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The politics of the invisible: Offshore finance and state power

A country-level comparison

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Preface

This dissertation is the result of my own work and includes nothing which is the outcome of work done in collaboration except as declared in the Preface and specified in the text. It is not substantially the same as any that I have submitted, or, is being concurrently submitted for a degree or diploma or other qualification at the University of Cambridge or any other University or similar institution except as declared in the Preface and specified in the text. I further state that no substantial part of my dissertation has already been submitted, or, is being concurrently submitted for any such degree, diploma or other qualification at the University of Cambridge or any other University or similar institution except as declared in the Preface and specified in the text. It does not exceed the prescribed word limit for the relevant Degree Committee of 80,000 words.

Cambridge, 25. January 2019

Andrea Binder

Abstract

Seen from offshore, the shape of the contemporary international economy appears quite different from the conventional view. Some of its most fundamental elements appear bigger – for instance the amount of US dollar created offshore – or smaller – for instance the volume of foreign direct investment – than standard statistics suggest. That is, despite a growing body of research, important elements of the offshore economy remain invisible for researchers and the general public alike. What has become clear, however, is that offshore financial services are a central part of the international economy. They are used by wealthy individuals and corporations regularly and on a large scale. The purpose is to access credit not available onshore, to minimise tax bills, to avoid government regulations and to obscure legally and illegally made fortunes. Against the background of an offshore economy that is large in volume, but small in visibility the dissertation asks: How does offshore finance affect the power of the state to unite resources in order to finance its politics?

The inquiry into the power relationship between offshore finance and the state immediately raises questions about the nature of the modern state and the delineation between the offshore and the onshore economy. To avoid getting lost in the theory of the state or impoverishing the analysis by ignoring the concept altogether, I develop an analytical perspective that I call ‘the money view’ on the state by employing Max Weber’s concept of the modern state in combination with Geoffrey Ingham’s notion of sovereign money. The money view considers state power to be a function of the debtor-creditor relationships between the government, taxpayers and financiers. Regarding offshore finance, the thesis starts from the premise that offshore centres are tax havens and international banking hubs reflecting the intrinsic connection between taxation and banking through sovereign money in the onshore economy. Within this analytical frame, the thesis conducts a historical comparison across four cases: Britain, Germany, Mexico and Brazil. For each case, I determine the scope and pattern of the demand for offshore financial services based on international banking statistics and qualitative interviews. The findings are contextualised in a historical institutionalist analysis of taxation and banking in the respective country. These two analytical steps are then combined to determine the effect of offshore finance on state power.

Andrea Binder

The politics of the invisible: offshore finance and the state. A country-level analysis

The thesis finds that the relationship between offshore finance and state power varies from country to country. Yet, across all cases offshore money creation in the Eurodollar markets is more consequential for the power of the state than is offshore tax planning.

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Acronyms

BaFin	<i>Bundesanstalt für Finanzdienstleistungsaufsicht, Federal Financial Supervisory Authority</i>
BANAMEX	<i>Banco Nacional de México, National bank of Mexico</i>
BEPS	Base Erosion and Profit Shifting
BIS	Bank for International Settlements
BNDES	<i>Banco Nacional de Desenvolvimento Econômico e Social, National Bank for Economic and Social Development</i>
BP	British Petroleum
CBE	Capitais Brasileiros no Exterior, Brazilian Capital Abroad
CD	Compact Disc
CDU	<i>Christlich Demokratische Union, Christian Democratic Party</i>
CPI	<i>Comissão Parlamentar de Inquérito, Parliamentary Committee of Inquiry</i>
DM	<i>Deutsche Mark</i>
ECB	European Central Bank
EU	European Union
FATCA	United States Foreign Account Tax Compliance Act
FDP	<i>Freie Demokratische Partei, Free Democratic Party</i>
GDP	Gross domestic product
HMRC	Her Majesty's Revenues and Customs, Britain's tax authority
IMF	International Monetary Fund
IPE	International Political Economy
IR	International Relations
IRS	Inland Revenue Service, the United States' tax authority
NCA	National Crime Agency
OECD	Organization for Economic Co-operation and Development
PEMEX	<i>Petróleos Mexicanos</i>
PRI	<i>Partido Revolucionario Institucional, Institutional Revolution Party</i>
PT	Partido dos Trabalhadores, Workers' Party
RFB	<i>Secretaria da Receita Federal, Brazil's Federal Revenue Service</i>
SPD	Sozialdemokratische Partei Deutschlands, Social Democratic Party
UKIP	United Kingdom Independence Party
URV	<i>Unidade real de valor, Unit of Real Value</i>
VAT	Value added tax

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Finally, I am happy beyond words that my family Martin, Maja and Carla joined me on that journey. Without a doubt, our life has been incredibly full in the past four years, but the fun we had along the way was all worth it. I love you guys.

I Introduction

Offshore finance is like a house of mirrors. It reflects the international political economy and its underlying power relations. Yet, the reflection that offshore finance throws back is bewildering. Seen from offshore, the shape of the contemporary international economy appears quite different from the conventional view. Some of its most fundamental elements seem bigger or smaller than usual. For instance, the volume of US dollar created offshore appears much bigger than what banking statistics suggest. Excluding offshore transactions, these statistics do not capture all that is there. Other elements, such as the volume of global foreign direct investment, appear much smaller than what economic statistics suggest. Counting virtual offshore investments the same way as substantial onshore investments, these statistics capture what, in essence, is not there (UNCTAD 2015; Linsi and Mügge 2017). If there is more US dollar credit in the world than we may think and substantially less foreign direct investment, if the regulations of the international banking system are not what they seem, neither are the tax rates imposed on multinational corporations, it is highly likely that our view on the power relationships underlying the international political economy is distorted too. Offshore finance may cover up that we know much less about the politics of international finance than we might think.

Obviously, offshore finance itself is one important element of our ignorance. Despite growing public attention in past years, academically and politically, offshore finance is still treated as a marginal phenomenon of the international economy. On the other hand, practitioners – whether bankers, lawyers or finance journalists – insist that offshore finance *is* the global economy (Obermayer and Obermaier 2016; MacIntosh 2017). As far as we can trust the data, the practitioners seem to have a point. According to the estimates of Alstadsæter and colleagues (2018, Appendix) the world's well-to-dos keep private wealth totalling US\$7.6 trillion or about 10 per cent of the world's gross domestic product (GDP) offshore. Multinational corporations are estimated to annually shift another US\$600 billion in corporate profits there (Tørsløv, Wier, and Zucman 2018, 13). All those offshore assets are likely surpassed by the volume of money that is created offshore. There are no global estimates for credit denominated in so-called Eurocurrencies¹, but at the eve of the 2007–2009 Financial

¹ The most important Eurocurrencies are the Eurodollar and the Euroeuro. In 2008 the US dollar accounted for 70 per cent and the Euro for 20 per cent of offshore deposits (Aliber 2011, chap. 1). Despite the name,

Crisis, the four countries studied in this thesis alone accumulated over US\$1.7 trillion in offshore dollar liabilities. It might not be *the* international economy, but offshore finance clearly is a substantial part of it. Corporations and wealthy individuals use offshore financial services to minimise their tax bill, to conceal their fortunes from creditors and family members and to avoid regulation, legally or illegally (Palan, Murphy, and Chavagneux 2010; Sharman 2010; Zucman 2013a; Obermayer and Obermaier 2016). Firms also go offshore to access credit that is not available domestically and to do so under British common law, which is considered the most developed law regarding debtor-creditor relations (McCauley, Upper, and Villar 2013; Norfield 2016). If offshore financial services are a central part of the international economy, and if they are used to minimise tax bills, to avoid government regulations and to create money, it raises the question how offshore finance affects the power of the state.

1 State power and offshore finance

An enquiry into the relationship between offshore finance and state power immediately raises two further questions – one old and one new. The old one is the question about the nature of the modern state and its sources of power. The new one is the question about the nature of offshore finance and how it can be delineated from the onshore economy. The first question is particularly challenging since, in the words of Skinner (2009, 326), ‘there has never been any agreed concept to which the word *state* has answered.’ However, to avoid the concept of the state entirely, as most of the offshore literature does, is no solution either. It limits the understanding of the offshore phenomenon. For one, the term implies an onshore complement to which it stands in contrast and so to understand offshore, we must have a clear idea of what is ‘onshore’ too. Furthermore, not spelling out what the modern state and its sources of power are risks impoverishing the analysis by equating the notion of the state with that of the government and to obliterate the geographically and historically contingent nature of different states (Skinner 2009). To avoid getting lost in the theory of the state or impoverishing the analysis by ignoring the concept altogether, I develop an analytical perspective that I call ‘the money view’² on the state by employing Max Weber’s (1994, 316) concept of the modern state in combination with Geoffrey Ingham’s (2004, 112) notion of ‘sovereign money’ (see chapter 2).

Eurocurrencies are not necessarily created in Europe or denominated in the US dollar or Euro. Panama City, for instance, is an important Euromarket for Latin American currencies. Historically, the Eurodollar market developed first and from there all further innovation in the Euromarkets came into being (Burn 1999; O’Malley 2015). I use the terms Eurodollar and offshore dollar or Euroeuro and offshore Euro interchangeably.

² I borrow the term ‘the money view’ from Mehrling (2011). See chapter 2, footnote 1.

If the concept of the state does appear in the literature on offshore finance at all, it is predicated on Goldscheid and Schumpeter's (1976) notion of the *tax state* (see Christopher Hood 2003; Genschel 2005; Cameron 2006). Yet, empirically, the modern state has not one but four principal ways to finance itself. It can extract money from its citizens; it can create money by going into debt; it can earn money (for instance by exploiting natural resources) or it can mobilise money from the outside (for example by colonial extraction or conquest). The modern state can be a tax state, a debt state, a rentier state or a predator state. Across time and place, the public finances of most modern states comprise a combination of these sources of income. Weber's (1994, 316) idea of the state as 'an institutional association of rule' that unites³ resources in order to finance its operations, recognises, as Goldscheid and Schumpeter did, that revenue is a matter of life and death for the modern state. A constant flow of revenue is a precondition for the modern state to create and maintain its monopoly of physical violence, its legitimacy and its external security (Weber 1994). Without revenue, the state cannot exist. Importantly, however, unlike Goldscheid and Schumpeter, Weber leaves the actual source of these resources – tax, debt, loot, etc. – open. In the contemporary period, tax and sovereign debt are undoubtedly the two central sources of state revenue with the other sources playing, if at all, a complementing role in most state budgets (Bonney 1999; Macdonald 2003; Ingham 2004; Vogl 2015). As a result, the state is built around the power relationships between the government, taxpayers and the state's financiers. Central to this power relationship is what Ingham (2004, 112) terms 'sovereign money'.

