents of tax competition present in the OECD's harmful tax competition project.

A Critique from the Islands (Off-shore)

The critique of the OECD's project emerged from a variety of locations, and offered several points of contention. Perspectives were provided in the financial press, and by the media in general from among the affected jurisdictions. Suggestions were offered concerning the legal ramifications of the sanctions proposed in the OECD report. A potential conflict between these sanctions and World Trade Organisation (WTO) obligations was identified. Moreover, accusations framing the harmful tax competition initiative as an attack on state sovereignty were made. The major points of criticism of the OECD project explored here are: that it is an attack on the sovereignty of the identified states (and particularly small states); that the OECD is not the appropriate forum for the question of tax competition amongst sovereign states; and that the OECD has not fostered or promoted actions consistent with its intended goal of a 'level playing field'.

A Subversion of Sovereignty

The first and most basic criticism made about the OECD project was that it subverts the sovereignty of states. An attempt to change domestic choices about taxation is contrary to the principle of non-intervention in the domestic affairs of a state, which is fundamental to perceptions about the independent sovereign status of a state. Bishnodat Persaud addressed this aspect within the context of the OECD project's initial emphasis 'on "competition" and on targeting low-tax regimes.'⁴ By presenting the issue as one of lost tax revenue, many observers felt the OECD was motivated solely by this problem and nothing else. 'But such motivation implies interference in the sovereign right of nations to determine their own tax regimes.'⁵ Persaud highlighted the further point that the objectives of the harmful tax competition project exceeded anything that OECD member states had accomplished amongst themselves within the domain of tax co-operation. The particular problems encountered by the EU in its drive towards tax harmonisation were mentioned. The problems within the EU included the continuing intransigence of Austria and Luxembourg, using their sovereign independence to act in a manner they believed to be in the best interests of their citizens when it came to matters of financial legislation and regulation.⁶

The OECD project's insistence on transparency, discussed in the last chapter, conflicts with historical traditions of banking confidentiality and privacy. The most frequent criticism made is that banking confidentiality serves only to protect the 'guilty'. Nevertheless, even though one is innocent (and therefore has nothing to hide from the government), does not mean that an individual does not have a problem with their tax

⁴ Bishnodat Persaud, 'OECD Curbs on Offshore Financial Centres: A Major Issue for Small States', *The Round Table*, no. 359 (2001), p. 205. Persaud however does accept the OECD's principal assumption—'The question of harmful tax practices is a legitimate international concern.' (p. 203).

⁵ *Ibid.*

⁶ *Ibid.* p. 206. Persaud also noted that Swiss co-operation was required.

return becoming a matter of *public* knowledge. Tax collection bureaucracies in the United States and the United Kingdom have experienced problems with maintaining the privacy of tax returns submitted by public celebrities in the past. It is a simple desire to keep financial information private, away from the perusal of neighbours, co-workers, and 'charitable' fund-raising activities. This is particularly true for those working in a business environment where equal work does not necessarily mean equal pay.⁷

Fundamentally, this is about a society's option to choose. It concerns the structure of taxation, but also the confidentiality of information and the privacy of the individual. Moreover, this touches upon issues far beyond tax competition. With the initiation of a war on terror, the collection of data about individuals, their movement and financial transactions have become the indicators used to identify and pursue terrorists and potential terrorists. The different treatment of personal data between the United States and Europe has become a fractious issue in the struggle to deal with terrorism. Earlier attempts to reach a compromise agreement on personal data maintained by computer systems have now been caught up in an American campaign to identify potential terrorists before they might reach the United States.⁸

From a legal perspective, Rosemarie Antoine has suggested that legal questions about banking confidentiality involved state sovereignty, especially within the context of offshore financial centres, because of the involvement of more than one state's municipal law.

⁷ This is the norm among private businesses in the United States, which is a controversial issue in itself as it may conceal a variety of discriminatory practices. Nevertheless, this is the prevalent, court-sanctioned, business environment.

⁸ Stephen J. Kobrin, 'Safe harbours are hard to find: the trans-Atlantic data privacy dispute, territorial jurisdiction and global governance', *Review of International Studies* 30, no. 1 (2004).

Questioning offshore confidentiality laws is more than a mere legalistic inquiry. To some extent it is also questioning the right of sovereign governments to create laws in harmony with their own nationalist and developmental perspectives. As such, the protection of confidentiality should be seen as a duty in the public interest, even by the courts.⁹

As with matters of taxation and public goods, confidentiality and data privacy are also a matter of social preferences.

Banking secrecy laws are not impervious to all outside inquiries, even if it is perhaps inconvenient upon occasion for prosecutors to get the information they believe to be concealed.¹⁰ On this aspect of confidentiality laws, Antoine discussed the appropriate procedures and legal measures available to override the legislation. Such measures are often a part of a mutual legal assistance agreement between two states and are specifically intended for use when investigating *criminal* activity. In *Confidentiality in Offshore Financial Law*, Antoine explored the issue at length, referring at a number of points to the methods taken by U.S. courts.

The option, or opportunity, for mutual legal assistance has been ignored upon occasion, usually when it involves the interests of a large state in seeking information held in a small state. The United States in particular has not always used its existing mutual legal assistance treaties to wage its 'war on drugs' (and the associated money laundering activities) or even in the simple civil cases that are part of its pursuit of tax evasion. The result has been in effect an extraterritorial enforcement of the U.S. legal system throughout the Caribbean. In one case (*United States v. Field*) the Canadian manager of the Cayman Islands branch of the Bank of Nova Scotia was subpoenaed for an Internal Revenue

⁹ Rosemarie Antoine, 'The Offshore Financial Services Sector: Legal Policy Issues on the Path to Development: A Legal Defence', *Journal of Eastern Caribbean Studies* 26, no. 4 (2001), p. 12. Experience has shown that courts, particularly American courts, did not agree with this perspective. Antoine discussed this problem in depth in Rose-Marie Belle Antoine, *Confidentiality in Offshore Financial Law* (Oxford: Oxford University Press, 2002), pp. 282 - 292.

¹⁰ See the comments by Robert M. Morgenthau, Manhattan District Attorney to the United States Senate, Permanent Subcommittee on Investigations on July 18, 2001. Committee on Governmental Affairs, *Testimony of Robert M. Morgenthau before the United States Senate, Permanent Subcommittee on Investigations*, 18 July 2001, published by U.S. Senate, Available: http://www.senate.gov/~gov_affairs/071801_psimorgenthau.htm [accessed 22 July 2002].

Service (IRS) investigation of the bank's activities while he was in transit through the Miami airport.¹¹ As Alan Hudson described the dilemma for the bank manager and the bank, it was the fact that they 'operated across state boundaries and found themselves caught between two sets of laws.'¹² The U.S. Court of Appeals recognised this was an extra-territorial application of U.S. law, but the court found that

conflicts are inevitable. . . . This court simply cannot acquiesce in the proposition that US criminal investigations must be thwarted whenever there is conflict with the interest of other states.¹³

Essentially, U.S. courts have supported the use by federal officials and prosecutors of America's hegemonic position in the Caribbean, exhibiting an attitude that U.S. law superseded the law of other states. As Antoine commented, "The Supreme Court argued [against seeking international assistance] on the somewhat flimsy basis that such judicial assistance was costly and time consuming."¹⁴ In sum, the U.S. is likely to use its existing treaty structure only when convenient for its purposes. For the broader question of the OECD project and state sovereignty the answer is similar. The members of the OECD will use the threat of sanctions to force small states to comply with an information exchange regime.

The Right Place?

The next most common criticism after the issue of state sovereignty is the contention that the OECD is not the appropriate forum for this project.

¹¹ Antoine, 'The Offshore Financial Services Sector', p. 18; Alan C. Hudson, 'Reshaping the regulatory landscape: border skirmishes around the Bahamas and Cayman offshore financial centres', *Review of International Political Economy* 5, no. 3 (1998), 546 - 549

¹² Hudson, 'Reshaping the regulatory landscape', p. 547.

¹³ Ibid. p. 548. Hudson cited *US vs. Field*, US Court of Appeal, *Congressional Record*, 25 June 1976. Note that U.S. actions represent the resolution desired by Jeffery, as discussed above in chapter 3.

¹⁴ Antoine, *Confidentiality in Offshore Financial Law*, pp. 287 - 288.

It should be recalled that the OECD is a multinational grouping of 30 countries. It is not an international organization and it has no legal authority to speak for the world or to establish rules, norms or standards for any state except its own members. Nonetheless, it is now dictating terms on what, in short, could be described as cross-border tax matters.¹⁵

Given that a global problem involving harmful tax competition exists, then another international organisation, it was argued, should be the location for any discussions on tax competition. Persaud suggested the WTO and the IMF, as ‘more representative and relevant international organizations.’¹⁶ However, he noted that just as with the OECD some of the states identified as tax havens were not members of either of these two organisations. Consequently, he suggested this was an opportunity for a multilateral organisation such as the Commonwealth (where many of the affected states are already members) to co-ordinate a global discussion on taxation.¹⁷

One element of the contention that the OECD is not the correct forum is the question of participation in the decision-making process. The OECD has acknowledged that if harmful tax competition is framed as a global problem, ‘it is critical that as many countries as possible are involved in the dialogue.’¹⁸ In pursuit of this goal, the Committee on Fiscal Affairs ‘used its extensive outreach programme to engage in a dialogue with non-member countries.’¹⁹ It is unfortunate that of those states identified as having attended one of the three regional seminars held preceding the publication of the first report, only Jamaica is a member of the set of small states considered here. In addition, none of these

¹⁵ Ronald M. Sanders, ‘The Fight Against Fiscal Colonialism: The OECD and Small Jurisdictions’, *The Round Table*, no. 365 (2002), pp. 339 - 340. The author was the Antigua and Barbuda’s High Commissioner in London and Chief Negotiator on International Financial Services at the time.

¹⁶ Persaud, ‘OECD Curbs on Offshore Financial Centres’, p. 204.

¹⁷ Bishnodat Persaud is a former Director of the Economic Affairs Division of the Commonwealth Secretariat, and an Honorary Professor of the University of the West Indies.

¹⁸ Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD Publications, 1998), paragraph 13, p. 10.

¹⁹ *Ibid.*, paragraph 14, p. 10. Amongst the participants, the only states previously identified as possessing an ‘offshore financial centre’ were Malaysia, Philippines, Singapore, and Thailand. China also participated, but whether this meant the interests of the Hong Kong and Macao SARs were represented is not clear.

meetings had participation from any jurisdiction that was identified in 2000 as an ‘uncooperative tax haven’.²⁰ Viewed from this perspective, the suggestion that the Commonwealth could facilitate a broadening of participation in the discussion over harmful tax competition is understandable. At the same, the absence of small states may also help explain the involvement of the Commonwealth in subsequent discussions.

In addition to suggesting that the WTO would be a more appropriate venue for discussing the issue of tax competition, there are suggestions that any sanctions directed by the OECD could be challenged under the provisions of the dispute settlement mechanism of the WTO. ‘The targeted jurisdictions, acting together, could yet request the establishment of a tribunal to test the legality of any sanctions imposed by OECD countries against targeted jurisdictions in the context of the HTCI [Harmful Tax Competition Initiative].’²¹ The former legal counsel (until December 2000) in the OECD also suggested this tactic. Mark Warner highlighted the discriminatory nature of some of the proposed measures to be directed at a tax haven. These measures could be in violation of the prohibitions against trade discrimination that is part of the General Agreement on Tariffs and Trade (GATT) and General Agreement on Trade in Services (GATS). These sanctions would be particularly problematic if they were applied only against ‘harmful’ tax regimes but not against ‘preferential’ tax regimes.²²

²⁰ Organisation for Economic Co-operation and Development, *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices* (Paris: OECD Publications, 2000), p. 17. Moreover, reviewing the list of ‘cooperative tax havens’ listed on the OECD’s ‘Tax Haven Update’ webpage also shows that none of the six jurisdictions that provided a commitment to cooperate prior to publication of this report attended. See http://www.oecd.org/document/19/0,2340,en_2649_33745_1903251_1_1_1_1,00.html [accessed 11 June 2003].

²¹ Sanders, ‘The Fight Against Fiscal Colonialism’, pp. 340 - 341.

²² Cordia Scott, *OECD ‘Harmful’ Tax Competition Move May Violate WTO Obligations, Expert Says*, 24 April 2001, Web page; original source, *Tax Notes International*, Center for Freedom and Prosperity, Available: <http://www.freedomandprosperity.org/Articles/tni04-25-01/tni04-25-01.shtml> [accessed 4 April 2002]. This is from a speech made by Mark A. A. Warner on 23 April 2000. See also the remarks provided by a former Attorney-General of Barbados in David Simmons, ‘Some Legal Issues Arising out of the OECD Reports on Harmful Tax Competition’, *International Tax Competition: Globalisation and Fiscal Sovereignty*, ed. Rajiv Biswas (London: Commonwealth Secretariat, 2002).

Common Rules for a Common Problem?

The ubiquitous phrase ‘level playing field’ was discussed at the end of the previous chapter. As mentioned, the sanctions proposed against the tax havens (non-OECD members) were not equivalent to those proposed for use against the preferential tax regimes (OECD members or their non-self-governing jurisdictions). As a tactic to resolve this differential treatment, several of the jurisdictions identified as tax havens submitted *conditional* commitments to support the OECD project. These commitments were conditional on the fact that *all* states (whether or not a member of the OECD) acceded to identical conditions for transparency and effective exchange of information.²³ This tactic attempts to place normative pressure concerning tax competition back upon the OECD. However, in the ‘commonly asked questions’ Annex to a conference paper presented by Jeffrey Owens (Head of the Centre for Tax Policy and Administration at the OECD), the response to question eighteen indicates the OECD did not view this as a constraint upon their freedom of action. ‘The OECD would not accept a commitment to progress by any one country that is conditioned on the actions of all other countries.’²⁴ Nevertheless, the

²³ As an example, the relevant paragraphs from the Antigua and Barbuda commitment letter were:

The commitment is offered on the basis that:

1. Antigua and Barbuda is not included on the OECD list of un-cooperative tax havens nor subject to any framework of co-ordinated defensive measures;
2. Antigua and Barbuda is determined to protect its economic interests and fiscal autonomy in any future negotiations with OECD. The issue of a level playing field is critical to those interests.
3. Those jurisdictions, including OECD Member countries and other countries and jurisdictions yet to be identified, that fail to make equivalent commitments or to satisfy the standards of the 1998 Tax Competition Report, will be subject of a framework of co-ordinated defensive measures; and
4. Antigua and Barbuda is invited to participate fully on an equal basis with all committed jurisdictions and OECD countries in any discussion in the Global Forum on the design of internationally-accepted standards for the implementation of these and any similar commitments.

Office of the Prime Minister, *Commitment of Antigua and Barbuda*, 20 February 2002, PDF, OECD, Available: <http://www.oecd.org/dataoecd/0/6/2066005.pdf> [accessed 30 July 2003].

²⁴ Jeffrey Owens, *The OECD work on Tax Havens*, Presented at the conference on ‘Money Laundering and Tax Havens - The Hidden Billions for Development’ held in New York on 8-9 July 2002, 2002, PDF file, OECD Centre for Tax Policy and Administration, Available: <http://www.oecd.org/dataoecd/51/19/1940467.pdf> [accessed 22 July 2003], p. 7. This statement was later contradicted by the definition produced by the OECD’s ‘Sub-Group on Level Playing Field Issues’ in 2004, which emphasises this it is ‘fundamentally about fairness to which all parties in the Global Forum are committed.’ Global Forum on Taxation, *A Process for Achieving a Global Level Playing Field*, (Organisation for Economic

reply provided to Aruba's commitment letter, from the Secretary General of the OECD, stated,

I can confirm that it is the OECD Members' understanding that your commitment is made on the basis that:

- The principles that are applied to Aruba will also be applied to the assessment of regimes in OECD Member states; and...²⁵

Given that the Secretary General of the OECD speaks for the organisation, and on behalf of its members, this is in sharp contrast to the statement made by the head of its Centre for Tax Policy and Administration. Moreover, it is also important to note that any sanctions would be applied individually by states, and not by the OECD.²⁶

Ronald Sanders remained cautious concerning the engagement of the OECD towards the non-member states in 2002. He noted that, logically, a level playing field for all should lead to the application of sanctions against OECD member states.

A level playing field also means that countries such as the USA and the UK may also have to change existing regimes in financial services that compete with many of the targeted jurisdictions.²⁷

The EU Savings Directive has already been identified as demonstrating the unequal treatment afforded to some states, and justified Sander's cautious viewpoint. This method of pursuing 'fair' treatment has been attempted in a variety of economic sectors other than financial services as explored here. It was described by Armstrong and Read as 'the increasing dominance of multilateralism over bilateralism' in international trade and typified by the operation of the WTO. The level playing field, as an approach to trade, is

Co-operation and Development, 2004), p. 2, Available: <http://www.oecd.org/dataoecd/13/0/31967501.pdf> [accessed 12 June 2004].

²⁵ Donald J. Johnston, *Commitment Reply Letter to the Minister of Finance, Aruba*, 29 June 2001, PDF, OECD, Available: <http://www.oecd.org/dataoecd/12/56/1903656.pdf> [accessed 30 July 2003].

²⁶ The limitations inherent to this approach are recognised by the OECD's Committee on Fiscal Affairs. The 2004 project report declared 'that there are limits to the usefulness of unilateral and bilateral measures to respond to a problem that is inherently global in nature. Thus, the Committee has examined ways in which defensive measures may be co-ordinated to more effectively neutralise the deleterious effects of harmful tax practices.' Organisation for Economic Co-operation and Development, *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report* (Paris: OECD Publications, 2004), p. 14.

²⁷ Sanders, 'The Fight Against Fiscal Colonialism', p. 344.

compelled by an increase in ‘more rigorous international trade rules’.²⁸ With the increased use of a multilateral approach, the individual trade preferences contained in many bilateral trade agreements with developing states are deemed ‘illegal.’ This is to the detriment of the small developing economy where it occupies a niche in the marketplace that, combined with a trade preference, affords it a comparative advantage. An example relevant here is the cultivation of bananas in the Windward Islands. Levelling the agricultural playing field (at least in the developing world) has removed the comparative advantage previously created by a trade preference, and leaves European consumers to purchase what is now the cheaper product, bananas grown on the larger plantations of Central American states.²⁹

In a similar fashion, the campaign to level the financial services playing field (under the guise of eliminating tax avoidance/evasion opportunities with increased transparency and the establishment of an information exchange regime) is anticipated to reduce the size of the financial services sector in the economies of these small jurisdictions. The market niche they serve is not likely to disappear, however. It will just relocate to a more amenable jurisdiction. Quite probably, this shift will benefit any jurisdiction able to withstand the pressures of the OECD project, for instance those states with ‘preferential tax regimes’. This probability further justifies the case made for equivalent treatment between harmful tax regimes and preferential tax regimes. Otherwise, it appears that the whole effort to eliminate harmful tax competition is in actuality intended to displace funds from their offshore locations back to OECD financial centres. The nature and consequences of this aspect of the OECD project for the Caribbean is discussed in chapter 7.

²⁸ Harvey W. Armstrong and Robert Read, ‘Small States and the European Union: Issues in the Political Economy of International Integration’, *Current Politics and Economics of Europe* 11, no. 1 (2002), p. 40. See also Harvey W. Armstrong and Robert Read, ‘Trade and Growth in Small States: The Impact of Global Trade Liberalisation’, *World Economy* 21, no. 4 (1998).

²⁹ Stephen A. Royle, *A Geography of Islands: Small island insularity* (London: Routledge, 2001), 141 - 142; Clifford E. Griffin, ‘Democracy and Political Economy in the Caribbean’, *The Political Economy of Drugs in the Caribbean*, ed. Ivelaw L. Griffith (Houndmills, Basingstoke: Macmillan Press Ltd, 2000), pp. 118 - 119; Patsy Lewis, ‘A Future for Windward Islands? Bananas? Challenge and Prospect’, *Commonwealth & Comparative Politics* 38, no. 2 (2000).

The OECD Rebuttal

State sovereignty is not under attack

In a variety of ways and in a number of forums, the OECD has attempted to refute these criticisms and to keep the discussion focused on their definition of harmful tax competition and the dangers it presents to global society. The Head of Fiscal Affairs at the OECD has characterised these concerns as ‘misunderstandings’, and responded to them in an undated article posted to the OECD website.³⁰ The remarks that relate to those criticisms already raised are discussed here. The first misunderstanding identified was that the ‘OECD is threatening the fiscal sovereignty of Small States.’ The first point made in response was to acknowledge that this was a recurring theme about the harmful tax competition project. Jeffrey Owens offered three reasons to demonstrate that it was a misunderstanding. First, the OECD has no power to tell a government what it should do, it is simply a multinational organisation encouraging economic co-operation. Second, the OECD believes global co-operation will result in ‘more and not less fiscal sovereignty’, though this is obviously an untested proposition. Finally, just as ‘tax policy must remain the sovereign right of national governments’, these governments also have a sovereign ‘right to take action to protect [their] revenue base.’³¹ However, it is contestable that states have a sovereign right to pursue extraterritorial measures to solve a domestic problem. From these remarks, one would expect that the OECD should be encouraging global co-operation because it will enhance fiscal sovereignty, yet leaving it to each individual state to take whatever action it finds appropriate—domestically.

³⁰ Jeffrey Owens, *Promoting Fair Tax Competition*, n.d., PDF, Available: http://www1.oecd.org/daf/fa/harm_tax/PromotingFairTaxComp.pdf [accessed 20 March 2002]. In this document Jeffrey Owens was identified as Head, Fiscal Affairs, OECD.

³¹ *Ibid.*, emphasis in the original.

It is also agreed that the OECD does not possess the power to *tell* a state what action it should undertake. As already mentioned, the organisation could not even achieve unanimous support amongst its members for the project report in 1998. However, just as the OECD's 'extensive outreach programme' may induce the involvement of non-member states in its discussions on harmful tax competition, so may it *persuade* member and non-member states alike to take some punitive action as part of the project. In this instance, the OECD possesses a power of *moral suasion*. For example, non-co-operation by a jurisdiction on the issues of financial transparency and the exchange of financial information could be treated in a fashion similar to non-co-operation with the global anti-money laundering programme. If this approach were taken by OECD members, the targeted jurisdiction could find itself in a position similar to the Philippines in early 2003. Having failed to pass anti-money laundering legislation acceptable to the Financial Action Task Force (FATF), that organisation threatened to have the state's financial institutions 'blacklisted'.³² In tandem with this perception of the status of financial institutions and legislation in the Philippines, the Asian Development Bank announced it would withhold a needed loan package until the acceptable legislation had been passed. These two multilateral organisations are similar to the OECD in that while they putatively have little

³² The Financial Action Task Force is an actor in global finance that is discussed at several points in this thesis. It is a multi-lateral organisation charged with combating financial crime, created at the direction of a G-7 summit in 1989, and hosted at the OECD Secretariat in Paris. The current members of the FATF are (as of 11 February 2005): Argentina, Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, China, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, Kingdom of the Netherlands, New Zealand, Norway, Portugal, Russian Federation, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States. Additional members represent the European Commission and the Gulf Co-operation Council, and effective on this date, China was accorded observer status. The FATF sits at the centre of a network of similar multi-lateral organisations with a regional focus. At present these groups include: the Caribbean Financial Action Task Force (CFATF), Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL), Asia/Pacific Group on Money Laundering (APG), the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), the Financial Action Task Force for South America (GAFISUD), and since late 2004, the Eurasian Group (EAG, which covers China, Russia and several other former Soviet states), and the Middle East and North Africa Financial Action Task Force (MENAFATF). Financial Action Task Force, *FATF members and observers*, 11 February 2005, Web page, Available: http://www.fatf-gafi.org/document/52/0,2340,en_32250379_32237295_34027188_1_1_1_1,00.html [accessed 2 March 2005].

power to tell a state what to do, the threat of sanctions worked (even though it did so in the face of nationalist criticism from a number of Philippine Senators).³³

Among the issues raised by the Philippine Senators with respect to the changes directed by the FATF were a concern for a reduction in financial privacy (the relaxation of banking secrecy laws), and the sanctioning of bank account investigations in the absence of a court order. There were also accusations that the U.S. was interfering in the domestic political process of the Philippines, because it emerged that the U.S. government had provided funding to a lobby group in the Philippines.³⁴ The mere threat of sanctions appears to have had an immediate impact on the Filipino economy. Potential sanctions were 'cited by officials and foreign exchange traders as one of the reasons for the peso's recent weakness. The currency plunged to a two-year low of 54.58 to the U.S. dollar on Monday. It closed Tuesday [4 March 2003] at 54.50.' In addition to this immediate impact on the economy, blacklisting Filipino financial institutions held the potential for a much greater long-term impact to the economy. The increased surveillance of all cross-border financial transactions that would accompany any sanctions was predicted to slow their processing and consequently all capital transfers. Sanctions would impact currency transfers originating from Filipinos living abroad. These remittances were reported to

As such, the impact of FATF blacklisting in Caribbean jurisdictions is discussed in chapter 7 and the origins of the FATF as a U.S. initiative to extend the anti-money laundering elements of the domestic 'war on drugs' internationally is discussed in chapter 8.

³³ Daxim L. Lucas, 'FATF: Meet the enforcer', *The Manila Times* 23 January 2003, Available: http://www.manilatimes.net/national/2003/jan/23/top_stories/20030123top3.html [accessed 3 February 2003]; Sammy Martin, 'Bad money law sinks loan', *The Manila Times* 18 February 2003, Available: http://www.manilatimes.net/national/2003/feb/18/top_stories/20030218top1.html [accessed 28 February 2003].

³⁴ *FATF accepts anti-money laundering changes*, 4 March 2003, Web page, Reuters/abs-cbnNEWS.com, Available: http://www.abs-cbnnews.com/abs_news_body.asp?section=Business&oid=17329 [accessed 7 March 2003]; Jodeal Cadacio, *U.S.-funded lobbying behind BIR reform, solons claim*, 18 February 2003, Web page, Today newspaper, Available: http://uw2.abs-cbnnews.com/abs_news_body.asp?section=Headlines&oid=16284 [accessed 28 February 2003]; Mario B. Casayuran, *Senators decry FATF 'unfairness, bias' vs Philippines*, 15 February 2003, Web page, The Manila Bulletin ONLINE, Available: <http://www.mb.com.ph/news.php?art=27761&ssect=1&fname=MN03021527761o.txt> [accessed 28 February 2003].

amount to \$7 billion in 2002, and are a valued source of foreign currency and revenue for the Philippines' economy.³⁵

The potential effect on the economy from FATF-directed sanctions was emphasised with a reminder of the potential for capital flight. One Senator recalled the experience of 1999, when anti-money laundering legislation was first discussed in the Philippines. At that time, a relaxation of banking secrecy laws was suggested as well. He believed that simply entertaining suggestions to change the financial privacy regime reduced investments. 'Inward remittances dwindled and our local banks suffered. Local deposits were siphoned abroad or transferred to foreign banks or to domestic banks with overseas branches.' He linked this capital flight with the depreciation in the exchange rate of the Filipino Peso that occurred in the same time period.³⁶ As would be expected from a former colony, the debate among the politicians included statements declaring that the Philippines' sovereignty would be 'undermined by the government's apparent subservience to the demands of FATF.' The former Senate Majority Leader declared 'that Filipinos must learn to fully stand up and to behave like an independent country.'³⁷

In the end, a compromise was reached between the FATF and the Philippines. The FATF believed that 'the new legislation addresses the main legal deficiencies in the Philippine anti-money laundering regime previously identified by the FATF.'³⁸ At the same time, the interest of the Philippines in maintaining the existing checks and balances between state authority and financial privacy was upheld. The Philippines' Senate

³⁵ *FATF accepts anti-money laundering changes*. Compare this to the \$1.2 billion in official development aid received in 2002, see Central Intelligence Agency, *World Fact Book*, 11 May 2004, Web page, Central Intelligence Agency, Available: <http://www.cia.gov/cia/publications/factbook/index.html> [accessed 26 September 2004].

³⁶ Edgardo J. Angara, *Lifting 48-year bank secrecy will scare away depositors, cause peso to depreciate, against economy & people*, 27 February 2003, Web page, The Manila Bulletin ONLINE, Available: <http://www.mb.com.ph/news.php?art=28460§=1&fname=MN03022728460o.txt> [accessed 7 March 2003].

³⁷ Casayuran, *Senators decry FATF 'unfairness, bias' vs Philippines*.

³⁸ Financial Action Task Force, *Press Release - FATF decides not to impose counter-measures on the Philippines*, English, 13 March 2003, PDF file, Available: http://www1.oecd.org/fatf/pdf/PR-20030313_en.PDF [accessed 29 March 2003].

President announced following a meeting with the FATF regarding the legislative changes, '[FATF] officials agreed that the Philippine requirement for a court order to probe a bank account was in accordance with international standards and could remain.'³⁹ The passage of new legislation only removed the immediate threat of sanctions. The Philippines remained on the FATF's list of non-co-operative countries and territories (NCCT's) until 11 February 2005, and will continue to be monitored by the FATF to ensure 'adequate implementation' of the new anti-money laundering legislation.⁴⁰

The experience of the Philippines with the FATF serves as a cautionary example for the jurisdictions under threat of sanction by the OECD from the harmful tax competition project. This example highlights the influence exercised in financial markets by the threat of blacklisting. At the same time, this impact is exactly what those promoting the use of a campaign to 'name and shame' desire.⁴¹ The connection frequently made between the project against harmful tax practices and the campaign to prevent money laundering suggests that failing to co-operate with the former project will be treated as a failure to co-operate with the latter project.

The OECD is the correct forum

Concerning the second criticism (or misunderstanding) asserting that the 'OECD is the wrong Forum,' Owens did not directly reply in the Q & A document. At the same time, he also did not provide a clear statement explaining why the OECD was in fact the correct Forum. He did assert however, that while the OECD is an organisation of only thirty countries, it 'does have a global reach. We cover small and large countries and rich

³⁹ FATF accepts anti-money laundering changes.

⁴⁰ Financial Action Task Force, *Annual Review of Non-Cooperative Countries or Territories*, English, 10 June 2005, PDF file, Available: <http://www.fatf-gafi.org/dataoecd/41/26/34988035.pdf> [accessed 1 September 2005], p. 8.

⁴¹ William F. Wechsler, 'Follow the Money', *Foreign Affairs* 80, no. 4 (2001), p. 49.

and poor countries.⁴² For the most part one can agree with this statement. However, the membership of the OECD does not include a developing country, less developed country or lesser less developed country. The claim for participation by a poor country could be accepted as a valid one, but only if most of the members of the United Nations were first eliminated from consideration in the pool of 'potential' OECD members. In looking at the league tables for states' Gross National Income (GNI) per capita, one finds the membership of the OECD exists solely within the top 95 (of 208 jurisdictions). Moreover, if Turkey were not a member of the club, this would leave the remaining members within the top 80.⁴³ The claim that the OECD has 'poor country' membership is therefore a bit specious. One should also note that the membership of the OECD reflects the industrialised states of North Asia, Europe and North America (with Australia and New Zealand thrown in for global balance). Representation for Africa, South America, and the vast populations of China and the Indian Subcontinent is conspicuous by its absence.⁴⁴

A former Special Advisor to the U.S. Secretary of the Treasury wrote that the involvement of the OECD served a different purpose. The fact that the organisation had a limited membership was precisely the reason to give it the responsibility 'for investigating tax evasion and establishing a consensus...on how to tackle harmful tax practices.'⁴⁵ Acting in the belief that urgent action was required, it was necessary to use an organisation with limited membership. Otherwise, 'if the debate were brought to the U.N. General

⁴² Owens, *Promoting Fair Tax Competition*.

⁴³ Formerly Gross National Product (GNP), the GNI per capita calculations had the same general result for both methods used to calculate the values. It is interesting to note, however, that the Atlas method places several OFCs higher in the rankings than does the purchasing power parity (PPP) method. For example, Bermuda is ranked 1, while the Channel Islands ranked 8, San Marino at 11 and the Cayman Islands at 12. Consequently, these figures reflect the size of the financial services sector and of companies registered in these jurisdictions. See *GNI per capita 2002, Atlas method and PPP*, World Development Indicators database, July 2003, PDF file, World Bank, Available: <http://www.worldbank.org/data/datatopic/GNIPC.pdf> [accessed 1 August 2003].

⁴⁴ See the frontispiece of any major OECD document for the membership list (and date of accession) current at the time of publication. A cynic could suggest that the *economic co-operation and development* aspects of the organisation are limited to those states already developed, and extensively co-operating with each other.

⁴⁵ Wechsler, 'Follow the Money', p. 51.

Assembly, for example, nations with underregulated financial regimes would easily outvote those with a commitment to strong international standards.⁴⁶

The next argument made in favour of the OECD being the correct organisation for this issue was the fact that ‘we have recently created a Global Forum on Taxation in which all participating countries will have the same status.’ Owens’ statement continued by encouraging the establishment of further partnerships with other regional or global organisations. The OECD, however, remains identified as the focal point for all discussions of taxation, either by creating a forum serving their purpose, or accepting the co-operation and acquiesce of other multilateral organisations within the OECD domain. None of which directly addressed the contention that the OECD is not the appropriate forum in which to consider global tax competition. Nor does the creation of a ‘Global Forum’ necessarily mean that the group will hold meetings or possess representative participation. One conclusion reached by participants of the October 2004 meeting of the Global Forum on Taxation was ‘that ways should be explored to involve significant financial centres that are not currently participating in the Global Forum process.’⁴⁷

All states are treated equally

While Owens’ document did not contain the phrase ‘level playing field’, it did address the criticism/misunderstanding that ‘there are two standards—one for the OECD member countries and another for other jurisdictions.’ The response to this criticism was that ‘our work makes no distinction’ between member and non-member states, only ‘between those countries that wish to be part of the international community (cooperative

⁴⁶ Ibid. p. 49.

⁴⁷ The agenda and closing statements for the closed meeting of the Global Forum on Taxation held in October 2003 are available at <http://www.oecd.org/>.

jurisdictions) and those countries that do not (uncooperative jurisdictions).⁴⁸ While Owens may feel that the work of the committee made no distinctions, a review of the documents finds that only OECD member countries were identified as possessing preferential tax regimes, whereas the list of uncooperative jurisdictions presented in the *Towards Global Tax Co-operation* contained only non-member states. The 'Tax Haven Update' on the OECD website is no different in that it only contains non-member jurisdictions.⁴⁹

Again, the OECD without prior consultation with the target jurisdictions established the project and its initial agenda. Small states were not involved, and according to Weschsler, the absence of 'underregulated financial regimes' was intentional. Since the publication of the first report in 1998, representatives of the OECD have had to counter this accusation of differential treatment towards non-member states. As long as the organisation continues to control the agenda of this Global Forum, the perception of unequal treatment will continue to exist.

A view from the non-self-governing territories

Although the focus of this research concerns small sovereign states, the OECD project is also a dilemma for the non-self-governing territories. As already mentioned, the issue of hosting offshore financial centres was raised in 1999 in the UN's Special Committee on the Situation with Regard to the Implementation of the Declaration on the Granting of Independence to Colonial Countries and Peoples. At the meeting in St. Lucia in May 1999, 'an expert from the Cayman Islands' provided a presentation on the potentially negative impact of the OECD project for offshore banking in non-self-

⁴⁸ Owens, *Promoting Fair Tax Competition*. The implied value distinction of the 'international community' and 'cooperation' contained in this statement will be left for the reader to ponder.

⁴⁹ *Tax Haven Update*, 2003, Web page, Organisation for Economic Co-operation and Development, Available: http://www.oecd.org/document/19/0,2340,en_2649_33745_1903251_1_1_1_1,00.html [accessed 15 July 2003].

governing territories. Summarising this presentation, the UN press release included his strong critique of the project.

Viewed in the perspective of world trends, he said, the issue was not one of criminality, money laundering or tax evasion. It was one of forcing offshore centres, which depended on offshore services for their subsistence, to conform to a standard. There was no moral high ground, but rather a 'big bully syndrome'. The buzz-words of 'transparency and harmonization overall' were nothing more than a smokescreen for pure, unadulterated self-interest, where might was right. Those assaults on offshore jurisdiction were a thinly veiled overture to impose enforcement of domestic tax laws on an international basis.⁵⁰

Again, the situation with non-self-governing territories, offshore financial centers, and the harmful tax competition project contains additional complexities beyond those facing the small sovereign states. The first aspect confronting the non-self-governing territory is the role and public position taken with regard to the OECD project by its metropolitan state. For many of the non-self-governing territories with an OFC, the administering state is the United Kingdom. Press reports from the British government emphasised that 'Though a member of the Commonwealth, Britain strongly backs the OECD campaign. The subject is particularly dear to the Chancellor, Gordon Brown, ...'⁵¹ This position was reaffirmed in the project's 2004 progress report with the following statement.

The United Kingdom confirms that it will remain responsible for any international obligations arising from any international fiscal treaties, agreements or commitments which affect its Overseas Territories or Crown Dependencies within the framework of the OECD Harmful Tax Practices initiative, including any that may be necessary to fulfil commitments entered into by those Overseas Territories or Crown Dependencies.⁵²

In the course of the UN meeting in St. Lucia in 1999, the Financial Secretary of the Cayman Islands declared, 'Cayman is a British dependent [sic] and had made its position

⁵⁰ 'Offshore Banking in Island Non-Self-Governing Territories Discussed in Special Committee on Decolonization', *Press Release GA/COL/3004* (New York: United Nations, 28 May 1999), p. 1.

⁵¹ Rupert Cornwell, 'Commonwealth clashes with rich nations over tax haven clampdown', *The Independent* (London), 2 April 2001.

⁵² Organisation for Economic Co-operation and Development, *The OECD's Project on Harmful Tax Practices (2004)*, p. 12, footnote 10.

quite clear to the United Nations that it wants to remain dependent.⁵³ The government of the Cayman Islands is taking whatever measures are available in an effort to maintain their position as a pre-eminent global financial centre. At the same time, as a dependency of the United Kingdom, the Caymans are under pressure from London to comply and co-operate with the requirements of the EU Savings Directive. They were identified in the Directive as one of the ‘dependent or associated territories in the Caribbean’ and expected by the EU to co-operate with the mandate of the Directive.

The government of the Cayman Islands strongly resisted these efforts by the European Union, and at one point had a case in the European Court of First Instance to apply ‘for interim measures in respect to the ongoing legislative consideration’ of the proposed directive.⁵⁴ Negotiations continued between the government in London and the government in George Town throughout 2003. British government officials maintained their pressure on the government of the Cayman Islands to co-operate with the EU directive.⁵⁵ In February 2004, the government of the Cayman Islands announced that they had agreed to implement information exchange procedures to comply with the requirements of the EU directive. This action involves the passage of local legislation to require designated financial institutions registered in the Cayman Islands to collect data on EU citizens. This data will then be provided to the tax administration of the appropriate EU member state.⁵⁶ The Cayman Islands *Annual Economic Report* for 2003 stated that implementation ‘is contingent on other jurisdictions making similar commitments before

⁵³ ‘Offshore Banking in Island Non-Self-Governing Territories Discussed in Special Committee on Decolonization’, p. 3.