Without sovereign money, there would be no taxation and no possibility for any government to issue debt. The same is true the other way around: without a government going into debt and taxing its citizens, there would be no sovereign money (Ingham 2004). The cycle between money, tax, and debt is best understood if we look at it from the perspective of a balance sheet. The government creates money by going into debt. There is no other way to create sovereign money: The government prints notes, mints coins and, much more importantly today, sells government bonds. The issuing of notes, coins or government bonds is a liability on the government's balance sheet. This is why, to paraphrase Ingham (2004), all money is credit. A note in a national currency, say a £10 note, is nothing else than a promise of the British government to pay back £10 to whomever holds the note. The same is true for the government bond, only that its value is much larger. That is, those same coins, notes, and bonds that are liabilities for the British government are an asset for their owners. One can also look at it the other way around. If there are people owning sterling coins, notes and bonds as assets, someone

³ In the German original Weber uses the metaphor of uniting government resources in the hands of the institutionalised association of rule (see chapter 2).

else in the system has the corresponding liability. This someone else is, at the very beginning of the process, the state that creates sterling in the first place. In the same vein, a government can only create money by going into debt if it has an asset on the other side of its balance sheet. Otherwise, no creditor (small or large) would be willing to extend credit to the government. These assets are the citizens' tax debt. That is, a citizen in possession of our £10 note can, for instance, use it to buy a paperback book. Or, she can use the £10 note to discharge £10 of her tax debt. By exclusively accepting the money that the state itself issues as a means to discharge tax debt, the state ensures its monopoly power over sovereign money creation. This is why, simply put, one cannot repay a tax bill with a life insurance. The fact that the state only accepts a specific form of money – cash – as a means to pay tax, guarantees its validity (Ingham 2004). The cycle closes where the state's financiers extend credit to the government only if there is a valid money that can reliably account for how much the government owes them. The cycle of money, tax and debt underpins the struggle between the government, taxpayers and financiers over how to fund the state. This struggle is fundamental to the state's legitimacy, because the expectations of taxpayers are irreconcilable with those of financiers. Taxpayers expect public goods in return for their payments; corporate taxpayers hope for low interest rates and favourable bankruptcy laws in order to sustain company financing. Financiers, on the other hand, request that tax money be spent on serving interest payments and debt. They aim for interest rates that make their lending profitable and for laws that punish default. That is, public finance is a source of state power and, at the same time, a site of conflict and contestation between different groups in society over their material interests. In this conflict, the government cannot fulfil the material interests of all groups simultaneously. It has to prioritise some over others. As a result, the modern state faces, to cite Helen Thompson (2010, 147) its 'fundamental political problem of legitimating rule'. To create and extract money legitimately, the government has to negotiate successfully the debtor-creditor relations created by the cycle of sovereign money creation, tax and debt (Ingham 2004; Vogl 2015). The relationship between the government, the taxpayers and financiers is institutionalised in a country's tax and banking systems. The tax system is the institutional expression of the power relationship between the government and the taxpayers. It articulates who has to pay how much on the basis of which principles. The banking system is the institutional expression of the power relationship between the government and its financiers. It articulates who creates credit, who has access to credit and under which conditions. The central bank plays, indeed, a central role in that power relationship. A central bank makes it possible for financiers to extend private credit to the state. At the same time, creating central bank reserves through the issuing of government bonds, the state is – since Bagehot's days – the 'lender of last resort' to its own financiers (Mehrling 2011; Vogl

2015). Yet, as Weber (1994) points out, the state controls, but does not own, these resources. Public finances therefore make the state dependent on those who hold the ownership of the resources: financiers in the case of debt and taxpayers in the case of tax. The borrowing and taxing by the state are hence an expression of, and a limit to, its power (Ingham 2004; Vogl 2015). The power position of the government in its relations with financiers and taxpayers depends on its ability to successfully mediate the central political conflict about how the costs and benefits of tax and debt are distributed between different groups of society (Calomiris and Haber 2014; Levi 1989).

In sum, for the purpose of this thesis, I understand state power to be the state's ability – that is, the ability of the institutional association of rule (*Herrschaftsverband*), – to unite resources in order to finance its politics. This notion of state power has three implications. For one, it emphasises state autonomy – the ability of the state to act freely without external constraints – over state influence – the ability of the state to make others do what it wants (Cohen 2013). This emphasis reflects that the state's ability to unite and use resources in an autonomous way is a precondition for the state to exert influence. Second, by building on Weber, my concept of state power is premised on the historical development of the European state. However, I argue that its core, the idea of the state as an institutional association of rule can also account for the unique genealogy of the non-European states studied here (see below). The final implication is that, seeing the state from the money view puts a spotlight on the material dimension of state power, de-emphasising other, equally important dimensions such as military or ideational might.

The same is true for my understanding of the offshore phenomenon. Here, I concentrate on finance at the detriment of legal, geographical or other aspects. Regarding the nature of offshore finance, the literature tells two separate stories. One is about offshore financial centres as a hub for wealthy individuals and multinational corporations to minimise their tax bills, legally or illegally. This is a story about tax havens (see Palan, Murphy, and Chavagneux 2010; Sharman 2010; Zucman 2013a). The other, less researched and less well-known story is about offshore financial centres as a hub for banking. This story is about how banks use offshore financial services to expand their power to create money (see Helleiner 1994; Burn 1999; McCauley, McGuire, and Sushko 2015).

The two stories have indeed distinct histories. The first instruments of tax havens – secrecy and a distinction between residents and non-residents in tax matters – were developed in Switzerland, Liechtenstein and Luxembourg in the late 19th to early 20th century. Between then and the 1970s, Switzerland, Luxembourg and others – mostly small island states – decided to use their tax haven services as a deliberate economic development strategy (Hampton and

Abbott 1999, chap. 1). Offshore banking, on the other hand, developed in the 1950s and 1960s. It has its roots in the Eurodollar markets, which were created in the City of London in response to the highly regulated post-war economies of the United States and Britain. The post war regulatory environment limited the business of Britain's international banks. To improve their situation, some banks decided to use US dollar reserves from their international business to extend US dollar denominated credit to non-resident banks. Trading US dollar outside the US and among non-residents in London allowed circumvention of American and British regulations at the same time (Helleiner 1994; Burn 1999; Palan 2006; Green 2016). Freed from most regulations, in the almost five decades between 1960 and 2008, the Eurodollar markets grew exponentially and moved further offshore to the Channel Islands, the Cayman Islands, Singapore, Hong Kong and to other places.

Despite the distinct histories, the two stories of offshore tax havens and offshore banking are strikingly similar. Most obviously, they are placed in the same geographical locations. The Netherlands, Switzerland, the Cayman Islands, and many of the smaller offshore financial centres are usually both tax havens and a hub for offshore banking. Furthermore, in both stories offshore financial services exhibit the same four central features (see Palan, Murphy, and Chavagneux 2010; Sharman 2010). (1) They are exclusively offered to non-residents. (2) They entail zero or low taxation and regulation. (3) They offer invisibility⁴, and (4) they follow the logic of 'calculated ambiguity', to use Jason Sharman's (2010, 2) words. Calculated ambiguity means to structure a transaction such that the actors can give different answers to the same question, depending on who is asking it. This way, corporations, for instance, can claim to be loss-making vis-à-vis the tax authorities and to be profit making vis-à-vis their shareholders. Finally, the literature's two separate offshore stories share a common plot. Wealthy individuals, firms or banks, go offshore to avoid rules and regulations while (mostly) following the letter, but not the spirit of the law. Going offshore creates rents for the wealthy not available in the onshore economy for everyone else. This thesis starts from the premise that the similarities of offshore tax havens and offshore banking are no accident. They are a result of the intrinsic connection between taxation and banking through sovereign money creation.

To sum up, the thesis argues that we can fully appreciate the effects of offshore finance on state power only, if we recognise this intrinsic connection between tax and debt as a defining characteristic of the modern state. I consider offshore finance as a set of global financial services, which provide their non-resident users with invisibility, with low or zero taxation and

⁴ The terms used in the literature are usually 'secrecy' or 'anonymity'. I prefer invisibility over those terms because it better covers the intention of the provider and consumer of offshore services. Whether invisibility is achieved through secrecy, anonymity or by other means is changing across time and context. The invisibility of the offshore services, to the contrary, is fairly stable. See chapter 2.

regulation and with the logic of ‘calculated ambiguity’. State power, on the other hand, is the state’s ability to unite resources to finance its politics. It is a function of the underlying debtor-creditor relationships between the government, taxpayers and financiers. From the enquiry into the relationship between offshore finance and state power follows the thesis’s research question: How do offshore financial services affect the state’s ability to unite resources in order to finance its politics?

2 Researching the offshore world

Having introduced the research question and its two core concepts, I now discuss how the existing literature on offshore finance is largely tiptoeing around the issue of state power. Despite a growing body of research on offshore finance, the power relationship between offshore finance and state power remains a genuinely open question. The section also outlines how, in methodological terms, I go about providing one possible answer to it.

State of the art

Offshore finance has increased in prominence in public and academic debates in the past two decades. Accordingly, the literature on offshore finance has grown (Palan 1998; Sharman 2010; Zucman 2013a; Fichtner 2016; Garcia-Bernardo et al. 2017; Alstadsæter, Johannesen, and Zucman 2018; Tørsløv, Wier, and Zucman 2018). From that growing body of work, we can deduce insights about the two main channels through which offshore financial services potentially affect the power of the state. The first channel is offshore tax planning. Here, research demonstrates that, as tax havens, offshore financial centres create tax losses for the state (OECD 2013; Zucman 2013a; IMF 2014; Crivelli, De Mooij, and Keen 2015; Tørsløv, Wier, and Zucman 2018). However, these losses are not equally distributed across countries. Studies find that developing countries lose out more tax revenue than developed ones (Cobham and Janský 2017; Genschel and Seelkopf 2016; Crivelli, De Mooij, and Keen 2015); larger countries more than smaller ones (Genschel and Seelkopf 2016); open economies more than closed ones (Wibbels and Arce 2003); countries with high levels of crime and corruption more than those with lower levels (Genschel and Seelkopf 2016; Kar and Schjelderup 2015) and countries which are geographically close to offshore financial centres more than those at a distance (Zucman 2013a; Blanco and Rogers 2014; Haberly and Wójcik 2015b; Tørsløv, Wier, and Zucman 2018). Despite the general tendency of states to lose tax revenue due to offshore tax planning, researchers found, however, that international tax competition, of which tax havens are the proverbial tip of the iceberg, does not, in Genschel’s (2005a, 53) words, ‘fatally undermine the tax state’. Yet, it does alter the terms of settlement between different groups of

society over who has to pay how much tax. Across the globe, tax reform has shifted the tax burden from capital to labour (Genschel 2005; IMF 2014). While there is a convergence in the direction of tax reform, scholars argue that the effects of financial globalisation on tax policies are conditioned by domestic politics and institutions (Basinger and Hallerberg 2004; Genschel and Schwarz 2011; Swank 2016b). These findings on the relationship between offshore tax havens and onshore taxation speak to one part of the offshore phenomenon as understood in this thesis. The other part is offshore banking.