⁵⁴ *Government of the Cayman Islands v. Commission of the European Communities* (T-85/03). Court of the First Instance of the European Communities 2003

⁵⁵ See for example Christopher Adams, ‘Caymans defiant in dispute over Tax Savings Directive’, *The Financial Times* (London), 2 December 2003.

⁵⁶ Bruce Zagaris, ‘Swiss and EU Savings Tax Agreement is Delayed but Cayman Part Agreed’, *International Enforcement Law Reporter* 20, no. 4 (2004).

that date [1 January 2005].⁵⁷ The government of the Cayman Islands maintained their requirement for the prior existence of a 'level playing field' before they co-operate with any global tax initiatives.⁵⁸

The economic influence of the OFCs in these non-self-governing territories is comparable to the situation in the small states. Should this income source be suppressed, will the administering state step in and provide the necessary economic aid to cover the resulting budget shortfalls? It will be recalled that one of the underlying reasons helping to encourage decolonisation was the expense of maintaining the colonies (dependencies). Yet where dependencies have been maintained, the overall situation has not changed significantly in the past 40 years.⁵⁹ The territory could establish itself as an independent entity, which would satisfy the UN Committee, but because it would reduce the influence of the Administering State in the territory the latter might obstruct the process. Moreover, this solution would increase the difficulties facing the OECD project because it introduces yet another sovereign state with which to negotiate on tax issues. Indeed, it is just as likely that the OECD would find itself adding the new state to its list of 'unco-operative tax havens,' if the very reason to seek independence was in order to maintain the presence of an offshore financial centre in the territory.

Reflections upon the debate

The confrontation between the OECD and various OFCs has all the appearance of an effort to intervene into the domestic affairs of a select number of states. At the same

⁵⁷ Economic Research Unit, *Annual Economic Report 2003*, (George Town, Grand Cayman: 2003), p. 24, Available: <http://www.eso.ky> [accessed 30 September 2004].

⁵⁸ See for example John Burton and Andrew Parker, 'Is the global crackdown on tax evasion 'slowing to the speed of the last ship in the convoy?'' *The Financial Times* (London), 1 December 2003.

⁵⁹ It is quite probable that the presence of the OFC reduces the cost to the metropole. For the UK, the 1999 report *Partnership for Progress and Prosperity: Britain and the Overseas Territories* noted that the Cayman Islands, Gibraltar and Bermuda received no financial aid from Britain. Secretary of State for Foreign and Commonwealth Affairs, *Partnership*

time, the efforts by the OECD to achieve consensus and the inclusion of all potentially affected jurisdictions as participants prior to the publication of *Harmful Tax Competition* appear weak.⁶⁰ Jeffrey Owens conceded this point, but emphasised the fact that subsequent meetings sought wider participation. Furthermore, the OECD was making efforts ‘to improve the process of consultation by having extensive bi-lateral and multi-lateral dialogues.’⁶¹ This is an important factor, but as the Economist Intelligence Unit has observed, difficulties remain.

If tax havens amended their fiscal and regulatory systems to be more like those in the European OECD region, the offshore business would disappear, or move elsewhere. Almost certainly, it would not move back to the high-tax, heavily bureaucratic countries from which it originated, or with which it is linked. Low-tax countries’ economic growth opportunities would be blighted and high-tax countries would be none the richer—a classic lose-lose situation.⁶²

Indeed, if even a single state stood apart, it could find itself operating quite successfully as a tax haven (given that as long as a demand for the service exists, someone will attempt to satisfy it). On the other hand, in the absence of collective agreement, a situation could develop wherein all states effectively serve as tax havens for non-residents (preferential tax regimes). If it is accepted that this is truly a global problem, then it requires a participatory global solution. The goals sought by the OECD (and ultimately also by the EU) affect individual citizens, national and multinational corporations. All of these actors desire (in a rational sense) positive outcomes, and not necessarily at the cost of public goods. The discussion on fairness and redistribution presented in the last chapter showed that (while

for Progress and Prosperity: Britain and the Overseas Territories (London: Her Majesty’s Stationery Office, 1999), Available: <http://www.fco.gov.uk/>.

⁶⁰ However, on this point it should be recalled that OECD concerns with tax inequities goes back farther than 1996 when this specific initiative claims to have started. See Caroline Doggart, *Tax havens and their uses*, Research Report, 3rd ed. (London: Economist Intelligence Unit, 1982), p. 84. See Richard A. Gordon, *Tax Havens and Their Use by United States Taxpayers - An Overview* (Washington, D.C.: United States Government Printing Office, 1981), p. 31.

⁶¹ Owens, *Promoting Fair Tax Competition*.

⁶² Caroline Doggart, *Tax havens and their uses*, Research Report, 10th ed. (London: Economist Intelligence Unit, 2002), 10th ed., p. 18.

there may be national differences) all societies possess some concern for a balance between fairness and redistribution. They simply desire the freedom to determine and maintain their own social preferences.

For the OECD to reply to their critics that the Harmful Tax Competition Initiative is not an attack on sovereignty requires a selective and limited interpretation of state sovereignty. Requests for change or co-operation backed up with the threat of sanctions constitute an intervention into the domestic affairs of a sovereign state, as reflected in the opinion of some members of the Philippine Senate. Collectively agreeing to a need to change and the extent of change required would be a less threatening approach. This would entail a strategy predicated upon the recognition that it was a 'one for all, and all for one' agreement. Co-operation derives from a common agreement to the presence of a problem, and of an appropriate approach to solving the problem. The OECD collective action strategy taken against the 'non-cooperative' jurisdictions conveys the appearance of 'neo-colonialism', as suggested in the title of Sanders' article, 'The Fight Against Fiscal Colonialism'.⁶³

In dealing with the issue of the exchange of information, past practice required that the suspect activity be a crime in both locations; that it was considered a criminal activity in both the jurisdiction possessing the information, and the one requesting the information. Therefore, for Switzerland (and Bermuda) the request must satisfy their domestic definition of tax fraud, in order for information to be exchanged between police/justice authorities (tax authorities are excluded). The OECD (and the EU) recognise that points of national difference exist, and so far have been unsuccessful in their attempts to get less restrictive states to change (in particular Switzerland). Instead, the OECD approach to

⁶³ This having been said, the experience of recent efforts to produce multilateral treaty instruments, for example with the Kyoto Protocol to the United Nations Framework Convention on Climate Change and the Rome Statute of the International Criminal Court is not encouraging. It is a lengthy process that can be de-railed by the intransigence of a

deal with this obstacle was to clarify their meaning of ‘effective information exchange’ for the elimination of harmful tax competition in the 2001 progress report.

In the case of information requested in the context of a civil tax matter, the requested jurisdiction should provide information without regard to whether or not the requested jurisdiction has an interest in obtaining the information for its own domestic tax purposes.⁶⁴

The technique of changing the ground rules and ignoring existing structures of domestic legal systems (and mutual legal assistance treaties) is not unique to the OECD project. With the 2003 revision of their *Forty Recommendations*, the FATF has taken much the same tactic.

37. Countries should, to the greatest extent possible, render mutual legal assistance *notwithstanding the absence* of dual criminality.⁶⁵

This recommendation jeopardizes the due process legal procedures integral to the Western democratic tradition, and ultimately, through ‘mission creep’, could result in a variety of unintended consequences. In the global effort to combat terrorist financing for example, this predicament has already arisen where human rights are confronted by the use of ‘smart sanctions’ against individuals.⁶⁶

It was just this point in September 2003, in an effort to achieve a common definition for ‘tax fraud’, that would torpedo the efforts of the OECD to present a semblance of a ‘global level playing field’ in advance of a meeting of the Global Forum on Taxation. Prior to the meeting in Ottawa in October 2003, a headline in the *Financial Times* read ‘OECD tax plan faces collapse’ and pointed to the EU savings tax directive as the

major participant. The participation of the United States in the OECD harmful tax competition project is discussed in Chapter 8.

⁶⁴ Organisation for Economic Co-operation and Development, *The OECD’s Project on Harmful Tax Practices: The 2001 Progress Report* (Paris: OECD Publications, 2001), p. 11.

⁶⁵ Financial Action Task Force, *The Forty Recommendations (2003)*, English, 20 June 2003 2003, PDF file, Available: <http://www.fatf-gafi.org/dataoecd/38/47/34030579.PDF> [accessed 30 June 2003], p. 10. Emphasis mine.

⁶⁶ See Torbjörn Andersson, et al., ‘EU Blacklisting: The Renaissance of Imperial Power, but on a Global Scale’, *European Business Law Review* 14, no. 2 (2003); Joan Fitzpatrick, ‘Speaking Law to Power: The War Against Terrorism and Human Rights’, *European Journal of International Law* 14, no. 2 (2003); Iain Cameron, ‘UN Targeted Sanctions, Legal Safeguards and the European Convention on Human Rights’, *Nordic Journal of International Law* 72, no. 2 (2003).

source of contention. In a September 2003 meeting of the OECD governing council, Switzerland and Luxembourg blocked an OECD agreement on a common definition. The representatives for both these OECD member states listed the EU savings tax directive as one of the reasons that they could not support the OECD's proposal. At the same time, Austria and Belgium also objected to aspects of the proposal. Consequently, it was observed that "The split among OECD members is threatening to undermine the organisation's efforts to persuade tax havens to stick with the initiative."⁶⁷

Since the publication of *Harmful Tax Competition* in 1998, the topic has been raised at many international forums that included a number of the states involved. A meeting of the UN Committee on decolonisation has already been mentioned. The global conference held in London on the Development Agenda for Small States in February 2000 contained an on-going dialogue amongst several participants.⁶⁸ For example, the representative of the Caribbean Community (CARICOM) raised the point that it appeared that developing states were always those making the adjustments to accommodate change in the international trade regime.

In the OECD's project on harmful tax competition, countries with low levels of taxation were being asked to raise taxes to the level prevailing in developed countries. In the case of trade related taxes, which were higher in developing countries, the emphasis was on lowering them to levels prevailing in developed countries.⁶⁹

There is a need to recognise the small state's limited capability or capacity to deal with the impact of adverse events upon their small economy—of their *vulnerability* to the impact of exogenous events, whether or not the event is a hurricane, or a mandate from

⁶⁷ Andrew Parker, 'OECD tax plan faces collapse', *The Financial Times* (London), 10 October 2003.

⁶⁸ See Appendix 1 of David Peretz, et al., eds., *Small States in the Global Economy* (London: Commonwealth Secretariat, 2001). This contains the 'Summary of Proceedings' for the Global Conference on the Development Agenda for Small States organised by the Commonwealth Secretariat/World Bank Joint Task Force on Small States.

⁶⁹ *Ibid.*, p. 561 - 562. The CARICOM representative was Byron Blake, Assistant Secretary-General.

the FATF.⁷⁰ In the language of the military strategist, the small state had no ‘space’ in which to employ a ‘defence-in-depth’ economic strategy—something which is inherent to the nature of a larger economy, like those possessed by OECD member states. The size and capacity of the larger economy permitted or created opportunities for jobs to shift to new market sectors.

This recognition helps explain the criticisms made by the affected jurisdictions about the OECD harmful tax competition project. The small states expect to be treated as sovereign equals, irrespective of their paucity of military and economic power. Such is the normative expectation accompanying recognition by their peers as sovereign states. Therefore they question the right of an organisation composed of developed states to determine issues affecting non-members, and then expecting non-member states to accept the decisions made, or to ‘face the consequences’. The situation is especially galling, given the very limited participation initially afforded developing states in the decision-making process.

The question then involves sovereign choice, that of the individual in a democratic society, and of the state as a member of a society of states. Any international organisation, as a subset of the wider society of states, is engaged in a process of decision-making, shaping the sovereign choices that mediate the interaction and co-operation of its members. The member states participate in this process, and nominally have the option to withdraw from the organisation if they feel it no longer represents the better interests of their citizens. However, at issue here is an instance of an international organisation pursuing a course of action that it feels is in the best interests of most of its member states, but which only represents a particular set of interests in the international community. Moreover it seeks to impose that judgement upon the activities of non-member states. To

⁷⁰ The Commonwealth Vulnerability Index, which is intended to quantify the vulnerability of small states, is discussed in chapter 7.

frame the harmful tax competition project as one of global concern, requiring a global response does not justify the patently *undemocratic* imposition of limitations upon states that did not participate in their creation. If globalisation is the source of this problem with tax competition, then the response should be global; that is, a response that the whole community has agreed upon and not some wealthy subset of it.

This chapter has analysed some of the replies made to the criticisms posed by small states. Subsequent actions by the OECD indicate that an effort has been made to address the issues raised, but it nonetheless sought to maintain the schedule for co-operation, or sanction, originally established. This pace was slowed by several other factors in 2001, including the efforts undertaken by a number of small states to work together and present a united front against the OECD. They have worked at the regional level (in the Caribbean this has been under the auspices of CARICOM), while a number of small states have sought to involve those OECD member states that are also members of the Commonwealth. The collaborative activities of these small states, in the Commonwealth and beyond, are addressed in the next chapter.

WORKING TOGETHER – SMALL STATES IN THE COMMONWEALTH AND ELSEWHERE

In response to the question as to why the Commonwealth, and in particular its Secretariat, has been especially involved in the issues confronting small states, there is no more apt an explanation than that offered by Peter Lyon in *The Round Table*. Long the editor of this ‘Commonwealth Journal of International Affairs’, he was a cogent observer of the Commonwealth.¹

There is no intrinsic reason why the Commonwealth should be more concerned and more practical about the problems of small states than, say, the United Nations or the European Community. But in fact, over the last decade or so, it has been. The Commonwealth has proved to be more user-friendly for its small Anglophone members than have other roughly comparable bodies. The Commonwealth is likely to remain concerned about small states, given that about half of its current members may be so defined.²

Similarly, Paul Sutton described the provision of technical assistance to small states as an area in which the Commonwealth possessed ‘a comparative advantage’.³ This chapter does not seek to improve upon these explanations, rather it provides some evidence for their accuracy with respect to the particular instance of offshore finance in small Caribbean states. The Commonwealth Secretariat has been involved in a variety of ways, which include sponsoring research to be discussed at meetings of Commonwealth law or finance ministers, providing the ‘good offices’ of the Commonwealth to facilitate further negotiations between the OECD and OFCs, and developing model legislation for tailoring and implementation by member states.

¹ See the *Festschrift* issue for Peter Lyon, *The Round Table*, No. 376, September 2004.

² Peter Lyon, ‘Small States Reconsidered’, *The Round Table*, no. 340 (Oct 1996), p. 403.

³ Paul Sutton, ‘Small States and the Commonwealth’, *Commonwealth & Comparative Politics* 39, no. 3 (2001), p. 88.

The claim that small states benefit from Commonwealth membership (and international organisations more generally) is not universally held. The editors of one text on international political economy are among those that have suggested otherwise.

At the time of writing this book, a prevalent view among academics and policy-makers was that small states cannot survive alone in a globalized world economy and need to join forces, preferably in regional organizations. The rationale for such organizations, however, was not entirely clear.⁴

The initial (and obvious) response to this statement is to emphasise the increased influence (voice) that might accrue from participating in a larger collective entity. Certainly there is evidence to support this assessment from the experience of the smaller members of the European Union (EU).⁵ The belief behind these recommendations is that membership in regional and international organisations allows small states to ‘punch above their weight’ (the analogy frequently used in EU policy analysis).⁶ Speaking from a security perspective of military power and strategy an alternate analogy would frame the international organisation as a ‘force multiplier’ for the small state in an anarchic international system. The effect is that the viewpoint or opinion of a small state is magnified in impact when it becomes promoted as the viewpoint of the larger organisation. By focusing upon multilateral organisations, specifically *regional* multilateral organisations, the value from participation becomes clearer. A regional organisation offers more than just a means to increase the influence of any particular small state, it is also a way for neighbouring states to pool resources. For small states, with their limited financial and personnel resources, this

⁴ Ronen Palan, et al., *State Strategies in the Global Political Economy*, Revised ed. (London and New York: Pinter, 1999), p. ix.

⁵ See for example: Baldur Thorhallsson, *The Role of Small States in the European Union* (Aldershot: Ashgate, 2000); David Arter, ‘Small State Influence Within the EU: The Case of Finland’s ‘Northern Dimension Initiative’’, *Journal of Common Market Studies* 38, no. 5 (2000); Jeanne A. K. Hey, ed., *Small States in World Politics: Explaining Foreign Policy Behavior* (Boulder and London: Lynne Rienner Publishers, 2003).

⁶ This statement has been made also about the Caribbean Regional Negotiating Machinery (RNM) by Victor Bulmer-Thomas, ‘Regional Integration in Latin America and the Caribbean’, *Bulletin of Latin American Research* 20, no. 3 (2001), p. 367. For an example with respect to the EU see, Harvey W. Armstrong and Robert Read, ‘The importance of being unimportant: The political economy of trade and growth in small states’, *Issues in Positive Political Economy*, ed. S. Mansoob Murshed (London: Routledge, 2002), p. 78.

function is the great benefit. Instead of ‘punching above one’s weight’, the regional organisation provides an avenue for the small state to ‘get more bang for their buck’. In this fashion, the various multilateral initiatives in the Caribbean provide a means for promoting a Caribbean vision when engaging with larger entities. An example of this is the presence of the Caribbean Regional Negotiating Machinery (RNM) in Free Trade Area of the Americas (FTAA) negotiations and in negotiations with the WTO.⁷

Multilateral and regional organisations will experience difficulties with representing the varied perspectives and desires of their members. Small states are just as conscious of their sovereign independence as are large states. A difference between the policy position established by the multilateral organisation and any individual member state’s preferred policy position may result in an energetic public debate.⁸

This chapter explores the question of the effectiveness of an international organisation in promoting and serving the needs and aspirations of a small state, within the context of a very specific issue. The first part of the chapter details the contributions of the Commonwealth in support of small states and specifically involving the issue of harmful tax competition. The second section of the chapter presents an analysis of an international organisation formed especially to promote the interests of small jurisdictions with offshore financial centres. The chapter’s conclusions address the effectiveness of this process of collective action.

⁷ Patsy Lewis, ‘Unequal Negotiations: Small States in the New Global Economy’, *Journal of Eastern Caribbean Studies* 30, no. 1 (2005). See the RNM website for current details <<http://www.crn.org>>.

⁸ For example, the most public and pronounced disagreement amongst EU members in recent years involved the question of participation in the 2003 war with Iraq.

Table 6-1 – Commonwealth Members

<i>Antigua and Barbuda</i>	<i>Kiribati</i>	<i>Solomon Islands</i>
Australia	<i>Lesotho</i>	South Africa
Bangladesh	Malawi	Sri Lanka
<i>Barbados</i>	Malaysia	<i>St Kitts and Nevis</i>
<i>Belize</i>	<i>Maldives</i>	<i>St Lucia</i>
<i>Botswana</i>	<i>Malta</i>	<i>St Vincent and the Grenadines</i>
<i>Brunei Darussalam</i>	<i>Mauritius</i>	<i>Swaziland</i>
Cameroon	Mozambique	<i>The Bahamas</i>
Canada	<i>Namibia</i>	<i>The Gambia</i>
<i>Cyprus</i>	<i>Nauru</i>	<i>Tonga</i>
<i>Dominica</i>	New Zealand	<i>Trinidad and Tobago</i>
<i>Fiji Islands</i>	Nigeria	<i>Tuvalu</i>
Ghana	Pakistan	Uganda
<i>Grenada</i>	<i>Papua New Guinea</i>	United Kingdom
<i>Guyana</i>	<i>Samoa</i>	United Republic of Tanzania
India	<i>Seychelles</i>	<i>Vanuatu</i>
<i>Jamaica</i>	Sierra Leone	Zambia
Kenya	Singapore	Zimbabwe*

Source: Who We Are - Commonwealth Countries, 2003, Web page, Commonwealth Secretariat, Available: <http://www.thecommonwealth.org/dynamic/Country.asp> [accessed 28 April 2003]

Note: The small states, as identified by the Commonwealth Secretariat, are italicised.

* Withdrew from the Commonwealth, effective 7 December 2003.

Small States within the Commonwealth

As already noted, the Commonwealth is involved in a number of activities intended to support its smaller members. The Commonwealth Ministerial Group on Small States was created in 1993 to provide strategic direction for the Commonwealth activities assisting small states. A forum composed of senior officials, the Commonwealth Consultative Group on Small States, was established to provide recommendations that

would be used to prioritise Commonwealth Secretariat assistance to small states. Other activities include the Joint Office for Commonwealth Permanent Missions to the UN (Joint Office) in New York City (sponsored by the Commonwealth, it has provided space at the UN for the representatives of nine Commonwealth small states); and recent joint economic studies conducted by the Commonwealth Secretariat/World Bank Joint Task Force on Small States.⁹ To assist small states with WTO trade issues, the Commonwealth Secretariat maintains a trade facility in Geneva. This facility supports small states with WTO notifications and negotiations and on their use of the WTO Dispute Settlement Mechanism.¹⁰

The Commonwealth Secretariat maintains an Internet web site dedicated to the small state (<http://www.commonwealthsmallstates.org/>), in an effort 'to increase international awareness...and to highlight the assistance being provided by the Commonwealth Secretariat in addressing their special needs.'¹¹ As a means of promoting these accomplishments, information available on the web site covered a range of relevant topics, including trade, economics, environment, politics, security, social aspects, and vulnerability. In addition, the description provided on the website offers their rationale for the continuing involvement of the Commonwealth with small state topics.

⁹ Commonwealth Advisory Group, *A Future for Small States: Overcoming Vulnerability* (London: Commonwealth Secretariat, 1997), p. 147; David Peretz, et al., eds., *Small States in the Global Economy* (London: Commonwealth Secretariat, 2001). This activity evolved into the Small States Forum, see www.worldbank.org/smallstates.

¹⁰ *Background Information: Progress on the Small States Task Force Report Agenda*, (Washington, DC: International Monetary Fund - World Bank Group, 2002), p. 18, Available: [http://wbln0018.worldbank.org/html/smallstates.nsf/\(attachmentweb\)/2002SSFbckgrndDocENGLISH/\\$FILE/2002SSFbckgrndDocENGLISH.pdf](http://wbln0018.worldbank.org/html/smallstates.nsf/(attachmentweb)/2002SSFbckgrndDocENGLISH/$FILE/2002SSFbckgrndDocENGLISH.pdf) [accessed 4 August 2003].

¹¹ Commonwealth Secretariat, *About Commonwealth Small States*, 2003, Web page, Commonwealth Secretariat, Available: http://www.commonwealthsmallstates.org/small_states.html [accessed 28 April 2003].

As a major international agency where the majority of members are small states, the Commonwealth Secretariat has a comparative advantage in dealing with a wide range of small states' issues. Up to 60 per cent of the Commonwealth Secretariat's technical assistance is currently devoted to small states, ...¹²

The text also suggested that globalisation has 'marginalized small states and increased their vulnerability.'¹³ The concern with the impact of globalisation on small states goes beyond offshore financial centres and tax competition. The Commonwealth prepared guidance for small states covering a variety of international financial issues, including money laundering, electronic commerce and international capital flows.¹⁴

The Commonwealth Secretariat also assists small states in their interactions with the World Trade Organization (WTO). As a large, complex international organisation grounded in an extensive range of procedures and directives, the WTO can drain the personnel resources of the small state actively striving to participate in WTO activities. To offset this problem the Commonwealth Secretariat sponsored research, organised education and training sessions on WTO rules and related international standards, and provided technical assistance to the member states. It has published newsletters in order to disseminate information and guidance on trade matters to all its small state members.¹⁵ The potential importance of this assistance is that the WTO may offer an avenue for formal protests against the imposition of any economic sanctions directed by the OECD project.¹⁶

¹² Ibid.

¹³ Ibid.

¹⁴ Commonwealth Secretariat, *Combating Money Laundering: A Model of Best Practice for the Financial Sector* (London: Commonwealth Secretariat, 2000); Commonwealth Secretariat, *Law in Cyberspace* (London: Commonwealth Secretariat, 2001); Report of a Commonwealth Working Group, *Promoting Private Capital Flows and Handling Volatility: Role of National and International Policies* (London: Commonwealth Secretariat, 1997).

¹⁵ Commonwealth Secretariat, *Small States: Meeting the Challenges in the Global Economy*, FMM(03)10 (London: Commonwealth Secretariat, 2003), pp. 8 - 9, Available: [http://www.thecommonwealth.org/papers/fmm/docs/FMM\(03\)10.doc](http://www.thecommonwealth.org/papers/fmm/docs/FMM(03)10.doc) [accessed 8 September 2003].

¹⁶ Discussed above in chapter 5.

Several other Commonwealth Secretariat activities intersect with those supporting the small state offshore financial centres targeted by the Harmful Tax Competition project. Already in process when the *Harmful Tax Competition* report was published in 1998 were measures to address concerns with financial governance in small states. Representatives from finance ministries, law enforcement and judiciaries of Commonwealth member states have participated in a number Secretariat-sponsored working groups. Products from these activities include ‘A Model for Best Practice’ to counter money laundering and ‘A Commonwealth Code of Good Practice’ to be used by government officials promoting private capital flows.¹⁷ An extensive research programme on the particular vulnerability of small states led to the development of a small state vulnerability index. This activity and index is presented in the next chapter within the context of establishing an OFC as an economic diversification strategy.

A number of Commonwealth publications provided a favourable view concerning the use of offshore financial centres as an economic development method prior to the 1998 OECD report. In 1997, the report *Money Laundering: Key Issues and Possible Action* contained a chapter on the topic of ‘International Financial Centres’. This chapter began with an observation about the use of international finance for economic development—‘Many developing countries are looking to the development of a significant financial sector as a key to economic development.’¹⁸ Another Commonwealth report on *Promoting Private Capital Flows* included sections describing the experience of fourteen Commonwealth members with private capital flows. These discussions included the experiences of the offshore finance sectors in Mauritius and Vanuatu. In the case of Mauritius, the historical

¹⁷ Commonwealth Secretariat, *Combating Money Laundering*; Report of a Commonwealth Working Group, *Promoting Private Capital Flows and Handling Volatility*.

¹⁸ Commonwealth Secretariat, *Money Laundering: Key Issues and Possible Action* (London: Commonwealth Secretariat, 1997), p. 31. This observation remained (put into the past tense) in a subsequent publication from the Commonwealth Secretariat, *Combating Money Laundering: A Model of Best Practice for the Financial Sector* (2000), p. 24.

experience was one of transition from a single agricultural produce (sugar) economy to a more diversified economy.

The country has now a strong export manufacturing sector, predominately based on textiles and clothing, and a flourishing tourism sector. The financial services sector is fast becoming an important pillar of the economy.¹⁹

Highlights of the industry and tax environment of Vanuatu preceded a discussion outlining how it had facilitated initiatives to attract FDI to this small Pacific island. The situation in Vanuatu was described as ‘an example of the effects of the increased mobility of firms, people and investment capital’ and therefore a symbol for the *benefits* possible from economic globalisation.²⁰ The strategies recommended by *Combating Money Laundering* for offshore financial centres encouraged the development of a well-regulated and effectively supervised financial sector.²¹

In general, the activities of the Commonwealth Secretariat follow the guidelines determined by its member states. This guidance is developed and promulgated via the periodic meetings of the Commonwealth Heads of Government (these meetings are generally identified by the acronym, CHOGM). The report from the 1999 meeting (held in Durban, South Africa) included a brief mention of the OECD’s Harmful Tax Competition Initiative. The subsequent meeting in 2002 reflected the increased awareness and heightened concern with the OECD project and its potential impact on small member states. The report of the 5th meeting of the Ministerial Group on Small States in 2002 (held in conjunction with the CHOGM in Coolum, Australia) recommended to the Heads of Government that the Secretariat should undertake the following action.

¹⁹ Report of a Commonwealth Working Group, *Promoting Private Capital Flows and Handling Volatility*, p. 63.

²⁰ *Ibid.*, p. 78.

²¹ Commonwealth Secretariat, *Combating Money Laundering*, pp. 24 - 31.

Promoting dialogue on the OECD Harmful Tax Practices Initiative. The Secretariat should continue work under its mandate to promote dialogue between the Organisation for Economic Co-operation and Development (OECD) and non-OECD jurisdictions in this area, taking into account the OECD's attempt to respond to earlier concerns. The Secretariat should support the affected jurisdictions to mobilise assistance to meet international standards, strengthen and deepen their financial sectors and diversify their economies. The need to distinguish clearly between money laundering and tax competition was highlighted.²²

This declaration reflected the efforts of the Secretariat in the year prior to the 2002 CHOGM. The OECD project was among the topics discussed at a meeting of Commonwealth Finance Ministers in September 2000. Several months earlier the OECD had published their progress report for 2000, *Towards Global Tax Co-operation*. The report identified 35 jurisdictions that had met its technical criteria determining that they were 'tax havens'.²³ Prior to the publication of this report, the OECD announced that they already had advance commitments from six jurisdictions to co-operate with the OECD project, though these jurisdictions would remain unnamed in the report itself.²⁴ Those jurisdictions that were listed as tax havens in the report were permitted twelve months in which to decide if they would commit to cooperate with the OECD, otherwise they would be placed on a 'black list' identifying the unco-operative tax havens that was to be published in July 2001.

The communiqué from the Commonwealth finance ministers meeting conveyed their concern that this planned publication date for the list of 'unco-operative tax havens'

²² Commonwealth Ministerial Group on Small States, *Chairperson's Report to CHOGM*, 1 March 2002, Web page, Available: <http://www.chogm2002.org/pub/reports/smallstates.html> [accessed 9 March 2002].

²³ Organisation for Economic Co-operation and Development, *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices* (Paris: OECD Publications, 2000), p. 17. The Commonwealth jurisdictions were: Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, the Maldives, Nauru, Samoa, the Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Tonga, and Vanuatu. The British Dependencies and Overseas Territories listed were: Anguilla, the British Virgin Islands, Gibraltar, Guernsey, the Isle of Man, Jersey, Montserrat, and the Turks and Caicos Islands. Additionally, the New Zealand affiliated territories of the Cook Islands and Niue were listed as tax havens by the OECD.

²⁴ These jurisdictions were: Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino (all affiliated with the Commonwealth in some fashion with the exception of San Marino). See *Tax Haven Update*, 2003, Web page, Organisation for Economic Co-operation and Development, Available: http://www.oecd.org/document/19/0,2340,en_2649_33745_1903251_1_1_1_1,00.html [accessed 15 July 2003].

served as an ‘impediment to constructive dialogue.’ At the same time these finance ministers ‘strongly reaffirmed the right of sovereign nations to determine their own tax policies.’ The communiqué went on to reiterate the argument that tax competition ‘could in fact be helpful, and not harmful, because it can further spur governments to create fiscal environments conducive to generating growth and employment.’ With respect to the OECD and the Harmful Tax Competition initiative, the Commonwealth Finance Ministers requested that the Secretariat facilitate multilateral dialogue ‘in appropriate ways.’²⁵ The background paper prepared by the Commonwealth Secretariat for this agenda item included a point frequently overlooked in the production of international standards. ‘It is important in any global dialogue that large countries understand that a solution reached must be capable of being administered in countries with severely limited human resource bases.’²⁶

The requested process for multilateral dialogue was initiated by the Commonwealth Secretariat with a high-level consultation meeting in January 2001 amongst the affected small states and the OECD. A press release from 23 November 2000 announcing this meeting stated that the Secretariat was using ‘its good offices to facilitate these consultations’ and continued with a quote from the Commonwealth Secretary-General.

Many Commonwealth small states which have in good faith set up offshore financial centres have found themselves on the sharp end of OECD criticism. Fortunately, four of our members are also members of the OECD, which enables dialogue.²⁷

²⁵ Commonwealth Secretariat, *Commonwealth Finance Ministers Meeting St Julians, Malta, 19-21 September 2000 - COMMUNIQUÉ*, 2000, Web page, Commonwealth Secretariat, Available: <http://www.thecommonwealth.org/Templates/Internal.asp?NodeID=141664> [accessed 8 July 2005].

²⁶ Commonwealth Secretariat, *The Implications of the OECD Harmful Tax Competition Initiative for Offshore Financial Centres*, FMM(00)(O)4 (London: Commonwealth Secretariat, 2000), p. 9, Available: [http://www.thecommonwealth.org/papers/oecd/FMM\(00\)\(O\)4.doc](http://www.thecommonwealth.org/papers/oecd/FMM(00)(O)4.doc) [accessed 7 October 2002].

²⁷ Commonwealth News and Information Service, ‘eNews for the Commonwealth’, *Announcement for High-level Consultations on Harmful Tax Practices’ to be held in Barbados 8 - 9 January 2001* (London: Commonwealth Secretariat, 2000).

Throughout this series of meetings the press releases (some of them jointly issued by the Commonwealth Secretariat and the OECD) related the confidence with which the parties entered into negotiations with no hint of the chasm that existed between the viewpoints held by the participants. The initial meeting was framed as ‘high-level consultations’, while the statement released immediately prior to this meeting in Barbados noted that it would ‘provide the first real opportunity for multilateral dialogue between the OECD and other jurisdictions on “harmful tax competition”’.²⁸

The multilateral nature of the meeting included not only the participation of representatives from over forty interested jurisdictions, but also a number of interested international institutions, including the IMF, World Bank, Caribbean Development Bank, Inter-American Development Bank, the Centre for Inter-American Tax Administrators, CARICOM and the Pacific Islands Forum. The meeting itself was described as ‘a frank, open and ultimately fruitful exchange of views’ about the OECD project.²⁹ As a result of this meeting, a Joint Commonwealth-OECD Working Group was formed. The working group comprised tax and finance officials representing thirteen jurisdictions, including from the Commonwealth Antigua and Barbuda, Australia, Barbados, the British Virgin Islands, the Cook Islands, Malaysia, Malta, Vanuatu and the United Kingdom.³⁰ The other participants represented the OECD member states France, Ireland, Japan, and the Netherlands. The direction given to the Joint Working Group consisted of two wide-ranging tasks.

²⁸ Commonwealth Secretariat, *Commonwealth and OECD Countries to hold high-level consultations on ‘harmful tax competition’*, 3 January 2001, Press release, Information & Public Affairs Division, Available: <http://www.thecommonwealth.org/Templates/Internal.asp?NodeID=34634> [accessed 8 July 2005].

²⁹ Commonwealth Secretariat, *OECD, Commonwealth Agree to Work Towards Global Cooperation on Harmful Tax Practices*, 10 January 2001, Press release, Information & Public Affairs Division, Available: <http://www.thecommonwealth.org/Templates/Internal.asp?NodeID=34633> [accessed 8 July 2005].

³⁰ Participants at the meeting of Senior Commonwealth Law Officials in November 2001 remarked upon the fact that the representation to these meetings usually consisted of tax and finance officials. ‘Other Senior Officials emphasised that taxation was a legal issue as well as an economic issue and therefore there was a need to be careful not to limit taxation

1. To take the broad principles of transparency, non-discrimination and effective exchange of information and to find a mutually acceptable political process by which these principles could be turned into commitments. If successful, this process would replace the OECD's process in the context of its Memorandum of Understanding;
2. To examine how the recently created Global Forum on taxation can evolve into a truly inclusive forum which would promote global co-operation on tax matters. It will also identify further relevant tax issues for consideration by such a forum.³¹

The momentum of this process of dialogue would be maintained over the next few months with two further meetings.

The first meeting of the Joint Working Group was held in London three weeks later. Here the group explored the 'participants' understanding of the scope of [their] remit' and proposals for accomplishing the two tasks quoted above. While identifying areas of agreement, the meeting 'ended with an acknowledgement that further work' was necessary.³² The second meeting was held several weeks later, at the beginning of March in Paris. The short press release following this meeting contained a somewhat cryptic quotation from the co-chairs of the Working Group (Owen Arthur, Prime Minister of Barbados and Tony Hinton, Australian Ambassador to the OECD).

We are pleased by the improved understanding and progress achieved. A number of new proposals were put on the table by both parties, which we have agreed to examine further over the coming days.³³

The suggestion for the cryptic nature of this statement originates from a reading of Ronald Sanders' presentation of the activities of the working group. To begin with, he suggested

to a mere economic concept.' Commonwealth Secretariat, 'Summary Record of Discussions for the *Meeting of Senior Officials of Commonwealth Law Ministries*' (London, 6 - 9 November 2001), p. 16.

³¹ Commonwealth Secretariat, *Joint Commonwealth-OECD Working Group on Harmful Tax Competition to Meet in London*, 24 January 2001, Press release, Information & Public Affairs Division, Available: <http://www.thecommonwealth.org/Templates/Internal.asp?NodeID=34632> [accessed 8 July 2005].

³² Commonwealth Secretariat, *OECD-Commonwealth Working Group Continues Discussions on Tax Co-operation*, 28 January 2001, Press release, Information & Public Affairs Division, Available: <http://www.thecommonwealth.org/Templates/Internal.asp?NodeID=34649> [accessed 8 July 2005]. This news release was issued jointly by the Commonwealth Secretariat and the OECD Secretariat.

that the objective behind the working group was both to avoid confrontation, and to resolve the fiscal concerns of the OECD members ‘in a mutually satisfactory manner.’³⁴ By his account the ‘targeted jurisdictions’ submitted a three point proposal at the March 2001 meeting of the Joint Working Group. As Sanders described the meeting, the OECD representatives ‘expressed “discomfort” with some of the details’ and offered to respond with a revision more agreeable to their perspective. At the same time, a set of questions were submitted to the OECD in order ‘to ascertain from the OECD whether or not its own member states would be bound by the same rules’ as those directed at the non-member jurisdictions. Sanders described how when the answers were received from the OECD in July 2001 the situation did not seem to have been clarified. Instead, the reply made to these questions ‘clouded the issues even more and gave rise to deeper suspicion about the motives behind the OECD’s “harmful tax competition” scheme.’³⁵

Communication between the Commonwealth Secretariat and the OECD Secretariat was particularly tense at the time of the second Joint Working Group meeting. Reacting to a document that was purported to be meeting minutes from a January 2001 OECD Fiscal Affairs Committee meeting, the Commonwealth Secretary-General issued a stern rebuke to the OECD in a press release. ‘If this is a true and accurate record, I [Commonwealth Secretary-General Don McKinnon] am extremely disappointed.’ He emphasised that the non-OECD participants to these meetings were acting ‘in good faith with the OECD’ and they recognised the importance of dialogue on the harmful tax competition project because of the important economic benefits they gained from their financial services sectors. Moreover, the members of the Commonwealth were ‘all

³³ Commonwealth Secretariat, *OECD-Commonwealth Joint Working Group Concludes Meeting in Paris*, 5 March 2001, Press release, Information & Public Affairs Division, Available: <http://www.thecommonwealth.org/Templates/Internal.asp?NodeID=34656> [accessed 8 July 2005].