Here, the research can be divided in two comparatively small streams of work: one on offshore money creation, the other on offshore money laundering. The research on offshore money creation analyses the Eurodollar markets as the birthplace of offshore banking (McCarthy 1979; Burn 1999; O'Malley 2015), the related regulatory challenges for the state (Hawley 1984; Windecker Jr. 1993); the effect of offshore money creation on international financial stability (Black and Munro 2010; He and McCauley 2010a; Avdjiev, Chui, and Shin 2014); as well as the effect of offshore money creation on the host economy (Hines 2005; Blanco and Rogers 2011; Kim 2015). Regarding the question of state power, these works find that the Eurodollar system, although a nearly regulatory-free space, did by no means develop without the knowledge and active support of governments, in particular from the United States and Britain (Helleiner 2011; Burn 1999; Green 2016). Thus far, however, this literature does not touch upon the question of how offshore money creation affects the power sharing arrangement between state and banks regarding onshore money creation (Strange 1994) and the resulting ability of the state to unite resources through sovereign debt.

The literature on money laundering, on the other hand, considers offshore financial services, particularly those related to secrecy and limited regulation, as one of many ways to integrate the proceeds of ill-gotten funds into the regular economy (Hampton and Levi 1999; Sharman 2011, chap. 11). As such, offshore money laundering is not different from onshore money laundering in its effect on state power. It restricts law enforcement on the predicate crimes, for instance tax evasion, the financing of terrorism or grand corruption (Findley, Nielson, and Sharman 2014; J. C Sharman 2017). What this argument overlooks, however, is that offshore money laundering demands a higher degree of sophistication than traditional onshore techniques. It is thus particularly important for 'high-end money laundering,' running into 'billions of pounds' (NCA 2018, 39). All these funds accumulate on the asset side of banks' balance sheets and become an integral part of offshore banking. Hence, offshore money laundering reinforces the effect that offshore money creation may have on state power. It is in this perspective that the thesis integrates money laundering into its analysis.

Taken together, academic research on offshore financial centres as tax havens and as banking hubs remains largely silent on the question of state power. If considered at all, the question is deliberated in an implicit way. Research on offshore tax havens mostly alludes to a negative effect of offshore finance on the state's ability to extract money from its citizens, but one that can be mitigated by domestic institutions. Research on offshore banking implicitly acknowledges state agency through regulatory policies, but does not enquire, whether with a view on licit or illicit funds, how offshore banking affects the state's ability to unite resources. Besides the tacit treatment of the notion of the state and its sources of power, the works reviewed here share another common feature: their analyses are all on the aggregated level and therefore cannot account for the state's historically and geographically contingent nature. To be able to do so, the effect of offshore finance on state power must be studied on the level of the individual state.

Research approach

The dissertation scrutinises theoretically and empirically the relationship between offshore finance and state power across four countries: Britain, Germany, Brazil and Mexico. Employing Weber's concept of the state as an institutional association of rule attributes institutions and their historical development a central role in the analysis. Therefore, in the tradition of historical institutionalism, the thesis follows the premise that, fundamentally, politics is about the conflict over different groups' interests. The conflicts are reflected and shaped through historically grown political and economic institutions such that inescapably – though not unchangeably – some interests are privileged over others (P. A. Hall and Taylor 1996). Given that state power, as understood in this thesis, is a function of the relationship between the government, its financiers and taxpayers, and that offshore financial services affect the state through offshore tax planning and money creation, the two institutions at the core of the analysis are taxation and banking as institutionalised means for the state to unite resources in order to fund its politics.

The thesis is designed as a comparative case study. The four cases were selected on a regional basis, covering Europe and Latin America. Europe is in many ways the heart of the offshore world. It is here that offshore financial centres as tax havens and as banking hubs have had their origin. Europe is home to a number of the largest and most successful offshore financial centres – Switzerland, Luxembourg, the Netherlands and Ireland among them. Likewise, it is the region that is most strongly exposed to tax losses related to offshoring (Zucman 2013a) and that was, at least until the 2007–2009 Financial Crisis, the largest hub for Eurodollar banking (Snider 2017). In addition, Weber's (1994) ideal type description of the state as an institutional association of rule is premised on historical developments in Europe.

Employing this concept is hence most appropriate in relation to European states. Within Europe, I selected Britain and Germany as the two crucial cases to focus on (chapters 3 and 4). A crucial case is a case that most likely exhibits a given effect (Gerring 2009). In our context, this means a country where we can most likely observe an effect of offshore financial services on the state's ability to unite resources.

Britain is considered the first Western state that developed modern ways to finance itself through sovereign debt and taxation (Bonney 1999). Moreover, the country is considered the birthplace of Eurodollar banking (Helleiner 1994; Burn 1999; Green 2016) and a considerable number of classical offshore tax havens – from the Channel Islands to the Cayman Islands – are British Overseas Territories (Hampton 1996b; Tax Justice Network 2013). As a result, Britain holds a special place in the offshore world. Unlike in any other country, Britain is at the same time a large economy with corporations and wealthy citizens using offshore financial services elsewhere and one that offers offshore financial services to foreigners. This double identity as a user and provider of offshore financial services makes Britain a crucial case, and a tricky one. Some researchers argue that because Britain is a central node in the international web of offshore financial centres, it should be studied in the same vein as classical offshore financial centres such as Switzerland, Luxembourg or Ireland (Garcia-Bernardo et al. 2017). Most others who go through the pain to determine which countries are offshore financial centres and which are not, do not include Britain into their lists (cf. Dharmapala and Hines 2009; Johannesen and Zucman 2014; Gravelle 2015). Both approaches are reasonable but flawed in the context of this thesis, for they would create biases in the data (see below). I therefore work with a middle ground. I consider Britain an offshore banking centre (see Thompson 2017), but not a tax haven. Despite low corporate income tax rates, I do not consider Britain a tax haven, since its tax rules are not systematically different for residents and non-residents and, though large, the financial sector remains but one important sector in the British economy. Offshore tax services are not as crucial for the British economy as they are, for instance, for Ireland. This approach reflects Britain's important role in the Euromarkets, while keeping it apart from the classical tax havens (see chapter 3).

Germany, on the other hand, is a straight forward case. It is Europe's largest economy and shares a border with three of the globally most important offshore financial centres: the Netherlands, Switzerland and Luxembourg. In terms of tax loss, estimates suggest that Germany is among offshore finance's prime victims (Alstadsæter, Johannesen, and Zucman 2018). However, Germany is also a country that contributes substantially to the establishment, growth and maintenance of the Euromarkets. That is, like Britain, Germany also provides offshore financial services by creating money offshore. With the size of its economy, its

proximity to offshore financial centres and its involvement in the Euromarkets, we are able to clearly observe how offshore finance affects state power (see chapter 4).

Europe may be at the centre of offshore finance, yet offshore markets are among the rare phenomena which are truly global. As such, offshore finance cannot be understood from the European vantage point alone. Yet, IR and even more so international political economy (IPE) scholarship, though recognising the need, have a difficult time to conceptually overcome Eurocentric analyses (Mills 2015). This thesis is no exception. My pragmatic course out of that impasse is to select cases which are empirically relevant, and which can be reasonably covered by the concept of state power put forth here. These two criteria pertain to Latin America. The region is significantly exposed to offshore finance, both in terms of estimated tax loss (Zucman 2015, 53) and in terms of exposure to the Euromarkets (McCauley, McGuire, and Sushko 2015b). In addition, since their independence in the 19th century, many Latin American states explicitly crafted their constitutions after European ones (Centeno and Ferraro 2013). While uneven, Europe and Latin America's paths to the modern state have sufficient parallels to be analysed by the same concepts.

Within Latin America, I selected Brazil and Mexico as the two crucial cases to focus on (chapters 5 and 6). Brazil is the typical case of a state whose firms and wealthy individuals use offshore financial services, both legally and illegally. Though geographically removed from most offshore financial centres, their services are deeply ingrained in the Brazilian economy. As a result, the power relationship between offshore finance and the state is clearly observable in Brazil (see chapter 5). Mexico, on the other hand, appears to be a typical case at first sight only. It has a large open economy with a geographical proximity to the Caribbean – after Europe the world's most important offshore hub. In addition, Mexico faces endemic problems of crime and corruption. We would hence expect a considerable demand for legal and illegal offshore services, which in turn should help in observing how offshore financial services affect state power in Mexico. Puzzlingly, the empirical evidence suggests otherwise. Mexican firms and individuals make comparatively little use of offshore financial services. This unexpected finding transformed Mexico from a crucial into an outlier case, which nevertheless provides insights into the relationship between offshore finance and state power (see chapter 6).

Dealing with data

Each of the four cases passes through the same three analytical steps. I first analyse the extent to which actors use offshore financial services, a precondition for establishing *how* they affect state power. In addition, it stands to reason that their effects get more pronounced as the scope of offshoring increases. However, quantifying the uses and abuses of offshore financial services

is notoriously difficult (Henry 2012; Zucman 2013a; Garcia-Bernardo et al. 2017). The opacity of offshore finance and its blurry boundaries towards the onshore economy make quantification difficult. In addition, standard macroeconomic data, such as national accounts and investment data loose quality over time, precisely because of the offshore phenomenon (Zucman 2013b; Linsi and Mügge 2017). In essence, researchers choose one of two different approaches to deal with this challenge. One group of scholars works with formal models and applies those models to individual countries (Crivelli, De Mooij, and Keen 2015; Cobham and Janský 2017; Garcia-Bernardo et al. 2017; Tax Justice Network 2018c). The other group of scholars estimates the total global scope of offshore finance and then apportions parts of that global total to individual countries (Henry 2012; Alstadsæter, Johannesen, and Zucman 2018; Tørsløv, Wier, and Zucman 2018). Both approaches have contributed to a better understanding of the scope of the offshore phenomenon. However, they also come with two important limitations. First, the formal models only cover a single aspect of offshore finance, for instance corporate taxation or foreign investment, leaving out all other – equally vital – aspects of the phenomenon. To remedy that problem, the second approach combines different macroeconomic data sets ranging from national accounts data, over investment data, to tax and banking data. This approach provides a more sophisticated view on offshore finance in its entirety but creates a second problem. For each data set the authors use, the underlying concepts and their statistical expressions are contested (Linsi and Mügge 2017). Combining different sources of data may create a comprehensive perspective on the offshore world, but it also leads to combining conceptual and statistical shortcomings.