³⁴ Ronald M. Sanders, ‘The Fight Against Fiscal Colonialism: The OECD and Small Jurisdictions’, *The Round Table*, no. 365 (2002), p. 337.

committed to adhering to the highest standards of fiscal probity.’ McKinnon declared that the document portrayed the desire of the OECD committee not only to be ‘the world’s financial policeman’ but also the ‘prosecutor, judge, jury and jailor.’³⁶

The Commonwealth press release garnered a rapid reply from the OECD Secretary-General. His response declared that the document was false, and that the Commonwealth Secretary-General’s statement, without confirming the accuracy of the document, was unhelpful to the on-going discussions. This intervention by the Commonwealth Secretary-General was characterised as ‘most inappropriate.’³⁷ The tension represented by this public display ‘between two normally sedate international bureaucracies reflects deep divisions between first and third worlds’.³⁸ It was all the more striking given the otherwise confidential nature ascribed to the contents of these meetings. Even though the closing press release from the Commonwealth (quoted above) referred to the ‘improved understanding and progress achieved’ and the new proposals under consideration by both parties, this particular ‘Joint Working Group’ never met again.³⁹

The fact that the OECD did not continue participating in this particular forum would be remarked upon at a later Commonwealth-sponsored workshop. This later meeting was organised specifically for those jurisdictions ‘engaged in the provision of international financial services’. The consensus opinion of the participants concerning

³⁵ Ibid. pp. 337 - 338.

³⁶ Commonwealth Secretariat, *Statement by Commonwealth Secretary-General on Document Related to Tax Talks*, 28 February 2001, Press release, Information & Public Affairs Division, Available: <http://www.thecommonwealth.org/Templates/Internal.asp?NodeID=34653> [accessed 8 July 2005]. A news service saw a similar (if not the same) document and described it as ‘a personal minute by one of the participants in an OECD Fiscal Affairs Committee meeting of Jan 30 [2001]’. See AFX European Focus, ‘OECD threatens sanctions to force ‘tax havens’ into line’, *AFX News Limited* (London), 28 February 2001.

³⁷ Eugene Bingham and John Andrews, ‘Islands face dirty-money backlash’, *The New Zealand Herald* 3 March 2001; Rupert Cornwell, ‘Commonwealth clashes with rich nations over tax haven clampdown’, *The Independent* (London), 2 April 2001; ‘Fur flies at OECD talks’, *International Money Marketing*, 12 April 2001; ‘Can’t we all just get along?’ *International Money Marketing*, 12 April 2001.

³⁸ Cornwell, ‘Commonwealth clashes with rich nations over tax haven clampdown’.

³⁹ Commonwealth Secretariat, *OECD-Commonwealth Joint Working Group Concludes Meeting in Paris*.

OECD inactivity after the second meeting was to describe it as a consequence of the fact ‘that OECD personnel had no real authority to speak for any one, let alone all, the OECD member states.’ The concluding comments made about the effectiveness and purpose ascribed to the Joint Working Group were blunt.

The working group owed its brief existence to asymmetrical expectations harboured by the small offshore finance centre (OFC) jurisdictions on the one hand and OECD representatives on the other. The list of specific questions agreed upon by the small states within the working group context elicited no relevant responses from the OECD. The exercise merely served to reinforce the feeling among small states that they were being discriminated against.⁴⁰

The sentiments expressed by this quotation reflect the practicalities of the OECD as an international organisation. While the Secretariat acts on *behalf* of its member states, public statements do not necessarily reflect the policy positions of its members, nor can it impose any policy upon its unwilling members. Consider on this latter point the abstention from the tax competition reports of four OECD states by the time the 2001 progress report was published. As Luxembourg stated when recalling their abstention to the original report, *Harmful Tax Competition*, in 2001, not only did that abstention still apply, but ‘[Luxembourg] regrets that the 2001 progress report is further away from the goal of combating harmful tax competition with respect to the location of economic activities.’⁴¹

As an international organisation, this observation is just as true for the Commonwealth. The Commonwealth Secretariat does not speak on behalf of any individual member state, nor does it have a capability to enforce any policy position on its members. The Commonwealth essentially operates as a forum in which to develop a collective (consensus) opinion or a recommended course of action that member states are

⁴⁰ Commonwealth Secretariat, *Report of a Workshop on the International Financial Sector in Small Vulnerable Economies*, FMM(O3)(INF)2 (London: Commonwealth Secretariat, 2003), p. 3 Available: [http://www.thecommonwealth.org/papers/fmm/docs/FMM\(O3\)\(INF\)2.doc](http://www.thecommonwealth.org/papers/fmm/docs/FMM(O3)(INF)2.doc) [accessed 8 September 2003]. This report was prepared ‘For the Information of Delegates’ to the Commonwealth Finance Ministers meeting held 16-18 September 2003.

⁴¹ Organisation for Economic Co-operation and Development, *The OECD’s Project on Harmful Tax Practices: The 2001 Progress Report* (Paris: OECD Publications, 2001), p. 4.

encouraged to pursue.⁴² So while the statement from the Secretary-General concerning the fact that the intersection of the Commonwealth and the OECD (four members in common) ‘enables dialogue’ is true, the same circumstance carries with it the opportunity for conflict. The question emerging out of this situation is towards which set of competing goals and objectives on tax competition (OECD or Commonwealth small states) do these common members adhere? As noted earlier, the UK is further conflicted beyond the OECD project when it comes to tax competition issues because its EU membership involves additional obligations concerning the EU Savings Tax Directive. In this context, the foreign policy dictum that ‘where you stand, depends upon where you sit’ involves more than simply the ministry one represents in the meeting, it also involves the particulars of the forum or meeting in which one is participating—the OECD, the EU, the Commonwealth, or even domestic governmental meetings that involve tax revenues or the British Overseas Territories. A similar situation confronts New Zealand because of their relationship to the Pacific island jurisdictions of the Cook Islands, Nauru, and Niue. ‘A senior New Zealand official said this week [3 March 2001] that the OECD's naming and shaming approach was not always helpful in the Pacific and that the Government preferred to help island Administrations.’⁴³

The concluding observations quoted above from the workshop on the international financial sector represent one perspective on the situation for the joint working group between the Commonwealth and the OECD. Alternatively, the case may be that the objectives to be accomplished by the ‘Joint Working Group’ were consolidated into those of the Global Forum on Taxation. Recall that the second task presented to the

⁴² For example, the difference of opinion amongst Commonwealth members on how to respond to the unilateral declaration of independence by Rhodesia in 1965 was a crisis that overshadowed all other Commonwealth issues in the 1960s. See W. David McIntyre, *A Guide to the Contemporary Commonwealth* (Basingstoke, Hampshire: Palgrave, 2001), pp. 31 - 37.

⁴³ Bingham and Andrews, ‘Islands face dirty-money backlash’.

Joint Working Group was 'To examine how the recently created Global Forum on taxation can evolve into a truly inclusive forum which would promote global co-operation on tax matters.'⁴⁴ Given the limited resources available to the small state participants in particular, to consolidate the negotiation efforts of the Commonwealth-OECD working group into the 'global' working group would be a more efficient use of these limited resources.

Perceptions about the OECD vary most clearly amongst observers and commentators when the organisation extends beyond what are generally held to be its areas of expertise. As a collector of economic data concerning its members and a promulgator of 'Model' treaties and legislation the OECD has been exemplary. The harmful tax competition project as an attempt to impose a regulatory regime upon jurisdictions that are not part of its membership goes beyond the organisation's remit.⁴⁵ The difficulty experienced in this attempt by the OECD to 'go global' underscores an argument made by Jason Sharman concerning the use of 'weapons of the weak' by small states. He found that the small states engaged in tactics similar to those of NGOs in their relations with other international organisations.

More specifically, through normative appeals, argument and rhetoric based on the principles of the 'level playing field' and inclusive, consensual standard setting, small states have often undermined the legitimacy of core state proposals.⁴⁶

More explicitly, in this specific case it was a matter of international politics and negotiations amongst sovereign entities. These negotiations reproduce the sovereign status of the participants as independent territorial jurisdictions that represent a distinct population with their unique interests and desires. As an international organisation, the OECD does not

⁴⁴ Commonwealth Secretariat, *Joint Commonwealth-OECD Working Group on Harmful Tax Competition to Meet in London*.

⁴⁵ Richard Woodward, 'Global Monitor - The Organisation for Economic Cooperation and Development', *New Political Economy* 9, no. 1 (2004), pp. 115 - 116.

⁴⁶ Jason Sharman, 'Small States and Weapons of the Weak in the Global Governance of Tax and Financial Services' (paper presented at the Australasian Political Studies Association, University of Tasmania, Hobart, 29 September - 1 October 2003), p. 2, Available: <http://info.utas.edu.au/government/APSA/RefereedPapers.html> [accessed 1 July 2005].

represent a specific constituency and instead proclaimed that it was acting on behalf of all citizens in tackling the issue of harmful tax competition as a threat to global welfare.⁴⁷ At the same time, the OECD report emphasised the point that it was not an attempt by the OECD to impose some optimal rate of tax upon individual domestic constituencies. ‘Countries should remain free to design their own tax systems as long as they abide by internationally accepted standards in doing so.’⁴⁸ Faced then with the assertions of sovereign independence that accompany the statement that the small states were absent from the discussions that produced the initial report, the OECD found itself in a position where it had to follow through and act upon its claims for multilateral participation and inclusiveness.⁴⁹

Statements from the Commonwealth Secretariat reinforced the individual critiques from various Caribbean states, and added a gloss of collective voice to the public debate. The OECD attempted to use its imposing size and presence (as a reflection of its membership) to convince the small jurisdictions that co-operation was required. The threat implicit in the creation of a ‘blacklist’ of non-co-operative jurisdictions demonstrates the hazards of the situation for small states. Absent co-operation, the implication is that sanctions would be recommended and, as suggested by the experience of the Philippines, these sanctions have the potential to cripple a small economy (though it depends quite naturally upon the extent of participation of the world financial community to enforce the sanctions). The progress of the OECD project from early 2001 up to 2004 was less than initially desired by the OECD Secretariat. Target dates slipped and further meetings

⁴⁷ Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD Publications, 1998), p. 8.

⁴⁸ *Ibid.*, p. 15.

⁴⁹ ‘The Committee recognises that since the problems discussed in this Report are of an inherently global nature, it is critical that as many countries as possible are involved in the dialogue. ... It is for these reasons that the Committee has attached particular importance to associating non-member countries with its analytical and policy discussions on harmful tax competition.’ *Ibid.*, p. 10.

arranged that implied progress, while delaying the achievement of the ultimate objective—the elimination of tax competition.⁵⁰

At the conclusion of the Joint Working Group meeting in March 2001 the targeted jurisdictions were facing a July 2001 deadline to publicly commit to cooperate with the tax competition project. This deadline was later postponed to 28 February 2002, after which any ‘uncommitted’ jurisdictions would be formally identified by the OECD on a List of Unco-operative Tax Havens. The Project Report for 2001 explained that in light of the progress made during the year and ‘the number of ongoing discussions with jurisdictions on the conclusion of commitments’ this extension was in accord with their aim for a ‘co-operative process’.⁵¹ The extension was fairly successful, as it permitted ‘intensive negotiations’ that resulted in most of the identified jurisdictions making a commitment.⁵² The List of Unco-operative Tax Havens, when it was initially published in April 2002, would contain only seven jurisdictions (Andorra, Liechtenstein, Liberia, Monaco, Marshall Islands, Nauru, and Vanuatu).⁵³ Recall the earlier discussion about these commitment letters—many contain the explicit qualification that all conditions applicable to non-OECD jurisdictions must be equally applicable to the OECD member states.⁵⁴

The next significant activity with respect to the non-OECD jurisdictions was undertaken through an Informal Contact Group established under the oversight of the

⁵⁰ This demonstrates the changes that have occurred within the process of international negotiations since the end of the Cold War. Negotiations are no longer subject only to the distribution of power amongst participants existing in the previous environment of global insecurity. International negotiations are facilitated now by negotiation tactics that give ‘weak actors’ more influence. See J. P. Singh, ‘Weak Powers and Globalism: The Impact of Plurality on Weak-Strong Negotiations in the International Economy’, *International Negotiation* 5 (2000).

⁵¹ Organisation for Economic Co-operation and Development, *The OECD’s Project on Harmful Tax Practices (2001)*, p. 10.

⁵² Anthony Payne, ‘Small States in the Global Politics of Development’, *The Round Table* 93, no. 376 (2004), p. 629. These commitment letters are prominently displayed on the OECD website, see <http://www.oecd.org/document/19/0,2340,en_2649_33745_1903251_1_1_1_1,00.html> [accessed 23 March 2003].

⁵³ Jeffrey Owens, *The OECD work on Tax Havens*, Presented at the conference on ‘Money Laundering and Tax Havens - The Hidden Billions for Development’ held in New York on 8-9 July 2002, 2002, PDF file, OECD Centre for Tax Policy and Administration, Available: <http://www.oecd.org/dataoecd/51/19/1940467.pdf> [accessed 22 July 2003], p. 2. At the time of writing, only five remain on the list; Nauru’s commitment letter was dated 3 December 2003 and Vanuatu’s was dated 7 May 2003.

OECD's Global Forum. The Contact Group arranged a meeting in October 2003 to discuss the issue of a level playing field and it was attended by the representatives of forty OECD and non-OECD jurisdictions. The tone of discussions was set at the start of the meeting by the welcoming remarks of OECD Deputy Secretary General Hecklinger, who emphasised that it was about assuring compliance with international rules. 'This is not about one country acting as a tax collector for another: it's about international cooperation and good international relations between neighbours.'⁵⁵ The argument has already been made that from the perspective of small states, the 'international' rules must recognise that they too are sovereign entities, and not merely tax agents for the OECD.

The OECD's progress report in 2004 discussed the accomplishments of the subgroup's October meeting. 'Virtually all the participants reaffirmed their commitments to the principles underlying the exchange of information standard and acknowledged the need to continue their discussions to establish bi-lateral mechanisms for effective exchange of information.'⁵⁶ The use of the word 'virtually' in the progress report masks the forceful dissent of the representative from Antigua and Barbuda concerning the results of the meeting. In a statement reported by the Caribbean Media Corporation, the Prime Minister of Antigua and Barbuda urged other regional jurisdictions to withdraw from the OECD's Global Forum because 'his country remains very concerned that a level playing field still does not exist between OECD and non-OECD countries, which make up the Global Forum.'⁵⁷

⁵⁴ See above, chapter 5.

⁵⁵ OECD Global Forum on Taxation, *Welcoming Speech by Deputy Secretary General Hecklinger*, OECD, 2003, PDF file, OECD, Available: <http://www.oecd.org/dataoecd/13/20/16647699.pdf> [accessed 12 November 2003], p. 1.

⁵⁶ Organisation for Economic Co-operation and Development, *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report* (Paris: OECD Publications, 2004), p. 21.

⁵⁷ Caribbean Media Corporation. A report in *The Financial Times* (London) stated that two Caribbean countries, including Antigua and Barbuda were 'suspending their commitments'. See Ken Warn, 'Go-ahead for plan to crack down on tax evasion', *The Financial Times* (London), 16 October 2003.

Throughout this period, the Commonwealth Secretariat continued to exercise its 'good offices' to facilitate meetings and sponsor technical assistance for the non-OECD participants. One of these activities was mentioned in passing above, the Workshop on the International Financial Sector in Small Vulnerable Economies.⁵⁸ The participants at this gathering represented both the member jurisdictions of the International Tax and Investment Organisation (ITIO) and a number of interested non-member jurisdictions with international financial services sectors. Of particular note was the fact that the Commonwealth Secretariat organised a meeting for the members of another organisation, though many are also members (or affiliated to a member) of the Commonwealth. The ITIO is the focus of the next section.

Beyond the Commonwealth

In March 2001, several offshore jurisdictions joined together and established the International Tax and Investment Organisation (ITIO) 'as a forum in which small and developing economies (SDEs) work on an equal basis and speak with a common voice.'⁵⁹ The choice of terms in this description is intentional, as the organisation comprises both sovereign states and non-self governing territories.⁶⁰ The creation of the ITIO diversified the opportunities for collective action by small states specifically for the international finance domain and outside the structure of the Commonwealth, CARICOM and Pacific Islands Forum. Most international organisations involving the international financial sector are composed predominantly of the larger developed states. Establishing the ITIO as a

⁵⁸ The papers tabled and debated by the workshop participants were published by the Commonwealth Secretariat, see Andreas Antoniou, ed., *International Financial Services Sectors in Small Vulnerable Economies: Challenges and Prospects*, vol. 60 (London: Commonwealth Secretariat, 2004).

⁵⁹ ITIO, *About the ITIO*, 2003, Web page, International Tax and Investment Organisation, Available: <http://www.itio.org/about.htm> [accessed 30 July 2003].

⁶⁰ Anguilla, Antigua and Barbuda, The Bahamas, Barbados, Belize, British Virgin Islands, Cayman Islands, Cook Islands, Malaysia, St. Kitts & Nevis, St. Lucia, Turks & Caicos Islands and Vanuatu; with the Commonwealth Secretariat, Pacific

forum for small and developing economies and one from which they could ‘speak with a common voice’ provides them with an alternative to these former institutions on the harmful tax competition issue, and other similar financial sector initiatives.⁶¹ Furthermore, the ITIO is not limited to sovereign states, opening its membership to any small and developing economy, including the non-self-governing territories. These latter jurisdictions are often left uninvited to the international conference table, simply because they are not sovereign entities. Yet in this circumstance, some of the largest actors in the offshore financial sector are non-self-governing territories. The Cayman Islands is frequently identified as a top world financial centre, for example from the *Financial Times*, ‘The Caymans’ banking sector is the fifth-largest in the world and is a leading centre for hedge funds.’⁶² With membership in the ITIO, the interested non-self-governing jurisdictions now have a forum in which to meet and discuss the issues of concern that are common to any small jurisdiction with a similarly structured economy.

The first major topic the ITIO addressed was not the harmful tax competition project, but instead involved a related OECD effort, the ‘Misuse of Corporate Vehicles for Illicit Purposes.’ The OECD report for that initiative approached the topic with an emphasis on corporations registered in non-OECD member states, particularly in offshore jurisdictions. As with harmful tax competition, the OECD framed a very specific economic concern for its members as a global problem, and then proceeded to identify the source of the problem as laying substantially *outside* its membership. ‘While the report examines both onshore and offshore jurisdictions, it places a greater focus on offshore financial centres (OFCs) for three reasons.’ The rationale given was that 1) the ‘excessive’

Islands Forum Secretariat, CARICOM Secretariat, Caribbean Development Bank and Eastern Caribbean Development Bank participating as formal observers.

⁶¹ See ITIO, *About the ITIO*.

⁶² John Burton and Andrew Parker, ‘Ultimatum to Caymans on EU tax directive: Caribbean territory urged to comply in crackdown on evasion’, *The Financial Times* (London), 1 December 2003, p. 1.

secrecy provided by some OFCs ‘create a favourable environment for their misuse for illicit purposes’; 2) shell companies exist as a ‘substantial proportion of the corporate vehicles established in some OFCs’; and 3) the ‘specialised, sophisticated, and robust regimes’ for information exchange in some OFCs should serve as a model for other jurisdictions.⁶³ It was this focus on OFCs, that led the ITIO to prepare a report responding to it and in that rebuttal to defend the interests of the targeted offshore jurisdictions.

The ITIO teamed with an interested industry organisation, the Society of Trust and Estate Practitioners (a ‘professional body for the trust and estate profession worldwide’), to commission the international Canadian law firm of Stikeman Elliott to study the OECD’s report and to prepare an analysis of it. In the foreword to their study, the Chairman of the Society of Trust and Estate Practitioners noted his organisation’s interest and concern with the OECD’s report. The fact that the OECD had not found it necessary to consult with the industry affected by its proposals caused this professional community to be ‘concerned with a process for change in which they are denied effective participation.’⁶⁴ In this concern, the professional community had common cause with the small jurisdictions as they too were not participants with drafting the report.

The ITIO analysis of the OECD Report focused on three specific concerns, first with its emphasis on non-OECD ‘IFCs’ (international financial centres), second with the regulatory burden placed upon the affected jurisdictions by these regulations, and finally on

⁶³ Organisation for Economic Co-operation and Development, *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes* (Paris: OECD Publications, 2001), pp. 7 - 8, Available: <http://www1.oecd.org/publications/e-book/2101131e.pdf> [accessed 20 August 2002]. This report was initially released to the G-7 Finance Ministers in May 2001 and was developed by an *ad hoc* group of experts convened by the OECD Steering Group on Corporate Governance.

⁶⁴ Stikeman Elliott, *Towards A Level Playing Field: Regulating Corporate Vehicles in Cross-Border Transactions*, (International Tax and Investment Organisation and The Society of Trust and Estate Practitioners, 2002), p. 1, Available: <http://www.step.org/showarticle.pl?id=363&n=&toparticle=363> [accessed 7 October 2002]. Certainly, the case could be made that this particular ‘professional community’ was not the relevant epistemic community, and that in fact it included some of the elements that the OECD report sought to constrain. Nevertheless, the individuals identified as authors of *Towards a Level Playing Field* were all lawyers ‘admitted to practice’ in a variety of OECD jurisdictions, including Canada, New Zealand, the United Kingdom and the United States.

the erosion of the privacy of individual citizens.⁶⁵ Similar to *Harmful Tax Competition*, this OECD report identified a number of practices as an offshore problem that are equally problematic amongst OECD members. Secrecy is a feature of trusts and foundations in the United Kingdom and Austria for example, and the creation of shell (brass plate) companies is as much a commodity of Delaware (U.S.A.) as it is of the Channel Islands.⁶⁶ The point raised about financial secrecy is in fact neither unique nor specific to OFCs. The concern identified about the regulatory burden is equally applicable to any international standard or best practice, vis à vis the small state. These regulatory standards are created with little or no participation from small jurisdictions and are likely to strain the limited resources of the small jurisdiction. The same circumstance holds for the anti-money laundering recommendations promulgated by the FATF and audited by the IMF's Offshore Financial Centre (OFC) Assessment Program.⁶⁷ The issue about the erosion of personal privacy with respect to private corporations is similar to the situation involving taxpayer data and information exchange as part of banking confidentiality laws. In this case, the privacy issue includes the specific feature that is sought by the use of corporations, trusts, foundations, and limited partnerships in their function as contractual vehicles for personal financial transactions—the desire to obscure beneficial ownership.⁶⁸ For *personal* privacy there may be solid ground for this concern within common law

⁶⁵ It is interesting to note that this study *vigorously* avoids the use of the term 'offshore' – except in those circumstances where it was used by others, at which point it takes exception to the term. This is perhaps an effort to incorporate non-self-governing territories into the responsible state (an OECD member), or simply because the connotation of 'offshore' implies a small island economy, which ignores the non-resident financial business conducted in a number of OECD member states. See Organisation for Economic Co-operation and Development, *Behind the Corporate Veil*, p. 10 and the associated citation to the Working Group on Offshore Financial Centres, Report of the Working Group on Offshore Centres.

⁶⁶ Ibid., pp. 25 - 28, 49, and 56.

⁶⁷ Monetary and Financial Systems Department, *Offshore Financial Centers: The Assessment Program—A Progress Report*, (Washington, D.C.: International Monetary Fund, 2005), Available: <http://www.imf.org/external/np/pp/eng/2005/022505.htm> [accessed 12 March 2005].

⁶⁸ The concern with privacy is an important yet possibly losing proposition in light of the efforts to increase surveillance, including of all monetary/financial transactions, as part of the burgeoning 'war on terrorism.' See for example, Kirstie Ball and Frank Webster, eds., *The Intensification of Surveillance: Crime, Terrorism and Warfare in the Information Age* (London: Pluto Press, 2003).

jurisdictions, but for *public corporations* recent business history reminds us this feature is far more problematic. The use of special purpose vehicles registered in offshore jurisdictions by Parmalat and Enron to obscure malfeasance underscores the OECD argument—not only that corporate vehicles are used for illicit purposes, but that the transnational nature of these activities requires a global response.

Any connection between the OECD documents on the Misuse of Corporate Vehicles and Harmful Tax Competition is not explicit, and illicit or harmful tax practices are only briefly mentioned in the Foreword and Introduction of *Behind the Corporate Veil*. However, a reading of the latter report does identify threads between these two OECD projects. The OECD report on Corporate Vehicles refers to ‘illicit tax practices’ while the phrase ‘tax evasion’ only appears in reference to a United States Internal Revenue Service observation concerning the ‘proliferation in the use of OFC trusts and corporations in tax evasion schemes due to the difficulty in tracing their beneficial owners.’⁶⁹ Consequently, the OECD has avoided the issues surrounding juridical definitions of tax evasion as outlined earlier. ‘In this Report, conduct is “illicit” if it is illegal in the perpetrator’s country of citizenship, domicile, or residence.’ Thus, if illegal in some territory in which a ‘perpetrator’ has a nexus, the fact that it is *not* illegal at the location of the account or corporate registration (i.e. – another jurisdiction, offshore or onshore doesn’t matter) has become immaterial. This approach then is perhaps not an *extraterritorial* enforcement of state law, because the action deemed illicit occurred in the location where it was illegal, although the corporate vehicle may be registered in some other jurisdiction.

On the other hand, if the action was illegal in the state in which one is a citizen, but not illegal in the state where one is resident (or even where the event occurred) this could

⁶⁹ Organisation for Economic Co-operation and Development, *Behind the Corporate Veil*, p. 36. The preferential tax status of a corporation in U.S. tax statutes is left unexplored, by either the OECD or the IRS in this context. However, the lower rate of tax on a corporation, versus individual income tax rates would suggest incorporation as a benefit for high net worth individuals, over and above the secrecy aspect.

be seen as an extraterritorial enforcement of domestic law. One example would be in the legal perception of ‘corruption’ wherein a corporate executive, living in one state, makes a contribution which is categorised as illicit in the state of their citizenship, or corporate registration, but not in the state where payment was made.⁷⁰ The complexities of the Elf Aquitaine bribery and corruption case in France offer a ready example for the intricacies associated with transnational illicit conduct.⁷¹ Many of the 37 defendants were French citizens, but also charged were a Turkish businessman, a German businessman, and an ‘Iraqi-born British billionaire’. While Elf Aquitaine was a state-owned business during the period under investigation, the absence of any prominent French political figures was noted in some reports. The investigation produced a 1,045-page indictment with 44,000 pages of supporting documentation, the aftermath of what *The Guardian* (London) described as ‘probably the biggest political and corporate sleaze scandal to hit a western democracy since the second world war.’⁷²

No longer could economic activity be considered in a similar context to the foreign policy maxim—‘where you stand depends on where you sit’. The OECD report would establish conduct as illicit if a connection could be made between the perpetrator (individual or firm) and some territory in which the legal system has established it to be illicit conduct. Therefore, the fact that Enron used corporate vehicles registered in a Caribbean jurisdiction is inconsequential because ultimately they were implicated by authorities in the United States for illegal financial transactions involving the parent firm.

⁷⁰ Consequently the campaign to outlaw corrupt practices globally, such as the United Nations Convention Against Corruption.

⁷¹ The relationship between France and its former African colonies were described by one author as ‘fundamentally corrupt.’ The Elf-Aquitaine affair is merely symptomatic of the complex economic nature of these circumstances. Jean-François Médard, ‘France-Africa: Within the Family’, *Democracy and Corruption in Europe*, eds. Donatella Della Porta and Yves Mény (London and Washington: Pinter, 1997), p. 23.

⁷² Jon Henley, ‘Gigantic sleaze scandal winds up as former Elf oil chiefs are jailed’, *The Guardian* (London), 15 November 2003; John Tagliabue, ‘3 Elf executives convicted of graft’, *International Herald Tribune* 14 November 2003.

Territorial jurisdiction was treated as immaterial to the pursuit of domestic justice.⁷³ The OECD objective in their report investigating corporate vehicles and illegal conduct is to simplify access to information that *may* be involved in some criminal activity. Note that this treatment of the illicit resonates with the solution to the level playing field proposed by the OECD's Global Forum. As noted above, in order to 'level the playing field' and achieve an effective exchange of information any domestic laws involving banking confidentiality and the legal requirement that the case in question involve conduct considered criminal in both jurisdictions no longer apply.⁷⁴

Concluding thoughts on collective action

Some authors have suggested that the effort for international tax harmonisation (or at the very least tax-related information exchange) is simply one aspect of the larger process of globalisation.⁷⁵ Increases in trade volume and the increased internationalisation of manufacturing and services have created negative effects for public welfare. Consequently, international co-ordination on taxation may be seen as part of a broader effort to reduce the negative impact of events and activities that spill over the territorial boundaries of one state into the territory of another state.⁷⁶ The larger effort by developed economies to stabilise the international financial sector also includes international standards

⁷³ A similar concern involved changes made to U.S. banking laws following the 2001 terrorist attacks and was raised in the Commonwealth Law Ministers meeting in 2002. 'Ministers noted that the provisions of the US legislation have the potential to circumvent mutual legal assistance treaties between member countries and the United States.' Commonwealth Secretariat, 'Minutes and Memorand for the 2002 Meeting of Commonwealth Law Ministers and Senior Officials' (Kingston, St. Vincent and the Grenadines, 18 - 21 November 2002), p. xiii. The USA Patriot Act is discussed further below in chapter 8.

⁷⁴ See Organisation for Economic Co-operation and Development, *The OECD's Project on Harmful Tax Practices (2001)*, p. 11.

⁷⁵ Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', *Harvard Law Review* 113, no. 7 (2000); Johan Deprez, 'International tax policy: recent changes and dynamics under globalization', *Journal of Post Keynesian Economics* 25, no. 3 (2003); Philipp Genschel, 'Globalization, Tax Competition, and the Welfare State', *Politics and Society* 30, no. 2 (2002).

⁷⁶ This includes environmental problems, the flow of illegal narcotics, 'blood diamonds' from central Africa, and refugees (economic and political).

for bank capitalisation and supervision (the Basle Accord) and recommendations to combat money laundering (the Financial Action Task Force). A broad co-ordination of the efforts by a number of international financial agencies and institutions is managed through the Financial Stability Forum, which has prepared a compendium of relevant international standards.⁷⁷ Compliance costs for these activities are small within the context of a large developed economy, yet the impact for a small developing economy with limited resources looms large. The Attorney General of the Bahamas described the OECD project to be representative of globalisation's 'dark side', and he 'conceded that certain provisions of the [legislative] regime were impractical and "imposed unnecessary costs" on many financial institutions.' The government estimated it would cost \$45 million to implement the changes enacted in 2000 by the Bahamas in an effort to comply with the broad requirements of the tax competition project.⁷⁸

The Commonwealth has been effective in providing infrastructural support to small states to overcome the resource limitations. This support includes research work (such as the vulnerability studies), aggregation of interests (such as with non-resident WTO representation), and the creation of model legislation (for example a model law on money laundering). Existing as a venue in which to consolidate small state interests and to promote small state interests with a larger voice is only one aspect of the Commonwealth's involvement, even if this is the aspect often suggested by the foreign policy literature. Another aspect of the Commonwealth role involves the limitations confronting the small state, those of resources, capacity and the capability to create, legislate, regulate, administer, audit and report for all the myriad 'best practices' increasingly promulgated in the international community (financial, legal, environmental, counter-terrorism, etc.). The

⁷⁷ See <http://www.fsforum.org/compendium/about.html>.

Commonwealth has been instrumental towards facilitating a more inclusive discussion of tax competition, beyond the OECD club. The absence of some grand dramatic change in the treatment of OFCs does not mean this international governmental organisation has not had a positive influence on behalf of its small state members.

In his analysis of ‘weak-strong negotiations in the international economy’ J. P. Singh observed that ‘international organizations are usually storehouses of data/information during any negotiation’ and may utilise this knowledge advantage to persuade other participants in the negotiations.⁷⁹ In this case, the OECD has been an established storehouse of economic data for decades and has collected and analysed data on taxation throughout much of that time. The formation of the ITIO served to create an alternate viewpoint on these matters and specifically for the affected small jurisdictions. This alternative storehouse supplemented the support provided by the Commonwealth. Taken together these two OECD projects actively pursue a goal to control and regulate financial services beyond the direct legislative reach of OECD states. Juxtaposing the ITIO analysis of the OECD report on corporate vehicles with the tax competition project suggests the existence of a wider agenda against international financial services in the offshore landscape.

The observation that the Commonwealth possesses a ‘comparative advantage’ for engaging with the international/multilateral concerns of small states overlooks the nature of the organisation itself. The Commonwealth Secretary-General observed the fact that four Commonwealth members were also members of the OECD, and that this situation provided the opportunity for dialogue. Beyond that circumstance, however, is the fact that the Commonwealth serves as a venue for this disparate collection of states to meet and

⁷⁸ Martella Matthews, ‘Globalisation’s ‘dark side’’, *The Nassau Guardian* (Bahamas), 16 September 2003, Available: <http://www.thenassauguardian.com/business/296675893818414.php> [accessed 29 October 2003]; Simon Gray, ‘Dust settles after general election upset’, *International Money Marketing*, August 2002.

discuss amongst themselves matters of international concern. In this environment the small state representatives have the opportunity to express their viewpoints on these matters, and to highlight those items that possess a particular concern for them, for example trade in agricultural products or the environment and climate change.⁸⁰ They may both familiarise the other members' representatives to their concerns and lobby for their support when attending other international gatherings (for example the WTO and the EU). The shared history and common (for most members) legal tradition of the Commonwealth serve as a basis for mutual understanding and communication, or at least a starting position and common point of reference. To develop a sound and convincing argument, using the terms and concepts understood by larger states may be a case of small states 'using the weapons of the weak'. It is also the constructive problem solving approach touted by international institutions in order to reduce conflict and avoid violence in an anarchic international system.

⁷⁹ Singh, 'Weak Powers and Globalism', p. 461.

⁸⁰ Payne, 'Small States in the Global Politics of Development'.

CARIBBEAN OFFSHORE FINANCE UNDER PRESSURE

Sometimes it seems as if small states were like small boats pushed out into a turbulent sea, free in one sense to traverse; but, without oars or provisions without compass or sails, free also to perish.

– Shridath Ramphal¹

As discussed in the previous chapter, the Commonwealth sought to assist its small state members with the OECD and the project against harmful tax competition. In this chapter the focus is on the several of the Caribbean jurisdictions themselves. There are sixteen offshore financial centres in the Caribbean, along with the North Atlantic island of Bermuda, which is often grouped together with the Caribbean OFCs in studies of global finance. Eight of these financial centres are sovereign states: Antigua and Barbuda, the Bahamas, Barbados, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. The remaining offshore financial centres are located in non-self governing jurisdictions, six British (Anguilla, Bermuda, the British Virgin Islands, the Cayman Islands, Montserrat, and the Turks and Caicos Islands), two Dutch (the Netherlands Antilles and Aruba), and the United States-associated Commonwealth of Puerto Rico. Underscoring the observations of Shridath Ramphal (at the time, Commonwealth Secretary-General), there are a number of hazards in the waters surrounding these small ships of state, including natural disasters, transnational crime, and American foreign and economic policy for the Caribbean region. Accompanying the fear that a state might be ‘captured’ by the offshore business sector, there is also a potential for

¹ Shridath Ramphal, ‘Small is Beautiful But Vulnerable’, *The Round Table*, no. 292 (1984), 369.

the state to be captured by external criminal elements.² In many cases, these islands support only one significant exportable cash crop, which is then subject to the vagaries of the global market place. Taken together, these obstacles to economic development and democratic freedom create an atmosphere of vulnerability affecting citizens and their governments. The specific involvement of the United States with offshore finance is discussed in the next chapter.

Several research projects have attempted to quantify and understand the specific characteristics of small state vulnerability and the Commonwealth sponsored some of this work. The rationale of these research efforts and their conclusions are discussed in the next section. One aspect of small state vulnerability is the limited range of economic opportunities available to these small territories. The major economic sectors for many of the Caribbean islands are tourism, bananas, sugar and offshore business services. Data from several of them are presented in more detail in the second section of this chapter. The argument highlights the role and importance of the offshore financial business to these specific jurisdictions. The Central Bank of the Bahamas for example, has tracked the contribution of the financial services industry to their national economy over a number of years. By contrast, while Dominica and St. Vincent possess small offshore financial centres, for these two small states it has been banana cultivation that historically was the major source of employment and export income. Finally, the British non-self-governing territory of the Cayman Islands is widely acknowledged as one of the largest financial centres in the world. For this small territory banking and financial services has become a significant factor in the economy, originally as a means to overcome the vulnerable

² For the argument that an offshore business sector has 'captured' the state apparatus, see Mark P. Hampton and John Christensen, 'Treasure Island revisited. Jersey's offshore finance centre crisis: implications for other small island economies', *Environment and Planning A* 31 (1999); Mark P. Hampton and John Christensen, 'Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance', *World Development* 30, no. 9 (2002). Similar to this is the concept of a 'shadow government', which one author identified as a problem in Belize. See Rosaleen

characteristics of agriculture and tourism. Ironically, offshore financial services are now themselves a source of vulnerability for the small developing economy.

The third section of this chapter provides a broader discussion of financial flows to and through the Commonwealth Caribbean. This analysis of international banking combines data from the Bank for International Settlements (BIS), the Eastern Caribbean Central Bank (ECCB), and a number of the individual jurisdictions. It considers the impact of the various global initiatives to constrain, restrain, manage and control offshore finance, whether as an environment permitting criminal money laundering or facilitating civil tax avoidance. The impact of these measures on local employment and revenue is highlighted because they are the reason for resistance to the OECD project, in particular by the small Caribbean jurisdictions.

Quantifying vulnerability

Stephen Ambrose wrote that the intervention in Grenada by the United States in 1983 was a success for ‘gunboat diplomacy’.³ Outside of the U.S. however, it was heard as a wake-up klaxon directed at America’s nominal allies within the Commonwealth. It represented a reminder that American perceptions of *its* national interests superseded other obligations. It is not a new message, reflecting as it does the history of U.S. foreign policy in the Caribbean and Latin America. The Monroe Doctrine anchors the traditional American policy in the Western Hemisphere, and it was first announced in 1823 with the intention of keeping the European powers out. The fact that Grenada was a member of the Commonwealth was immaterial to the U.S. decision to invade the island. ‘The flagrant

Duffy, ‘Shadow players: ecotourism development, corruption and state politics in Belize’, *Third World Quarterly* 21, no. 3 (2000).