To circuit these shortcomings and in light of the purpose of the thesis – to determine the effect of offshore finance on state power, not to study the scope of the offshore phenomenon as such – I have chosen a mixed methods approach, combining quantitative data from the locational banking statistics of the Bank for International Settlements (BIS) with qualitative data from interviews with participants in the offshore world.

For the quantitative analysis, the advantage of bank data over other macroeconomic statistics is its balance sheet approach. Each economic interaction between economic actors in a specific state and an offshore financial centre, whether it is trade or investment, real or virtual, is recorded through the related financial transaction of the involved banks. That is, rather than dealing with contested concepts and their statistical expression, bank data records how money changes its location on banks' balance sheets as cross-border economic activity unfolds. Moreover, building on central bank data, the BIS statistics are of an equally high quality for all four case studies. Nevertheless, the BIS data has its own limitations. To begin with, as with all datasets dealing with offshore finance, the question is which jurisdiction counts as an offshore

centre and which does not. The BIS classifies a number of countries as offshore financial centres, but the list excludes important European offshore centres such as Switzerland, the Netherlands or Luxembourg. The estimates provided in this thesis use the BIS list and adds to it the missing European jurisdictions identified as offshore financial centres in Garcia-Bernado et al. (2017)⁵. The only exception is, as discussed above, Britain. Although I consider Britain an offshore banking centre, I do not include it into the list of offshore counterparts for transactions by German, Mexican and Brazilian economic actors for the BIS data cannot be disaggregated by sector. Therefore, treating Britain as an offshore counterpart for the other case study countries would mean to label all economic interaction between them, including trade, as offshore transactions. However, Britain's financial sector is only one of several economic sectors and even within the financial sector not all transactions are offshore services. Given the overall size of the British economy, this approach would create a considerable bias towards overestimating offshore services. The situation is different when analysing British supply of offshore services. Here, the BIS data allows distinguishing between residents and non-residents and between domestic and foreign currency transactions (see chapter 3). This then allows me to differentiate between offshore (non-residents, foreign currency) and onshore transactions (residents, home currency). In the case of Britain, I hence analyse the demand and supply side of offshore banking services (including money laundering). For offshore tax planning services, I focus on the demand side only. Besides the question of who is and who is not an offshore financial centre, another shortcoming of the BIS data is that it misses out on off-balance sheet transactions. For instance, fiduciary funds and trusts are two asset-holding structures that are legally off a bank's balance sheet. However, both structures are valued vehicles for individual and corporate offshore investments (Harrington 2016b; Zucman 2013b). That means the BIS data provides us with a coherent idea of the face of the offshore system while being oblivious to its underbelly.

Irrespective of the approach taken, the opacity of offshore finance limits the explanatory power of purely quantitative analyses. This is all the more the case for money laundering. It is impossible to determine which of the assets registered in the BIS statistics are of a legal and which are of an illegal origin. I therefore do not provide my own quantitative estimates on the scope of offshore money laundering. To strengthen the empirical evidence, I collected additional qualitative data through 60 in-depth participant interviews. I designed the interviews as open-ended expert interviews structured around two sets of questions. One set of questions was the same for all interviews, and the other set was specifically tailored to the expertise of

⁵ Appendix 1 provides the full list.

the respective interviewee. This approach allowed identifying recurring patterns, while covering the different aspects of offshore finance. All interviewees had everyday experience with offshore finance, be it as lawyers, bankers, wealth managers, policy-makers or civil society activists. I conducted the interviews between November 2015 and November 2018 in the four case study countries. The interview results are mainly used to triangulate the quantitative data. However, where appropriate, they also inform the historical-institutionalist analysis.

The historical institutionalist analysis is the second analytical step each case study passes through. It concentrates on how public finances reflect and shape the power relationships between different groups in society over time (P. A. Hall and Taylor 1996). In other words, it traces the development of the respective state from the money view. That is, starting in the 19th century, the beginning of modern taxation and banking in most of the case study countries, it scrutinises which groups of society belong to the association of rule (*Herrschaftsverband*) and documents the struggle between its taxpayers and financiers over how to finance the state. This long-term perspective helps to contextualise the empirical evidence collected on the contemporary power relationships between the government, taxpayers and the financiers and hence to account for geographical and historical contingencies. The analysis draws on primary and secondary sources. The third and last step of the case study analysis brings together the assessment of the scope of offshoring and the historical analysis, discussing how offshore financial services affect the power of the state.

3 The argument in brief

The dissertation starts with an open view on the potential effects of offshore finance on state power. Offshore finance may limit, enhance or simply leave untouched the ability of the state to unite resources. However, contrasting offshore financial services on one side with state power on the other, should not lead us to conclude that offshore finance has been established without the state. Offshore financial services may be outside states' realm, yet, as Palan (1998, 2002) argues, states play an active role in creating and maintaining the international system of offshore finance. He contends that by creating offshore spaces, states 'bifurcate' their sovereignty, understood as the right of a state to write its own laws, into a space where it withdraws from interfering into the economy (offshore) and one where the state continues to fulfil or extend its traditional roles (onshore) (Palan 1998, 626–27). That is, given globally mobile capital, states created extraterritorial spaces of limited state power to salvage said power within their territory. His thesis is plausible. For instance, a fourth of all offshore financial centres are British Overseas Territories, crown dependencies or commonwealth territories with London either having the power to influence law-making directly or acting as final court of

appeal (Hampton and Levi 1999; Tax Justice Network 2013). In addition to Britain, other major powers, such as China, the United States, and powerful members of the European Union have direct influence on prominent offshore financial centres, including Hong Kong and Macao, Delaware and the United States Virgin Islands, Luxembourg and Cyprus to name but a few. It seems improbable that the big fish watch helplessly as the minnows prey on their power to extract and create money. The dissertation hence builds on Palan's argument of the active role of the state in creating and maintaining the offshore system. However, it goes on to ask *how* the offshore system, once established, affects the power of the state to unite resources to finance its politics. Did offshore bring the hoped-for salvage for state power domestically by voluntarily limiting it in offshore spaces? Or did it turn the modern state into Goethe's sorcerer's apprentice who no longer commands the spirits that he cited?

Across the four case studies, the thesis finds that the relationship between offshore finance and state power varies from country to country. Nevertheless, there are common patterns across all four cases. The thesis's conclusion (chapter 7) discusses these common patterns and their consequences for the state and the international financial system in detail. Overall, two observations stand out. First, tax planning happened in governments' plain sight. As the response to the 2007–2009 Financial Crisis strained public budgets and offshore tax planning moved into the public light due to data leaks, those governments successfully introduced laws to curb it. Offshore tax planning does not systematically limit the state's power. Rather, via the politics of the invisible, offshore tax planning offers the wealthy in Britain, Germany and Brazil respite from the demands of financing the welfare state; in Mexico – to the degree that offshore services are used – they are a luxurious extension of the rents created at home. Even more notably are, second, the similarities regarding offshore money creation. Despite strongly varying economies and currencies as well as different positions within the Euromarkets (as net lenders, net borrowers or, as in the case of Britain, with a balanced account), offshore money creation greatly enhanced the power of the state to unite resources in the three decades between 1950 and 1979. However, in Latin America, the price of offshore money creation – the limited ability of the state to do anything effectively to halt problems that have been created offshore – became clear with the debt crises of the 1980s and 1990s. In Europe, it took until the Financial Crisis of 2007–2009 that this price materialised. Yet, by then, the size of the global Euromarkets had grown so big and had become so intrinsic to corporate and trade financing that none of the case study countries, apart from Mexico, found a way to get out of it. As a result, Britain, Germany and Brazil are now stuck with a system of offshore money creation that is at once indispensable and dysfunctional. The state has thus little choice but to prop it up, which ties up political and economic capital of enormous proportions. From the money view, offshore money

creation turned the state, and with it its financiers, into the sorcerer's apprentice. Unlike in Goethe's ballad, however, a decade after the Financial Crisis, the master sorcerer has yet to get home and call the spirits off.

II The money view on state power and offshore finance

State power and offshore finance are contested concepts. They cannot be given definitive meaning; they can only be interpreted within their historical and geographical contexts (Berenskoetter 2016). Hence, before moving into the empirics, this chapter provides an analysis of the concepts of state power and offshore finance as I use them in this dissertation. The chapter develops a money view⁶ on the state by combining Max Weber's (1994) concept of the modern state with Geoffrey Ingham's (2004) notion of sovereign money. The money view on the state provides the conceptual frame to guide the subsequent case studies.

1 The state from the money view

The modern state is a highly contested concept, because, as Skinner (2009, 326) writes, 'there has never been any agreed concept to which the word *state* has answered.' It would hence be hopeless to attempt, as a political economist, to find a definitive answer for what constitutes the modern state and how it exerts power. There are two principal ways to deal with that conundrum. One can bracket out the concept to avoid contestation. This is what most of the offshore literature (see Palan, Murphy, and Chavagneux 2010; Sharman 2010; Garcia-Bernardo et al. 2017) and, paradoxically, most of the literature on the relationship between globalization and the nation state do (see Swank 2003, 2016a). Alternatively, one can employ an existing concept of the modern state, including its contested aspects. The thesis opts for the latter approach. 'Offshore' implies an onshore complement to which it stands in contrast and so to understand offshore, we must have a clear idea of what 'onshore' is too. Furthermore, not spelling out what the modern state is, risks impoverishing the analysis by equating the notion of the state with that of the government (Skinner 2009).

The modern state

If the concept of the state does appear in the literature on offshore finance at all, it is predicated on Joseph Schumpeter and Rudolf Goldscheid's (1976) notion of the tax state (see Christopher Hood 2003; Genschel 2005). The two Austrian economists coined that concept in the wake of World War I. Schumpeter pondered the tax state's calamity in face of ever-growing demands for social protection. Goldscheid, on the other hand, criticised the tax state, arguing that, by

⁶ I borrow the term 'the money view' from Perry Mehrling (2011, 1–10). He uses the expression to distinguish his analysis of the US financial system from those who treat the availability of liquidity in a financial system as a free good that comes without economic and political costs attached.

spending resources that it does not own, the tax state becomes the destitute capture of the owners of those resources: the moneyed classes. The two economists agreed, however, that it is public finances that make the state and determine the fortune of its people (Goldscheid and Schumpeter 1976). Schumpeter and Goldscheid made the fiscal perspective on the modern state prominent. Contemporary political economists continue to employ the concept to analyse questions of state power through the fiscal lens (see O'Connor 1973; Christopher Hood 2003; Lieberman 2003; Genschel 2005).

Illuminating in many ways, this scholarship overrates, however, taxation as the key source of state revenue. The state has not one but four principal ways to finance itself: it can tax its citizens; it can go into debt; it can earn money, for instance by selling its natural resources; or it can mobilize money from the outside e.g. through conquest and colonialization. The modern state can be, among others, a tax state, a debt state, a rentier state or a predator state. Across time and place, the public finances of most modern states comprise a combination of these different sources of income. Weber's (1994, 316) concept of the state 'as an institutional association of rule (*Herrschaftsverband*), ... which unites in the hands of its leaders the material means of operation' recognizes, as Goldscheid and Schumpeter did, that revenue is a matter of life and death for the modern state. Importantly, however, unlike his Austrian contemporaries, Weber leaves the actual sources of state revenue open. This conceptual openness allows for an analysis of state revenue other than taxation. In addition, to define the modern state, Weber created the neologism *Herrschaftsverband*. The compound noun is difficult to translate into English. It brings together the two nouns *Herrschaft* and *Verband*. The latter term is simply an association, that is, a group of people coming together for a specific purpose. *Herrschaft*, however, is much harder to define. In German, the term has a historical and a sociological meaning. In the historical sense, a *Herrschaft* was the fiefdom of a nobleman; it was the lowest rank with full feudal rights. The *Herrschaft* constitutes the institutionalised relationship between *Herr* and *Vasall*, between lord and liege. This feudal relationship was characterised by a clear hierarchy but also by mutual support. The notion of a hierarchical but mutually beneficial relationship lives on in the sociological meaning of the term *Herrschaft* (rule), which describes a hierarchical power relationship that sets itself apart from sheer power insofar as the ruler can only rule if considered legitimate by the ruled. It follows that the term *Herrschaftsverband* signifies two things. First, the association of a number of *Herrschaften* in the historical sense reflecting the administrative centralisation and collectivisation of material means as feudal relationships developed into the modern state. Second, it captures the process of uniting people and means with the purpose to exert power. The state, as I understand it, incorporates both meanings of the concept.

The idea that rule (*Herrschaft*) sets itself apart from sheer power through a mutually beneficial relationship between the ruler and the ruled does not mean that all states are automatically legitimate. To the contrary, the state is a space of contestation within the institutional association of rule and between those inside and outside of that association. In Thompson's words (2010, 145–47) all states face the 'fundamental political problem of legitimating rule that arises out of the clash of interests and beliefs among their citizens'. From the money view deployed here, the conflict that is of interest for the analysis is the conflict over how to finance the state: who has to contribute, by which means, how much and under which conditions?

In the contemporary period, empirically tax and debt are the two defining, indispensable and intertwined funding sources with the other sources (rents, conquest etc.) playing, if at all, a complementing role. As a result, most modern states are built around creditor-debtor relationships between the government, its taxpayers and financiers (Bonney 1999; Ingham 2004; Vogl 2015). These relationships are institutionalized in a country's tax and banking systems. The tax system is the institutional expression of the power relationship between the government and the taxpayers. It articulates who must pay how much based on what principles. The banking system is the institutionalized expression of the power relationship between the government and its financiers. It articulates who creates credit, who has access to credit and under which conditions (Calomiris and Haber 2014, chap. 1). Yet, since the state only controls, but does not own these resources (Weber 1994), public finances make the state dependent on those who hold the ownership: financiers and taxpayers. Borrowing from and taxing citizens are thus an expression of, and a limit to, state power (Ingham 2004; Vogl 2015). It follows, then, that the power position of the government depends on its ability to mediate successfully the central political conflict about how the costs and benefits of tax and debt are distributed between different groups of society (Calomiris and Haber 2014; Levi 1989). The struggle between these groups is fundamental for the state's legitimacy because the expectations of individual and corporate taxpayers are irreconcilable with those of the financiers: Individual taxpayers expect public goods in return for their payments. Firms expect low interest rates and favourable bankruptcy laws to sustain company financing. Financiers, on the other hand, request that tax money is spent on serving interest payments and debt. They aim for interest rates that make their lending profitable. And so '[t]he state cannot possibly, at any given moment, act as the guardian of all its citizens' material interests. It has to side with some over others' (Thompson 2010, 145). The terms of the settlement between the different groups in society are in principle fully negotiable. Historically, however, sovereign debt has been one of the most powerful sources for the creation of private wealth, which in turn is an important

source for state financing (Vogl 2015; Hager 2016). Underneath the struggle between the government, taxpayers and financiers over how to finance the state thus lies the question of class (Ingham 2004; Macdonald 2003).

Sovereign money

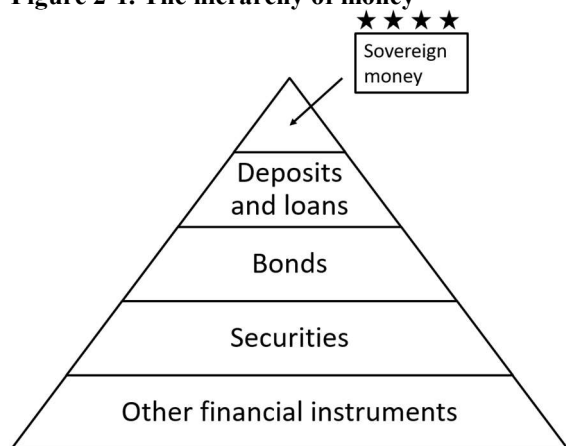
It is no coincidence that tax and debt together are the dominant sources of state finance today, for they are intrinsically linked to each other through the development of sovereign money. There is a cycle of money, tax and debt. Throughout the 15th to 17th centuries first taxation and then sovereign debt developed as two separate state practices. Yet over time, the two sources came to reinforce each. The tax state has, according to Schumpeter, ‘grown out of the [financial] crisis of its predecessor, the feudal relationship’ (1991, 102). The growing costs of warfare and of maintaining the court exceeded, in the long-run, the private revenue the prince could mobilise from its principedom or through conquest (Schumpeter 1991; Tilly 1990). Running into a systemic financial crisis, the court started to tax land and to get into debt with private financiers, that is, it began to create public revenue to spend on public matters (mainly fighting wars). For the state to develop the capacity to tax, it had to accumulate and centralise a considerable amount of the material means its economy produced, making the nascent tax state dependent on private capital. Private capital accumulation, in turn, relies on liquidity and so over time the personal financial markets of 15th and 16th century Europe developed into impersonal markets by creating general and tradable credit instruments (Vogl 2015). These impersonal financial markets could only develop because the state created money by as Knapp (1976, cited in Ingham 2004, 47-48) writes ‘declaring it will accept the discharge of tax debt, assessed in the unit of account, at the public pay offices’. The importance here is not so much that the state issued money, but that it accepted the credit created by private financiers as money via tax payments.

That is, sovereign debt led to a mutual dependency between the state and the merchant classes. The two historically struggled over the power to create money. The merchant classes dominated the system of private debt and the state possessed the monopoly over coinage and currency issue (Ingham 2004; Vogl 2015; Schumpeter 1991). The foundation of the Bank of England in 1694, then, represented the first compromise in that struggle. It divided monetary sovereignty between the banks and the state (Ingham 2004; Vogl 2015; Strange 1994). This compromise laid the foundation for the development of modern sovereign money.

In his theory about the nature of money, Ingham (2004) conceptualises money as a net of social relations constructed between its issuers and users. Money is a liability for the issuer and a credit for the user. Consequentially, the state and banks cannot create money without

simultaneously creating debt. Yet at the same time, no creditor would extend credit if there were no assets on the other side of the balance sheet. In the case of the state, these assets are its citizens tax debts. That is, money is a means to account for and settle debt, most importantly tax and sovereign debt. Furthermore, money cannot exist without an *authority* that accepts its existence and thereby guaranteeing its validity. In other words, the social relations constructed by money are organised in a hierarchy in the sense that there are different degrees of credibility to the promise to pay back that constitutes all forms of credit (Knapp 1924; Ingham 2004; Mehrling 2012). At the top of the hierarchy is sovereign money, the state’s promise to pay. It is the most sought-after credit because it is backed by tax revenue and the state’s monopoly power of issue. Sovereign money is followed in the hierarchy by deposits, loans, securities and all sorts of financial instruments (see figure 2.1 below). Differential rates of interest, expressing the risk of broken promises, organises the hierarchy. The further up at the top, the more transferable becomes one form of credit into another. The distinctiveness of sovereign money is that it alone is transferable into any other form of credit. This means that the various forms of private debt – deposits, loans, bonds, securities, other financial instruments – become monetised once they are exchanged ‘for sovereign promises to pay that are fully transferable and acceptable anywhere within the monetary space defined by the money of account’ (Ingham 2004, 138).

Figure 2-1. The hierarchy of money



The central bank plays an important role in the transferability of different forms of private debt into sovereign money by taking the banking system’s liabilities on its balance sheet, that is by buying them (Ingham 2004; Mehrling 2016). However, not all private debt is monetised. Rather, the proliferation of debt contracts and debt instruments allows for the creation of credit and hence capitalist expansion. These contracts and instruments constitute, in the words of

Ingham (2004, 30) ‘near money’. They entail not only the promise to pay back but also the promise to be transferable into sovereign money at some point in the future. Transferring near money into sovereign money, the central bank becomes the interface between the state and financial markets. It links the state with the moneyed classes.

The central bank is one part of the institutionalised expression of the power struggle between the government, taxpayers and financiers about the costs and benefits of money creation (Vogl 2015; Ingham 2004). Next to the central bank, the commercial banks, public banks and non-bank financial institutions reflect that power struggle over money creation. In that struggle, the government and financiers negotiate over market entry (who can open a bank), access to credit, price of debt, bank regulation and allocation of losses in case of default (Calomiris and Haber 2014). These rules, in turn, determine the competitive structure and size of the banking sector in the respective country. Access to credit determines who in a society can spend today and repay in the future. The price of debt comprises the economic, political and social costs the different actors face when going into debt. Bank regulation determines what banks can do and at which level of risk. Finally, the allocation of losses determines which social groups must bear the costs of sovereign debt, sovereign default and bank failures.

Through cross border financial flows in different national currencies, states also struggle among each other over how to create money internationally (Koddenbrock 2017). Between 1931 and 1971, this struggle was embedded in the global system of credit pegged to gold. Once Nixon unpegged the US dollar from gold in 1971, ‘the world entered’ in Graeber’s (2012, 362) words a new phase of financial history – one that nobody completely understands’. However, what we do know is that given that the US dollar became the *de facto* world reserve currency, the exchange rate to the US dollar and a state’s level of US-dollar-denominated debt are limiting the power to create credit internationally for all states other than the United States. Issuing debt in international markets means that states trade access to credit in return for some influence over domestic decision-making. It makes a difference for the power of a state whether it is indebted to its own people or to foreigners (Krasner 1999; Macdonald 2003; Thompson 2007).