³ Stephen E. Ambrose, *Rise to Globalism: American Foreign Policy Since 1938*, fourth revised ed. (New York: Penguin, 1986), p. 332.

intervention into the internal affairs of a small (but still sovereign) state was apparently the last straw: this was the catalyst that led to a spate of treatises highlighting and exposing powerlessness and dependency.⁴ Godfrey Baldacchino's observation certainly describes the range of research on small states sponsored by the Commonwealth in the 1980s.

The invasion was widely criticised by many located outside of the region, even though the governments of several other Caribbean states supported the U.S. intervention, including Antigua, Barbados, Dominica, Jamaica, St. Lucia, and St. Vincent.⁵ For example, the Commonwealth Secretariat convened a Consultative Group and tasked it to consider the consequences for small states denoted by the intervention in Grenada. This group's report was published in 1985, and had a strong emphasis on security issues that was consonant with the experience of the times.⁶ Following the end of the Cold War concerns shifted, and a subsequent report produced by the Commonwealth Secretariat analysing the predicament of small states addressed the economic and development challenges facing small states, reducing the emphasis upon security.⁷

Studies of small state vulnerability and the effort to quantify it were one line of research work taken in response to the 1985 Commonwealth report. In particular, this

⁴ Godfrey Baldacchino, 'The Challenge of Hypothermia: A Six-proposition Manifesto for Small Island Territories', *The Round Table*, no. 353 (2000), p. 66. Baldacchino lists eight specific works, including the Commonwealth Consultative Group's 1985 report on *Vulnerability*, and C. E. Diggins, 'The Problems of Small States', *The Round Table* Special edition, 75th anniversary issue (1985); Sheila Harden and David Davies Memorial Institute of International Studies, *Small is Dangerous: Micro States in a Macro World; Report of a Study Group of the David Davies Memorial Institute of International Studies* (London: Frances Pinter, 1985); Colin G. Clarke and Anthony Payne, *Politics, security and development in small states* (London: Allen & Unwin, 1987). Further publications include M. Abdul Hafiz and Abdur Rob Khan, eds., *Security of Small States* (Dhaka, Bangladesh: University Press Limited, 1987); United Nations General Assembly, 'Protection and security of small states', *A/RES/44/51* (1989); Helen M. Hintjens and Malyn D. D. Newitt, eds., *The Political Economy of Small Tropical Islands: The Importance of Being Small* (Exeter: University of Exeter Press, 1992); Hiroshi Kakazu, *Sustainable Development of Small Island Economies* (Boulder: Westview Press, 1994).

⁵ Patrick E. Tyler and David Hoffman, 'U.S. Invades Grenada, Fights Cubans', *The Washington Post* 26 October 1983, p. A1. Reflecting back on the event, one could re-conceptualise the invasion as a precursor for the humanitarian interventions of the 1990s. See also Patsy Lewis, 'Revisiting the Grenada Invasion: The OECS Role and its Impact on Regional and International Politics', *Social and Economic Studies* 48, no. 3 (1999).

⁶ Commonwealth Secretariat, *Vulnerability: Small States in the Global Society* (London: Commonwealth Secretariat, 1985).

⁷ Commonwealth Advisory Group, *A Future for Small States: Overcoming Vulnerability* (London: Commonwealth Secretariat, 1997).

effort attempted to quantify the vulnerability inherent to the small island economy (SIE).⁸ A number of factors were studied, including natural disasters, economic dependence on a single export crop and environmental vulnerability. Global warming projections for example suggest that there could be an extensive melting of the polar ice caps and mountain glaciers. This melting would in turn raise sea levels and thereby inundate many low-lying islands, as well as low-lying continental coastal areas. As a result, the issue of global warming is a vital concern for small islands, even though the impact would be substantially the same for any low-lying coastal areas.⁹

The validity of the methods and conclusions reached by the effort to demonstrate empirically a significant difference in the economic, political and social conditions of small states versus other states has been contested. Nonetheless, it serves to emphasise two points: first, that there is a self-perception of difference among the residents of these societies, and this perception is conveyed and maintained by the external institutions and individuals that study small states. The second point is the diversity of topics for which size and location are considered factors in the efficient operation of an economy, both in its utilisation of resources and in its ability to provide for its citizens. The problem involves 'economies of scale' and some specific sectors are communication and transportation connections, and ready access to training and education resources.¹⁰ Both points are part of the challenge facing the capacity and capability of a small state to participate in the global economy.

⁸ Lino Briguglio, 'Small island developing states and their economic vulnerabilities', *World Development* 23, no. 9 (1995). See also the short comparative summary by Robert Read, 'Growth, economic development and structural transition in small vulnerable states', *Globalization, Marginalization and Development*, ed. S. Mansoob Murshed (London and New York: Routledge, 2002), pp. 179 - 181.

⁹ Another organisation, the Alliance of Small Island States (AOSIS), addresses the common concerns and challenges facing island and low-lying coastal microstates (AOSIS is associated with SIDSnet – Small Island Developing States Network, the Global Network for the Barbados Programme of Action).

¹⁰ The effect of economies of scale on transportation services for example involves the number and frequency of airline flights and freighter visits. See Gorgon Titchener, 'The Role of Transportation in the Trade Patterns of the Lesser

The Commonwealth report, *A Future for Small States*, referred to the ‘pioneering work of Briguglio’ in demonstrating a correlation between size and economic vulnerability (for small island developing states).¹¹ The report also noted the intention of the Commonwealth Secretariat to ‘refine the index with the example of the widely-used Human Development Index very much in mind.’¹² This in turn led to the creation of the Commonwealth Vulnerability Index (CVI).¹³ The factors used by the Index to derive the score for any particular state are: economic exposure, remoteness and insularity, susceptibility to environmental events, and other sources. The last factor was a catchall variable for the model as an attempt to capture and incorporate other, less quantifiable, factors such as government stability and emigrant labour remittances. The results of the modelling exercise demonstrated that remoteness was not a necessary and sufficient cause of vulnerability. Reliance on a single commodity and susceptibility to natural disasters are also significant influences on any individual state’s vulnerability index score.¹⁴

The significant conclusion reached by Christopher Easter was that because the primary factor influencing a small state’s vulnerability differed from state to state, any attempt to address this vulnerability must necessarily also differ between individual states. In sum, there is no single solution than can be applied across the board for all small states.¹⁵ The conclusions made in the report’s presentation of the vulnerability index

Antilles’, *The Political Economy of Small Tropical Islands: The Importance of Being Small*, eds. Helen M. Hintjens and Malyn D. D. Newitt (Exeter: University of Exeter Press, 1992).

¹¹ Commonwealth Advisory Group, *A Future for Small States*, p. 15. The statement is referring to Briguglio, ‘Small island developing states and their economic vulnerabilities’.

¹² Commonwealth Advisory Group, *A Future for Small States*, p. 15.

¹³ Jonathan P. Atkins, et al., *A Commonwealth Vulnerability Index for Developing Countries: The Position of Small States* (London: Commonwealth Secretariat, 2000). One of the co-authors published an earlier article outlining the results in 1999. See Christopher Easter, ‘Small States Development: A Commonwealth Vulnerability Index’, *The Round Table*, no. 351 (1999).

¹⁴ For example, consider the extensive evacuation and devastation of the Caribbean island of Montserrat, following the resumption of volcanic activity.

¹⁵ See the Appendix to his article for a complete discussion of the model and its results. Easter, ‘Small States Development: A Commonwealth Vulnerability Index’, pp. 413 - 422.

emphasise a further point concerning the use of this evaluation. The Commonwealth Vulnerability Index was ‘designed as an indicator of vulnerability, not as a means to identify LDCs or to indicate level of development status.’¹⁶ This last point is especially relevant when assessing the criticism made with respect to the Vulnerability Index project.

Contradicting these conclusions, two World Bank economists found that after controlling for a variety of variables, ‘small states have on average higher income rate and productivity levels than large states.’¹⁷ In their model, these authors considered per capita income, growth, openness and volatility, and opportunities for diversification. The broad conclusion from this latter analysis was that it is not necessary to create special measures in support of small states. Income rates in small states were similar to other states in their respective regions, and growth rates were not significantly different between small and large states. It was only in the area of trade volatility that smaller states suffered, ‘but this is largely due to their greater trade openness—and the net benefits of openness on growth are positive.’¹⁸ The authors acknowledged that small states have economic problems; nevertheless they concluded that these problems were no different from any experienced in other poor economies.

These two models are operating at cross-purposes and evaluating different data in order to arrive at their differing conclusions. The Commonwealth Vulnerability Index focused on factors that distinguish the vulnerable aspects of an economy (and a small state as a society) not only in the present, but also for the future. The work of Easterly and Kraay on the other hand, analysed discrete economic data for economic performance

¹⁶ Atkins, et al., *A Commonwealth Vulnerability Index for Developing Countries*, p. 26.

¹⁷ William Easterly and Aart Kraay, ‘Small States, Small Problems? Income, Growth, and Volatility in Small States’, *World Development* 28, no. 11 (2000), p. 2014.

¹⁸ *Ibid.* p. 2024. Therefore, because the net benefits are positive for society as a whole, the negative impact experienced by any individual person or firm was acceptable for the greater good. While trade openness is frequently encouraged for small developing economies, it is not practised by the developed economies. Consider the U.S. implementation of steel tariffs to reduce the impact of imported steel on the domestic industry in 2001 as an example.

between 1960 and 1995. An argument that preferential treatment is not needed, based on past performance, should be treated cautiously given that the small developing economies of concern were operating with preferential trade regimes during the data period. Therefore, the recommendation that the Commonwealth Vulnerability Index be used as a tool for evaluating vulnerability, rather than as a means to assess developmental status remains reasonable. This may not be sufficient to convince the WTO as a trade organisation that small states require special trade regime treatment, an objective for which vulnerability studies are often cited.¹⁹ However, the results deserve consideration in any evaluation of the economic situation of a small state.

In addition to these small state vulnerability studies there is the research program of Harvey Armstrong, Robert Read, and their colleagues. In addition to small developing states, they considered the economic status of the small state members of the European Union. The noteworthy aspect of their research conclusions for European small states is the similarity that they have to the economic development choices made by Caribbean small states. In the 1995 *World Development* article discussing EU small states and autonomous regions they concluded,

The most successful of the micro-states and autonomous regions are those with well-developed financial service sectors (the single most important variable), a valuable natural resource base (endowment) or a strong tourism sector (in this order of importance) – or some combination of these three factors.²⁰

This conclusion could just as readily have been applied to the more successful small Caribbean jurisdictions at that time (for example the Bahamas and the Cayman Islands). Their subsequent research work however, concluded that the vulnerabilities inherent to

¹⁹ Paul Sutton, for example, felt that the effort to quantify vulnerability was unlikely to convince sceptics due to the 'multidimensional' nature of vulnerability; Paul Sutton, 'On Small States in the Global System: Some Issues for the Caribbean (with particular reference to financial flows and aid effectiveness)', *Caribbean Survival and the Global Challenge*, ed. Ramesh Ramsaran (Kingston, Jamaica: Ian Randle Publishers, 2002), p. 101.

²⁰ Harvey Armstrong and Robert Read, 'Western European Micro-States and EU Autonomous Regions: The Advantages of Size and Sovereignty', *World Development* 23, no. 7 (1995), p. 1239.

remoteness and size that affect many small states are aggravated by efforts in the WTO and elsewhere to create a level playing field in the global economy.²¹ This conclusion reinforces the concern with vulnerability amongst many Commonwealth small states—the impact of size and distance upon their small economies. Of particular relevance here has been the change of attitude towards the use of financial services as a means for achieving economic development. The OECD’s campaign against harmful tax competition represents this new attitude towards offshore finance.

A further observation to be made about longitudinal economic analysis such as that applied in vulnerability studies is the limited recognition afforded to the historical trajectory of what are predominately former colonial societies. Present economic circumstances are the result of an accumulation of trade and agriculture decisions that may go back two hundred years in some instances. During its time as a colony economic decisions would often be made within the context of the larger collectivity of the metropole state and its other colonies. In this context the preferential treatment for the products of any individual subordinate colony was accepted practice. The practice of preferential treatment continued after independence, but in recent years has come to be challenged by the principles of free and open trade amongst all states promulgated by the WTO. Just as with location, size and the weather, history also makes these small jurisdictions vulnerable.

Notwithstanding the economic and quantitative analysis of small state vulnerability, in part vulnerability is a matter of perception. If investors perceive a location to be particularly vulnerable (whether due to government instability, prevailing weather patterns leading to frequent hurricanes, or a reliance upon a single agricultural product) they will not

²¹ See Harvey W. Armstrong and Robert Read, ‘The importance of being unimportant: The political economy of trade and growth in small states’, *Issues in Positive Political Economy*, ed. S. Mansoor Murshed (London: Routledge, 2002).

necessarily invest in that location.²² Correspondingly, if residents perceive themselves as living in a particularly vulnerable location, the perception encourages emigration, in addition to requests for special and differential treatment on trade and finance activity from international organisations. Perceptions are just as much a factor in the decision-making process as the use of econometric figures and other data. The perceptions surrounding small state vulnerability become judgements upon their political stability and a risk factor for financial and investment analysts.²³ Moreover, they are an unquantifiable component of reputation, and all financial centres seek to create a good reputation, whether or not they exist ‘offshore’, in order to retain current business and attract new business.²⁴

The imbalance between the OECD and any individual jurisdiction hosting a targeted offshore financial centre inherently emphasises the vulnerable position of the small state/territory. These studies suggest that perceptions of economic vulnerability should have induced those small states hosting an OFC to be extremely cooperative with the OECD project. As will be seen, the offshore business sector is a valuable source of revenue in these jurisdictions. It would appear to the outside observer that co-operation with the OECD (with an intention to reach a resolution maintaining current levels of government revenue) is a reasonable decision. Instead, as discussed in the previous chapter, efforts were made to assemble a collective response amongst the affected jurisdictions, via the Commonwealth and with the creation of a purpose-built organisation (the International Tax and Investment Organisation). But as will be seen below, even though these jurisdictions are vulnerable, and their business affected by the harmful tax

²² Similar to this perspective is the business case used to explain foreign direct investment in manufacturing facilities. Recall the one explanation offered for the decision by Intel to place a global facility in Costa Rica, which included political stability, infrastructure, and quality of life. See above, chapter 1.

²³ Richard Anthony Johns, *Tax Havens and Offshore Finance: A Study of Transnational Economic Development* (London: Frances Pinter, 1983), p. 191.

²⁴ Recall that the proposed OECD ‘blacklisting’ of non-cooperative jurisdictions explicitly affects the reputation of the OFC in question.

competition project, the overall effect does not include a reduction in foreign deposits amongst the Caribbean OFCs.

Caribbean Offshore Financial Centres

The origins of offshore finance within international finance were presented above in Chapter 3. While the OECD's harmful tax competition initiative with respect to small states is the case used in this study of state sovereignty, it is not the only international programme addressing offshore finance and offshore financial centres. The Financial Action Task Force (FATF) was introduced in chapter 5 with specific reference to its use of a 'blacklist' to identify 'non-cooperative countries and territories' (in that instance, the experience of the Philippines was outlined). From the Caribbean the FATF list contained Antigua and Barbuda, the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, Dominica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.²⁵ The impact of this listing on the specific Caribbean jurisdictions covered in this chapter is included when relevant.

This section considers four of the available sixteen jurisdictions with offshore financial centres in the Caribbean. The selection includes one state with a relatively large sector, the Bahamas, and two states with comparably small sectors, Dominica and St. Vincent and the Grenadines. The fourth example represents the non-self-governing jurisdictions of the Caribbean, the Cayman Islands, which is also a major actor in offshore finance. An offshore financial centre provides more than just banking services. In the Caribbean, various jurisdictions also specialise in providing international business company

²⁵ Financial Action Task Force, *Review to Identify Non-Cooperative Countries or Territories: Increasing the World-Wide Effectiveness of Anti-Money Laundering Measures*, English, 22 June 2000, PDF file, Available: http://www.fatf-gafi.org/pdf/NCCT2000_en.pdf [accessed 21 March 2002]. The other jurisdictions identified on this first 'blacklist' included Belize, the Cook Islands, Cyprus, Gibraltar, Guernsey, the Isle of Man, Jersey, Israel, Lebanon, Liechtenstein, Malta, the Marshall Islands, Mauritius, Monaco, Nauru, Niue, Panama, Philippines, Russia, and Samoa.

registrations, insurance company registrations, shipping registrars, and mutual (hedge) funds.

The emphasis in this review of offshore finance in the Caribbean is on the material economic contribution for the jurisdiction coming from the presence of an OFC. As already highlighted in chapter 3, for economic development in a small jurisdiction the OFC provides both employment and government revenue. Spillover effects for other local industries, construction, tourism, etc. accompany these direct contributions. However, it will quickly become apparent that in most instances, the economic contribution of the OFC to the local economy has declined since 1998. At the same time, the following analysis of the flow of mobile capital through the Caribbean finds that the foreign assets reported on deposit in local institutions increased over the period in question.

The Bahamas

The Bahamas is a chain of islands lying close to Cuba and Florida, and it has been a significant global player in the offshore business sector for a number of years.²⁶ One author attributed the development of offshore banking in the Bahamas during the 1960s to banking regulation in the United States.²⁷ Its economy is heavily dependent on tourism (mostly from North America) and on offshore business. A study of offshore banking in the Bahamas published in 1985 noted that offshore banks contribute to the local economy not only via the employment provided, but also through foreign exchange. In particular, this ‘foreign exchange benefit arises from the fact that since the “pure” offshore banks have no Bahamian dollar income, all local expenses’ would be satisfied with foreign

²⁶ In 1983, Richard Johns identified five major offshore financial centres in the Caribbean basin – Bermuda, the Bahamas, the Cayman Islands, the Netherlands Antilles, and Panama. Johns, *Tax Havens and Offshore Finance*, p. 191.

²⁷ Carlene Y. Francis, ‘The Offshore Banking Sector in the Bahamas’, *Social and Economic Studies* 34, no. 4 (1985), pp. 92 - 93.

currency converted to Bahamian dollars.²⁸ During the period 1990 - 1998, the Bahamian services sector absorbed 80 per cent of the labour force, and in 2000 tourist receipts contributed 67 per cent of total export earnings. Tourist receipts amounted to a total of US\$ 1,814 million in 2000, 38 per cent of GDP (US\$ 4,800 million).²⁹ The global economic slowdown and decline in tourism after 2001 hit the Bahamian economy hard, and the offshore financial services sector also experienced a decline.³⁰ The economic impact on offshore services was in part also a result of new legislation targeted at strengthening anti-money laundering enforcement in the Bahamas.

The action to strengthen the anti-money laundering laws was a necessary response to the FATF report in 2000, which included the Bahamas on the list of non-co-operative 'countries or territories'. The FATF report found that '[a]lthough the Bahamas has comprehensive anti-money laundering legislation, there are serious deficiencies in its system.'³¹ It did point out as well that new legislation was pending in the Bahamas that would address the weak points identified. The revised legislation was enacted and subsequently the Bahamas was removed from the list of non-co-operative jurisdictions in 2001. From the perspective of the FATF and other organisations dealing with the problem of international money laundering, this case was represented as a 'success' for blacklisting as a method to persuade states to implement FATF-approved standards. Within the Bahamas, the new legislation led to the closure of a number of institutions unable or unwilling to comply with some aspect of them.

The Central Bank of the Bahamas in its reports highlighted one specific change in the new licensing requirements. There is now a requirement for financial institutions to

²⁸ Ibid. pp. 98 - 99.

²⁹ Commonwealth Secretariat, *Small States: Economic Review and Basic Statistics*, vol. 8 (London: Commonwealth Secretariat, 2003), pp. 111, 135.

³⁰ Ibid., p. 9.

³¹ Financial Action Task Force, *Review to Identify Non-Cooperative Countries or Territories (2000)*, p. 2.

maintain ‘an appropriate physical presence in the jurisdiction’. In March 2001, an analysis of the impact of the new regulation to offshore banking in the Bahamas predicted ‘that approximately 60 banks will not be able to comply with the new physical requirements and will wind-up their managed operations’.³² This analysis proved to be accurate, for the number of offshore banks and trusts licensed by the Bahamas declined from 395 in 1999 to 333 in 2001 and then down to 250 in 2003.³³ The decline in the number of institutions was accompanied by a decline in employment within the financial services sector. More recent analysis from the Central Bank remained optimistic about the long-term consequences of the changes in financial sector regulation. ‘Ongoing efforts to strengthen the supervisory framework should enhance The Bahamas’ reputation as a safe, well regulated jurisdiction.’³⁴ The reason for this continued optimism is clear, for even with ‘a significant reduction in the number of licensed banks and trust companies’, the financial services sector of the Bahamas continued to contribute an estimated 15 to 20 per cent of GDP in 2004.³⁵

Dominica and St. Vincent

Dominica is a small island in the Lesser Antilles. Together with Grenada, St. Lucia, and St. Vincent and the Grenadines it comprises the Windward Islands. The Central Intelligence Agency’s *World Factbook* introduces its entry for the island with the observation that it was the last to be colonised by Europeans ‘due chiefly to the fierce resistance of the native Caribs’.³⁶ The island is described as rugged and mountainous with lush and varied flora and fauna. Consequently, its natural resources are timber, hydropower and

³² The Central Bank of the Bahamas, *Quarterly Economic Review* 10, no. 1 (2001), p. 38.

³³ See Appendix A, Table 1 for the figures on licensed institutions and employees.

³⁴ The Central Bank of the Bahamas, *Quarterly Economic Review* 13, no. 1 (2003), p. 43.

³⁵ *Ibid.* p. 34.

³⁶ Central Intelligence Agency, *World Fact Book*, 1 January 2002, Web pages/Download zip file, Central Intelligence Agency, Available: <http://www.cia.gov/cia/download.html> [accessed 11 June 2003].

agriculture. Agricultural land constitutes approximately 20% of the island's 754 square kilometres of territory and is used primarily for bananas. In addition to the impact of hurricanes on the banana industry, banana exports were also affected by changes to the banana trade agreements affecting the Caribbean industry over the past decade.³⁷ The contribution of agriculture to the island's economy as a result has declined, from 1988 when it comprised 28.8 per cent of GDP down to a recent 17.6 per cent (2003).³⁸ A lack of beaches on the island's rugged coastline and the absence of an international airport hamper Dominica's ability to diversify into the tourist sector. Consequently, Dominica turned to offshore financial services for economic development diversification. The legislation establishing the offshore sector was enacted in 1996 with the goal of positioning the jurisdiction as a low cost service provider.³⁹

The IMF report on *Caribbean Offshore Financial Centers*, included data for Dominica's offshore sector for the year 2001. In their report the IMF listed five offshore banks, six gaming companies and 7,536 IBCs; in addition to these entities, the report indicated that there were also two offshore insurance companies and five trust companies. By contrast in August 2004, Dominica reported that their offshore sector comprised one offshore bank, four Internet gaming companies and approximately 1200 international business companies (IBCs) a significant decline in three years. As a contributor to Dominica's GDP, Banks and Insurance provided 10.4 percent in 1988, and had increased only to 13.2 percent by 2003. This economic sector has failed to offset the decline in the banana industry over the

³⁷ For a discussion on the EU Banana Regime trade dispute see Christopher Stevens, 'Trade with Developing Countries: Banana Skins and Turf Wars', *Policy-Making in the European Union*, eds. Helen Wallace and William Wallace, Fourth ed. (Oxford: Oxford University Press, 2000).

³⁸ Percentages calculated from Eastern Caribbean Central Bank data on GDP by Economic Activity at Factor Cost, in Constant Prices. See Appendix C, Table 3.

³⁹ Jackie Feracho and Wendell A. Samuel, 'Regulation and Financial Services Development in the ECCB Area', *Social and Economic Studies* 46, no. 2 & 3 (1997), p. 250; Esther C. Suss, et al., *Caribbean Offshore Financial Centers: Past, Present, and Possibilities for the Future*, Working Paper of the International Monetary Fund, WP/02/88 (Washington, D.C.: International Monetary Fund, 2002), pp. 29 - 30.

period 1988 - 2003. Agriculture provided 28.8% of GDP in 1988, dropping to 17.7% of GDP by 2003.⁴⁰

The small offshore sector of Dominica was identified by the FATF as a non-cooperative jurisdiction in their first report in 2000 and was removed from the blacklist in October 2002. The 2003 report listed Dominica as 'among the first to place its offshore banks under the direct supervision of the Eastern Caribbean Central Bank (ECCB), in conjunction with the local supervisory authorities'.⁴¹ Other changes undertaken by Dominica were the establishment of a financial intelligence unit and new legislation strengthening anti-money laundering capabilities. By coordinating bank supervision with the ECCB, Dominica was able to overcome the FATF concern that their OFC appeared to be 'largely unregulated'.⁴²

The circumstances of the collection of islands and cays known as St. Vincent and the Grenadines are similar to Dominica. These islands are volcanic and mountainous, and their natural resources consist of hydropower and agriculture. Amongst these islands, 30 percent of the land is used for agriculture (out of a total area of 389 square kilometres). The most important crop has been historically bananas for export, but just as with the other banana producing Caribbean islands, their contribution to the economy has declined. In 1988 agriculture provided 21.2 percent of GDP for St. Vincent and the Grenadines, but by 2003 agricultural products had dropped to just 11.2 percent of GDP. Concurrently, the

⁴⁰ Percentages calculated from Eastern Caribbean Central Bank data on GDP by Economic Activity at Factor Cost, in Constant Prices. Research Department (Statistics Unit), *Statistics*, 2004, Web page, Eastern Caribbean Central Bank, Available: <http://www.eccb-centralbank.org/Statistics/index.asp> [accessed 25 July 2004]. Total GDP in 1988 was 351.7 million Eastern Caribbean dollars, and grew to 415 million (constant prices) by 2003. See Appendix C, Table 3.

⁴¹ Financial Action Task Force, *Annual Review of Non-Cooperative Countries or Territories*, English, 20 June 2003, PDF file, Available: http://www.fatf-gafi.org/pdf/NCCT2003_en.pdf [accessed 30 June 2003], p. 13.

⁴² Financial Action Task Force, *Review to Identify Non-Cooperative Countries or Territories (2000)*, p. 5.

contribution of the Banks and Insurance sector provided 7.4 percent of GDP in 1988 and increased slightly to provide 9.48 percent in 2003.⁴³

The offshore sector of St. Vincent and the Grenadines was established in 1976 to provide trust and international company registration services. It did not do as well as local officials had hoped.⁴⁴ As a result of the limited success with these services, the government of St. Vincent made a policy decision in 1996 to set the offshore financial services sector at 'the forefront of the national economy.' This policy required an extensive revision of existing legislation and the creation of additional legislation to define the limits and operation of their offshore financial services sector.⁴⁵ The revisions did not, however, find approval with the Financial Action Task Force with respect to the deterrence of financial crime. In particular, 'it was the strict secrecy afforded by the Confidentiality Act [1996] that brought St Vincent and the Grenadines to the attention of the [FATF].'⁴⁶ As with Dominica, the FATF identified St. Vincent's small offshore financial sector as a non-cooperative jurisdiction in 2000. The list of specific shortcomings included the absence of anti-money laundering regulations for the offshore sector and the limited resources that were allocated to supervising offshore financial institutions.⁴⁷ The government of St. Vincent enacted a series of further legislative changes to respond to the assessment results of the FATF. Again, as with Dominica, one change was the provision for joint supervision of offshore banks between the Eastern Caribbean Central Bank and the International

⁴³ Percentages calculated from Eastern Caribbean Central Bank data on GDP by Economic Activity at Factor Cost, in Constant Prices. See Appendix C, Table 4.

⁴⁴ Feracho and Samuel, 'Regulation and Financial Services Development in the ECCB Area', pp. 249 - 250.

⁴⁵ International Financial Services Authority, *Tracing the Development of St. Vincent and the Grenadines as an International Financial Centre*, September 2004, Web page, Available: http://www.stvincentoffshore.com/offshore_indus.htm [accessed 10 September 2004].

⁴⁶ Fitz-Roy Drayton, 'Anti-Money Laundering Legislation in St Vincent and the Grenadines', *Journal of Money Laundering Control* 7, no. 2 (2003), p. 170.

⁴⁷ Financial Action Task Force, *Review to Identify Non-Cooperative Countries or Territories (2000)*, p. 10.

Financial Services Authority of St. Vincent.⁴⁸ The IFSA emphasised the fact that the ECCB brought ‘a wealth of experience in banking supervision to the offshore sector.’⁴⁹

The size of the offshore finance sector within St. Vincent and the Grenadines is similar to Dominica but with some key differences. Data provided for August 2004 identified one offshore bank and 620 international business companies. There are a small number of international trusts, mutual funds and insurance firms, but no Internet gaming companies. These figures represent a decline in the size of St. Vincent’s offshore sector over the previous seven years. From the data provided by the IFSA of St. Vincent and the Grenadines, the number of offshore banks peaked in 2000, when there were 13 in these islands. Similarly, the high point for IBCs was 1999, when they reported that there were 2,704. This pattern holds for the other offshore entities based in St. Vincent and the Grenadines. Even with some fluctuations between 1997 and 2004, in general there were fewer offshore entities in each category in 2004 than in previous years.⁵⁰

The varied experiences of the OFCs in the Bahamas, Dominica and St. Vincent reflect their historical circumstances. As mentioned, the Bahamas have operated a successful OFC for several decades. It has a long established reputation and an experienced workforce that is particularly focused on offshore banking and investment services. As a result, the Bahamas had the capacity to respond to international pressure effectively and, further, to establish a bilateral agreement with the U.S. on the exchange of tax information.⁵¹ This agreement maintains a positive relationship with the OFC’s largest

⁴⁸ Drayton, ‘Anti-Money Laundering Legislation in St Vincent and the Grenadines’, pp. 172 - 173; Financial Action Task Force, *Annual Review of Non-Cooperative Countries or Territories (2003)*, p. 6.

⁴⁹ International Financial Services Authority, *Tracing the Development of St. Vincent and the Grenadines as an International Financial Centre*.

⁵⁰ The data provided by the International Financial Services Authority of St. Vincent and the Grenadines is available in Appendix A, Table 5.

⁵¹ David Spencer, ‘OECD Project on Tax Havens and Harmful Tax Practices: An Update (Part 2)’, *Journal of International Taxation* 13, no. 5 (2002), p. 36.

source of customers.⁵² By contrast, both Dominica and St. Vincent were smaller centres and not as well established. They sought to establish and extend their presence by competing on cost and, at least from the perspective of the FATF, limited regulation. Their response to the international pressure was both to change legislation governing the offshore sector and to increase banking sector supervision with the assistance of the Eastern Caribbean Central Bank. As a consequence, these two smaller jurisdictions were no longer as attractive as was formerly the case and their business shrunk. The experience of the Cayman Islands was different from these three small states, as discussed in the next section.

British Overseas Territories

In 1997, the new British government initiated a review of Britain's relationship with its dependencies. One of the results of this review was the re-designation of these non-self-governing jurisdictions as the British Overseas Territories, replacing their previous identification as the Dependent Territories. A number of these Overseas Territories are located in the Caribbean, specifically Anguilla, the British Virgin Islands, the Cayman Islands, Montserrat, and the Turks and Caicos Islands. The British government White Paper published in 1999 identified four significant motivating factors for the review. These factors were the election of a new British government in 1997; the increase of volcanic activity on Montserrat; an increased awareness of the economic problems facing these small jurisdictions (particularly St. Helena); and, most importantly for this discussion, 'the growing significance of the offshore financial centres – in particular, Bermuda, the Cayman

⁵² Lindsay Thompson, 'Clients' job to provide credit card data to U.S. IRS', *The Nassau Guardian* (Bahamas), 18 March 2003, Available: <http://www.thenassauguardian.com/business/284215735111517.php> [accessed 3 April 2003]; Martella Matthews, 'TIEA will "boost tourism"', *The Nassau Guardian* (Bahamas), 11 December 2003, Available: <http://www.thenassauguardian.com/business/377187935495657.php> [accessed 7 January 2004].

Islands, and the British Virgin Islands'.⁵³ Again, while the islands of Bermuda are actually located in the North Atlantic Ocean some distance from the Caribbean Sea, they are often grouped with the jurisdictions of the Caribbean with regards to offshore finance.

In general, the trends in offshore finance that are found in the sovereign small states are present also in these small non-self-governing jurisdictions. As offshore financial centres, they range in size from Montserrat, suffering from the depredations of a number of volcanic eruptions over the past 10 years, to the Cayman Islands, which is widely recognised as a global financial centre. Indeed, the Financial Services Commission of Montserrat replied to a request for data on their offshore business sector by stressing the impact of the volcano upon the industry. Even though they feel that the volcano has had far greater impact on Montserrat than any OECD initiatives, they nevertheless intend to revive their offshore industry.⁵⁴

The Cayman Islands on the other hand are the exemplar for a small jurisdiction offshore financial sector. In 2003, the offshore sector in the Caymans included 322 banking trust firms (Category 'B' licenses), 644 captive insurance firms, 4,808 registered offshore mutual funds (also known as hedge funds), and 68,078 registered companies.⁵⁵ As the business most directly affected by the OECD harmful tax competition project, the number of banking trust firms has declined from the number licensed in 1997.⁵⁶ Similar to the offshore financial sector of other jurisdictions, the downward trend has been in the number of firms operating in the international banking sector. The Cayman Islands Monetary Authority, however, did not specifically point at increased regulation concerning taxation and financial crimes as the cause for the reduction in the number of licensed firms.

⁵³ Secretary of State for Foreign and Commonwealth Affairs, *Partnership for Progress and Prosperity: Britain and the Overseas Territories* (London: Her Majesty's Stationery Office, 1999), Available: <http://www.fco.gov.uk/>.

⁵⁴ Personal correspondence with the author, 12 August 2004.

⁵⁵ The Category 'B' Banking and Trust license is issued specifically to firms providing services to international markets and performing inter-bank transactions.

Rather, the phrase most frequently used in their annual reports to explain the year to year fluctuation in the number of licenses was that changes resulted from ‘mergers and acquisitions in the global financial market’.⁵⁷

The downward trend in licenses issued to offshore banking institutions was not present in other segments of the Cayman Islands’ offshore business sector. Licenses issued for captive insurance firms, offshore mutual funds and registered companies have all increased throughout the period 1996 - 2003. The number of captive insurance firms licensed in 1996 was 418 and increased to 644 in 2003.⁵⁸ These firms reported total assets of US\$ 19.2 billion in 2003, up from the US\$ 8.4 billion reported for 1997. Likewise, the number of registered mutual funds grew from 1,335 in 1996 to 4,808 in 2003, a figure noted by the *Annual Economic Report* in 2003 as representing more than half of all hedge funds globally.⁵⁹ For the economy of the Cayman Islands, the fees collected on bank and trust licenses, insurance licenses, mutual funds administrators and company registrations generated between 18 and 28 percent of all government revenues in the period 2000 - 2003. As a point of comparison, revenue collected from taxes on international trade ranged between 34 and 39 percent during the same period.⁶⁰

Arguably, the view of the Cayman Islands Monetary Authority concerning the decline in the number of banks licensed in the Cayman Islands is accurate. Mergers are a

⁵⁶ Specifics are available at Appendix A, Table 3.

⁵⁷ Cayman Islands Monetary Authority, *Annual Report 2002*, (2003), p. 8; Cayman Islands Monetary Authority, *Annual Report 2001*, (2002), p. 6; Cayman Islands Monetary Authority, *Annual Report 1999*, (2000), p. 6; Cayman Islands Monetary Authority, *Annual Report 1998*, (1999), p. 7; Cayman Islands Monetary Authority, *Annual Report 1997*, (1998), p. 12.

⁵⁸ Details are available in Appendix A, Table 3.

⁵⁹ Economic Research Unit, *Annual Economic Report 2003*, (George Town, Grand Cayman: 2003), p. 21, Available: <http://www.eso.ky> [accessed 30 September 2004].

⁶⁰ Appendix A, Table 4. Taxes on international trade included travel & cruise ship tax and the Environmental Protection Fee imposed on all visitors as well as duties placed on imported goods.

significant factor in the landscape of global business.⁶¹ Since most of the major international banking firms are represented in the Cayman Islands, the local business sector will feel and reflect industry consolidation.⁶² The decline in revenue from bank license fees has been substantially offset by revenue from license fees associated with mutual funds and captive insurance firms. A more interesting question about offshore finance in the Caribbean involves the quantity of capital that continues to transit through these financial centres, which is the subject of the next section.

Foreign assets 'offshore' in the Caribbean

If a major determinant of the flow of capital to and through offshore financial centres is tax minimisation (within an environment of banking confidentiality), then one should expect to find that these flows have declined since 1998 in anticipation of the imposition of an information exchange regime. Certainly, the establishment of a global information exchange regime anticipates the extension of the state's ability to collect taxes due from the interest accruing in offshore accounts. The information sharing component of the EU Savings Tax Directive is expected by some either to 'bring capital home' or to force it beyond the reach of its fundamentally European information exchange regime.⁶³ In the case of one empirical research project, Harry Huizinga and Gaëtan Nicodème asked the question 'Are international deposits tax-driven?' The declared purpose for their paper was to determine the influence of tax policy and the enforcement of tax policy on international banking flows.⁶⁴ They concluded that 'non-bank external liabilities [those

⁶¹ Simon Caulkin, 'What's the big deal?' *The Observer* (London), 31 July 2005, Available: <http://observer.guardian.co.uk/business/story/0,6903,1539460,00.html> [accessed 6 September 2005].

⁶² Visit the web site of the Cayman Islands Monetary Authority for a list of the currently active licenses at <http://www.cimoney.com.ky/templates/HTMLPage/defaultdisplay.asp?text_id=HTMLPage73574&button=11>.

⁶³ John Burton and Andrew Parker, 'Is the global crackdown on tax evasion 'slowing to the speed of the last ship in the convoy'?' *The Financial Times* (London), 1 December 2003.

⁶⁴ Harry Huizinga and Gaëtan Nicodème, 'Are international deposits tax-driven', *Journal of Public Economics* 88 (2004), p. 1094.

deposits not owed to another bank] have been positively related to interest income taxes and to the presence of domestic bank interest reporting.’ They take this to be ‘evidence that international deposits are in part intended to facilitate tax evasion.’⁶⁵ The states studied by Huizinga and Nicodème were limited to a subset of the states that report data on external deposits and liabilities to the Bank of International Settlements. Crucially, their methodology contained only a few OFCs (the Bahamas, Bahrain, Cayman Islands, Hong Kong and Singapore), while the remaining states analysed were OECD members.⁶⁶

Huizinga and Nicodème found that between 1983 and 1992 the relationship between external deposits and interest income was statistically significant, but that the relationship changed during the period 1992 - 1999. They offered two possible explanations to account for why the tax burden became ‘almost insignificant’ relative to patterns of external bank deposits. The first possible explanation was the decline in the rate of tax imposed on deposit interest across the OECD member states.⁶⁷ If it was the tax on interest that motivated citizens to deposit their funds offshore, then as the tax rate declined it was no longer a strong motivator for tax avoidance. Statistically, there was a relationship between external deposits and the tax burden when the interest on deposits was taxed. However, as the rate of tax declined, this statistical relationship also declined. At the same time, the quantity of non-bank external deposits did not decline. This development led to the second explanation proposed by Huizinga and Nicodème, which was that there was a decline in the ‘relative importance of individual tax evaders, as holders

⁶⁵ Ibid. p. 1115.

⁶⁶ See Table 1, Ibid. p. 1097.

⁶⁷ Ibid. Figure 1, p. 1102. This accords with the ‘race to the bottom’ thesis, see for example Daniel W. Drezner, ‘Globalization and Policy Convergence’, *International Studies Review* 3, no. 1 (2001). For the case of corporate income taxes, the thesis has been very effectively rebutted by John Hobson in John M. Hobson, ‘Disappearing taxes or the “race to the middle”? Fiscal policy in the OECD’, *States in the Global Economy: Bringing Domestic Institutions Back In*, ed. Linda Weiss (Cambridge: Cambridge University Press, 2003).

of non-bank external liabilities'.⁶⁸ This explanation implied that there was not a decline in tax evasion by citizens, but rather that there was an increase in the proportion of total external deposits held by actors that would not be responsive to changes in personal income tax rates – corporations, mutual funds or insurance firms.⁶⁹ The implication of these explanations is that because tax evasion could not be directly measured, these authors assumed that it continued at the same rate, even though the motivating force (the tax rate) was no longer present.

Huizinga and Nicodème also attempted empirically to determine the influence of information reporting between states upon the patterns of external bank deposits. This effort was limited to information collected from bilateral international information exchange agreements in place and available for one year (1999). Naturally, they were unable to establish a significant impact for information exchange due to the rather limited coverage accomplished by the bilateral agreements in effect for the sample year. In 1999, many likely locations for external deposits, including offshore financial centres, were not party to a bilateral information exchange agreement covered by their research set.⁷⁰ This result led them to conclude that 'the international exchange of information has to cover most industrialized countries and other financial centers to be truly effective.'⁷¹ Clearly, this is a conclusion that supports the implementation of a global information exchange regime, even though the conclusion is derived from a belief in the effectiveness of information exchange and not from the empirical economic data they analysed.⁷²

⁶⁸ Huizinga and Nicodème, 'Are international deposits tax-driven', p. 1112.

⁶⁹ Ibid.

⁷⁰ See Table 6, Ibid. p. 1107. Switzerland for example did not automatically provide data to another state in 1999, while it did receive data automatically from Australia and Finland.

⁷¹ Ibid. p. 1116.

⁷² But see also Huizinga and Nielsen, which used a model to evaluate the respective potential benefits of information exchange versus a withholding tax. The conclusion was that information exchange may be the desired solution to taxing international deposits' interest, because it 'repairs a residence-based taxation of interest.' Harry Huizinga and

Turning now to a consideration of global financial flows, the BIS introduced the sectoral and geographical breakdown of banking statistics in the early 1970s in order ‘to provide information on the development and growth of the eurocurrency markets’.⁷³ The first chart (Figure 7-1) provides an historical overview for the period from 1977 to 2002 with a data point every five years. It shows not only an increase in the foreign assets on deposit in offshore banks, but also the much greater increase in foreign deposits held within OECD members. The line for the OECD substantiates an observation made about ‘globalisation’, that most FDI (and international financial flows in general) involves financial exchange amongst developed states, and not between developed states and developing states.⁷⁴ The most recent ten-year period for the same data is presented in Figure 7-2. This graph shows the trend amongst OECD member states, the BIS-designated offshore centres, and Commonwealth Caribbean states.⁷⁵ The data used to produce these charts is drawn from the locational banking statistics collected by the BIS. They consolidate data reported by all banking offices resident in those reporting jurisdictions. To reduce the amount of banking information presented here, only the figures for outstanding assets reported on deposit in these jurisdictions are used.⁷⁶ Specifically, the data used is from Table 6a of the June 2004 *Quarterly Review* published by the BIS. This table contained the external positions of the banks reporting quarterly balance sheet data to the BIS, with respect to the identified individual jurisdictions. Thus, it reflected the assets and liabilities of all reporting banks with respect to financial

Soren Bo Nielsen, ‘Withholding taxes or information exchange: the taxation of international interest flows’, *Journal of Public Economics* 87, no. 1 (2002), p. 68.

⁷³ Monetary and Economic Department, *Guide to the international banking statistics*, BIS Papers, No 16 (Basel: Bank for International Settlements, 2003), p. 1, Available: www.bis.org [accessed 30 July 2004].

⁷⁴ See for example David Held, et al., *Global Transformations: Politics, Economics and Culture* (Stanford, California: Stanford University Press, 1999), Chapter 5.

⁷⁵ See Appendix B for the data tables and category members used in these figures.

⁷⁶ This approach parallels the use of Eastern Caribbean Central Bank data on non-resident deposits, see below page 219.

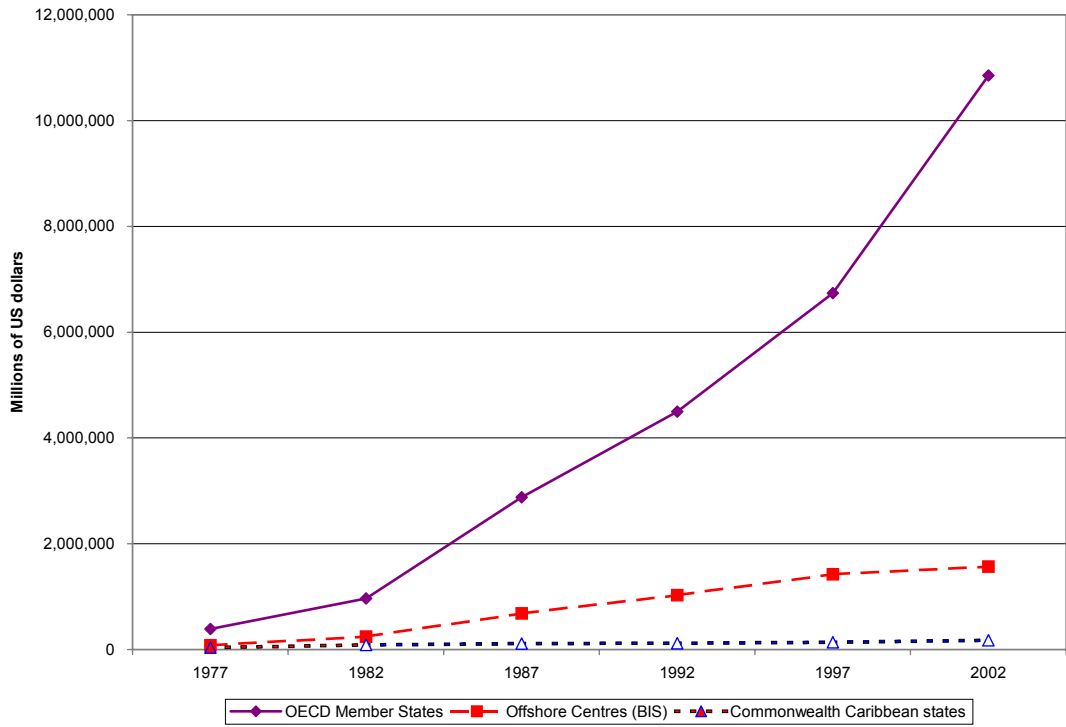


Figure 7-1 – Foreign assets on deposit, OECD and offshore (1977 - 2002, 5 year increments)

Source: Bank for International Settlements, *Quarterly Review*, June 2004, available at <<http://www.bis.org/>> [accessed 30 July 2004].

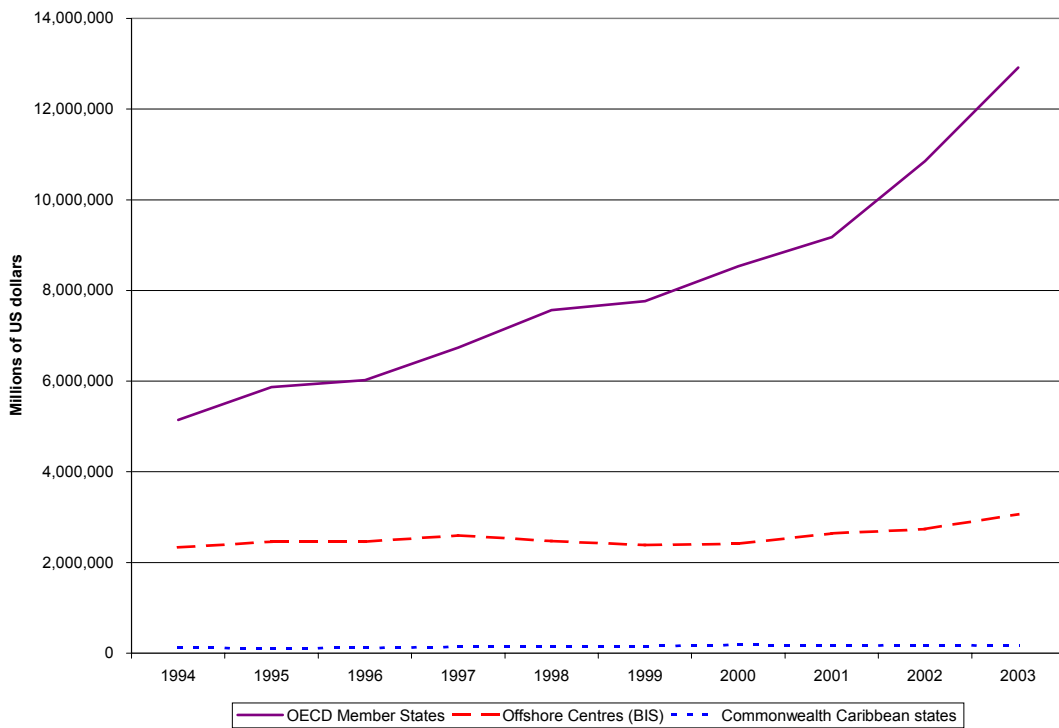


Figure 7-2 – Foreign assets on deposit, OECD and offshore (1994 - 2003)

Source: Same as Figure 7-1.

institutions located in another jurisdiction. For example, the table contained the assets and liabilities of all reporting jurisdictions that are held by a financial institution located in the Bahamas.

The two non-OECD categories depicted in these graphs overlap in part because of the criteria used to determine membership in the group. The first category consists of those jurisdictions that have been designated by the BIS as an offshore centre. The BIS classified a jurisdiction as an offshore centre if it satisfied three criteria: first, the external assets and liabilities of resident banks and/or international securities markets are large in relative terms (where they are half or more of the jurisdiction's GDP); second, the external assets and liabilities of resident banks and/or international securities markets are large in absolute terms; and third, the jurisdiction is not classified as a developed state.⁷⁷ This classification methodology excludes some of the jurisdictions identified by other organisations (such as the International Monetary Fund) as an OFC.⁷⁸ One reason for this difference is that while a small jurisdiction may meet the first criterion, it does not meet the second criterion, for example St. Vincent and the Grenadines. While the assets of the banking institutions may be large in relative terms (76.8 % of GDP in 2003), they are not large in absolute terms (US\$ 285 million for St. Vincent as compared to the Bahamas in 2003 with US\$ 152,650 million, when the GDP of the Bahamas was US\$ 5,260 million). A second reason is that the jurisdiction is otherwise classified as a developed state, for example Luxembourg, which is reported as an OECD member state in the BIS data rather than as an offshore financial centre. The second non-OECD category of data displayed in the chart consists of the Commonwealth Caribbean states reported in the BIS data. The

⁷⁷ Jesper Wormstrup, Deputy Head of International Financial Statistics, Monetary and Economic Department, Bank for International Settlements, personal correspondence, 27 August 2004.

⁷⁸ See Luca Errico and Alberto Musalem, *Offshore Banking: An Analysis of Micro- and Macro-Prudential Issues*, Working Paper of the International Monetary Fund, WP/99/5 (Washington, D.C.: International Monetary Fund, 1999). The table was reproduced above, Table 3-1.

overlap between these two categories results from the fact that the Bahamas and Barbados are both designated by the BIS as offshore financial centres.

An analysis of data reported for the Eastern Caribbean Currency Union (ECCU) leads to a similar conclusion. The membership of the currency union comprises both Commonwealth member states and British Overseas Territories.⁷⁹ Of the eight members of the ECCU, banking statistics on four are also collected and reported by the BIS. The data from the Eastern Caribbean Central Bank (ECCB) is presented in Figure 7-3 and shows the non-resident bank deposits of currency union members reported for the period 1994 - 2003. These are deposits held by commercial banks resident in the ECCU for non-resident account holders. On occasion, there was a decline in the deposits reported within the period, nonetheless, the trend remained one of overall increasing levels of non-resident bank deposits. An individual jurisdiction may have experienced a decline during the period 1994 to 2003, for example, St Kitts and Nevis between 1998 and 2003 (with the actual low point in 2001). However, the aggregate level of non-resident bank deposits for the entire ECCU in 2003 is greater than the amount on deposit in 1994.⁸⁰ Consideration of the ten year period 1994 to 2003 emphasises the point that the publication of *Harmful Tax Competition* in 1998 does not appear to have affected the flow of foreign capital to Caribbean OFCs.

⁷⁹ Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines are all Commonwealth members. At present, Anguilla and Montserrat are British Overseas Territories.

⁸⁰ See Appendix C, Table 1.

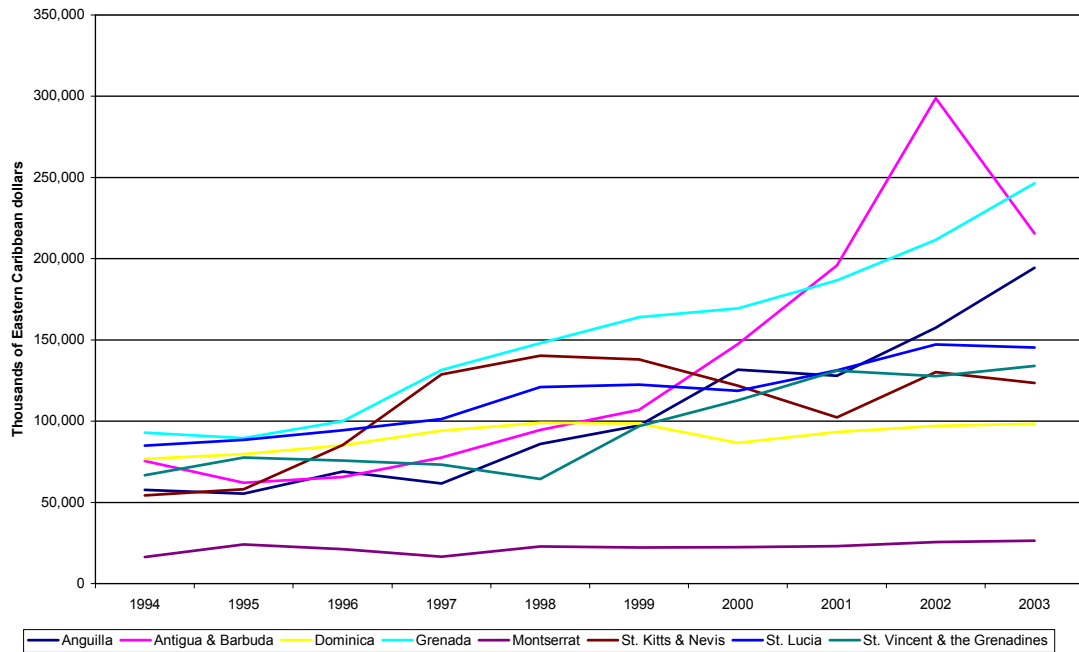


Figure 7-3 – Commercial Banks’ Total Deposits of Non-Resident Depositors, Eastern Caribbean Currency Union (1994 - 2003)

Source: Eastern Caribbean Central Bank, *Statistics*, available at <<http://www.eccb-centralbank.org/Statistics/index.asp>> [accessed 25 July 2004].

Even though financial flows increased, data from several Caribbean jurisdictions demonstrate that there has been a marked decline in the number of financial institutions registered in the Caribbean offshore financial centres. The growth of offshore financial flows, even though they are utilising fewer institutions, indicates that global finance has not been impacted by the OECD’s harmful tax competition project. On the other hand, the Caribbean economies themselves have been affected just as predicted by some representatives of the affected small Caribbean states. Employment and non-tax revenues from offshore banking within these small economies have declined. Fewer institutions employ fewer citizens and pay less in licensing and other fees. At the same time, any expectations that publicity about the OECD campaign by itself would reduce the use of OFCs (and thereby tax avoidance) have not been met. Mobile capital continues to flow to

offshore financial centres, in the Caribbean and elsewhere, before being recycled to return as investments in the OECD states.

In sum, the *market* response to OECD efforts to reduce international tax competition and harmful tax practices argues that their efforts are a minor concern to financial markets. Similar to the ECCU, an analysis of the Commonwealth Caribbean data available from the BIS finds that the outstanding assets on deposit fluctuated in several states between 1999 and 2003.⁸¹ But again, the aggregate values for offshore centres maintained a continuing upward trend (increasing deposits). Among those factors influencing global financial flows to, and through, offshore centres, tax minimisation behind a veil of banking confidentiality does not possess the weight attributed to it. This is a fundamental aspect of the OECD's argument against harmful tax competition. With transparency and information exchange, interested states would have access to data on offshore deposit accounts, and thereby the information required to collect appropriate taxes from citizens. Yet expectations for the implementation of such a regime, accompanied by sanctions against those jurisdictions that fail to comply with the regime, have not been reflected in data on deposits within Caribbean OFCs. Other factors and other concerns motivate the actions of depositors. Thus, the continued trend of increasing deposits may demonstrate a perception by market participants that the impact of the OECD measures against tax competition remains a distant future event, if they are even implemented. In this case, deposits may reflect near-term strategies, and so the amounts on deposit would decline in the event an information exchange regime is agreed upon and an implementation schedule publicised.⁸² From the perspective of the FATF, this institutional reduction in the offshore banking sector advanced the global effort to reduce

⁸¹ See Appendix B, Table 2.

financial crime and promoted the international regime against money laundering. Yet the regime against money laundering has had apparently little impact on the trend of increasing foreign bank deposits.⁸³

Conclusions

The experience of small Caribbean OFCs with respect to outside agencies demonstrates that the vulnerabilities of small open economies extend beyond security, trade preferences, and the environment. Externally mandated initiatives, whether from the FATF, the OECD or the IMF, strain the limited human and financial resources of these jurisdictions. Often, the limited resources applied to regulation enforcement and countering financial crime were identified as a criticism by the FATF. Yet failing to cooperate with these initiatives raises the threat of retaliatory measures that could isolate the jurisdiction within the structures of global finance. This isolation could effect not only the operation of financial institutions, but also all transnational transfers—by the government, by businesses and by individual citizens sending money to family and friends.

The actuality, however, has been rather different. The international perspective offered by the BIS in its June 2004 *Quarterly Review* highlighted the fact that in the fourth quarter of 2003 interbank activity had returned to the levels present earlier in the year. ‘US dollar-denominated claims led the recovery, as banks in offshore centres, the United Kingdom and the euro area lent to one another and to banks in the United States’.⁸⁴ In the specific case of the United States, ‘US banks lowered inter-office claims by \$41 billion, but increased loans to other banks by \$19 billion, virtually all of which was booked in offices in

⁸² Near-term investment strategies have short time horizons. Huizinga and Nicodème looked for a lagged response to their policy variables, but found that ‘there is no evidence that depositor response policy change is stretched out over more than a year.’ Huizinga and Nicodème, ‘Are international deposits tax-driven’, p. 1113.

⁸³ Financial Action Task Force, *Annual Review of Non-Cooperative Countries or Territories (2003)*, pp. 6, 13.

⁸⁴ Bank for International Settlements, *BIS Quarterly Review: International banking and financial market developments* (Basel: Bank for International Settlements, June 2004), p. 13, Available: www.bis.org [accessed 30 July 2004].

offshore centres'.⁸⁵ The Cayman Islands' *Annual Economic Report* for 2003 highlighted the increase in 2003 of the financial claims on offshore institutions over those that had been made on them in 2002. 'More than half of this [claims on offshore institutions] was attributed to banks in the Cayman Islands, whose share of business in US currency has recently rivalled that of the United Kingdom.'⁸⁶

These financial claims involved inter-bank activity rather than deposits by individuals seeking to avoid taxation of bank interest payments. It must therefore be emphasised that this data on global financial flows does not reflect the extent to which it contains the deposits of individuals. Recall that citizens avoiding taxes do not volunteer this information and as a result are the indirect target of the OECD project, for it is their avoidance of tax that motivated the project and its information exchange regime. Nonetheless, to limit one's conclusions about the OECD project to census figures tracking a declining number of offshore banks, offshore trusts, international business companies, etc. would suggest that the *threat* of reprisals against non-cooperative jurisdictions has succeeded. But by expanding the analysis to data on the assets and liabilities managed by this reduced number of financial institutions produces a contradiction with respect to global financial flows. The individual small state offshore finance sector may have experienced a decline in funds on deposit between 2000 and 2003, as was the situation for the Bahamas. Nevertheless, the assets reported on deposit in the Bahamas for 2003 still exceeded those reported for any of the years between 1994 and 1999.⁸⁷ As already discussed, the Bahamas underwent an extensive effort to comply with international anti-money laundering standards, leading to a reduced number of offshore banks in this small

⁸⁵ Ibid., p. 15.

⁸⁶ Economic Research Unit, *Annual Economic Report 2003*, p. 18. In the case of the Cayman Islands these international financial flows cannot be interpreted as simply an increase in non-resident funds on deposit in fewer banks. The large numbers of captive insurance firms and offshore hedge funds have vast financial assets that are also flowing in and out of the Cayman Islands.

state. The decline seen in the size of foreign assets on deposit in the Bahamas in 2001 may also have resulted from the economic recession in the United States, rather than fewer banks. The decline experienced in the Bahamas was subsumed within the aggregate data for all Caribbean offshore financial centres, or amongst the group of jurisdictions designated by the Bank of International Settlements as an OFC.⁸⁸ In the broader context of Caribbean offshore financial centres as a group (and the offshore world more generally), this means that in 2003 there were fewer financial institutions servicing a greater sum of offshore assets and liabilities than was the situation prior to the publication of *Harmful Tax Competition: An Emerging Global Issue* in 1998.⁸⁹

In the specific case of the OECD's harmful tax competition project and small Caribbean states, it could be characterised as a 'lose-lose' situation. The flow of capital through these offshore financial centres continued to increase, while the implementation schedule for the information exchange regime desired by the OECD has been repeatedly postponed. Essentially, this latter aspect of the situation represents a 'lose' for the OECD. Capital assumed to conceal tax evasion flowed through the OFCs in ever-greater amounts, while the information exchange methods intended to identify the responsible individuals remain to be established. The economic benefits that were provided by a successful offshore business sector have shrunk during the period explored here for small Caribbean states. Levels of employment and the revenue from associated licensing fees for the offshore banking industry declined along with the number of registered bank and trust

⁸⁷ See Appendix B., Table 2.

⁸⁸ Aruba for example had a significant decline in 2001, while Barbados, Bermuda, the Cayman Islands, Jamaica, and Trinidad and Tobago all maintained their upward trend line. See Appendix B, Table 2.

⁸⁹ Even the implementation of the European Union's Directive on the Taxation of Savings Income does not appear to have affected the marketing of offshore financial services within the EU. In October 2003 for example, the airline magazine available to passengers on a British Airways domestic flight from London to Edinburgh contained an article discussing offshore accounts. 'Shrouded in secrecy, offshore bank accounts are difficult to define, not least because they don't even have to be 'offshore'. So what are they? What are their key benefits? And who are they for?' See Martin Baker, 'Shore thing', *Business Life*, October 2003. More recently, the British Airways in-flight magazine for August 2005 contained three full page advertisements for offshore banks.

firms. As predicted, the Harmful Tax Competition project resulted in a 'lose' for the economic development of these small states. The experience of the Cayman Islands suggests that it is beneficial for one's offshore sector to be diversified. For this non-self-governing jurisdiction, revenues from licensing non-bank businesses continued to grow even though revenue from bank and trust licensing fees declined.⁹⁰

Whatever the future trajectory of international financial regulation, offshore financial centres continue to pursue business opportunities in order to promote this sector of their economies. One approach was described in an article in the *Journal of Money Laundering Control* in 2003. The vignette was drawn from the 'economic psychological analysis' of the author's PhD thesis and described a situation in which the unnamed (but 'well-known') jurisdiction presented its revised anti-money laundering legislation to a seminar of lawyers, accountants and fund managers in London in 1997. The relevant conclusion from this article was that, notwithstanding the measures taken to comply with international standards against money laundering, the new legislation in this jurisdiction still afforded a space with banking confidentiality. Presentations by the Prime Minister and Attorney General preceded that of a bank director. This latter presentation demonstrated the case that there remained a supply of confidential financial services 'in this OFC to meet the onshore demand after the new anti-money laundering legislation.'⁹¹

⁹⁰ But this does not guarantee continued success for the Cayman Islands, British Virgin Islands and other locations specialising in the registration of International Business Companies (IBCs). As discussed in the previous chapter, the OECD is engaged in a separate campaign to counter the use of 'corporate vehicles for illicit purposes'. Given the use of corporate entities registered in the Cayman Islands in both the ENRON and Parmalat corporate scandals, this will remain an issue of concern. See Organisation for Economic Co-operation and Development, *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes* (Paris: OECD Publications, 2001), Available: <http://www1.oecd.org/publications/e-book/2101131e.pdf> [accessed 20 August 2002].

⁹¹ Conrad Oberg, 'A Balancing Act: Offshore Financial Centre Strategy and the Global Anti-Money Laundering Movement', *Journal of Money Laundering Control* 7, no. 2 (2003), p. 157.

On the other hand, an Assistant Regulator with the Nevis Financial Services Department emphasised the provision of ‘risk management’ as a value-added feature offered by the offshore industry.

The increased emphasis being placed on risk management, has caused many service providers to realise that there is much more business out there than the typical fiduciary (company/trust management) business that we have all grown accustomed to over the years.⁹²

Combined with the enhanced regulatory regimes implemented in response to FATF initiatives, the emphasis on risk management has led to an improvement in the quality of the industry in the Caribbean. The perception of quality may be yet another explanation for the observation that while the number of institutions have declined, the overall size of financial flows through the Caribbean continues to increase. The subject of risk management is also found in the annual reports of the Cayman Islands Monetary Authority.

With regards to the private sector the Monetary Authority is committed to consultation and collaboration, and encourages financial services providers to play their part in the continuing growth of the financial services industry and adopt appropriate risk management techniques when conducting business.⁹³

Risk management of a different nature is the concern for U.S. policy makers with respect to the Caribbean. This actor presents the last region of the global terrain of international finance and tax competition to be considered in this thesis. American policy has been to address the risks to society and the economy emerging from the Caribbean region, and particularly from drug trafficking and money laundering. Since 2001, terrorism and the financing of terrorism has been added at the top of the list. Continuing from a brief discussion of the impact of the United States in Caribbean history, the next chapter discusses the United States’ participation in the harmful tax competition project (and to

⁹² Vieoence C. Prentice, Assistant Regulator, Nevis Financial Services Department, personal correspondence, 15 October 2004.

⁹³ Cayman Islands Monetary Authority, *Annual Report 2002*, p. 7. See also pages 8 and 11.

some extent international finance, taxation, and financial crime more generally). As will be seen, the dominating presence of the U.S. in the Caribbean has historically prompted a unilateralist approach to inter-state relations.

AMERICAN INFLUENCE AND POWER: THE CARIBBEAN AND TAX COMPETITION

While the focus of this chapter is upon the presence and role of the United States in relation to the harmful tax competition project, there are other events during the period 1998 - 2003 that influenced U.S. actions. First, the change of presidential administration in Washington, D.C., that brought with it a very different viewpoint on taxation. Then, the response to the terrorist attacks of September 2001 involved the related issue of money laundering, identifying it as a probable method to finance terrorism. Yet, even with what some may have viewed as climactic change, there was a measure of continuity between the Clinton and Bush administrations.

Before looking at U.S. policy related to tax competition and offshore financial centres in the Caribbean, the next section provides some background on the topic of money laundering. This is necessary and practical for two reasons. First, money laundering is widely conflated with the harmful tax competition initiative, mostly because money laundering is presented as a particular problem for offshore financial centres, a perception which is reproduced by the media for its sensational aspects (visions of *Miami Vice*). The second reason is because anti- 'financing of terrorism' efforts have been bound into anti-money laundering initiatives. Thus, the case is made that the effort to combat global terrorism via its financing could utilise the information exchange regime that is part of the harmful tax competition initiative. Consequently, a back door approach for implementing the information exchange regime is underway, using the war on terrorism as its rationale. The expansion of surveillance means that private citizens now encounter the

inquisition nature of the Leviathan more frequently, within a framework intended to root out the terrorist hiding amongst us.¹

Following the discussion of the various ways in which anti-money laundering initiatives overlay harmful tax competition, is further discussion of the American ‘shiprider’ policy in the Caribbean briefly mentioned in chapter 2. This tactic for the American war on drugs directly confronts Caribbean state sovereignty. From this issue of American foreign policy in the Caribbean, the next section moves on to consider the intersection between U.S. domestic politics and the harmful tax competition project. This includes the Clinton Administration’s support of the initiative, as well as the shift away from that position by the succeeding Bush Administration. As a continuation of the earlier discussion of taxation and tax avoidance/evasion, the subsequent section explains why the U.S. approach to tax evasion does not require the information exchange regime of the OECD project. Here the pursuit of American tax evaders using Caribbean banks (for suspected tax evasion purposes) demonstrates the independent capacity of the U.S. tax administration amongst Caribbean OFCs. The chapter’s final section assesses the impact of the 2001 terrorist attacks upon global anti-money laundering efforts, and by extension, the Harmful Tax Competition project.

Money laundering – smoke screen for the harmful tax competition initiative

The accusation is frequently made that OFCs provide the methods and means to facilitate the laundering of money and effectively (and for some, explicitly) encourage the activity. Money laundering however, was not considered a crime in and of itself in the United States until 1986, well after the emergence of offshore finance. To define money

¹ For a readable overview of surveillance in society from a Canadian sociologist, see David Lyon, *Surveillance after September 11* (Cambridge: Polity, 2003).

laundering as an independent crime for American law enforcement served to open up a second front in the war on drugs.² After domestic criminalisation, the U.S. government actively undertook the initiative to establish money laundering as a crime internationally, given the cross-border nature of the activity and with illegal drug trafficking identified as its primary source. The 1995 report from the Office of Technology Assessment (OTA) stated, ‘To launder money is to disguise the origin or ownership of illegally gained funds to make them appear legitimate. Hiding legitimately acquired money to avoid taxation also qualifies as money laundering.’³ The first international convention to direct the criminalisation of the activity was the United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (1988 – the Vienna Convention). As noted in chapter 5, the Financial Action Task Force (FATF) was created to support the anti-money laundering campaign by identifying the financial activities and techniques used to launder money. From this information, the FATF produced evaluation criteria that are now used to determine the susceptibility of any firm, agency or national financial system to money laundering activities.⁴ With these objectives in mind, the FATF created the Forty Recommendations and has overseen the development of ‘typologies’ to describe the methods and techniques used to conceal money laundering.⁵ As discussed in the previous chapter, another product of the FATF has been the Non-Cooperative Countries or Territories (NCCT) list. From its first publication in 2000, this document served to

² Prior to this, it was simply part of the underlying (predicate) crime that it helped serve to conceal. See U.S. Congress Office of Technology Assessment, *Information Technologies for Control of Money Laundering* (Washington, D.C.: U.S. Government Printing Office, 1995), p. 3.

³ *Ibid.*, p. 2. In the 1996 version of the Forty Recommendations, the Financial Action Task Force started from the definition ‘money laundering – the processing of criminal proceeds in order to disguise their illegal origin.’

⁴ Financial Action Task Force, *Financial Action Task Force on Money Laundering Report*, English, 1990, PDF file, Available: www.oecd.org/fatf/pdf/AR1990_en.pdf [accessed 21 March 2002]; U.S. Congress Office of Technology Assessment, *Information Technologies for Control of Money Laundering*.

⁵ Initially released in 1990, this document was revised in 1996 to account for the first six years of experience formally combating money laundering. There was a major revision in 2003 to incorporate measures to counter the financing of terrorism. Financial Action Task Force, *The Forty Recommendations (2003)*, English, 20 June 2003 2003, PDF file, Available: <http://www.fatf-gafi.org/dataoecd/38/47/34030579.PDF> [accessed 30 June 2003].

identify jurisdictions that had not met the Forty Recommendations as the standard for anti-money laundering legislation and enforcement. As one part of a strategy towards global compliance/co-operation against money laundering, it would appear to have been successful. The first NCCT list evaluated twenty-nine jurisdictions and found fifteen of them to be non-cooperative.⁶ The most recent list at the time of writing contains only three jurisdictions—Myanmar, Nauru, and Nigeria—a most significant reduction in just 5 years time.⁷ The experience of the Caribbean jurisdictions discussed in the previous chapter was similar to the experiences of the other jurisdictions identified by the NCCT.

Some commentators argue that the information exchange regime of the harmful tax competition project will enhance the enforcement of anti-money laundering legislation and combating the financing of terrorism.⁸ Looking at the issue from the other side, the OECD argues that there are ‘substantial similarities between the techniques used to launder the proceeds of crime and to commit tax crime.’⁹ In general, the objective of money laundering is to get the funds into the financial system and available for use, while successfully disguising its origins, illegal or legal. The intense scrutiny placed on OFCs by a number of international organisations has mitigated their general usage for these purposes. The previous discussion of the Philippines is relevant in this context.¹⁰ Furthermore, some

⁶ Financial Action Task Force, *Review to Identify Non-Cooperative Countries or Territories: Increasing the World-Wide Effectiveness of Anti-Money Laundering Measures*, English, 22 June 2000, PDF file, Available: http://www.fatf-gafi.org/pdf/NCCT2000_en.pdf [accessed 21 March 2002].

⁷ Financial Action Task Force, *FATF Welcomes China as an Observer*, 11 February 2005, Press release, Available: <http://www.fatf-gafi.org/dataoecd/51/2/34423127.pdf> [accessed 18 February 2005].

⁸ Dr. William Witherell, ‘Strengthening the Offshore Defences against Economic Crime and Abuse’ (paper presented at the 20th Cambridge International Symposium on Economic Crime, Jesus College, Cambridge, 10 September 2002), Available: <http://www.oecd.org/pdf/M00034000/M00034314.pdf> [accessed 8 December 2002]; Thomas J. Biersteker, ‘The Return of the State: Financial Reregulation in the Pursuit of National Security After September 11’, *The Maze of Fear: Security and Migration After 9/11*, ed. John Tirman (New York & London: The New Press, 2004).

⁹ Centre for Tax Policy and Administration, *Centre for Tax Policy and Administration Brochure*, 31 August 2001, PDF, Committee on Fiscal Affairs, Available: <http://www.oecd.org/dataoecd/38/17/1909369.pdf> [accessed 7 August 2002], p. 33; Organisation for Economic Co-operation and Development, *Access for Tax Authorities to Information Gathered by Anti-Money Laundering Authorities*, Country Practices, (Paris: OECD, 2002), Available: <http://www.oecd.org/pdf/M00036000/M00036918.pdf> [accessed 8 December 2002].

¹⁰ See above, p. 146.

of the most widely publicised cases of money laundering have not involved offshore financial centres, but instead implicated a number of large international banks located in the major global banking centres. For example, there was the specific case of the Bank of New York and \$7 billion of Russian funds (thought to be foreign aid monies) laundered for the benefit of a small group of Russian citizens.¹¹ For purposes of the present discussion, it is sufficient to note that there is an international consensus on the criminality of money laundering, if not the means to eradicate it. As noted already, there is no such international consensus for tax crimes (evasion, avoidance or abusive) as they are state-specific in their identification as well as enforcement.

Security within an American War on Drugs

The end of the Cold War did not eliminate security concerns for small states, even those under the shelter provided by a United States' security umbrella over the Caribbean basin. An ongoing challenge to state security and social order is represented by drug trafficking—not only the drug dealers and their associated arms merchants, but also in part from the efforts of American officials and law enforcement to interdict this trade offshore.¹² The discussion of small state perceptions of sovereignty in Chapter 2 mentioned as one example the establishment of 'shiprider' agreements between the United States and a number of Caribbean and Central American states. The negotiations to agree

¹¹ Minority Staff of the Permanent Subcommittee on Investigations, *Report on Correspondent Banking: A Gateway For Money Laundering*, (Washington, D. C.: U.S. Senate Committee on Government Affairs, 2001), pp. 253 - 254, Available: http://www.senate.gov/~gov_affairs/020501_psi_minority_report.htm [accessed 17 July 2002]. However a caution is offered by Michael Levi, '...though it is not clear how much Russian money was related, respectively, to drugs, to organized crime, or to capital flight searching for an economically and politically safer home.' Michael Levi, 'Money laundering and its regulation', *Annals of the American Academy of Political and Social Science*, no. 582 (2002), p. 189.

¹² This is not to say that there are not other security threats, both internal and external. For example, small island states in the Indian Ocean have been victimized by foreign mercenaries. Additionally, in the Pacific Ocean domestic dissent reached a point where newspapers could report that 'Island disappears out of the world's sight,' as with Nauru in early 2003. This situation resulted from internal political and economic strife that included the 'collapse' of the telephone system and the grounding of the national airline due to non-payment for its leased aircraft. See Hideyuki Takahashi, 'Maldivian National Security--And the Threats of Mercenaries', *The Round Table*, no. 351 (1999); Kathy Marks, *Island disappears out of the world's sight*, 24 February 2003, Web page, Independent Digital (UK) Ltd, Available: http://news.independent.co.uk/world/pacific_rim/story.jsp?story=381080 [accessed 7 March 2003].

on appropriate law enforcement measures demonstrated the different perceptions held about the value assigned to (perceptions of) sovereignty. Several Caribbean states were reluctant to sign the agreements, because of their concern with maintaining a sense of sovereignty and independence from U.S. directives. Even with the controversy over sovereignty, independence and self-determination, the dissenting Caribbean states ultimately co-operated, because the drugs trade is as much a domestic security threat for them as it is for the United States.¹³ At the same time, the United States was a bit heavy-handed in its negotiating methods. For example, when Jamaica and Belize did not immediately cooperate by signing the agreements presented to them, the United States threatened them with decertification.