On the other side of the balance sheet, the conflicts underlying taxation are equally important. In that struggle, the government must mediate between the interests of different groups in society. Generally, the state taxes capital by putting a levy on the value of capital stock (e.g. real estate, estate and wealth taxes) or on the flow of capital income (e.g. the capital income tax). Levies on labour are wage taxes and social security contributions. In addition, the state collects indirect taxes (e.g. VAT and other consumption taxes). Indirect taxes are not linked to the source and level of income of the tax payer. They are thus a particularly heavy burden for those with lower incomes because they accumulate to a larger share of their

disposable income than for wealthier groups (Piketty 2014, chap. 13). The struggle between the different groups of taxpayers, then, is about how the different sources of tax are balanced and how the revenue is spent – most centrally to fight wars, to finance the welfare state or to service sovereign debt. For the government to be successful, the negotiation must create trust among taxpayers that each group pays its fair share. In addition, to sustain tax compliance, the state must ensure that taxpayers are confident to receive the promised, though not guaranteed, material returns for their contribution (Levi 1989).

Through cross-border trade, taxation has also an international dimension. Here the state struggle over the division of tax revenue arising from international trade and investment. To date, a network of over 3000 bilateral tax treaties determines how tax revenue is divided between the residence state, where the taxpayer lives, and the source state, where the taxpayer generates its income. The initial purpose of the tax treaties was to remove double taxation as a barrier for international trade and investment, which they did. However, the so achieved international capital mobility also opened the possibility to shift capital across borders for the sole purpose of avoiding taxation. This is why governments started to complement the network of tax treaties with multilateral initiatives against tax avoidance and evasion, most recently in form of the Base Erosion and Profit Shifting (BEPS) project of the Organisation for Co-operation and Development (OECD) and the Anti-Tax Avoidance Directive of the European Union (EU) (see Rixen 2008; Genschel and Rixen 2012; Dietsch and Rixen 2016).

Power

If the nature of the state is contested, the same is true for its sources of power (see Finnemore and Goldstein 2013). Against the conceptual background provided here, I understand state power to be the ability of the institutional association of to unite resources to finance its politics. Whereby the settlement over how to finance the state is determined by the government's success in mediating the conflicts around taxation and banking.

This notion of state power has two implications for the subsequent analysis. First, the concept puts a spotlight on the material dimension of state power, de-emphasizing military, ideational or cultural dimensions. Concretely, my material perspective highlights the importance of the tax and banking systems as institutions to reckon with. Second, it emphasizes state autonomy, the ability of the state to act freely without external constraints, over state influence, the ability of the state to make others do what it wants (Cohen 2013). This emphasis reflects that the state's ability to extract resources from its citizens and to use them in an autonomous way is a precondition for the state to exert influence.

2 Offshore finance

Unlike the concept of the state, the notion of offshore finance is contested not so much because of its layered and shifting meanings, but because of a still fragmentary empirical understanding of the phenomenon. For instance, estimates about the size of the offshore world cover only specific elements. Gabriel Zucman (2013a) estimates how much global individual wealth is offshore. The United Nations provides an assessment of how much foreign direct investment is channelled through offshore financial centres (UNCTAD 2015) while the Bank for International Settlements offers insights into the size of offshore corporate bond issuance (McCauley, Upper, and Villar 2013). This patchy empirical basis is still too thin to even evaluate dissenting perspectives on offshore finance (Haberly and Wójcik 2015b). Nevertheless, most scholars agree on four central characteristics of offshore finance (see Palan, Murphy, and Chavagneux 2010) (1) Offshore financial services are exclusively offered to non-residents of the respective jurisdiction. (2) They entail zero or low taxation and regulation. (3) They offer secrecy, and (4) they follow the logic of ‘calculated ambiguity’ (Sharman 2010, 1). The meanings of the first two characteristics are straight forward. Those of secrecy and calculated ambiguity, on the other and, warrant some more discussion.

Most scholars use the terms secrecy or anonymity to describe the obscure nature of offshore finance. Yet, secrecy and anonymity are only two ways of obscuring economic realities. Other means include, for instance, trusts and accounting techniques. A trust is a legal construct that allows the owner of something, say shares in a company, to give away these shares to the benefit of a third person, without making this beneficiary the new owner of the shares. Rather, the trust holds and manages them according to the will of the original owner. That is, the original owner gives up legal ownership but retains control over their assets. The third person, in turn, can enjoy the benefits, for instance the dividend payments, without being their legal owner. The wealth, private or commercial, and its owner become invisible (Langbein 1997; Harrington 2016b; Knobel 2017). Or take banks’ accounting techniques. Banks can keep certain financial instruments or transactions, such as trust or fiduciary funds, off their balance sheet (Zucman 2014; Harrington 2016b). They can also book certain transactions as taking place offshore when in reality they all take place onshore (see below). This way whole asset classes or financial flows can disappear from the books. What these and similar instruments have in common is that they purposefully make ownership and liabilities invisible. In this thesis, I therefore talk about invisibility rather than secrecy or anonymity to. Next, calculated ambiguity means that, thanks to offshoring, a company or an individual can appear simultaneously rich and poor, here and elsewhere, as the owner of something or not. The very same transaction can be legal in one context, but illegal in another and a seemingly corporate

activity may, in fact, be the doings of an individual. The answer to the underlying questions of wealth and legal status depends on who is asking. For example, the response to a question about the financial health of a company may turn out quite differently if asked by the tax authorities or the company's shareholders (Palan and Nesvetailova 2014; Sharman 2010). As invisibility, calculated ambiguity is intended.

Now, the four characteristics of offshore finance – ring fencing, little taxation and regulation, invisibility and calculated ambiguity – help us to give meaning to the complex reality of offshore finance. Yet, they do not definitively determine a line between onshore and offshore. This is problematic when aiming to make offshore visible through quantifying the phenomenon. To tackle that problem, researchers have compiled criteria to identify a certain jurisdiction as an offshore financial centre or a tax haven (see Dharmapala and Hines 2009; Johannesen and Zucman 2014; Gravelle 2015; Garcia-Bernardo et al. 2017). Yet, determining which country is an offshore financial *centre* or, even more normatively charged, a tax haven, is an academically and politically controversial question as offshore can be anywhere (Palan and Nesvetailova 2014). To stay clear of the politics of attribution, this dissertation focuses on offshore financial *services* rather than offshore financial *centres*. Yet, where I do have to be determinant about the lines between offshore and onshore finance, I follow Garcia-Bernardo and colleagues' (2017) list as it is based on the most comprehensive analysis of international financial flows (see appendix 1 for details). Importantly, the four characteristics of offshore financial services mark both, offshore banking and offshore tax planning as the following two sections demonstrate.

Euromarkets: the hierarchy of money goes offshore

In the final years of World War II, the United States and Britain established the Bretton Woods System to regulate the international monetary order. They introduced capital controls, a fixed exchange rate system with the dollar pegged to gold and other currencies pegged to the dollar and other regulations aimed at creating financial stability to prevent another Great Depression. Yet, the resulting highly regulated domestic economies limited the business of Britain's international banks who, up until the war, were the world's leading banks running sophisticated financial transactions in the then *de facto* reserve currency sterling. The US American banking system, to the contrary was still parochial and not necessarily up to its new international role (Mehrling 2016; Helleiner 1994). Smelling an opportunity in the 1950s, British bankers came up with the idea to create US-dollar-denominated credit against their growing US dollar reserves from international clients. The Bank of England made the trade in US dollar possible by accepting a new accounting technique. The City's merchant bankers, merging ring fencing

with little regulation, suggested that transactions where all parties were non-resident would be considered offshore and not subject to national financial regulation. All other transactions would be onshore and regulated by the Bank of England. Trading US dollar outside the US meant that transactions were outside the jurisdiction of the Federal Reserve and the US Treasury. Trading US dollar among non-residents in London meant they were outside the jurisdiction of Britain. The new technique allowed circumventing US American and British regulations at the same time (Helleiner 1994; Burn 1999; Palan 2006; Green 2016). The so established Euromarkets are interbank markets. Today, the BIS distinguishes between two empirically relevant types of Euromarkets: pure offshore and round-tripping. In pure offshore transactions ‘the residence of the placer of funds, the residence of the borrower of funds, the booking location of the deposit and the loan, and the jurisdiction governing the transaction are all outside the US’ (He and McCauley 2012, 36). However, the funds may still flow through the United States’ banking system. Round-tripping means that residents of the United States deposit US dollar with banks outside the country, who then lend the money back to residents in the United States. For the most part of the history of Euromarkets, pure offshore transactions were significantly more important than round-tripping (He and McCauley 2012).

The Euromarkets also display little tax and invisibility among their characteristics. As is the case for all interbank deposits, the interest paid on deposits or coupons in the Euromarkets is paid gross to the non-resident investor, who then chooses to declare (or not) this income to the country of residency. In the same vein, Eurobonds, for instance, are bearer bonds and hence ownership remains anonymous (Norfield 2016). Tax incentives helped propel the Euromarkets. Moreover, the British tax code and the Inland Revenue were also seminal in growing London’s Euromarket business (O’Malley 2015; Norfield 2016). As Stanislas Yassukovich, one of the bankers involved in market making for Eurobonds, recalls:

‘[We] had a young tax advisor in London who took us to see a senior Inland Revenue official. He pointed out that the UK tax code included a provision to facilitate inter-Empire trade [...] arranged through a London representative office but not involving a UK resident counterparty [...]. [T]he official opined we could engage in foreign security market making in London, between non-resident counterparties, and continue to be taxed, as are all branches of overseas firms in the UK, on an expense basis. The [subsequent] move to London of our market making brought the overwhelming bulk of the secondary market in [Euro]bonds to London’ (cited in O’Malley 2015, 16).

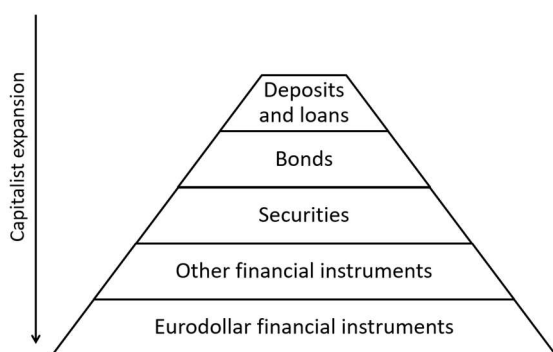
Although strictly outside the national banking system, the history of Euromarkets reflects the same entanglement of state and financiers and of tax and credit as in the onshore economy (Helleiner 1994; Green 2016). As a result of the absence of regulation and thanks to favourable tax rules, offshore dollar credit was cheaper and available in volumes not accessible through onshore banking (He and McCauley 2010b; Norfield 2016). The Euromarkets hence grew

substantially and went from London further offshore particularly to the Cayman Islands and later to Asian offshore financial centres (Norfield 2016; Snider 2017a). Already by the end of the 1980s, Eurodollar deposit markets alone outsized the domestic dollar deposit market (Windecker Jr. 1993). And although the Euromarkets had developed in response to capital controls, reserve requirements and withholding taxes, they did not vanish when the US and other major economies successively abandoned these regulations between the 1970s and 1990s (Valdez 2007; He and McCauley 2010b). The power to create US-dollar-denominated credit was incentive enough for the banks to continue to act as Eurodollar makers. Over time, Eurodollar became, according to an interviewee, ‘the global currency.’⁷

Despite the importance of the Euromarkets, the Federal Reserve and the US Treasury did not – and do not until this day – recognise their existence. To them, there is only a domestic dollar (Mehrling 2016). To understand why both perspectives are correct – there is only one US dollar but nevertheless the US dollar and the Eurodollar are two separate ‘monies’ – it helps to go back to the idea of the hierarchy of money as introduced above. Once the US dollar was created and traded offshore, something important happened: the top layer of the hierarchy was removed (see figure 2.2).