Elliot Abrams supported the solution to these problems in the Caribbean ‘front-yard’ of the United States. Writing in *The National Interest*, he believed ‘the small states of the Caribbean may well be best off accepting and trying to regularize American intervention ... in exchange for certain economic and trade benefits.’¹⁴ From this statement and others throughout the article, Ian Boxill found that ‘a close reading of Abrams’ article suggests that he is advocating a kind of protectorate status for most CARICOM countries.’¹⁵ It is a proposal that Boxill critically resists, while agreeing that it must be treated seriously. ‘Others, including those who share more extreme views may not be as forthcoming.’¹⁶ He strives in his discussion of sovereignty and globalisation to make the argument that even though both of these concepts impact different states in differing ways, there remains a space for small states (and here he speaks directly of the Caribbean)

¹³ Holgar Henke, ‘Drugs in the Caribbean: The “Shiprider” Controversy and the Question of Sovereignty’, *European Review of Latin American and Caribbean Studies*, no. 64 (1998), p. 42. See above Chapter 2, p. 58.

¹⁴ Elliot Abrams, ‘The Shiprider Solution: Policing the Caribbean’, *The National Interest*, no. 43 (1996), p. 91. It will be recalled that Abrams had been Assistant Secretary of State for Inter-American Affairs in the Reagan Administration, and in 2005 was Deputy Assistant to the President and Deputy National Security Advisor for Global Democracy Strategy in the Bush Administration.

¹⁵ Ian Boxill, ‘Sovereignty, Globalization and Caribbean Integration’, *Social and Economic Studies* 48, no. 4 (1999), p. 242.

to exercise self-determination.¹⁷ Moreover, Boxill's objective is 'to suggest that as globalization intensifies the natural impulse will be for societies to have a greater say in their own destiny and feel that they belong to some particular space.'¹⁸

The domestic security threat posed by the drug trade to Caribbean states is a product of the illegal activity and its impact upon domestic safety and security. The violence that surrounds the transport of illegal drugs has spread to other areas of Caribbean society, raising local crime rates and threatening lawful activities such as tourism. A decline in tourism further shrinks the local economy, which encourages residents to seek other means for their livelihood. This has raised the concern that drug trafficking and crime in general may increase. Naturally, the large sums of cash generated by the drugs trade may lead to increased corruption in society.¹⁹ Moreover, the financial services sector is threatened by the attempts made to launder the profits.

One author has characterised the entire situation as placing 'sovereignty under siege' in the Caribbean. Ivelaw Lloyd Griffith's analysis concluded that illegal drug trafficking is not the only source for the threat to state sovereignty. The sovereignty of small Caribbean states is also threatened when other states and a variety of international and non-governmental organisations place Caribbean states into a 'subordinate status' within their campaign to counter the trade in illegal drugs.²⁰ The linkage made by U.S officials between local government efforts against the drug trade and other policy issues, such as free trade with the U.S. and the marketing of Caribbean bananas, substantiates his

¹⁶ Ibid. p. 244.

¹⁷ Ibid. p. 244ff.

¹⁸ Ibid. pp. 230 - 231.

¹⁹ Henke, 'Drugs in the Caribbean', p. 37. Duffy described this situation in Belize, Rosaleen Duffy, 'Shadow players: ecotourism development, corruption and state politics in Belize', *Third World Quarterly* 21, no. 3 (2000).

²⁰ Ivelaw Lloyd Griffith, *Drugs and Security in the Caribbean: Sovereignty Under Siege* (University Park, PA: Pennsylvania State University Press, 1997), p. 235.

argument.²¹ While some illegal drugs may be grown in the Caribbean, they have not yet become a major cash crop for the region. The major export produce of Caribbean states remains bananas and sugar. It was from within this broader perspective of the Caribbean within the world that Cynthia Barrow-Giles wrote on 'Sovereignty, Self-Determination and Resistance'.

So that while the notion of sovereignty is challenged by global developments and is not as monolithic today as thirty years ago, it should remain important to countries which have experienced centuries of oppression, domination and subordination.²²

This was the historical experience behind the Caribbean perception of sovereignty, and the value assigned to it, during the establishment of the shiprider agreements. This same historical experience is embedded within Caribbean resistance to the OECD project as these small states strive to control their local destiny.

U.S. Domestic Politics and Harmful Tax Competition

The presence and prevalence of offshore financial centres in the Caribbean is itself partly a consequence of the U.S. presence and economic influence in the region. Several authors find the emergence of the Caribbean OFCs as partly in response to U.S. financial regulation and capital controls, particularly Regulation Q.²³ At the same time, the nature of the continuing relationship of some jurisdictions with the United Kingdom, and the British legal tradition, has fostered the development of the offshore space. As already suggested, a major difficulty facing the OECD project rests not with uncooperative non-member states,

²¹ Trevor Munroe, 'Cooperation and Conflict in the US-Caribbean Drug Connection', *The Political Economy of Drugs in the Caribbean*, ed. Ivelaw L. Griffith (Houndmills, Basingstoke: Macmillan Press Ltd, 2000), p. 196.

²² Cynthia Barrow-Giles, 'Dangerous Waters: Sovereignty, Self-determination and Resistance', *Living at the Borderlines: Issues in Caribbean Sovereignty and Development*, eds. Cynthia Barrow-Giles and Don D. Marshall (Kingston, Jamaica: Ian Randle Publishers, 2003), p. 51.

²³ Including Susan Strange, *Mad Money* (Manchester: Manchester University Press, 1998), p. 30; Mark P. Hampton, *The Offshore Interface: Tax Havens in the Global Economy* (London: Macmillan Press Ltd, 1996), pp. 56 - 59; Richard Anthony Johns, *Tax Havens and Offshore Finance: A Study of Transnational Economic Development* (London: Frances Pinter, 1983), pp. 10 - 15.

but with its own members. In particular this difficulty is with its largest member. As one opponent to the OECD project has commented, having a tax cartel without the U.S. 'would be like trying to set up a hardware store cartel without Home Depot or a software cartel without Microsoft.'²⁴ At issue is the simple fact that the U.S. does not collect tax on non-resident non-citizens' accounts, nor does it report their existence.²⁵ Consequently, the U.S. should be identified as the largest offshore tax haven in the world.

At the end of 2002, total foreign-owned assets in the United States exceeded \$8.5 trillion, up from \$6 trillion in 1998. This includes over \$5.4 trillion (up from \$3.6 trillion in 1998) in direct investment composed of U.S. Treasury securities, U.S. currency, and liabilities reported by banking and nonbanking concerns.²⁶ One argument against the introduction of information exchange is that it would lead to massive capital flight, seriously impacting the U.S. financial system. This is one of the reasons offered to oppose U.S. support of the OECD project.²⁷ Certainly, the government is as aware of the role played by the vast investment by foreign states in the American deficit as the news media and its pundits have publicised the situation.²⁸ Moreover, just as there is an historical experience to explain the German desire for a information exchange regime in the EU, so too there is an historical precedent behind concerns with inter-state tax competition. As noted in a variety of statements from public officials, the international environment influences the cross border impact of domestic tax decisions. The prominent spillover

²⁴ Daniel J. Mitchell, *The Adverse Impact of Tax Harmonization and Information Exchange on the U.S. Economy*, November 2001, PDF file, *Prosperitas* (Vol. I, Issue IV), A Publication of the Center for Freedom and Prosperity Foundation, Available: <http://www.freedomandprosperity.org/Papers/taxharm/taxharm.shtml> [accessed 4 April 2002], p. 2. Obviously, the OECD resists the characterisation of their project as an effort to create a 'tax cartel'.

²⁵ Marshall J. Langer, 'New EU, U.K., and U.S. Reporting Rules on Bank Deposit Interest Paid to Nonresidents', *Tax Notes International*, 28 January 2002, p. 404, Available: <http://www.freedomandprosperity.org/langer2.pdf> [accessed 3 April 2003]. Langer states that 'For more than 80 years, U.S. banks have paid tax-free interest to foreign persons.'

²⁶ Elena L. Nguyen, 'The International Investment Position of the United States at Yearend 2002', *Survey of Current Business* 83, no. 7 (2003), Available: <http://www.bea.doc.gov/bea/pub/0703cont.htm> [accessed 5 December 2003].

²⁷ See Langer, 'New EU, U.K., and U.S. Reporting Rules'; Mitchell, *The Adverse Impact of Tax Harmonization and Information Exchange on the U.S. Economy*.

²⁸ See for example, Faisal Islam, 'Asian connection in \$2 pound', *The Observer* (London), 22 February 2004.

event frequently used as the point of reference is the Tax Reform Act of 1986 during the second Reagan Administration. The across-the-board reduction in corporate income tax rates was perforce echoed by other developed states, lest they lose business and capital to America.²⁹

As part of its analysis of the world economy, the OECD monitors and tracks national taxation regimes and develops analysis and recommendations for improvement. Governments keep an eye on the proposals of their peers, striving to assess the potential impact of foreign tax reductions, and tax increases, on domestic savings and investment (as well as domestic business activity). From this perspective, the co-operation of the United States is clearly necessary, if only to prevent the spillover consequences of the 1986 corporate tax reduction from repeating themselves. The extensive deregulation of financial activity by developed states since the later 1980s would also enhance the spillover effects.

There is a general perception that the Clinton Administration had been shifting U.S. foreign policy towards increased multilateral participation on global issues, whereas the subsequent Bush Administration's foreign policy has been stridently unilateral in its conduct and actions. This perspective was increasingly prevalent after September 2001, and in particular concerning the conflict in Iraq. However, this viewpoint may not hold up under structured political analysis and research. In the course of a critique of Philip Bobbitt's *The Shield of Achilles*, Gopal Balakrishnan declared,

In offering the most systematic theorization of American imperial interventions to date, *The Shield of Achilles* makes clear that the major ideological innovations powering them are the creation of the Clinton, not of the Bush Presidency.³⁰

²⁹ The Reagan corporate tax reduction was from 46% to 40% in 1987, and thence to 34% in 1988. Deborah L. Swenson, 'Tax Reforms and Evidence of Transfer Pricing', *National Tax Journal* LIV, no. 1 (2001), p. 14. For a view across all OECD members, see Table 1 of Peter Birch Sørensen, 'The case for international tax co-ordination reconsidered', *Economics Policy* 15, no. 31 (2000), p. 436.

³⁰ Gopal Balakrishnan, 'Algorithms of War', *New Left Review* Second series, no. 23 (2003), p. 8.

Through its foreign policy initiatives to defend human rights, counter terrorist activities and ‘rogue states,’ and to prevent nuclear proliferation, the Clinton Administration established a strategy for the post-Cold War period. Balakrishnan believes that the Bush Administration was simply following the line of policy established by the Clinton White House.

The principal difference has been tactical—the lesser extent to which it has concerted with its European allies—rather than juridical: the degree to which it has cast aside previous constraints of international law.³¹

While there has been change, there has also been a continuity of foreign policy initiatives between these Administrations. The actions taken by states are perforce predicated on earlier events and policies. For example, Christopher Hill observed in the case of the Middle East that it was ‘remarkable how much continuity there has been over decades in American foreign policy despite the vicissitudes of electoral politics.’³² In his description of the first few months of the Bush Administration, Andrew J. Bacevich similarly outlined a continuity of American foreign policy across the Democratic/Republican divide.³³

In the case of the harmful tax competition initiative, the change of Administration did indeed however, lead to a change in the official U.S. position as reflected in the statements made by government officials. Certainly the case can be made that the Republican majority in Congress would have legislatively blocked U.S. co-operation on the OECD project, whatever the inclinations of the White House. However, convincing officials in the Executive that U.S. co-operation would be against the national interest is far easier than convincing sufficient members of Congress to block U.S. co-operation. (The

³¹ Ibid.

³² Christopher Hill, *The Changing Politics of Foreign Policy* (Basingstoke, Hampshire: Palgrave, 2003), p. 221.

³³ Andrew J. Bacevich, ‘Different Drummers, Same Drum’, *The National Interest*, no. 64 (2001). A larger treatment of the subject is in Andrew J. Bacevich, *American Empire: The Realities and Consequences of U.S. Diplomacy* (Cambridge: Harvard University Press, 2002).

lobbying effort undertaken to do the necessary convincing is discussed at the end of this section.)

On 26 June 2000, the U.S. Treasury 'welcomed' the publication of the OECD progress report, *Towards Global Tax Co-operation*.³⁴ The Secretary of the Treasury in the Clinton Administration, Lawrence H. Summers, was quoted in a press release.

The identification of tax havens and potentially harmful tax regimes is a crucial step in preventing distortions that could undermine the benefits of enhanced capital mobility in today's global economy.³⁵

As an economist, this is a topic that Summers would understandably find very familiar. This statement followed a press release from a week earlier in support of the OECD announcement that six jurisdictions had agreed to cooperate with the harmful tax competition project. Summers justified his support for the OECD project in his comments to a tax administrators conference in July 2000. 'In today's global environment, a country cannot develop its tax policy or administer its tax laws without giving consideration to the actions of other jurisdictions.'³⁶ This statement reinforces the perception of a multilateral, cooperative, foreign policy strategy during the Clinton Administration.

As already mentioned, the incoming Bush Administration in 2001 was ambivalent about the harmful tax competition initiative. Initially, the Bush Treasury Department followed the policy of the Clinton Treasury Department, 'On February 17th, following a meeting of G7 Finance Ministers in Palermo, I [U.S. Secretary of the Treasury Paul O'Neill] indicated that certain aspects of the OECD project were under review by the

³⁴ Organisation for Economic Co-operation and Development, *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices* (Paris: OECD Publications, 2000).

³⁵ Lawrence H. Summers, *Treasury Welcomes OECD Report on Harmful Tax Competition Havens*, LS-735, 26 June 2000, Web page, Office of Public Affairs, Available: <http://www.ustreas.gov/press/releases/l735.htm> [accessed 17 January 2004].

³⁶ Lawrence H. Summers, *Tax Administration in a Global Era*, LS-759, 10 July 2000, Web page, Office of Public Affairs, Available: <http://www.ustreas.gov/press/releases/l759.htm> [accessed 17 January 2004].

Administration.³⁷ Uncertainty about the U.S. position in early April 2001 intersected with the Commonwealth Secretary General's strong criticism of the OECD project. One London newspaper reported an unnamed OECD official as saying, 'This is making recalcitrant countries even more recalcitrant. If the US were to abandon its support it would be a major blow.'³⁸ Nevertheless, support for the project by the United States was once again 'reaffirmed' by the Secretary at yet another G7 meeting in April 2001, 'However, [O'Neill] declined to comment on the contentiousness of offshore financial centres.'³⁹

Subsequent perceptions of the emergence of a Bush Administration position on the project suggested that effective lobbying had moved critical members of the Administration out of the neutral space and on to the side of critics of the project. The Center for Freedom and Prosperity is usually identified as the focal point for the lobbying effort, but various business interests and members of Congress joined it.⁴⁰ Lobbying activities attempted to widen the dialogue in the public sphere via editorials and articles, in addition to their efforts to persuade government officials of the dangers of co-operation.⁴¹ At the same time, one writer observed that 'pressure is also coming from Democrats, particularly the Afro-American caucus within the US Congress, which are allying itself [sic] with Caribbean Islands against the OECD initiative.'⁴² The momentum of the entire

³⁷ Paul O'Neill, *Statement of Paul H. O'Neill before the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, OECD Harmful Tax Practices Initiative*, PO-486, 18 July 2001, Web page, Office of Public Affairs, Available: <http://www.treas.gov/press/releases/po486.htm> [accessed 22 July 2003].

³⁸ Rupert Cornwell, 'Commonwealth clashes with rich nations over tax haven clampdown', *The Independent* (London), 2 April 2001, p. 17.

³⁹ Amy Carroll, 'US ambivalence grows towards OECD initiative', *Private Banker International*, 14 May 2001, p. 1.

⁴⁰ The article in *Private Banker International* identified lobby groups as placing pressure on the Bush Administration, 'particularly the Centre [sic] for Freedom and Prosperity, which is bankrolled by various wealthy Americans.' Ibid. This observation was also made by Akiko Hishikawa, 'The Death of Tax Havens?' *Boston College International & Comparative Law Review* 25, no. 2 (2002), p. 412, Available: http://www.bc.edu/bc_org/avp/law/lwsch/journals/bcicl/25_2/10_FMS.htm [Accessed 21 June 2002].

⁴¹ An extensive history of these documents is available on the website of the Center for Freedom and Prosperity. See <<http://www.freedomandprosperity.org/>>.

⁴² Carroll, 'US ambivalence grows towards OECD initiative'.

OECD project would fade quickly, following a statement in May 2001 by the U.S. Secretary of the Treasury concerning the OECD's 'working group that targets "harmful tax practices".'

I am troubled by the underlying premise that low tax rates are somehow suspect and by the notion that any country, or group of countries, should interfere in any other country's decision about how to structure its own tax system. I also am concerned about the potentially unfair treatment of some non-OECD countries.⁴³

Secretary O'Neill would make a very similar declaration before the U.S. Senate, after which reports in the media suggested 'The threat of sanctions for small island states accused of supporting tax evasion is receding.'⁴⁴ This statement supports the case for fiscal sovereignty, without addressing the OECD's desire for information exchange.

This situation suggests again the role of lobbies and lobbyists in democratic politics (and particularly in U.S. politics). The one organisation frequently identified by American supporters of the harmful tax competition initiative was the Center for Freedom and Prosperity. It is interconnected, however, with the Cato Institute (a libertarian think tank promoting limited government and free markets) through its board of directors, while another prominent opponent of the tax competition project is with the Heritage Foundation (a conservative think tank promoting free enterprise and limited government).⁴⁵ All three of these organisations have taken a position against the OECD

⁴³ Paul O'Neill, *Treasury Secretary O'Neill Statement on OECD Tax Havens*, PO-366, 10 May 2001, Web page, Office of Public Affairs, Available: <http://www.treas.gov/press/releases/po366.htm> [accessed 22 July 2003]. It should be noted that the U.S. was not the only OECD member to raise this concern, similar remarks from New Zealand, for example, were quoted in chapter 6. Australia issued a similar statement in early 2002, once again on behalf of the Pacific island states with OFCs. Agence France Presse, 'Australia calls for OECD leniency for Pacific tax offenders', (Sydney), 1 March 2002.

⁴⁴ BBC News, *US eases stance on 'tax havens'*, BBC News Business, 20 July 2001, Web page, BBC, Available: <http://news.bbc.co.uk/1/hi/business/1446603.stm> [accessed 30 July 2002].

⁴⁵ See <<http://www.cato.org/people/rugy.html>> and <<http://www.heritage.org/About/Staff/DanielMitchell.cfm>> [accessed 29 January 2004].

efforts on harmful tax competition. This action is in conjunction with the policy view they present on the wider issue of taxation more generally in the United States.⁴⁶

Consequently, the concerns held by small states with respect to the issue of tax competition and pressure from the OECD were framed in the context of U.S. domestic politics by think tanks and lobbyists with a limited government and free market agenda. In this way, the small states benefit from what could be characterised as the ‘knock-on’ effect of the American domestic agenda. This issue was presented to the American government and electorate (via op-ed pieces and letters to the editor of major newspapers) as one of American fiscal sovereignty, with the potential to lose a significant amount of foreign investment in the American economy. Indeed, one Caribbean-based commentator has urged the Bahamas actively to lobby in the U.S. against the OECD project as one of a number of policy recommendations.⁴⁷

Notwithstanding the factors or motivators behind the U.S. policy shift on harmful tax competition between the Clinton and Bush Administrations, the fact remains that a shift occurred. Because of the change, the progress of the OECD project has slowed, and some small states, taking advantage of the U.S. move, continued to resist. As will be seen in the next section, the U.S. pursues American tax evaders quite vigorously, even without the information exchange regime sought by the OECD.

The U.S. Approach to Tax Evasion in the Caribbean

It will be recalled from the previous discussion on taxation that for a territorial-based tax system, official knowledge of income earned offshore is only required once it has

⁴⁶ See Oliver Lorz, ‘Capital mobility, tax competition, and lobbying for redistributive capital taxation’, *European Journal of Political Economy* 14, no. 2 (1998), for an economic analysis of the effects of capital mobility, tax competition and lobbying

⁴⁷ Gilbert N.M.O. Morris, ‘The Loss of Sovereignty, the United Nations, and Offshore Financial Centres’, *Tax Notes International* 23 (2001), 1298.

become taxable—after that income is transferred into the territorial boundaries of the taxpayer’s resident state. For a world-wide-based tax regime, such as that maintained by the United States, access to information on foreign income is necessary in order to discourage, if not prevent, tax evasion. Amongst the subordinate jurisdictions of the United States, this problem is resolved by using federal income tax return data to calculate the local income tax. Federal regulations and legislation created a national income information reporting regime comprised of data submitted by employers and financial institutions. The sub-national jurisdictions rely on that regime in order to collect their income tax revenue. The individual, however, must voluntarily report foreign source income.

American judicial attitudes towards requesting evidence for criminal investigations from offshore financial centres were discussed earlier. A flexible approach to criminal investigation and evidence gathering has been the norm. The effective extraterritorial enforcement of American law was touched upon in chapter 5. The example commonly offered is the case of the Canadian manager of a Cayman Islands branch for the Bank of Nova Scotia who was served an American subpoena while transiting through Miami airport.⁴⁸ Moreover, Antoine highlighted the fact that U.S. courts found the effort to seek juridical assistance in the Caribbean as ‘costly and time consuming.’⁴⁹

By way of example, consider the most recent engagement between the U.S. and the Caribbean financial centres. In keeping with past practice for extraterritorial enforcement of tax policies, the IRS initiated a fishing expedition in search of tax evasion by U.S. citizens in 2000. Yet, rather than pursuing specific suspects using a spear gun, they engaged a trawler with a drift net, sifting all possible fish with offshore credit card accounts managed by a bank in one of several Caribbean jurisdictions. The IRS first began to

⁴⁸ Refer back to p. 139.

pursue offshore credit card accounts in 2000 by presenting U.S. based firms with court orders to release the account information to the government. A federal judge in Miami supported the effort with a court order authorising the use of 'John Doe' summonses. These generic summonses demanded transaction records and account holder information from American Express and MasterCard.

These summonses were designed to obtain limited information for 1998 and 1999 revealing U.S. participants in offshore arrangements who hold credit cards issued by banks from Antigua and Barbuda, the Bahamas, and the Cayman Islands. It is not illegal to have an offshore credit card. However, there is a reasonable basis for believing that some people are using offshore credit cards to evade paying U.S. taxes.⁵⁰

This justification would be repeated frequently and comes with the implicit suspicion that the holder of a foreign account is engaged in tax evasion. This suspicion was underscored by an initial claim that 1 to 2 million citizens maintained an offshore credit card account, while only 117,000 taxpayers reported having any offshore account in 1999.⁵¹

The campaign continued in March 2002, when the IRS used a federal judge in San Francisco to get additional information from Visa covering credit card account transactions for 1999 - 2001. These summonses covered 'cards issued by banks in over 30 tax haven countries.' The court petition was supported by an affidavit detailing MasterCard International's acquiescence to IRS demands, providing the records for accounts located in Antigua and Barbuda, the Bahamas, and the Cayman Islands.⁵²

Collecting data directly from the credit card issuing corporations was not sufficient in this quest for tax evaders. First, the IRS found that it was unable to identify individuals from the data provided by MasterCard. MasterCard International processes credit card

⁴⁹ Rose-Marie Belle Antoine, *Confidentiality in Offshore Financial Law* (Oxford: Oxford University Press, 2002), pp. 287 - 288.

⁵⁰ *IRS Chronology On Credit Cards and John Doe Summons*, 2003, Web page, Internal Revenue Service, Available: <http://www.irs.gov/newsroom/article/0,,id=105698,00.html> [accessed 16 July 2003].

⁵¹ Associated Press, *New I.R.S. Request on Credit Card Data*, Business, 16 August 2002, Web page, *The New York Times*, Available: <http://www.nytimes.com/2002/08/16/business/16CARD.html> [accessed 20 August 2002]. These figures, attributed to the General Accounting Office in one report, were widely repeated.

⁵² *IRS Chronology On Credit Cards and John Doe Summons*.

transactions, but all data on individual account holders remained with the issuing bank.⁵³ Because of this fact, it is the bank itself, which must provide data on any specific individual. In the case of one bank in the Bahamas that refused to cooperate, MasterCard was pressurised by the IRS to withdraw the bank's license to issue credit cards. The result was the sudden, abrupt closure of *all* MasterCard accounts managed by the Bahamian Leadenhall Bank and Trust, affecting its non-American customers as well as any potential targets of the IRS tax evasion investigation.⁵⁴ An earlier statement by the bank's Managing Director pointed out that customers were responsible for complying with U.S. government regulations, and not the bank.⁵⁵ While the point is historically accurate, however, circumstances have changed, and there is now an increased awareness of 'suspicious financial transactions'. The emphasis now is on the fact that it is a responsibility of bank employees and banks to report suspicious account activity—to *local* authorities.⁵⁶ This latter point is the crux of the matter, for an action which may be suspicious in the eyes of the IRS (or another tax administration) may not be questionable under the laws of the Bahamas, the Cayman Islands, Switzerland, etc. Nevertheless, similar 'know your customer' policies are implemented by these Caribbean banks as required by FATF anti-money laundering recommendations. The fundamental existence of these differences between jurisdictions however, prevented the establishment of an OECD agreement on a common definition for tax fraud in September 2003.⁵⁷ It should also be noted, as a point

⁵³ Ibid.

⁵⁴ Martella Matthews, 'IRS pressure kills Leadenhall Mastercards', *The Nassau Guardian* (Bahamas), 30 July 2003, Available: <http://www.thenassauguardian.com/business/278287488782622.php> [accessed 19 August 2003].

⁵⁵ Lindsay Thompson, 'Clients' job to provide credit card data to U.S. IRS', *The Nassau Guardian* (Bahamas), 18 March 2003, Available: <http://www.thenassauguardian.com/business/284215735111517.php> [accessed 3 April 2003]. A similar position was assumed on the part of bankers in Luxembourg. See Jeanne A. K. Hey, 'Luxembourg: Where Small Works (and Wealthy Doesn't Hurt)', *Small States in World Politics: Explaining Foreign Policy Behavior*, ed. Jeanne A. K. Hey (Boulder and London: Lynne Rienner Publishers, 2003), p. 81.

⁵⁶ This is discussed in the context of U.S. domestic policy and the USA PATRIOT Act below.

⁵⁷ Andrew Parker, 'OECD tax plan faces collapse', *The Financial Times* (London), 10 October 2003. See also David Spencer, 'Tax Information Exchange and Bank Secrecy (Part 1)', *Journal of International Taxation* 16, no. 2 (2005); David Spencer, 'Tax Information Exchange and Bank Secrecy (Part 2)', *Journal of International Taxation* 16, no. 3 (2005).

of interest, that U.S. Department of the Treasury Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, requests account details – including the type of account (Bank, Securities, or Other), account number and financial institution where the account is held. There is also a selection of check boxes to identify the ‘Maximum value of account’. From this form, it is not obvious that submission of it is even required if one only possessed a foreign credit card account. Particularly since the form includes the note, ‘No report is required if the aggregate value of the accounts did not exceed \$10,000.’⁵⁸

The second consequence of collecting insufficient data from the credit card companies was the need to issue further summonses. These IRS summonses were targeted at ‘a limited number of businesses that engaged in business or financial transactions with individuals using MasterCard payment cards issued by or through banks in Antigua and Barbuda, the Bahamas or the Cayman Islands.’⁵⁹ This work-around to collecting the data directly from the banks was reported in *The New York Times* as targeting a variety of firms including airlines, hotels, rental car companies and Internet service providers.⁶⁰ The focus on these three Caribbean jurisdictions is also noteworthy. A report in *The Royal Gazette* (Hamilton, Bermuda) discussed the IRS program and the local criticism of it as ‘another example of misconceptions surrounding so-called tax havens.’ At the same time however, the paper emphasised Bermuda’s absence from the list, implying that banks in the jurisdiction were not involved in any questionable activity.⁶¹ Local bankers suggested this

⁵⁸ Observe that this is also the cut-off point for filing a currency transaction report (CTR) in compliance with anti-money laundering statutes. Information and a downloadable version of the form are available at <<http://www.irs.gov/formspubs/index.html>>.

⁵⁹ *IRS Chronology On Credit Cards and John Doe Summonses*.

⁶⁰ Associated Press, *IRS Wants Wider Credit Card Probe*, Business, 29 August 2002, Web page, *The New York Times*, Available: <http://www.nytimes.com/aponline/national/AP-Tax-Havens.html> [accessed 1 September 2002].

⁶¹ ‘IRS credit card scheme under fire’, *The Royal Gazette* (Hamilton, Bermuda), 15 January 2003, Available: <http://www.theroyalgazette.com/apps/pbcs.dll/article?Site=RG&Date=20030115&Category=BUSINESS&ArtNo=101150058&Ref=AR> [accessed 19 January 2003]. At this time Bermuda does not possess a legislatively-defined structure for an offshore financial centre.

absence was because of Bermuda's 'due diligence processes' and their rejection of any prospective customer demonstrating 'improper motives.'⁶²

The IRS claimed in July 2003 that 'about 2,800 tax returns' were undergoing audit with the expectation 'that number will continue to grow.' At the same time, the IRS had referred 'dozens of cases' for possible criminal prosecution. Actually, this is an encouraging figure, for it suggests that the vast majority of the account holders remain honest, tax-paying citizens. To find possible prosecutions in the range of 'dozens', after announcing an estimate of over a million possible undeclared offshore accounts, produces an infinitesimally small percentage of possible tax evasion cases involving credit card accounts. If there were six dozen possible cases for example, that is a mere 0.0072 percentage of the estimated one million suspect accounts. Of more interest to the rest of the taxpaying public may be the cost for these efforts, as compared with the tax revenue recovered by the program. While the IRS reported in July 2003 to have collected \$3 million through this program, its costs have not been reported.⁶³ However, we may contrast the accomplishment of this IRS effort with an official claim that some \$20 - 40 billion in tax revenue is lost annually because of offshore tax evasion.⁶⁴ A report from the General Accounting Office to the Senate Finance Committee in 2003 underscored the fuzzy nature of estimating tax evasion. 'The full scope of the abusive tax scheme problem is unknown because estimates are difficult to make based on imperfect data.'⁶⁵

⁶² Ibid.

⁶³ *Offshore Compliance Program Shows Strong Results*, 30 July 2003, Web page, Internal Revenue Service, Available: <http://www.irs.gov/newsroom/article/0,,id=111987,00.html> [accessed 20 August 2003].

⁶⁴ General Accounting Office, *Internal Revenue Service: Efforts to Identify and Combat Abusive Tax Schemes Have Increased, but Challenges Remain*, (Washington, D.C.: General Accounting Office, 2002), p. 7, Available: <http://www.gao.gov/new.items/d02733.pdf> [accessed 8 November 2002].

⁶⁵ *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Schemes*, (Washington, D.C.: General Accounting Office, 2003), p. 6, Available: <http://www.gao.gov/new.items/d0450.pdf> [accessed 7 January 2004]. This report contained the latest figure for U.S. taxpayers engaged in abusive tax schemes as 'more than 400,000.' This estimate reflects a new method of assessing the limited data on tax avoidance in the United States. It was qualified by the GAO's statement that 'We are unaware of a specific IRS or other policy that requires contemporaneous documentation of a figure like the 400,000 estimate of taxpayers IRS expects to identify as engaged in abusive schemes. (p. 7).'

The pursuit of offshore credit cards is similar to the case discussed earlier for the use of an ATM card backed by an offshore bank account. Where an ATM card often has a daily transaction limit, a credit card does not, just a limit upon the line of credit. Moreover, with a credit card, undeclared income need never come ashore, as the credit card account could be paid directly from a linked account. Finally, it is possible to have a rather large credit limit, permitting the purchase of an extensive range of goods and services. Consequently, while the IRS fear is quite reasonable, the limited focus on these few Caribbean jurisdictions targets weak opponents. Even discounting some offshore jurisdictions as too 'inconvenient', it does not explain why for example, Panama was not subjected to the same inquisitive methods.

Combating Terrorist Financing

The terrorist attacks of 11 September 2001 are not central to the argument of this thesis. However, these events have reverberated throughout the international system, affecting how states treat with each other, and how they interact with both their citizens and the citizens of other states. In this section the events and their consequences are viewed in the context of the changes to domestic and foreign policy in the United States affecting international finance. As noted in the previous discussion on money laundering, measures to counter money laundering are now also measures to counter the financing of terrorism. Added to this are the international (extraterritorial) implications of the domestic imposition of the USA PATRIOT Act. This was a hodgepodge of law enforcement measures that had been set aside whenever suggested in the past after determining they were contrary to American ideals of liberty, freedom, and civil rights. However, they were resuscitated and legislated in very short order after 11 September 2001. The full extent of this hasty action is increasingly experienced by U.S. residents, and those firms that conduct business with and within the United States.

Impact on financial businesses

Measures against money laundering as distinct from other criminal activity have been in place in the United States since 1986. However, the intensity and scope of the surveillance of financial and financial-related transactions expanded significantly after 2001. The reaction to the terrorist attack gave state authorities the opportunity to include businesses that they had previously been unable or unwilling to force into the campaign against money laundering. This change is reflected in both the USA PATRIOT Act revisions to U.S. banking and anti-money laundering laws, and the 2003 revision of the FATF Forty Recommendations for anti-money laundering legislation. The explicit inclusion of various non-financial services business activities and individuals conscripted them into the fight against both money laundering and the financing of terrorism. The previous version of the Forty Recommendations suggested that ‘appropriate national authorities should consider applying’ the Recommendations to any *financial* transactions a non-financial services firm might perform. These firms were characterised as ‘designated non-financial businesses and professions’, and they are now explicitly identified. Amongst the named non-financial firms are casinos, realtors, lawyers, accountants, jewellers, and trust and company service providers. Thus, while they are not ‘financial’ businesses, they all potentially handle sizeable quantities of money. With the 2003 version of the FATF document, Recommendation 20 now encourages the application of the Recommendations to any other businesses and professions ‘that pose a money laundering or terrorist financing risk.’⁶⁶

At the same time, the sheer magnitude of the task facing the financial services industry and government agencies must be recognised. Every significant financial transaction (one that is either suspicious or in excess of \$10,000) is subject to review and

⁶⁶ Financial Action Task Force, *The Forty Recommendations (2003)*, p. 7.

analysis. Just to focus on a single data stream, the monitoring of international currency transactions provides an idea of the magnitude of this surveillance challenge. The Office of Technology Assessment's 1995 report contained figures of 700,000 wire transfers a day occurring in the United States for a total in excess of \$2 trillion ('of which perhaps from 0.05 percent to 0.1 percent represent money laundering').⁶⁷ A magazine article in 2000 noted that the Financial Crimes Enforcement Network (FinCEN) received over 12 million Currency Transaction Reports (submitted for a cash transaction over \$10,000) and an average of 10,000 Suspicious Activity Reports a month from banks.⁶⁸ With reporting requirements now expanded to include check cashing services, investment/brokerage firms, lawyers, accountants, insurance companies, etc., the figure reported for fiscal year 2002 was still only 12.8 million.⁶⁹ Just as academics and researchers find themselves overwhelmed by the sheer mass of information available, so too are financial analysts, bank staff, and regulatory and crime enforcement agencies. Essentially, by defining the pursuit of money laundering and the financing of terrorism to include 'non-financial businesses and professions,' governments are carpet-bombing the global financial system in pursuit of a handful of needles buried in the hay stack (to mangle my metaphors). The imposition of increased data collection only serves to conceal suspicious transactions further.

⁶⁷ U.S. Congress Office of Technology Assessment, *Information Technologies for Control of Money Laundering*, p. 9. This percentage amounts to between \$1 and \$2 million a day of *possible* money laundering.

⁶⁸ Julie Wakefield, *Following the Money*, 1 October 2000, Web page, Government Executive Magazine, Available: <http://www.govexec.com/features/1000/1000s5.htm> [accessed 10 May 2002].

⁶⁹ Financial Crimes Enforcement Network, *Use of Currency Transaction Reports*, Report to the Congress, (Washington, D.C.: U.S. Department of the Treasury, 2002), p. 2, Available: <http://www.fincen.gov/section366report.pdf> [accessed 25 January 2004].

‘It’s a huge burden on the banks. It could mean that every time somebody trades in some stock and just buys other stock with the same money, it’s got to be reported to FinCEN. [They] are giving themselves millions of times more information than they can possibly handle or analyze. ...What if you get a \$25,000 or \$50,000 book advance? ‘Oh, that’s an anomaly; let’s look at this guy.’ Think of the probably millions of anomalies occurring every day. It’s really stupid.’⁷⁰

Efforts to manage and analyse this data has led to the expansion of a burgeoning security industry, of high-tech firms developing hardware and software to identify faces in a crowd, or the suspicious purchases made with your credit card. This financial security structure now comprises financial institutions, the U.S. Treasury and related government offices, and the suppliers of government and business software and services. One analysis concluded that the predicted cost for anti-money laundering surveillance amongst banks, investment and insurance firms could reach \$10.9 billion by 2005. This assessment is premised upon an estimate that \$856.6 billion would be laundered worldwide in 2002, of which perhaps 0.25% was by terrorist groups. The remainder was attributable to illegal drugs, other international smuggling activities, and similar illegal conduct.⁷¹

The impact of these financial surveillance measures in the United States (and similarly other developed states) is no less momentous for the offshore financial centres. After expanding banking supervision capabilities in response to the 2000 Non-cooperative Countries or Territories report from the FATF, they now find themselves further extending already stretched resources to search out terrorist financing.⁷² Moreover, the procedures must not only satisfy the United Nations or assessments of compliance with

⁷⁰ John Berlau, ‘Show Us Your Money’, *Reason*, November 2003, p. 27, Available: <http://www.reason.com/0311/fe.jb.show.shtml>. The author is quoting J. Michael Waller, vice president of the Center for Security Policy (‘a hawkish D.C. think tank’) and professor of international communications at the Institute of World Politics.

⁷¹ Liz Rappaport, *Anti-Money Laundering Costs Expected To Reach \$10.9 Bln By 2005, Predicts Report*, 18 October 2002, Web page, InstitutionalInvestor.com, Available: <http://www.institutionalinvestor.com/iiochannel/banking/20021017000900.htm> [accessed 28 October 2002].

⁷² Lindsay Thompson, ‘Terrorist financing eludes region’, *The Nassau Guardian* (Bahamas), 7 June 2004, Available: <http://www.thenassauguardian.com/business/293696005069027.php> [accessed 28 June 2004].

the FATF's Special Recommendations on Terrorist Financing, but they must also satisfy the USA PATRIOT Act.

Extraterritorial influence

Action against money laundering and the financing of terrorism is not only recommended by the FATF. In September 2001, the United Nations Security Council approved a resolution that mandated UN member states to act against terrorist financing.⁷³

Startling even many longtime U.N. watchers, the Security Council ordered members to implement new antiterrorism measures under the charter's tough 'Chapter 7' provision--meaning countries that didn't comply could, at least in theory, be compelled to do so. The resolution on Sept. 28, 2001, required countries to criminalize the financing of terrorist groups, setting up a committee to monitor compliance. The resolution was 'one of the most intrusive the organization has ever passed,' says John Ruggie, a Harvard professor of international relations and former U.N. official.⁷⁴

As suggested above, the difficulty is not limited to complying with the UN. Now, foreign firms with offices in the U.S., or conducting business within the U.S. must comply with USA PATRIOT Act provisions. An editorial in *The Manila Times* highlighted the magnitude of fines facing Filipino financial institutions with U.S. branches, if they failed to have satisfactory surveillance (anti-money laundering controls).

Even if there isn't a clear-cut money laundering case, poor AML controls can also lead to fines. A US Money Services Business—Western Union—has had to pay a fine of US\$8 million for poor AML controls. The New York branch of the Bank of China was fined US\$20 million in January 2002 by the US OCC [Office of the Comptroller of the Currency] for irregular loans—they are also embroiled in a nasty money laundering scam that links from China to Hong Kong and Canada.⁷⁵

As pointed out in the previous discussion of the Philippines' experience with the FATF, this could have a major impact on the economy of this developing state. Anything which

⁷³ United Nations Security Council, 'Resolution 1373 (2001)', *S/RES/1373 (2001)* (2001).

⁷⁴ Alix M. Freedman and Bill Spindle, 'Global Upheaval Shakes Roots of U.N. Mandate to their Foundations', *The Wall Street Journal Europe* (Brussels), 19 - 21 December 2003, p. 8.

⁷⁵ Rohan Bedi, 'The new anti-money laundering regime', *The Manila Times* 3 March 2003, Available: <http://www.manilatimes.net/national/2003/mar/03/opinion/20030303opi5.html> [accessed 7 March 2003].

constrains the banking system, and in particular the international transfer of money, will constrain the remittances made by Filipinos living abroad. Given the quantity of these remittances the situation could have a significant impact to the national economy. The same set of circumstances will apply to any economy where such remittances are an influential factor in the domestic economy.⁷⁶

An article in a New Zealand business weekly highlights another aspect of how the USA PATRIOT Act affects local financial institutions. The Act established that if an American bank (financial institution) is unable to certify that a foreign partner had implemented effective systems for verifying the identity of its customers, then the American bank was 'forbidden' from conducting any business with the foreign institution.

The regulations are wide reaching. For example, if American credit card system operators, Mastercard, Visa and American Express, can't ensure an organisation which issues its cards and receives payment on its cards has adequate systems in place, it is not allowed to let that organisation issue its cards.⁷⁷

The consequences of this reach beyond the pursuit of terrorist financing. For example, if it were determined that the Caribbean banks targeted by the IRS in its pursuit of tax evaders via credit cards had not implemented 'effective' systems of customer identification, the U.S. could force MasterCard, Visa, etc. to terminate their licenses to issue credit cards. This hypothetical situation could result if a case were made that local bank confidentiality laws interfered with an external assessment of the banks' customer identification systems. By extension, this evaluation would lead to the termination of all financial dealings with these banks from the U.S., and from any other states following the lead of the U.S. on international financial activity. In this fashion, laws ostensibly intended to combat

⁷⁶ Total remittances reported for 2004 by the Central Bank of the Philippines were US\$8.5 billion. Central Bank of the Philippines, *Overseas Filipino Workers' Remittances By Country and By Type of Worker*, 3 June 2005, Web page, Available: <http://www.bsp.gov.ph/statistics/sefi/ofw.htm> [accessed 10 June 2005].

⁷⁷ Lesley Springall, 'Conscripted By US Patriot Act', *The Independent* (Auckland), 22 November 2002, Available: <http://xtramsn.co.nz/business/0,,5007-1938571,00.html> [accessed 27 November 2002].

terrorism could be applied against jurisdictions with banking confidentiality because they are seen as facilitating tax avoidance.⁷⁸

While it is true that *agreement* to counter financial crimes, whether in New Zealand, United States or United Kingdom, is an international public good—at issue is the question of *who* determines the *banned*? For example, the U.S. bans commercial contact with Cuba, but Canada and most European states no longer take this action. In the case of the USA PATRIOT Act, the Offshore Finance Inspector for St. Vincent and the Grenadines declared in 2002 that,

It single-handedly casts the anti money laundering standards of the US government on all institutions across the world seeking to benefit from the US banking system. It is potentially more far reaching than any black list. Like the President George W Bush said – you are either with us or against us. There is always a choice – you can comply or not comply but if you don't comply do not expect to do business with the US.⁷⁹

Again, there is a global consensus for the need to fight both criminal money laundering and the financing of terrorism. There is no such consensus on tax avoidance/evasion, yet these same laws could be deployed as part of the campaign against 'tax havens'. Moreover, it must be recognised that U.S. extraterritorial initiatives extend beyond international finance. There are also regulations concerning passenger data on international airline flights and security inspections and shipping invoice data from container ships bound for U.S. ports.⁸⁰

⁷⁸ For example, the U.S. Treasury announced on 21 April 2005 that it had 'judiciously and strategically utilized the power of Section 311' of the USA PATRIOT Act and designated two financial institutions in Latvia as 'primary money laundering concerns.' A news report from Riga, Latvia stated that one of the two banks affected had revealed 'a sharp drop in assets' immediately following this announcement. U.S. Treasury, *Treasury Wields PATRIOT Act Powers to Isolate Two Latvian Banks Financial Institutions Identified as "Primary Money Laundering Concerns"*, JS-2401, 21 April 2005, Web page, Office of Public Affairs, Available: <http://www.treas.gov/press/releases/js2401.htm> [accessed 19 September 2005]; The Baltic Times, *U.S. government blacklists two Latvian banks*, 28 April 2005, Web page, Realty.lv, Available: <http://www.realty.lv/eng/news/?category=&id=38396028042005113132> [accessed 19 September 2005].

⁷⁹ S. Louise Mitchell, 'The Implications of the USA Patriot Act on Foreign Banking Institutions' (paper presented at the National Anti Money Laundering Training Seminar, Kingstown, St. Vincent and the Grenadines, 24 May 2002), Available: <http://www.stvincentoffshore.com/pdf/USA%20Patriot%20Act.pdf> [accessed 10 September 2004].

⁸⁰ Sara Kehaulani Goo, 'Passenger Lists Sought For Flights Over U.S.' *The Washington Post* 21 April 2005, Available: <http://www.washingtonpost.com/wp-dyn/articles/A6015-2005Apr20.html> [accessed 21 April 2005]. For a brief discussion of the Container Security Initiative see Patrick Lenain, 'The economic consequences of terrorism', *Business and Security: Public-Private Sector Relationships in a New Security Environment*, eds. Alyson J.K. Bailes and Isabel Frommelt (Oxford: Oxford University Press, 2004).

Thoughts on the U.S. presence in the tax competition debate

The transition from support to ambivalence by the United States presents a problem for those members of the OECD promoting the information exchange element of the OECD project. The characterisation of the U.S. as the world's largest offshore tax haven was noted and emphasises the OECD's need for the full co-operation and participation of the U.S. in its project. Even with low interest rates in the United States, the ability to collect interest without taxation (for non-resident non-citizens) remains attractive as an alternative to possessing an account in a place deducting income taxes. Yet the OECD has not explicitly and publicly confronted this opportunity for tax avoidance. Similarly, the OECD did not consider Singapore as a potential tax haven when it began the project.⁸¹ As a result, the OECD has never listed this small island state as an uncooperative jurisdiction, nor was it identified as a location required to exchange taxpayer data with the EU. Consequently, Singapore has been touted as a potential safe haven, 'and is welcoming European private banks that want to develop their wealth management operations.'⁸² This anomaly was noted in a *Financial Times* article reviewing the tax competition project at the end of 2003. It went on to indicate that the OECD was expected to open discussions with Singapore on information exchange in 2004, though there is no public indication that this activity occurred.⁸³ Significantly, the U.S. also remains outside the functional parameters of the project when the only activity identified as a preferential tax regime was the same Foreign Sales Corporations regime that was subject to a WTO challenge.⁸⁴

⁸¹ Bruce Zagaris, 'OECD Issues Progress Report on Harmful Tax Practices and Outlines "Defensive Actions"', *International Enforcement Law Reporter* 20, no. 5 (2004).

⁸² John Burton and Andrew Parker, 'Is the global crackdown on tax evasion "slowing to the speed of the last ship in the convoy"?' *The Financial Times* (London), 1 December 2003, p. 17.

⁸³ *Ibid.*

⁸⁴ Organisation for Economic Co-operation and Development, *Towards Global Tax Co-operation*, p. 14; Organisation for Economic Co-operation and Development, *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report* (Paris: OECD Publications, 2004), p. 9. As the 2004 Report correctly noted, the Foreign Sales Corporation regime was abolished. At the same time, however, the relevant legislation also created 'extraterritorial income exclusion provisions'

The U.S. is in the position that it does not require global co-operation on taxation or information exchange. With the aggressive pursuit of abusive tax schemes by the IRS (the offshore credit card investigation is just one element of the process), and its development of an extensive web of bilateral agreements, the U.S. is able to threaten, if not achieve, a significant level of interdiction against tax evasion by individual tax payers.⁸⁵ The pursuit of international corporate tax minimisation is rather more complex. That is a multi-player game involving the firm, the U.S., and every other state in which the firm has some presence and where it surrenders a measure of tax revenue. Within this game are such additional factors as tax holidays and tax abatements to attract foreign direct investment, the use of transfer pricing and thin capitalisation by the firm to transfer profits to lower tax jurisdictions, and the existence of jurisdictions that do not tax capital in which to establish corporate accounts (for example a holding company in the Cayman Islands). Nevertheless, some research shows that revenue from corporate tax has not declined, though it also perhaps has not increased in line with overall economic growth in some sectors.⁸⁶ Yet, we stand at a point in time where economic figures, calculations and estimates are suspect. Models built on data from the 1990s reflect the economic growth and ‘new economy’ boom of that decade. More recent data (since the recession of 2001) is not yet available in quantity for analysis. Certainly, all tax revenue has declined in the past several years, which only seems reasonable since profits, interest and dividends have also declined.⁸⁷

in U.S. tax law. These new features for corporate tax preferences have also been challenged at the WTO and at the time of writing WTO Dispute Case DS108, ‘United States – Tax Treatment for “Foreign Sales Corporations”’, remains active.

⁸⁵ For an analysis of the U.S. Tax Information Exchange Agreements with the Bahamas and the Cayman Islands in the context of the OECD harmful tax competition project, see David Spencer, ‘OECD Project on Tax Havens and Harmful Tax Practices: An Update (Part 2)’, *Journal of International Taxation* 13, no. 5 (2002), pp. 35 - 36.

⁸⁶ John M. Hobson, ‘Disappearing taxes or the “race to the middle”? Fiscal policy in the OECD’, *States in the Global Economy: Bringing Domestic Institutions Back In*, ed. Linda Weiss (Cambridge: Cambridge University Press, 2003).

⁸⁷ Organisation for Economic Co-operation and Development, *Revenue Statistics, 1965 - 2002* (Paris: OECD Publications, 2003).

Finally, as suggested by the short discussion of domestic lobbying activity on the topic of taxation and tax competition, the OECD project is but one facet of domestic politics concerning taxation. Throughout the past few decades of both government budget deficits and budget surpluses, taxation has been an important issue within domestic politics. Notwithstanding the attention paid to globalisation, global trade, and the increasing American trade imbalance, debates in the United States on taxation and information exchange will remain embroiled in domestic political concerns for the foreseeable future.

CONCLUSIONS

The end may justify the means as long as there is something that justifies the end.

– Leon Trotsky¹

Within this research on small state sovereignty, the controversial nature of the case study itself should be very apparent. Taxation is a domestic issue exciting great emotion on the part of taxpayers and tax administrators alike. In this instance then, a domestic policy concern intersects with relations between states, over the actions of their citizens and resident firms in relation to decisions made about who, what, and how much to tax. Global tax minimisation is not however, an intersection represented by a singular point; it is rather a collection of points variously representing individuals, firms, and the cross-section of state actors, large and small. Moreover, it is facilitated, and opposed, by an extensive network of lawyers, accountants, bankers and financial advisors.²

The first section of this chapter summarises a number of salient points from the preceding chapters about small states, state sovereignty and taxation. With this accumulation of relevant details refreshed, the next section considers the impact of the offshore taxation issue upon small states, for their efforts to maintain sovereignty, construct sovereignty, and, where necessary, share sovereignty. The final section tackles the overarching question of what this case study about offshore finance indicates for the

¹ Quoted in Alberto Pozzolini, *Antonio Gramsci: An introduction to his thought*, trans. Anne F. Showstack (London: Pluto Press, 1970), p. 21.

² Prem Sikka and Mark P. Hampton, 'The role of accountancy firms in tax avoidance: Some evidence and issues', *Accounting Forum* 29, no. 3 (2005); Jonathan Weil, 'How Big Banks Played Key Role in Tax Shelters', *Wall Street Journal Europe* (Brussels), 19 August 2005.

future of small state sovereignty, and the continued presence of the 'offshore' in international society.

A Summation

In order to present an analysis that is focused on the sovereignty of small states, a number of preliminary topics were explored and their relevance delimited. A common understanding for both sovereignty and size was established for use within the context of this research project. The first topic discussed was *sovereignty*, with an implicit acceptance that states exist and are sovereign in terms of independence of action and (relative) freedom from outside interference. The inside/outside dichotomy inherent in accepting the state as given simply acknowledges the social nature of the situation as an organising method for groups of people to interact with other, similar groups of people. Either one is a member of a group, or one is not a member of that group. This is a constant circumstance, whether the group is a schoolyard clique, one's co-workers within a large corporation, a political party, or the citizenry of some bounded territory.

A definition of the 'small' state was identified and justified; the one used here is the same as that used by the Commonwealth, a multinational organisation with a significant number of small states among its members. Moreover, the definition emerges from a literature extending back a number of decades and efforts made to understand and incorporate the proliferation of small states following decolonisation. Thus, for this research project a small state is one possessing less than 1.5 million residents, and on this criterion 28 Commonwealth members were identified as small states. These states are also developing economies, explaining in part the efforts made by the Commonwealth to assist them in a variety of ways on development matters.

The discussion then turned to features of the specific controversy over tax competition, which has been used by a number of developed states to dispute the

sovereign decisions of a number of small states. Characteristics of offshore financial centres were placed into historical and geopolitical context, as a prerequisite to developing an understanding of the nature of the threat posed to their sovereignty by the OECD project on harmful tax competition. The project, as described by OECD publications, is contingent upon creating a perception that offshore finance does not meet the regulatory standards of onshore jurisdictions, and that offshore financial services exist solely to serve the interests and needs of money launderers, tax avoiders and drug traffickers. Offshore jurisdictions are viewed as somehow existing ‘outside’ the system of sovereign states, and continuing in the pirate traditions of their ancestors by ‘poaching’ the tax revenues of developed states. Through the provision of offshore finance, small states facilitate the efforts of citizens to operate as ‘free-riders’ on the public goods of their state of residence by not contributing tax revenue towards their maintenance.

The OECD perspective confronts the very nature of *fiscal* sovereignty—the right of a sovereign state to determine what, and how much, tax to impose on its residents and citizens.³ The topic of fiscal sovereignty is a fundamental point of contention with respect to the OECD project, and a source for the tension embedded within the OECD declaration that tax competition is a form of global harm. On the one hand, their documents clearly state that this effort is not intended to negate the fiscal sovereignty of any sovereign state. On the other hand, they also declare that as a consequence of the different approaches to taxation (such as choosing not to have an income tax), this diversity is itself the source of harmful tax competition and thereby a source of global harm. The study by Ramon Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation*, argued that long-held concepts of sovereignty are impeding the

³ Again, the distinction between *residents* and *citizens* is important. Most states impose some measure of income taxation upon all residents, whether or not they are citizens of that state. In addition to this tax, some states have decided to tax the global income of their *citizens* irrespective of where they reside. The differing impact on questions of tax evasion/avoidance in the context of territorial versus worldwide income taxation was discussed above at p. 98.

efforts of states to enforce their own tax laws. Efforts to enforce domestic tax law upon residents have been impeded by a lack of information concerning any foreign assets or investments. This information has not been forthcoming because sovereign independence means that no state is obligated to function as the tax agent for any other sovereign state. A similar argument could be made about any number of issues impacted by globalisation (*qua* interdependence) due to differences in state legal structures and regulations, for example labour standards.⁴ However, in order to satisfy the desires and concerns over public goods, the state requires sovereignty (the independence to act) over its fiscal activity, for both the collection of revenue and the allocation and distribution of the revenue. This situation is just as relevant to the small state with the OFC as it is to the large state with an extensive public welfare apparatus. It is simply a matter of scale between the two extremes.

Fundamental differences exist between states in this area, and domestic perceptions about taxes shape both the depiction of harmful tax competition emerging from the OECD, and reactions to the project. Consequently, a vital factor for the success of the harmful tax competition project is co-operation amongst all sovereign states to support and enforce its objectives. As suggested by the brief historical example of the American experience with alcohol prohibition in the early twentieth century, without co-operation the means and opportunity to circumvent any information exchange structure resulting from the OECD project will likely remain available. Indeed, this is explicitly recognised by the inclusion of a process to ‘name and shame’ non-co-operative jurisdictions into acquiescing to the OECD’s demands, and of proposals to impose ‘defensive’ reprisals should blacklisting prove insufficient to force co-operation. Here again, global co-operation is essential to impose and maintain an effective reprisal regime. Without it, a space would exist which could permit the uncooperative jurisdiction to circumvent the

⁴ Anita Chan and Robert J S Ross, ‘Racing to the bottom: international trade without a social clause’, *Third World Quarterly* 24, no. 6 (2003).

regime and continue to serve the financial services needs of its customers, beyond the oversight of an OECD-mandated information exchange regime.

Rather than disrupting this need for co-operation, small states focused instead on several very specific aspects of the OECD project that directly impede their sovereign independence to regulate and manage the financial services sector of their economies. The first aspect of the OECD project that small states find problematic is the imposition of these changes upon them, without their involvement in the policy formulation process. Fundamentally, the changes expected by the OECD are in conflict with existing laws concerning confidentiality and privacy in financial services. The next aspect addressed was the contention that the OECD is not the appropriate forum in which to negotiate the solution to an ostensibly global problem. The small states identified by the OECD as harmful competitors are not members of the club, while members of the OECD club appear to receive different (preferential) treatment concerning their financial sectors and tax administrations. This second point leads quite naturally into the third aspect of the critique presented concerning the OECD project, which is the expectation that efforts to counter harmful tax competition embody common standards and rules for all jurisdictions. Some small states submitted conditional agreements to co-operate with the OECD, subject to the condition that all states operating financial service centres be treated the same—whether or not the state in question is a member of the OECD club.

In response to these concerns, OECD representatives emphasised the establishment of a Global Forum on Taxation, which includes representation from non-OECD member states. Moreover, they insisted that the OECD is the correct multilateral organisation to tackle the issue of tax competition and that one standard of conduct applies, whether or not a state is a member of the OECD. The discussion then went beyond small states to include the small non-self-governing territories that host an OFC. These territories are identified as independent from their administering state on the list of

non-co-operative jurisdictions, yet they are treated as an extension of that state for the purposes of compliance. Furthermore, dependencies of the United Kingdom and the Netherlands are under pressure to comply with the requirements of the EU Savings Tax Directive.

As part of the effort to contest the rationale behind the harmful tax competition project, and to counter-balance the OECD, some small states looked to the Commonwealth as a site for collective action. This international organisation may have originated as a club for the United Kingdom and its former colonies, but it has transformed itself into a vocal advocate for small states since the early 1980s on a variety of international issues. The Commonwealth has served as a collective voice for its small members on the issue of tax competition, and the Secretariat has facilitated and mediated meetings between small states and the OECD. At the same time, there was an effort to overcome the lack of international representation for the non-self-governing jurisdictions with an OFC by inviting them to become members of the International Tax and Investment Organisation. Again, this is an international non-governmental organisation intended to serve 'as a forum in which small and developing economies (SDEs) work on an equal basis and speak with a common voice' irrespective of their sovereign status.⁵

As discussed earlier, the flow of mobile capital through the offshore world has not declined since the publication of the OECD's initial report in 1998 and the sums involved are immense. As noted in particular with the Cayman Islands, but relevant to the Caribbean as a whole, these sums include the vast financial assets of captive insurance firms, offshore hedge funds, and special purpose vehicles (such as the international

⁵ ITIO, *About the ITIO*, 2003, Web page, International Tax and Investment Organisation, Available: <http://www.itio.org/about.htm> [accessed 30 July 2003].

business companies formed by Enron and Parmalat).⁶ While it must be agreed that estimates of tax avoidance are as nebulous as estimates of money laundering, nonetheless these figures will contain some measure of assets that are hiding from state revenue authorities. Yet the economies of these small Caribbean states are vulnerable to the implied threat of the OECD project. Consequently, the number of financial institutions registered in their offshore financial centres has declined; reducing in tandem the employment of local residents and the revenue collected from licenses. At the same time, it must be acknowledged that factors other than the OECD may be responsible for the decline, including the recession in the U.S. economy, the anti-money laundering efforts of the FATF, and the on-going consolidation of large multinational financial firms.

Finally, the multifaceted influence of the United States with respect to this case study was discussed. Given the size of the U.S. economy and in particular its financial sector, the U.S. is a significant actor for global financial flows and a major contributor to the activities of the OECD. The American policy position on the harmful tax competition project changed between 1998 and 2002, partly due to the 2000 presidential election and further influenced by the efforts of lobbyists and terrorists. The frequent conflation of tax evasion/competition with criminal money laundering was used by supporters of the harmful tax competition project to justify the urgent need to implement the information exchange component. Since 2001 that emphasis has shifted to imply that the OECD project also can be used to interdict terrorism. The actions of this particular large state have reverberated through the harmful tax competition project and supported the efforts of the small states to resist the OECD.

⁶ In 2005 hedge funds are receiving increased interest, both from investors and regulators. See for example Gregory Zuckerman, 'Hedge-Fund Firms Prepare For Costs of More Regulation', *The Wall Street Journal Europe* (Brussels), 9 June 2005; Financial Services Authority, *Hedge funds: A discussion of risk and regulatory engagement*, Discussion Paper, 05/4 (London: 2005), Available: <http://www.fsa.gov.uk> [accessed 22 August 2005].

Sovereignty for Small States

The focus of this work is on small states, as they strive to deal with the consequences of the actions taken by large developed states in global politics and in the global economy. In 2003, Peter Katzenstein had an opportunity to reflect upon the continued relevance of his 1985 text, *Small States in World Markets*. He commented upon the experience of the European small states, possessing open economies and following flexible economic policies, for dealing with economic change.

Whether we call it internationalisation or globalisation, the underlying condition, however, is here to stay and will force important change in how large states exercise their reconstituted sovereign powers.⁷

Yet, a large state may resist any change encouraged by this interdependence and maintain its existing economic policies. It may also seek to coerce its economic partners to cooperate in this effort in order to maintain the economic status quo. In the instance of competitive tax regimes, the OECD states are resisting the pressure from a liberalised financial system to adjust to the competition introduced by the offshore financial sector. Rather, they seek to establish a global information exchange regime to overcome the tax arbitrage possibilities provided by state sovereignty and facilitated by capital mobility. The approach of the OECD would compel co-ordination amongst states, as a means to maintain the current level of income taxation in OECD member states. Consequently, large economies are continuing to follow the policy approach described by Katzenstein in *Small States in World Markets*. 'Large industrial states tend to export the costs of change while the small European states tend to live with them.'⁸ The conclusion from Katzenstein's research was that small open economies handle increased interdependence (globalisation) better than the larger economies, in the sense that they are more adaptive.

⁷ Peter J. Katzenstein, 'Small States and Small States Revisited', *New Political Economy* 8, no. 1 (2003), p. 27.

⁸ Peter J. Katzenstein, *Small States in World Markets: Industrial Policy in Europe* (Ithaca and London: Cornell University Press, 1985), p. 59.

Within the larger realm of *state sovereignty*, the point is that the independence of action conferred by sovereignty is, has been, and will remain important for the state as part of international society. At issue here is more than just an intervention into the domestic activities of a politically defined entity (a state). It is also the concern for the freedom of choice available to citizens for them to best determine the distribution of social/public goods. In answering the question of ‘who gets what’ the relative independence of the territory to choose, and to be able to act on that choice, is important.⁹ The problem for large states is that they have residents who desire the public goods available to them while at the same time they don’t wish themselves to actually pay for these public goods.

Irrespective of how the ‘offshore world’ emerged in the global economy, the fundamental aspect remains the same. Whether it involves shipping registries, financial services or corporate residency, it is the intentional usage of sovereignty that is at the core of the activity in question. It is sovereignty and the ability not only to establish the law for a bounded territory, but to be able to fashion the law free of undesired external influence, that facilitates the presence of the ‘offshore’ in a global financial landscape. This is the problem that the OECD has to address, not that there is tax competition, harmful or otherwise, but that state sovereignty as a constituent element of the international system has been manipulated to serve as a barrier to the flow of information and thereby creates a space of privacy (secrecy) not available to citizens within the bounds of the state itself.

Maintaining sovereignty

Fiscal sovereignty, as an aspect of state sovereignty, prevents the OECD from forcing the low/no tax jurisdictions to raise their rate of tax, which would remove tax

⁹ Alternatively, as phrased by Alan James – ‘It asks, who rules - or, who is sovereign? In so doing, it echoes a famous definition of politics as the business of deciding “who gets what, when, how?”. This issue is, of course, always of supreme importance to those who are engaged in the domestic political conflict.’ Alan James, ‘The Practice of Sovereign Statehood in Contemporary International Society’, *Political Studies* XLVII (1999), p. 458. James noted – ‘This was the title of a famous book by H. D. Lasswell, *Politics: Who Gets What, When, How* (New York, Whittlesey House, 1936).’

avoidance as a motivation to maintain a foreign bank account. An attempt to do so could open for debate a complex issue within the OECD itself concerning member states' 'preferential' tax regimes and relative tax rates on income and capital. The complex and arcane structures of developed state municipal tax law result from the competing interests and desires of domestic politics. Tax rates, tax credits, deductions and exclusions are all part of the tax code in order to encourage, or discourage, certain behaviours or developments, to support targeted activities, to reward faithful constituents, ad infinitum. The very nature of these structures discourages debate over a 'global tax regime' because of the many vested interests contained within each domestic community. The situation, again, involves the right to choose the distribution of public goods within the defined territory of the state.

The resistance of small states, in the Caribbean and elsewhere, to the OECD initiative is an explicit effort to maintain their independence of action, their sovereignty. The decision to create and sustain an offshore regime, whether in banking, shipping, Internet domains, or satellite parking orbits, was made in pursuit of economic development for the small jurisdiction and the welfare of its residents.¹⁰ As demonstrated above with respect to several Caribbean jurisdictions, the offshore financial centre can be a significant contributor to the local economy. For a number of small states, particularly the 'late' entrants to this industry, the OFC was an alternative to the declining economic contribution made by the agricultural sector. The options for economic diversification in a small state are limited, and the OECD project has produced yet another constraint for this diversification.

¹⁰ Anthony van Fossen, 'Globalization, Stateless Capitalism, and the International Political Economy of Tonga's Satellite Venture', *Pacific Studies* 22, no. 2 (1999).

Constructing Sovereignty

The desire for self-determination is a desire for sovereignty, as a space in which the society is able to establish its own structure of laws and regulations for public goods and collective welfare. It is accepted that sovereignty is a basket of rights and privileges guiding the conduct of independent, territorially-bound societies, but the socially constructed nature of society provides some room for variation amongst practitioners in the discourse encompassing small states and the offshore financial landscape.

In an article exploring globalisation and ‘offshoreness’ for a geo-political economy, for example, Alan Hudson did not use the generally accepted understanding of *fiscal* sovereignty as deployed in this research. In that instance, sovereignty was treated as a bundle of capabilities, and ‘by choosing to maintain a low or zero tax rate, the OFCs in effect surrender some of their sovereignty-derived regulatory powers.’¹¹ The implied assumption behind this assertion would be that the only proper exercise of fiscal sovereignty is to impose taxes, rather than understanding it as the right and freedom to choose whether, what, and how much to tax. As was noted earlier, because small jurisdictions have proportionately small government revenue requirements, they may find revenue sources other than individual and corporate income tax satisfy their needs. This assumption was a prerequisite to his case for an ‘offshore unbundling of sovereignty’ and the argument that this produces a post-modern geo-political economy. This assumption is also implicit in the criteria used by the OECD to determine a harmful versus a preferential tax regime. The difference between the two is predicated upon the collection of ‘significant revenue’ from the taxation of income by the state with a preferential tax regime.¹²

¹¹ Alan Hudson, ‘Offshoreness, globalization and sovereignty: a postmodern geo-political economy?’ *Transactions of the Institute of British Geographers* 25, no. 3 (2000), p. 272. See also pp. 276, 279.

¹² Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD Publications, 1998), pp. 19 - 20.

Similar to this discussion of offshore finance and income taxes are the arguments made concerning Internet-based commerce and consumption taxes. For example, ‘if taxation of Internet based transactions becomes problematic, the ability of governments to provide essential services could be compromised.’¹³ This situation would be due to the fact, as discussed earlier, that any given state is not responsible to become the tax collector for any other state’s tax administration. As with Jeffery’s argument that state sovereignty hinders the requisite collection of tax in the face of globalisation, so too has the increased incidence of commercial transactions via the Internet hindered the collection of consumption taxes. ‘Electronic commerce breaks down the necessary and clear connection between territory and commerce, and makes this type of information more difficult to obtain, thus complicating the task of taxing income based on source or residence.’¹⁴ The problem of tax collection from Internet transactions (and control of other illegal and illicit Internet activity) may be overstated. A case for the ‘abiding significance of territorial sovereignty’ emphasised the point that something somewhere retained a physical presence in a sovereign territory. Consequently, appropriate legal and legislative action could be taken in that territory against Internet-based activity.¹⁵ This approach is reflected by the action taken by France to ensure that Yahoo (an American firm) complied with French law concerning the sale of Nazi memorabilia within its territory.¹⁶

¹³ Stephen J. Kobrin, ‘Territoriality and the Governance of Cyberspace’, *Journal of International Business Studies* 32, no. 4 (2001), p. 689.

¹⁴ Roland Paris, ‘The Globalization of Taxation? Electronic Commerce and the Transformation of the State’, *International Studies Quarterly* 47, no. 2 (2003), p. 162.

¹⁵ Jack L. Goldsmith, ‘The Internet and the Abiding Significance of Territorial Sovereignty’, *Indiana Journal of Global Legal Studies* 5, no. 2 (1998). Goldsmith recognizes the continuing hazard of spillover, where an action deemed legal in one jurisdiction causes harm in another jurisdiction. This spillover problem ‘can be diminished through international harmonization. But they can only be eliminated by abolishing national (as opposed to international) lawmaking entities altogether, or by eliminating transnational activity.’ (p. 488) This observation encapsulates the problem the OECD is attempting to identify and resolve with the harmful tax competition initiative.

¹⁶ Kobrin, ‘Territoriality and the Governance of Cyberspace’, pp. 691 - 692.

The point for this discussion of an Internet-based ‘offshore’ landscape is to emphasise once again that sovereignty is about choice without interference from superior (outside) authority. Globalisation is only in part the cultural homogenisation decried by an anti-globalisation movement against (predominantly American) multinational corporations. As a process, it is also leading to the imposition of Western ideals via the international institutionalisation of ‘best practices’. These best practices, standards and codes are intended to supersede local choice of action regarding finance, legislation, transparency, social provision, etc. The presumption is that because they work in developed states they are actually *better*, and not simply the result of a hegemonic influence of Western practices of governance (corporate and political). The formulation of these standards is problematic in that they tend to follow an ‘Anglo-American’ business model, which conflicts with the business practices of both continental Europe and East Asia.¹⁷ These standards and procedures have also been promoted as leading to a level playing field, which again will only result in facilitating the continued dominance of developed states’ businesses. Therefore, to incorporate these standards and practices locally entails accepting a curtailment of sovereignty, in that it constrains local freedom of choice and action concerning the regulation of the economy. The constraints produced by placing developed states’ practices upon developing states’ economies lead to social tensions that threaten political elites and local conceptualisations of sovereign statehood.¹⁸ More recently, the UN Security Council passed Resolution 1617 (2005), which ‘Strongly urges all Member States to implement the comprehensive, international standards embodied in the Financial Action Task Force’s (FATF) Forty Recommendations on Money Laundering and the

¹⁷ Susanne Soederberg, ‘The promotion of ‘Anglo-American’ corporate governance in the South: who benefits from the new international standard?’ *Third World Quarterly* 24, no. 1 (2003).

¹⁸ For a critical view of the impact of this international financial architecture on developing economies, see Susanne Soederberg, *The Politics of the New International Financial Architecture: Reimposing Neoliberal Domination in the Global South* (London & New York: Zed Books, 2004).

FATF Nine Special Recommendations on 'Terrorist Financing'.¹⁹ Consequently, while the discussion here has focused on the sovereignty of *small* states, the challenge to state sovereignty in the financial domain is not limited to these small jurisdictions.

Sharing Sovereignty

There are areas of international governance that operate without the conflict noted above, and foster cooperative conduct amongst groups of states. For example, as discussed in chapter 2 the Schengen Agreement among European states established standards for passport control, visas and a separation between those approved for access to the Schengen zone, and those not approved. In acceding to this agreement, the participating states yield a portion of their sovereignty (border controls of the defined territory), with an explicit understanding that the other member states continue to exercise control of mutually external borders up to acceptable standards. Thus, the other member states provided passport control at external borders (the periphery of the Schengen zone) on their behalf. In presenting the Schengen Agreement as an example, the emphasis is placed on the matter of shared sovereignty amongst a variety of states. Moreover, not all signatories of the Schengen Agreement belong to the European Union, nor do all members of the EU participate in the Schengen Agreement. In this fashion, it provides an example for the cession of fiscal sovereignty amongst a variety of states that do not otherwise co-operate extensively on other matters. In the latter case involving extensive co-operation the EU (or its predecessors) serves as a better example for yielding state sovereignty to a multinational organisation.

To recover tax revenue from income which had 'escaped' national controls, OECD states are endeavouring to establish standards for interstate information exchange,

¹⁹ United Nations Security Council, 'Resolution 1617 (2005)', *S/RES/1614 (2005)* (2005).

in order to track and pursue recalcitrant (reluctant) taxpayers.²⁰ However, a sense of common objectives and shared community amongst the jurisdictions expected to participate in this process is absent. This absence represents a significant difference from the example of shared sovereignty offered by the Schengen Agreement. Moreover, there is not a sense of shared benefit from participation in the process. With the Schengen Agreement, the participating governments no longer maintain internal border controls amongst themselves, thereby reducing government expenditures. With the OECD project, small states would have increased costs due to the compliance requirements, while at the same time they will collect fewer licensing fees as the financial sector shrinks when mobile capital moves along to other locations. The exclusion of small states from the process makes it all the more difficult to create a sense of common purpose. The result was acrimonious meetings and the subsequent postponement of OECD deadlines for co-operation.

The abiding significance of the state

The debates surrounding sovereignty and the 'retreat of the state' as an actor in global politics were outlined in chapter 2. As noted at the beginning, the practice of sovereignty by small states (demonstrated by their resistance to the OECD project) represents the continued salience of the state as an institution. The OECD itself recognised this fact from the beginning of their campaign against tax competition.

The Committee concludes that there is a strong case for intensifying international co-operation when formulating a response to the problem of harmful tax competition, although the counteracting measures themselves will continue to be primarily taken at the national, rather than at the multilateral level.²¹

²⁰ The exchange of taxpayer information was incorporated in a 2004 revision of the OECD Model Income Tax Treaty. For a treatment of this change see, David Spencer, 'Tax Information Exchange and Bank Secrecy (Part 1)', *Journal of International Taxation* 16, no. 2 (2005); David Spencer, 'Tax Information Exchange and Bank Secrecy (Part 2)', *Journal of International Taxation* 16, no. 3 (2005).

²¹ Organisation for Economic Co-operation and Development, *Harmful Tax Competition*, p. 38.

The desired objectives and proposed methods to achieve these objectives may be the product of an international organisation (OECD or FATF), but the changes are implemented by *states*. Legislation must be changed or introduced by *state* governments and acted upon by *state* agencies. The collection and exchange of taxpayer information are performed by *state* tax administrations. Just as sovereignty creates the space in which a small state can produce a tax-friendly financial regime, sovereignty also creates the borders through which a large state can control the passage of international transactions. This latter aspect of sovereignty was demonstrated for example by the imposition of ‘counter-measures’ (including increased surveillance of all transactions) against Nauru in 2001 because of its non-compliance with FATF anti-money laundering recommendations.²² Notwithstanding the existence of international standards (for example the Basle Capital Accord), the regulation, de-regulation, and re-regulation of finance within a specific territory remains a responsibility of the *state* and not of the collection of financial institutions operating within that jurisdiction.

The FATF’s identification of Nauru as a non-cooperative country is an example of the increased role of international standards in the structure of a state. As suggested in the first chapter, there has been an increased re-regulation of international finance through the promulgation of international standards and best practices. The action of the FATF was in response to the failure of one small state to be fully compliant with its Forty Recommendations against money laundering. These Recommendations, along with the Basle Capital Accord are perhaps the best-known examples of international standards for state regulation and supervision of financial institutions. They exemplify the quiet growth over the past couple of decades of a global financial regulatory regime. These standards

²² Financial Action Task Force, *Review to Identify Non-Cooperative Countries or Territories: Increasing the World-Wide Effectiveness of Anti-Money Laundering Measures*, English, 21 June 2002, PDF file, Available: http://www.fatf-gafi.org/pdf/NCCT2002_en.pdf [accessed 1 July 2002]; Her Majesty’s Treasury, *HM Treasury Acts Against Money*

and practices are intended for implementation by all jurisdictions participating in global finance, yet select groups representing a limited number of states create them. The extent of their influence is apparent from the fact that since 2000 the IMF has conducted financial sector assessments that measure compliance against standards produced by the Basle Committee on Banking Supervision, International Association of Insurance Advisors, and the International Organization of Securities Commissions, as well as the FATF's Forty Recommendations.²³ As discussed previously, the extent and range of these standards and practices increased the cost burden for small states to administer and supervise an offshore financial centre. Moreover, they strain the capacity of the limited personnel resources of these jurisdictions to monitor and enforce compliance with financial regulation, a specific point of concern for the FATF with regard to anti-money laundering efforts.²⁴ The resulting consequences from this use of non-treaty instruments to manage and regulate the global political economy have been analysed by Susanne Soederberg.²⁵

Where does this leave us? Small States in the Twenty-first Century

It seems appropriate to return to the topic of 'offshore' in some of its various dimensions, to open this reflection on what the future may hold for small states. The economic (as opposed to the political) nature of offshore surfaced in the public consciousness in the United States over the course of 2003. This event is suitably symbolised not by some quantification of newspaper or magazine column inches of text devoted to the topic. Nor even by the amount of airtime the 'offshoring' of business

Laundering Risks in Nauru, 14 December 2001, Press Notice, Her Majesty's Treasury, Available: http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2001/press_145_01.cfm [accessed 23 August 2005].