⁷ Author’s telephone interview with financial analyst, May 2017.

Figure 2-2. The hierarchy of money offshore



Since the Eurodollar is traded between non-residents, the Federal Reserve does not take the private promises to pay of non-resident banks onto its balance sheet. The Eurodollar, in other words, remains, at every stage in the hierarchy ‘near money’, which is denominated in US dollar. As a result, the Eurodollar system could expand US dollar credit *as if* it were transferable into sovereign money, though it was not – the signature of calculated ambiguity. In the words of an interviewee:

‘The fundamental proposition of the Eurodollar market [is that] there is no dollars in it. So the things that banks are actually trading are promises to get dollars, which nobody ever wants. I mean no corporation that has a Eurodollar arrangement with a Eurodollar bank actually converts into physical Federal Reserve notes. This doesn’t happen, nobody wants dollars. They just want to be able to transact these various forms of liabilities so that they all can claim that they have dollars, because that’s what allows it to work. ... The Eurodollar market is the furthest thing away from actual currency, because nobody wants the currency. They just want to have liabilities that they, if ever needed to, can convert to dollars somehow. What it really boils down to is the market saying, oh we don’t have any dollars but we are very certain that we can attain them if we ever needed to.’⁸

Essentially, the Euromarkets were creating, in Hayek’s (1990) sense, ‘denationalised money’. Eliminating the top layer of the hierarchy meant that, for the first time since the 17th century, money creation became ostensibly fully private, competitive and removed from central banking – whether through the Federal Reserve Bank as the holder of the monopoly power of issue or the Bank of England as the regulator of banking activity within the City. The Euromarkets severed all links to a lender of last resort.

And between the 1950s and the early 2000s it seemed as if Hayek (1990) was right – the private denationalised money that the Eurodollar appeared to be performed well. The market was growing. Liquidity problems were solved through financial innovation in form of swaps, futures and other derivatives that allowed effectively matching surplus and deficit banks

⁸ Author’s telephone interview with financial analyst, May 2017.

(Mehrling 2016; O'Malley 2015). The transferability of near money from a lower level in the hierarchy to a higher level in the hierarchy was ensured by shadow banks. They transferred 'opaque, risky, long-term assets into money-like, short-term liabilities' (Pozsar et al. 2010). The resulting Eurodollar system performed so well that by the early 1980s, the interest rate differentials between onshore and offshore dollars became effectively inexistent (Browne and Blundell-Wignall 1991; Snider 2018a). Expressed in the logic of the hierarchy of money, the vanishing of the interest rate differentials between the Eurodollar and the US dollar meant that market participants thought that credit denominated in these two currencies had the same risk of a broken promise to pay back. They were on the same level in the hierarchy and one was transferable into the other. The difference between money and near money became invisible. It appeared as if the Eurodollar does not need an authority to guarantee its validity as a means to account for and settle debt.

However, with the meltdown of the financial markets in 2007, interest rate differentials between the US dollar and the Eurodollar soared (Goldberg, Kennedy, and Miu 2010; Snider 2018a). It became clear that the pricing of the Eurodollar was fundamentally flawed. When the Federal Reserve had no intention to buy the 'promises to pay' by non-American Eurobanks to ensure their liquidity, it became apparent that the Eurodollar is *not* automatically transferable into the US dollar; the validity of the Eurodollar was called into question. The hierarchy of money had broken down (Snider 2017b). As a result, interbank lending through the Euromarkets slowed down significantly. European banks withdrew from the market, when US banks were no longer willing to take their US-dollar-denominated liabilities on their balance sheets and the Federal Reserve also did not consider it their role to step in. Recognising that their 'dollar gap' – the difference between their Eurodollar liabilities and assets was unsustainable – the Eurobanks turned to their central banks for help. The European central banks and the European Central Bank (ECB) aimed to help the banks by selling off US Treasuries and lending on the resulting US dollar to European banks to close their US dollar gap. While these emergency measures took liquidity pressure off the Eurobanks, their withdrawal from the market and the related US dollar credit squeeze could not be halted by these measures (CGFS 2008). The theoretical maximum European central banks and the ECB could inject into the system would be the amount of their foreign reserves. However, this is obviously not a replacement for the pre-crisis ability of European banks to create US-dollar-denominated credit as if they were American banks⁹. Initially, Caribbean banks and later Asian banks moved into the gap left by European banks in the Euromarkets, but with the renewed

⁹ Author's telephone-interview with financial analyst, May 2017.

financial troubles of 2011 and 2014 respectively, they withdrew from the market, too (Snider 2017a). Finally, the slack was taken up by institutional investors, such as funds and asset managers. That is, after the Financial Crisis non-bank financial institutions became the new money makers in the Eurodollar system (McCauley, McGuire, and Sushko 2015b).

The above described difference between the US dollar and the Eurodollar cannot be reflected statistically. Individual institutions such as the Federal Reserve, the Bank of England and the BIS initially traced the emergent Eurodollar system statistically. Yet, they all unwound their statistical efforts when the interest rate differentials between the US dollar and the Eurodollar had ended in the early 1980s. The Eurodollar, by intent or neglect, became invisible. Besides the disappearing price difference between the Eurodollar and the US dollar, another reason for a lack of statistical differentiation between the two monies is probably the absence of an agreement what a Eurodollar actually is (cf. Friedman 1971). Contested concepts have real-world consequences.

Even so, the BIS always kept a finger on the pulse of the Eurodollar, with a small but constant stream of studies (McCauley 2005; He and McCauley 2012; McCauley, McGuire, and Sushko 2015a, 2015b; Serena and Moreno 2016; Kreicher and McCauley 2016). Today, these papers talk about the ‘global dollar’ or ‘offshore dollar’, but essentially cover what in the past had been termed ‘Eurodollar’. According to the BIS estimates, by 2014, Eurodollar credit to firms and governments collectively amounted to about U\$8 trillion or 13 per cent of non-US GDP (McCauley, McGuire, and Sushko 2015b). However, these numbers are contested by market participants and other financial experts as too low. They remark that the BIS statistics do not cover any Eurodollar transactions that are off-balance sheet, like repo and swap transactions.¹⁰ They estimate that the Euromarkets are the biggest funding markets in the world (MacIntosh, 2017; Mehrling, 2016). When I asked a market participant in Brazil about that claim, he interrupts me laughing: ‘Well, that’s a fact!’¹¹ A German investment banker was a bit more cautious: ‘I am not sure it is the biggest funding market, but it is certainly among the biggest in the world.’¹² The middle ground between the BIS statistics and the sense of market participants appears to be that, irrespective of its absolute size, the offshore ‘global dollar system’ has become bigger than the onshore dollar system (Cecchetti 2014). A money market that has historically been designed to be strictly outside national financial systems has become bigger than those national systems themselves.

¹⁰ Author’s telephone interview with financial analyst, May 2017.

¹¹ Author’s interview with banker, Rio de Janeiro, April 2017.

¹² Author’s telephone interview with investment banker, May 2017.

Let it shine: offshore money laundering

Since their inception, the Euromarkets promoted the free movement of money across borders (Helleiner 1994; He and McCauley 2012). Once the money was moving, financial flows – whether in form of Eurodollar, US dollar or any other currency – could be used for tax avoidance and evasion. Of course money laundering is a practice that is much older than the offshore world (Gelemerova 2009). Yet, its offshore embodiment, obviously, depends on money flowing through offshore financial centres. With their propensity to ring-fence the national economy, to have little regulation and taxation, to provide invisibility and calculated ambiguity, offshore financial services are naturally attractive for those who made fortunes through drug trafficking, tax fraud, corruption or plain robbery. The re-introduction of illicit money into the licit economy is a precondition for the criminal to enjoy her wealth. She cannot pay with suspicious money for the world-class education of her children or for that nice beach side apartment in Rio de Janeiro. Yet, using offshore financial services to launder money requires, as their lawful use, an important level of legal and accounting sophistication. The resulting higher transaction costs lead to a crowding out of small amounts of ill-gotten funds. Offshore services are particularly relevant for so-called ‘high-end money laundering’ involving large sums white washed through the professional and financial services sectors (NCA 2018, 39). Therefore, offshore money laundering is often related to grand corruption and organised transnational crime (Sharman 2011; 2017). These large amounts of ill-gotten funds accumulate on the asset side of banks’ balance sheets and hence contribute to the ability of offshore banks to create money by providing credit to governments, corporations, each other and, at times, even wealthy individuals. They become an integral part of offshore banking.

Yet, it is difficult to determine which share of the offshore money stems from legal and which from illegal activities; not least because money laundering is a ‘derivative crime’ (Sharman 2011, 28). This is, it depends on the laws that regulate the underlying activity. As the law changes regarding these activities, the nature of the money changes, too. For instance, paying bribes to foreign businesses was, until the late 1990s, considered a business expense in many OECD countries. It was thus not only legal, but also tax deductible (J. C Sharman 2017, 1–21). Once the practice was out-lawed, the funds became illicit and, if still paid, needed to be laundered (see Obermayer and Obermaier 2016). The combination of the obscure nature of offshore financial services and the illusiveness of money laundering makes the quality of quantitative data on the matter questionable. To build on it would mean to further a ‘politics of numbers’, to quote Andreas (2008) rather than scientific enquiry. My assessment of offshore

money laundering therefore exclusively builds on qualitative data and considers offshore money laundering a part of offshore banking.¹³

Revenue on the run: offshore tax planning

As with money laundering, offshore tax planning depends on money flowing through offshore financial centres. Again, tax avoidance and evasion are old practices, possibly as old as taxation itself. But the systematic offering of tax haven services to non-residents took off only in the 1960s and 1970s when small banking centres such as Switzerland or the Cayman Islands made these services a deliberate strategy for economic development (Palan, Murphy, and Chavagneux 2010; Genschel 2005).