²³ Monetary and Financial Systems Department, *Offshore Financial Centers: The Assessment Program—A Progress Report*, (Washington, D.C.: International Monetary Fund, 2005), Available: <http://www.imf.org/external/np/pp/eng/2005/022505.htm> [accessed 12 March 2005].

²⁴ See the annual FATF reports that review their assessments of 'Non-Cooperative Countries or Territories'.

²⁵ Soederberg, *The Politics of the New International Financial Architecture*.

activities garnered on business news programs or from political pundits (both radio and television). Instead, I suggest its presence in popular media was better reflected by its appearance on the 21 September 2003 Sunday comics page of many American newspapers (see the reproduction of this *Doonesbury* cartoon on the next page).

The political humour to be found in this comic strip teases at the subject of the offshore as a force with more immediate impact on an individual American, than that suggested by the existence of a relatively small number of citizens possessing bank accounts in some Caribbean ‘Treasure Island’. The point of re-presenting this emanation of the offshore is to emphasise the fact that the offshore is more than a simple construction of the modern states system. Offshore has become, in the parlance of some political thinkers, the Other. It is now a threat to ‘respectable’ society, extending beyond global finance and taxation to incorporate other practices that are deemed illegal, illegitimate or illicit in an ‘onshore’ jurisdiction. The offshore world is more than financial centres and corporate holding companies, for it now involves the relocation of white-collar service jobs beyond the sea to some exotic location. Similar to the OECD concern with losing potential tax revenue to OFCs, here the concern with the offshore has expanded to include the loss of jobs and a reduction of the tax base itself. In a liberalised (globalised) world economy it appears that practically anything can be moved ‘offshore’ with a related loss to the domestic economy.

The transfer of jobs to India is the dominant form of ‘offshore’ presented in the U.S. media, as reflected by the cartoon strip.²⁶ While India is not a small state, nevertheless small states are also attempting to profit from offshore economic development opportunities other than banking services. Many of these opportunities are facilitated by

²⁶ This is also a starting point for the recent book, *The World is Flat: A Brief History of the Twenty-first Century* by Thomas L. Friedman (New York: Farrar, Straus and Giroux, 2005).

[Image removed for copyright reasons.]

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²⁷ Permission to reprint the *Doonisbury* cartoon of 21 September 2003 in this Ph.D. thesis received from Universal Press Syndicate Permissions Department via e-mail on 1 December 2003. Copy on file with the author.

the same telecommunications links that support offshore finance. Thus we should see the OFC as but one facet of the larger phenomenon of the 'offshore world'. On the one hand, these concerns engender the unease felt by some and attributed by them to globalisation. However, the term also is being used to name their sense of a loss of power. Decisions that previously were contained within the local community are no longer limited in scope, or even made locally. Yet a firm's *economic* choice to improve its competitiveness, whether by lowering labour costs or by pursuing a strategy of tax minimisation, ultimately impacts the lives of local citizens. At the same time, this movement of service jobs behind the earlier movement of manufacturing jobs represents the operation of economic principles like comparative advantage. In order to remain competitive in an open, global, marketplace, firms large and small are seeking ways to keep their costs down in order to offer their products and services at a competitive price.

In global financial services, small jurisdictions used their fiscal sovereignty to take advantage of their ability to create a space for regulatory arbitrage. These opportunities attract firms and mobile capital to the offshore financial centre, which then contributes to the local economy through license fees and employment. The difficulty experienced by the OECD's harmful tax competition initiative to change this situation suggests that there is a space in the global economy for small states to manoeuvre. This space is created whenever there is not a broad-based consensus amongst the major national economies for a global regime. Historically, this may be reflected by the failure to establish a New International Economic Order or more recently the failure to enact a Multilateral Agreement on Investment. In some sense, the WTO serves as a venue for the production of a global consensus on topics of trade, services, and intellectual property. Failing the production of a consensus, the alternative function of the WTO is to provide a legal arbitration mechanism to promote compliance with already existing standards of economic conduct. The small jurisdictions of the Caribbean and elsewhere are able to participate in the WTO

and other multilateral governmental organisations. This membership affords them a voice, however small it may appear, that is a *sovereign* equal to that of any other member. The difficulty lies in first achieving membership in the WTO, and then to navigate the intricacies of the rules and policies required before utilising the arbitration mechanism. In this latter aspect the Commonwealth and its trade facility in Geneva has provided the additional knowledge and guidance necessary for small state members to benefit more fully from WTO membership.

The use of the WTO dispute mechanism by Antigua and Barbuda against the United States highlights the potential of an 'equal opportunity' for the small state as represented by membership in a multilateral organisation. In that case, the small Caribbean state of Antigua and Barbuda protested a U.S. law criminalising the use of offshore, Internet-based casinos. The WTO Appellate Body agreed with Antigua and Barbuda that the U.S. law was discriminatory and in contradiction with WTO obligations with trade in services.²⁸ Clearly, other research work has shown that membership in multilateral organisations enhances the limited international influence of a small state. At the same time however, politics continue to exist within their organisational structure. The very basic activity of setting and maintaining the agenda of an organisation constricts the individual initiative(s) of a state. In this, the relative power (within the confines of the organisation as much as in the world at large) of a member state affects the extent of their influence on the agenda-setting process. Moreover, it is at this point that the knowledge, skills and abilities of the individual representatives contribute to each state's relative

²⁸ BBC News, *US and Antigua dispute WTO ruling*, 7 April 2005, Web page, BBC News, Available: <http://news.bbc.co.uk/go/pr/ft/-/2/hi/business/4422457.stm> [accessed 8 April 2005]. The complete Appellate Body report is available at: http://www.wto.org/english/tratop_e/dispu_e/285abr_e.pdf [accessed 8 April 2005].

position, with individual powers of persuasion influencing the agenda construction and their success in negotiation.²⁹

The formation of the International Tax and Investment Organisation (ITIO) in March 2001 is a sign of the recognition of this predicament and serves as a route towards overcoming it.³⁰ The fact that the ITIO is especially focused on the domain of global finance determines the nature of their agenda. Additionally, because of the targeted nature of its membership (for and by small jurisdictions) the ITIO serves to provide a means to project a collective voice for these small jurisdictions. At the same time, this small IGO (with its limited remit) possesses a smaller voice within the global cacophony of international relations. So, even though it is focused upon very specific areas of concern, the viewpoint expressed by the ITIO is overshadowed in the media by any pronouncements emanating from the OECD, IMF or World Bank.

The formation of an issue-focused organisation such as the ITIO emphasises the exclusionary nature of the OECD, FATF and other similar international organisations. In fact, at least one author has argued that the limited membership and control of the agenda of these latter organisations are benefits. ‘Coalitions of the willing can successfully influence and enforce international standards, especially if the coalition partners have a predominant interest in and influence over the subject at hand.’³¹ William Wechsler had most recently been Special Advisor to the Secretary of the Treasury in the Clinton Administration when this article was published in 2001. For critical security questions this may be a valid point, best represented by the work of the United Nations Security Council. The broad spectrum application of ‘international’ standards produced by a club, however, is not a consensual approach and so they will encounter resistance from

²⁹ David Arter, ‘Small State Influence Within the EU: The Case of Finland’s ‘Northern Dimension Initiative’, *Journal of Common Market Studies* 38, no. 5 (2000).

³⁰ Discussed above in Chapter 6.

amongst the excluded. Wechsler concluded from this experience with the anti-money laundering ‘name & shame’ exercise that ‘the initiative showed that U.S. leadership was essential even in a multilateral setting.’³²

This leads us back to the role and influence of the United States within global finance, and in particular within this very specific OECD project concerning harmful tax competition. From one perspective, it appears that the withdrawal of the United States from the OECD project has limited the likelihood of any implementation of sanctions. Without sanctions, efforts to force/encourage compliance become more difficult. Here the research work of Daniel Drezner is particularly applicable. In a paper presented to the American Political Science Association in 2002, he outlined a model for global regulatory co-ordination. The model considers the interplay of regulatory efforts by ‘great powers’ (in this case Drezner takes them to be the United States, Japan and the European Union), developing states, IGOs and NGOs. Within this theoretical framework, Drezner finds that ‘The effectiveness of both NGOs and IGOs clearly depends on state power and preferences.’³³ This assessment includes an IGO such as the OECD, and a regulatory co-ordination effort like the harmful tax competition initiative.

Most important, this theory makes it clear that great powers are the key actors in determining the pattern of global regulatory regimes. If they can agree among themselves, coordination will occur regardless of NGO, IGO, or peripheral state preferences. Opposition from these actors only affects the means of regulatory coordination, not the ultimate end.³⁴

Drezner’s theoretical work explains the empirical experience described by Wechsler. Consequently, the best efforts of the non-OECD states to effect a change in the regulatory structure of the OECD project were quite likely to fail, had the ‘great powers’ agreed upon

³¹ William F. Wechsler, ‘Follow the Money’, *Foreign Affairs* 80, no. 4 (2001), p. 53.

³² Ibid.

³³ Daniel W. Drezner, ‘Who Rules? The Regulation of Globalization’ (paper presented at the Annual Meeting of the American Political Science Association, Boston, 2002), p. 35. In mid-2005, Drezner had a book manuscript by the same title under review at Princeton University Press; see <<http://www.danieldrezner.com/research.html>>.

the structure and sanctions of the project. However, with the withdrawal of explicit support for the project by the United States, clearly one of the 'key actors' for this regulatory regime, the OECD initiative has effectively stalled. The result of this disagreement between the large states is that a space has been left in which the small states and their OFCs may continue to operate.

Thus, in the end, the conclusion to be reached about small states' ability to enforce their sovereign independence is that it will rely upon a combination of factors. For this specific case study, these factors included the resistance and intransigence of some small states towards the efforts of the OECD, the support of the Commonwealth (and in particular the Commonwealth Secretariat) on the behalf of small states by hosting joint meetings and funding research as part of an effort to ensure that they receive *equitable* treatment from the OECD, and the absence of any strong *national interest* on the part of the United States to support a European campaign to reduce tax *avoidance*. The Commonwealth Secretariat remains active in this issue area, for example by organising and hosting a conference in 2003 and attending the meetings of the OECD Global Forum on Taxation.³⁵

Part of the puzzle surrounding the OECD project is the fact that in the main the similar effort of the FATF to create a global anti-money laundering regime has succeeded. This may be seen as a reflection of a global consensus against this form of financial crime (and the various predicate crimes subsumed within money laundering charges, such as drug trafficking). It may also result from determined American action to promote and institutionalise anti-money laundering policies. The circumstances surrounding the Harmful Tax Competition initiative are not the same. There is not a global consensus on

³⁴ Ibid., p. 36.

³⁵ Select papers from the Commonwealth conference were published in Andreas Antoniou, ed., *International Financial Services Sectors in Small Vulnerable Economies: Challenges and Prospects*, vol. 60 (London: Commonwealth Secretariat, 2004).

tax competition as harmful in the first instance, or of tax avoidance/evasion as ‘criminal’ in the second instance. Within the OECD itself the lack of a consensus was apparent from the beginning with the abstention of Switzerland and Luxembourg from the 1998 report.

There are several lessons to take forward from this experience. First, the support of an intervening international organisation, such as the Commonwealth, against the efforts of another IGO affords a space in which the collective voice of small states may be coordinated and synchronised.³⁶ Second, lobbying one of the major actors to shift, or at least moderate, their position can lead to a change in the position of the group of large states. In this instance, it was a case of predominately domestic lobbying in the U.S. that contextualised the issue as a potential domestic problem (threat). Thus, the U.S. became the moderating influence upon a predominately European initiative, but this could also work in the other direction. For example, some might make an effort to convince the EU to moderate American initiatives to expand the data collection and surveillance of individuals (travellers) that is increasingly part of the war on terror.³⁷

I take the point that ‘sovereignty and its meaning have become a battleground’ with respect to the role and position of the state within international relations.³⁸ For the leaders and citizens of small states, however, the debate is superfluous and it is far more important to guard their self-perception of sovereign independence from the world at large, because for them to be sovereign is to have the freedom to choose. Any number of factors and influences may constrict the space within which they are free to act, as highlighted by

³⁶ Drezner notes a related phenomenon in his work, when states engage in ‘forum-shopping’ in pursuit of the international forum most amenable to national goals and objectives. See Drezner, ‘Who Rules? The Regulation of Globalization’, p. 35.

³⁷ Michael Levi and David S. Wall, ‘Technologies, Security, and Privacy in the Post-9/11 European Information Society’, *Journal of Law and Society* 31, no. 2 (2004).

³⁸ Christopher Hill, *The Changing Politics of Foreign Policy* (Basingstoke, Hampshire: Palgrave, 2003), p. 30.

Krasner and others.³⁹ These restrictions do not reduce the value held by small states for their sovereign independence. The multifaceted nature of sovereignty was underscored once again by R. J. B. Walker in a recent analysis.

Sovereignty, we have come to remember, can be understood simultaneously as a principle, an institution, and a practice, and, indeed, has to be understood historically as a complex site/event in which it is quite difficult, and perhaps necessarily impossible, to distinguish with much analytical clarity between principle, institution, and practice. We now speak about sovereignty less like an it, a thing, or achieved condition than as an act that works by producing a presence, a state of being, exactly where there is and can be no such thing.⁴⁰

It is exactly this need to reproduce themselves as independent sovereign territories that helps to motivate the leaders and involved citizens of the small Caribbean states to resist the efforts of the OECD. To resist serves to demonstrate the capacity to act, and forces the representatives of international organisations and their constituent member states to *acknowledge* their participation as sovereign actors.

Global financial flows suggest that markets are ignoring the efforts of the OECD. The withdrawal of U.S. support for the harmful tax competition project has delayed any implementation of an information exchange regime. At the same time, OECD member states have gone forward with reducing/eliminating the preferential tax structures identified by the project.⁴¹ The fact remains, however, that small states stood their ground and in the main insisted upon recognition of their sovereignty. The governing leadership teams of these Caribbean jurisdictions continued to pursue an economic development agenda for their citizens and societies that includes offshore finance.

³⁹ Stephen D. Krasner, ed., *Problematic Sovereignty: Contested Rules and Political Possibilities* (New York: Columbia University Press, 2001); Stephen D. Krasner, *Sovereignty: Organized Hypocrisy* (Princeton: Princeton University Press, 1999); Susan Strange, *The Retreat of the State: The Diffusion of Power in the World Economy* (Cambridge: Cambridge University Press, 1996).

⁴⁰ R. B. J. Walker, 'Conclusion: Sovereignities, Exceptions, Worlds', *Sovereign Lives: Power in Global Politics*, eds. Jenny Edkins, Véronique Pin-Fat and Michael J. Shapiro (New York and London: Routledge, 2004), p. 242.

⁴¹ Organisation for Economic Co-operation and Development, *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report* (Paris: OECD Publications, 2004).

CARIBBEAN OFFSHORE FINANCIAL CENTRE DATA

Table A-1 – The Bahamas, Offshore Entities and Employment

	1996	1997	1998	1999	2000	2001	2002	2003
Offshore banks & trusts (public and restricted)	n/a	n/a	398*	395	388	333	276	250
Bahamian employees	682	764	772	836	991	1,001†	987†	839†
Non-Bahamian employees	124	128	130	142	195	244†	239†	222†
Total employees	806	892	902	978	1,186	1,245†	1,226†	1,061†
Registered offshore entities	n/a	n/a	n/a	n/a	n/a	27,896	16,114	15,130*

Source: The Central Bank of the Bahamas, *Quarterly Economic Review*, March various years.

* estimated

n/a – not available

† These values were annotated with a ‘p’ indicating that the data was provisional in the *Quarterly Economic Review*, March 2004

Table A-2 – The Bahamas, Offshore License Revenue
(In thousands of Bahamian dollars)

Fiscal Year	1997/1998	1998/1999	1999/2000	2000/2001	2001/2002	2002/2003
Business and Professional License fees	33,678	58,504	55,061	54,661	55,778	53,776
includes Company fees and Registration	4,407	4,522	4,733	3,854	4,907	5,237
includes International Business Companies	8,010	17,381	17,247	13,290	18,000	16,604

Source: The Central Bank of the Bahamas, *Quarterly Statistical Digest*, August 2003 & 2004
(Table 7.2).

n.b. – all data values were annotated as provisional.

Table A-3 – Cayman Islands Offshore Entities

	1996	1997	1998	1999	2000	2001	2002	2003
Banking Trust Licenses	28	30	30	31	31	31	30	27
Category 'A' *								
Banking Trust Licenses	471	475	417	430	433	396	353	322
Category 'B' **								
Firms with a physical presence	107	108	114	112	117	113	128	n/a
Class 'B' (Captive) Insurance licenses	418	449	485	497	517	542	600	644
Registered mutual funds (Offshore hedge funds)	1,335	1,685	1,979	2,271	3,014	3,648	4,285	4,808
Trust Service Provider Licenses	n/a	n/a	n/a	207	225	233	243	n/a
Registered companies	37,919	41,163	45,169	50,951	59,922	64,495	65,259	68,078

Source: The Cayman Islands Monetary Authority, *Annual Report*, various years; Economic Research Unit, *Annual Economic Report*, 2002 and 2003.

* A license to provide services to domestic and international markets

** A license to provide services to international markets, and facilitate inter-bank transactions

Table A-4 – Cayman Islands offshore license fee revenue
(in millions of Cayman Island dollars)

	1996	1997	1998	1999	2000	2001	2002	2003
Banking & Trust Licenses	n/a	n/a	n/a	n/a	10.1	8.9	33.3	28.9
Insurance licenses	n/a	n/a	n/a	n/a	2.9	2.9	5.5	n.a.
Mutual Fund Administrators	n/a	n/a	n/a	n/a	3.2	3.7	11.8	12.5
Company fees	n/a	n/a	n/a	n/a	35.0	37.3	38.6	39.9
Sum of fee revenue	n/a	n/a	n/a	n/a	51.2	52.8	89.6	81.3†
Taxes on Domestic Goods & Services	n/a	n/a	n/a	n/a	104.8	113.1	150.8	153.4
Taxes on International Trade & Transactions*	n/a	n/a	n/a	n/a	110.0	106.2	106.7	117.6
Total revenue**	n/a	n/a	n/a	n/a	278.2	285.4	314.1	326.2
Fee revenue as percentage of total revenue	n/a	n/a	n/a	n/a	18.4%	18.5%	28.5%	24.9%†
International trade taxes as percentage of total revenue	n/a	n/a	n/a	n/a	39.5%	37.2%	34.0%	36.1%
Gross Domestic Product (GDP)	892.4	971.9	1275.2	1382.5	1444.9	1482.3	1546.0	1603.2
Fee revenue as percentage of GDP	n/a	n/a	n/a	n/a	3.5%	3.6%	5.8%	5.1%†

Source: The Cayman Islands Economic Research Unit, *Annual Economic Report*, 2002 and 2003.

* This includes travel & cruise ship tax and the Environmental Protection Fee imposed on all visitors as well as duties placed on imported goods.

** This includes items not listed here, property taxes, sales tax, etc.

† Incomplete data

Table A-5 – St Vincent and the Grenadines

Offshore Entity*	1997	1998	1999	2000	2001	2002	2003	August 2004
International Business Companies	1,188	1,540	2,704	2,175	1,438	858	742	620
International Trusts	19	210	236	251	124	37	12	7
Offshore Banks	2	10	11	13	6	0	0	1
Mutual Funds – Public & Private	0	0	1	3	3	3	0	3
Fund Manager/ Administrator	0	0	0	3	3	3	1	3
International Insurance & Insurance Manager/Broker	0	0	0	2	0	0	3	6

Source: International Financial Services Authority of St. Vincent and the Grenadines, August 2004.

* As categorised by the International Financial Services Authority of St. Vincent and the Grenadines. Note also that these figures do not necessarily reflect the number of entities in good standing in that year.

BANK FOR INTERNATIONAL SETTLEMENTS DATA

Table B-1 – Outstanding Assets/External Positions of Reporting Banks,
OECD and offshore
(1977 - 2002, by 5 year increments in millions of US dollars)

	1977	1982	1987	1992	1997	2002
OECD Member States	391,906	966,795	2,882,313	4,499,997	6,739,474	10,854,974
Australia	4,014	10,588	42,572	51,859	61,581	139,323
Austria	7,771	17,049	40,469	39,204	61,001	122,772
Belgium	40,339	94,148	132,528	155,100	173,508	239,683
Canada	9,697	37,224	68,011	86,601	131,846	181,839
Czech Republic	-	-	-	-	10,338	13,640
Czechoslovakia	1,685	2,883	4,236	4,913	-	-
Denmark	8,325	15,079	45,762	48,690	53,869	92,503
Finland	4,635	8,968	20,795	29,050	30,260	54,931
France	33,525	87,291	173,048	274,392	385,535	687,463
Germany	36,678	73,581	138,590	289,975	554,056	997,803
Greece	3,571	9,170	14,796	16,688	38,124	85,574
Hungary	4,752	6,604	12,381	8,649	9,596	19,037
Iceland	234	742	1,749	2,377	2,441	6,351
Ireland	3,865	7,560	18,022	35,945	88,749	251,346
Italy	20,295	52,343	113,242	275,955	323,161	586,049
Japan	25,059	72,479	608,768	894,669	912,381	585,795
Korea	4,657	16,642	28,933	42,654	104,547	73,035
Luxembourg	-	-	71,064	136,086	192,517	357,869
Mexico	12,831	52,116	75,845	67,800	65,057	64,411
Netherlands	18,371	26,966	66,705	140,845	218,292	543,055
New Zealand	876	2,532	16,754	15,383	17,748	23,478
Norway	7,271	11,284	23,092	18,447	30,431	86,418
Poland	9,366	13,512	12,252	13,116	8,945	26,155
Portugal	1,876	9,707	11,073	16,848	38,795	134,038
Slovakia	-	-	-	-	4,348	3,714
Spain	10,832	23,482	27,652	62,132	122,379	266,034
Sweden	7,732	17,824	32,934	76,789	70,978	129,391
Switzerland	15,537	30,437	76,211	117,564	220,765	458,204
Turkey	585	1,477	3,670	14,590	22,928	36,102
United Kingdom	63,844	155,526	427,586	672,883	1,215,047	1,925,088
United States	33,683	109,581	573,573	890,793	1,570,251	2,663,872

	1977	1982	1987	1992	1997	2002
Offshore Centres (BIS)	80,873	247,248	682,387	1,028,260	1,424,363	1,567,970
Aruba	-	-	74	219	194	305
Bahamas	38,603	82,865	112,689	113,753	128,612	160,930
Bahrain	3,907	10,833	16,518	17,560	18,222	25,618
Barbados	11	603	1,150	1,236	9,183	7,334
Bermuda	1,171	2,892	5,510	13,436	28,871	38,225
Cayman Islands	11,478	51,670	128,267	196,987	347,881	603,547
Gibraltar	2	66	307	4,057	2,421	4,812
Guernsey	-	-	-	-	-	65,632
Hong Kong SAR	6,862	28,836	225,950	400,471	473,525	146,236
Isle of Man	-	-	-	-	-	10,031
Jersey	-	-	-	-	-	167,899
Lebanon	588	1,632	1,870	1,756	3,247	2,846
Macau SAR	0	199	1,524	1,446	7,171	649
Mauritius	16	129	91	215	849	2,408
Netherlands Antilles	1,993	7,972	12,084	25,701	50,304	39,514
Panama	7,101	25,650	37,464	31,368	35,677	32,118
Singapore	8,841	33,389	136,530	213,507	297,640	232,181
Vanuatu	169	124	839	543	1,195	470
West Indies UK	131	388	1,520	6,005	19,371	27,215
Commonwealth Caribbean	38,931	84,701	115,381	116,287	140,674	173,056
Bahamas	38,603	82,865	112,689	113,753	128,612	160,930
Barbados	11	603	1,150	1,236	9,183	7,334
Belize	11	31	20	27	96	541
Dominica	0	0	8	6	168	130
Grenada	0	0	0	25	27	62
Guyana	70	108	84	45	68	36
Jamaica	118	413	484	431	717	943
St Lucia	0	0	1	15	47	63
St Vincent	0	0	2	64	208	352
Trinidad and Tobago	118	681	943	685	1,548	2,665

Source: Bank for International Settlements, Table 6a, *Quarterly Review*, June 2004, available at <<http://www.bis.org/>> [accessed 30 July 2004]

Table B-2 – Outstanding Assets/External Positions of Reporting Banks, OECD and offshore
(1994-2003, in millions of US dollars)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
OECD Member States	5,145,896	5,871,276	6,024,827	6,739,474	7,567,488	7,765,227	8,532,251	9,176,473	10,854,973	12,915,129
Australia	45,682	50,717	55,381	61,581	67,174	80,581	85,837	95,967	139,323	131,794
Austria	45,024	55,538	61,549	61,001	75,533	89,246	102,372	104,151	122,772	148,297
Belgium	160,362	185,303	176,123	173,508	196,132	229,712	200,729	213,302	239,683	327,775
Canada	106,141	110,458	114,887	131,846	145,938	132,895	146,660	158,993	181,839	176,816
Czech Republic	3,718	8,040	9,542	10,338	10,594	9,678	9,594	9,988	13,640	19,432
Denmark	44,858	44,976	48,737	53,869	71,811	69,734	76,576	75,428	92,503	127,137
Finland	30,152	30,662	29,903	30,260	37,016	35,870	49,665	53,095	54,931	59,205
France	317,355	347,587	352,712	385,535	470,491	486,418	535,257	598,614	687,463	858,474
Germany	415,715	518,109	515,975	554,056	742,075	764,627	812,437	834,221	997,803	1,213,252
Greece	21,383	29,324	37,919	38,124	42,322	54,190	67,701	64,631	85,574	108,221
Hungary	7,932	8,037	8,364	9,596	12,550	13,012	13,934	13,626	19,037	28,583
Iceland	1,656	1,705	2,044	2,441	3,499	4,356	5,209	5,331	6,351	8,811
Ireland	44,934	60,882	69,591	88,749	128,499	163,330	168,192	194,523	251,346	380,697
Italy	278,377	284,435	306,816	323,161	420,418	455,409	476,812	500,711	586,049	717,269
Japan	945,331	1,021,581	925,773	912,381	851,600	622,904	576,014	517,469	585,795	611,340
Korea	60,972	83,259	109,150	104,547	73,821	70,363	64,188	62,255	73,035	76,541
Luxembourg	165,667	193,033	183,443	192,517	226,682	246,133	245,322	291,476	357,869	455,407
Mexico	76,882	73,310	72,930	65,057	65,915	61,374	58,099	59,638	64,411	65,356
Netherlands	154,057	174,520	190,931	218,292	318,941	324,642	373,694	416,639	543,055	685,912
New Zealand	13,255	16,321	13,791	17,748	17,594	21,001	18,474	19,930	23,478	22,344

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Norway	17,597	17,966	25,466	30,431	36,293	39,002	49,887	58,900	86,418	108,243
Poland	7,488	7,835	7,079	8,945	12,772	16,469	18,903	20,599	26,155	33,179
Portugal	30,033	37,785	37,383	38,795	57,585	66,141	81,944	101,375	134,038	190,991
Slovakia	515	1,241	2,429	4,348	4,773	3,606	3,000	2,893	3,714	5,802
Spain	80,433	92,992	102,371	122,379	157,020	160,202	173,441	183,070	266,034	390,938
Sweden	62,244	75,061	77,487	70,978	102,946	95,223	107,077	116,166	129,391	158,930
Switzerland	134,175	143,076	166,133	220,765	244,574	321,588	425,334	403,902	458,204	505,272
Turkey	18,912	23,800	20,861	22,928	16,342	18,893	20,657	18,347	36,102	44,380
United Kingdom	863,709	1,025,889	1,085,681	1,215,047	1,327,985	1,313,416	1,494,199	1,643,117	1,925,088	2,392,734
United States	991,337	1,147,834	1,214,376	1,570,251	1,628,593	1,795,212	2,071,043	2,338,116	2,663,872	2,861,997
Offshore Centres (BIS)	2,332,187	2,455,589	2,459,262	2,596,073	2,474,455	2,389,227	2,412,884	2,639,883	2,739,680	3,068,725
Aruba	193	264	582	194	747	831	1,155	241	305	774
Bahamas	110,762	108,511	109,335	128,612	144,009	146,133	172,763	155,347	160,930	152,650
Bahrain	16,376	18,090	17,240	18,222	23,112	2,389,227	2,412,884	2,639,883	2,739,680	3,068,725
Barbados	1,854	1,903	3,642	9,183	8,936	831	1,155	241	305	774
Bermuda	16,509	17,035	20,810	28,871	24,896	146,133	172,763	155,347	160,930	152,650
Cayman Islands	196,156	250,120	262,228	347,881	400,595	24,284	29,857	32,042	25,618	29,317
Gibraltar	2,203	1,784	2,145	2,421	2,508	7,046	7,446	8,959	7,334	7,760
Guernsey	-	-	-	-	0	30,474	31,728	35,151	38,225	52,017
Hong Kong SAR	494,158	513,044	469,962	473,525	321,638	425,733	480,083	552,664	603,547	812,184
Isle of Man	-	-	-	-	0	4,988	5,474	7,803	4,812	5,452
Jersey	-	-	-	-	0	0	0	55,842	65,632	78,391
Lebanon	1,761	2,391	2,959	3,247	3,584	256,454	192,528	161,290	146,236	160,666
Macau SAR	1,666	1,728	1,507	7,171	7,428	0	0	8,801	10,031	12,045
Mauritius	462	594	715	849	1,101	0	0	135,136	167,899	224,450

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Netherlands Antilles	28,455	42,779	59,922	50,304	39,036	3,727	3,531	2,891	2,846	3,919
Panama	33,265	33,403	33,366	35,677	36,786	1,258	894	701	649	845
Singapore	248,007	282,026	287,242	297,640	268,148	1,308	1,872	2,080	2,408	3,488
Vanuatu	121	102	1,425	1,195	1,050	37,487	36,128	36,282	39,514	43,560
West Indies UK	8,529	10,105	14,472	19,371	19,171	35,803	34,328	32,910	32,118	34,330
Commonwealth Caribbean	114,499	112,296	115,013	140,674	155,772	223,885	220,398	216,617	232,181	240,951
Bahamas	110,762	108,511	109,335	128,612	144,009	973	1,110	1,044	470	161
Barbados	1,854	1,903	3,642	9,183	8,936	17,133	21,879	22,372	27,215	34,055
Belize	45	54	88	96	117	156,264	184,415	169,198	173,056	165,603
Dominica	26	36	32	168	250	146,133	172,763	155,347	160,930	152,650
Grenada	10	6	12	27	25	7,046	7,446	8,959	7,334	7,760
Guyana	42	42	94	68	30	163	1,012	860	541	623
Jamaica	604	554	624	717	599	43	72	116	130	45
St Lucia	9	16	37	47	43	17	40	61	62	57
St Vincent	84	163	149	208	276	21	38	62	36	41
Trinidad and Tobago	1,063	1,011	1,000	1,548	1,487	637	742	942	943	1,049

Source: Bank for International Settlements, Table 6a, *Quarterly Review*, June 2004, available at <<http://www.bis.org/>> [accessed 30 July 2004]

Appendix C

EASTERN CARIBBEAN CENTRAL BANK DATA

Table C-1 – Eastern Caribbean Currency Union – Commercial Banks’ Total Deposits of Non-Resident Depositors
(In thousands of Eastern Caribbean dollars)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Anguilla	57,574	55,413	69,059	61,668	85,985	97,350	131,795	127,995	157,393	194,336
Antigua & Barbuda	75,582	62,064	65,733	77,696	94,500	106,896	147,415	195,925	298,901	215,521
Dominica	76,806	79,607	85,106	94,165	98,928	98,571	86,679	93,401	97,120	98,388
Grenada	92,878	89,575	99,985	131,540	148,141	164,061	169,445	186,632	211,625	246,391
Montserrat	16,404	24,058	21,126	16,629	22,918	22,204	22,394	23,171	25,514	26,476
St. Kitts & Nevis	54,404	58,003	85,389	128,754	140,242	137,995	121,855	102,416	130,172	123,463
St. Lucia	84,876	88,476	94,373	101,368	120,997	122,464	118,742	131,268	147,211	145,311
St. Vincent & the Grenadines	66,744	77,688	75,691	73,218	64,415	96,867	112,921	131,141	127,728	134,095
ECCB totals	525,268	534,884	596,462	685,038	776,126	846,408	911,246	991,949	1,195,664	1,183,981

Source: Eastern Caribbean Central Bank – Statistics, <<http://www.eccb-centralbank.org/Statistics/index.asp>> [accessed 25 July 2004]

Table C-2 – Eastern Caribbean Currency Union – GDP By Economic Activity at Factor Costs, Constant Prices
(In millions of Eastern Caribbean dollars)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total GDP	3418.13	3617.25	3788.84	3816.22	3965.48	4066.67	4188.77	4216.22	4328.90	4470.33	4659.80	4858.60	4987.73	4919.76	4931.70	5117.48
Banks & Insurance	252.18	285.87	303.06	316.56	330.87	353.24	372.34	394.93	421.88	460.28	493.95	523.31	554.41	552.02	572.22	589.96
As % of Total GDP	7.38%	7.90%	8.00%	8.30%	8.34%	8.69%	8.89%	9.37%	9.75%	10.30%	10.60%	10.77%	11.12%	11.22%	11.60%	11.53%
Agriculture	467.42	434.91	462.91	427.22	467.69	462.79	400.21	420.36	417.15	385.34	385.27	369.84	372.89	342.05	361.24	345.38
As % of Total GDP	13.67%	12.02%	12.22%	11.19%	11.79%	11.38%	9.55%	9.97%	9.64%	8.62%	8.27%	7.61%	7.48%	6.95%	7.32%	6.75%
Hotels & Restaurants	310.91	318.58	336.29	351.98	382.05	407.51	469.28	416.34	430.39	461.73	463.09	479.51	473.83	449.04	446.75	505
As % of Total GDP	9.10%	8.81%	8.88%	9.22%	9.63%	10.02%	11.20%	9.87%	9.94%	10.33%	9.94%	9.87%	9.50%	9.13%	9.06%	9.87%

NB - Hotels and Restaurants provided as a proxy for the tourism business sector.

Source: Eastern Caribbean Central Bank – Statistics, <<http://www.eccb-centralbank.org/Statistics/index.asp>> [accessed 25 July 2004]

Table C-3 – Dominica – GDP By Economic Activity at Factor Costs, Constant Prices
(In millions of Eastern Caribbean dollars)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total GDP	351.72	347.78	369.84	377.78	388.14	395.35	403.84	410.31	422.94	431.3	443.24	450.47	456.35	437.35	415.15	414.99
Banks & Insurance	36.44	38.82	41.65	48.88	47.81	47.02	49.58	53.73	52.8	50.56	54.62	58.31	58.46	56.54	53.27	54.76
As % of Total GDP	10.36%	11.16%	11.26%	12.94%	12.32%	11.89%	12.28%	13.09%	12.48%	11.72%	12.32%	12.94%	12.81%	12.93%	12.83%	13.20%
Agriculture	101.44	86.61	92.49	91.96	93.69	94.05	90.55	83.19	87.74	86.43	84.71	82.9	81.98	76.59	76.09	73.31
As % of Total GDP	28.84%	24.90%	25.01%	24.34%	24.14%	23.79%	22.42%	20.27%	20.75%	20.04%	19.11%	18.40%	17.96%	17.51%	18.33%	17.67%
Hotels & Restaurants	5.28	5.52	7.63	8.82	9.02	10.67	11.37	11.66	11.03	11.25	10.8	11.26	11.7	10.83	10.47	11.34
As % of Total GDP	1.50%	1.59%	2.06%	2.33%	2.32%	2.70%	2.82%	2.84%	2.61%	2.61%	2.44%	2.50%	2.56%	2.48%	2.52%	2.73%

NB - Hotels and Restaurants provided as a proxy for the tourism business sector.

Source: Eastern Caribbean Central Bank – Statistics, <<http://www.eccb-centralbank.org/Statistics/index.asp>> [accessed 25 July 2004]

Table C-4 – St. Vincent & the Grenadines – GDP By Economic Activity at Factor Costs, Constant Prices

(In millions of Eastern Caribbean dollars)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total GDP	412.14	424.66	452.98	459.32	491.18	499.96	485.42	525.59	531.75	548.42	579.94	600.8	612.85	612.32	622.41	644.63
Banks & Insurance	30.55	32.61	34.65	35.33	36.67	37.65	39.42	42.37	45.13	49.61	51.41	57.08	60.17	55.61	59.42	60.31
As % of Total GDP	7.41%	7.68%	7.65%	7.69%	7.47%	7.53%	8.12%	8.06%	8.49%	9.05%	8.86%	9.50%	9.82%	9.08%	9.55%	9.36%
Agriculture	87.84	83.16	95.98	84	91.75	85.39	57.61	81.93	78.67	66.62	72.15	69.44	74.02	68.35	73.66	72.06
As % of Total GDP	21.31%	19.58%	21.19%	18.29%	18.68%	17.08%	11.87%	15.59%	14.79%	12.15%	12.44%	11.56%	12.08%	11.16%	11.83%	11.18%
Hotels & Restaurants	8.33	8.99	10.1	11	11.73	12.47	12.09	13.36	13.18	13.77	13.19	14.39	15.3	14.84	13.65	12.86
As % of Total GDP	2.02%	2.12%	2.23%	2.39%	2.39%	2.49%	2.49%	2.54%	2.48%	2.51%	2.27%	2.40%	2.50%	2.42%	2.19%	1.99%

NB - Hotels and Restaurants provided as a proxy for the tourism business sector.

Source: Eastern Caribbean Central Bank – Statistics, <<http://www.eccb-centralbank.org/Statistics/index.asp>> [accessed 25 July 2004]

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