As offshore tax planning is dependent on offshore financial markets, it does not come as a surprise that most offshore financial centres also offer tax haven services, including no, or low, corporate income tax rates, easy, anonymous and cheap incorporation and many others. In principle offshore services help customers to plan their taxes through four techniques: concealing ownership, shifting profits from high to low tax jurisdictions, shifting debt the other way or keeping it off a corporation's balance sheet altogether, and facilitating round-tripping, that is, turning domestic into foreign direct investment (Sharman 2010). To achieve the maximum impact, different services are combined through different layers of artificial corporate structures creating complex legal setups. BP, for example, has nearly 1200 affiliates in 84 countries across 12 layers, i.e. affiliates of affiliates of affiliates and so on (Palan and Mangraviti 2016). To navigate the murky offshore waters, individuals and corporations rely on the stewardship of international lawyers, accountants and bankers versed in the laws and regulations of the client's home country and that of the respective offshore financial centre. Without them, offshore finance became impossible (Sharman 2010; Sikka and Willmott 2013).

For a long time, Switzerland was the most prominent example of a financial centre that also offers tax haven services. Up until the 1980s, Switzerland was the leading European tax haven. Then Luxembourg, Liechtenstein, Hong Kong, Singapore, the Bahamas and others moved into the market, too. However, the increased number of offshore centres did not necessarily displace Switzerland from its leading position, particularly with regards to individual wealth management. Rather, a network of complementary services between the different offshore financial centres developed. For instance, a majority of bank accounts in Switzerland are held by intermediary shell companies incorporated in Liechtenstein, the British Virgin Islands and the Cayman Islands (Zucman 2013a). Panama and the British Virgin Islands specialise in the setup of shell companies, Luxembourg is one of the preferred locations for

¹³ See appendix 1 for details)

incorporation of mutual funds, hedge funds are usually headquartered in the Cayman Islands and money funds in Ireland (Fichtner 2016; Findley, Nielson, and Sharman 2014; Zucman 2013a). The advisors managing individual wealth or the treasury of a corporation channel investment through those offshore centres which have – given the original place of the investment and the final intended location – the most advantageous set of bilateral tax treaties. The practice of pooling the assets of wealthy individuals into collective funds and the use of shell companies has aligned the tax planning strategies of individuals with that of corporations. The exorbitant growth of global financial transactions between the 1980s and the early 2000s and the onset of the digitalisation of the economy made tax planning strategies standard practice for wealth managers and chief financial officers across the globe, and states engaged in fierce competition over attracting and taxing the increasingly footloose capital. The international tax regime, designed in the 1920s, was no longer fit for purpose (Dietsch and Rixen 2016). Unilateral and multilateral initiatives to protect the state’s tax base emerged, most notably the United States Foreign Account Tax Compliance Act (FATCA) and the OECD BEPS project (OECD 2014, 2013, 1998; Zucman 2013a). FATCA forces foreign banks to disclose financial information about their American customers to the internal revenue service (IRS) by threatening non-compliant banks with economic sanctions. Moreover, a series of data leaks from banks and legal firms culminating in the Panama Papers in 2015 showed the pervasiveness and brazenness of offshore tax planning by corporations and the well-to-dos (ICIJ 2016). The revelations made the news amid a climate of austerity, induced by the response to the Financial Crisis and the subsequent explosion of sovereign debt in many OECD countries. Public pressure to stop the practice of aggressive tax planning gave a sense of urgency to the OECD BEPS process and many unilateral initiatives. These measures had, as far as we can tell, mixed results. FATCA played a crucial role in effectively ending bank secrecy (Emmenegger 2017; Hakelberg and Schaub 2017; Eccleston and Gray 2014). The OECD BEPS project has contributed to the rise of automatic exchange of information, country-by-country reporting of corporate income and beneficial ownership registries. Yet it also failed to incorporate trusts into its new regulations allowing for new loopholes to be exploited by lawyers and accountants. In addition, the widespread use of offshore structures that were allegedly legal (or more correctly: not proven to be illegal) led to a normalisation of the practice as something that internationally active corporations and wealthy people do.

In short, offshore tax havens are dependent on offshore financial flows. Offshore tax havens operate, just as the Euromarkets, on the principles of non-residency, low or no taxation and regulation, invisibility and calculated ambiguity. Once the assets are offshore, corporations and the wealthy can effectively shield their money from extraction through the state. Depending

on the scale of offshoring in a country, tax planning can alter, in a largely invisible manner, the debtor-creditor relationship between the government and the taxpayer.

3 Conceptual frame

In the previous two sections I have developed a money view on the state. I also clarified what I mean when talking about offshore finance. Taken together, the conceptual analysis provides a frame to analyse the effect of offshore finance and state power in Britain, Germany, Brazil and Mexico. To do so means to enquire for each state individually the following four issues:

First, following Weber's notion of the modern state allows us to ask for each state individually, who associates to rule and how does this association unite resources to finance its politics? Second, Ingham's idea of sovereign money delivers the perspective to analyse the power relationship between the government, its taxpayers and financiers as reflected in a country's banking and tax institutions. It means to ask who contributes to financing the state, by which means and how is the resulting revenue spent? Third, Weber and Ingham can account for the fact that the very nature of the state as well as the power relationship between the government, taxpayers and financiers are not permanent. They change over time and across space. Given that both Weber and Ingham's concepts are ideal-type readings of European experiences, the question arises whether it is appropriate to employ these concepts outside the European context. Though not ideal, the most pragmatic way to overcome the Eurocentric nature of these concepts is to provide an interpretation of Weber and Ingham that is sufficiently open to account for the unique experiences of Mexico and Brazil. This approach is particularly valid here, as elites in Latin America modelled their constitutions explicitly after those of European states (Centeno and Ferraro 2013). The development between the two regions is uneven, but comparable. Fourth, the concept analysis of offshore financial services directs the country studies towards three uses of offshore finance: offshore money creation in the Euromarkets, offshore money laundering and offshore tax planning. In the following, each case study chapter enquires these four elements – the nature of the institutional association of rule and its strategy of how to finance the state; the power relationship between the government, its financiers and taxpayers; the historical and geographical specificities as well as the pattern and scope of offshoring – together. This analysis provides insights into how offshore financial services affect the power of the state and how this effect may vary over time and between Britain, Germany, Mexico and Brazil.

III Britain: Heartland of offshore finance

Britain has made many path breaking financial innovations, which shaped the political economy of states around the globe. Famously, Britain was one of the first European states to have sovereign money and sovereign debt, supported by a modern bank and tax system (Bonney 1999; Ingham 2004; Vogl 2015). It won the Napoleonic Wars because it understood how to unleash sovereign debt (Macdonald 2003). It was again on the winning side in World War II because the government found a way to finance the war effort through a combination of unprecedented high tax levels, domestic and international credit. However, less recognised, but possibly equally consequential, is the combination of two innovations, one old and one new.

The trust is the old innovation, dating back to the Middle Ages (Langbein 1997; Harrington 2016a, chap. 1). As explained in chapter 2, trusts make ownership of wealth invisible. That the wealth cannot be attributed to any one person shields the original owner and the beneficiary of the assets held in a trust from all sorts of laws and regulations. The trust is a legal instrument that exists exclusively in common law systems. It is used for private and commercial purposes (Langbein 1997; Knobel 2017; Harrington 2016a). The second, newer innovation was the idea of British bankers in the 1950s to devise offshore finance as a separate accounting mechanism for transactions done in foreign currencies and among non-residents. Today, offshore services – including the trust – are a core element of the international financial system (see chapter 2).

In this offshore world, Britain holds a special place. Unlike any other country, Britain is a high tax country, a large economy and an offshore banking centre all at the same time.¹⁴ Britain's corporate and wealthy citizens use offshore financial services abroad and the financial sector offers these services to foreign economic actors at home. Hence, both sides of the coin, the demand for and the provision of offshore services, affect the power of the British state to unite the material means to finance its politics. In Britain, the question about the power relationship between the state and offshore finance, therefore, is one about a relationship that is simultaneously external and internal to the state. To complicate matters further, Britain is, as argued in chapter 1, an offshore banking centre, but not a tax haven.

To account for that complexity, I use financial transactions undertaken between British and non-British banks¹⁵ denominated in a foreign currency as an indicator for the *provision* of

¹⁴ High tax country in the sense of tax revenue as share of GDP. Some researchers argue that the United States is also an offshore financial centre (see Tax Justice Network 2018d). However, unlike in Britain the US offshore financial service sector is not one of the country's largest economic sectors. Rather, in the United States offshore business is done in individual states such as Delaware, Nevada or Wyoming.

¹⁵ The term bank as used here also includes non-bank financial institutions, see appendix 1 for details.

offshore banking services. Transactions denominated in any currency between British banks and banks located in offshore financial centres as identified by Garcia-Bernardo et al. (2017) are the indicator for the *demand* of offshore financial services. This way, I can cover both Britain as an offshore financial centre to the rest of the world and British uses of other offshore financial centres.¹⁶ The estimate for offshore tax planning concentrates exclusively on the demand side, reflecting that Britain is not a tax haven. One data limitation in the British case was that unlike civil society activities, bankers, accountants and tax lawyers were reluctant to participate in interviews. Luckily, however, in Britain there is extensive primary and secondary literature on the issue, which I consulted to ensure a balanced analysis.

1 The uses and abuses of offshore finance

In Britain, offshore finance plays an important role for the country's political economy. This is the univocal and unsurprising result of the interviews. There was also agreement among the interviewees that the tax loss and the risk for money laundering related to offshoring must be significant. However, it is with the assessment of the effects of offshore finance on state power, that the agreement between interviewees ended. They roughly fall into one of two groups. The first, smaller group considers offshore money creation as the logical consequence of the continued internationalisation of British banking under the condition of US dollar dominance and offshore tax planning as within the logic of cost-efficient corporations. In this view, the demand for and supply of offshore financial services developed serendipitously with offshore tax evasion and money laundering as unintended side effects. The role of the state is one of a rule-maker, sometimes lacking rigor in its law making.¹⁷ The second, larger group considers offshore money creation and tax planning as a deliberate strategy by the government and professionals in the City of London to ensure the City's continued success under the new post-war geopolitical and economic conditions. They argue that the government deliberately turns a blind eye to tax evasion and money laundering to avoid undermining the City's success. The critical voices within this group of interviewees even talk about state capture.¹⁸

The BIS data on offshore claims (i.e. assets held in offshore banks) and offshore liabilities (i.e. debt issued there) supports the interviewees' judgement regarding the important role of offshore finance in Britain. The BIS data covers the time from 1977 to 2017. Figures 3.1 and 3.2 below show the level of demand of British economic actors¹⁹ for offshore financial services.

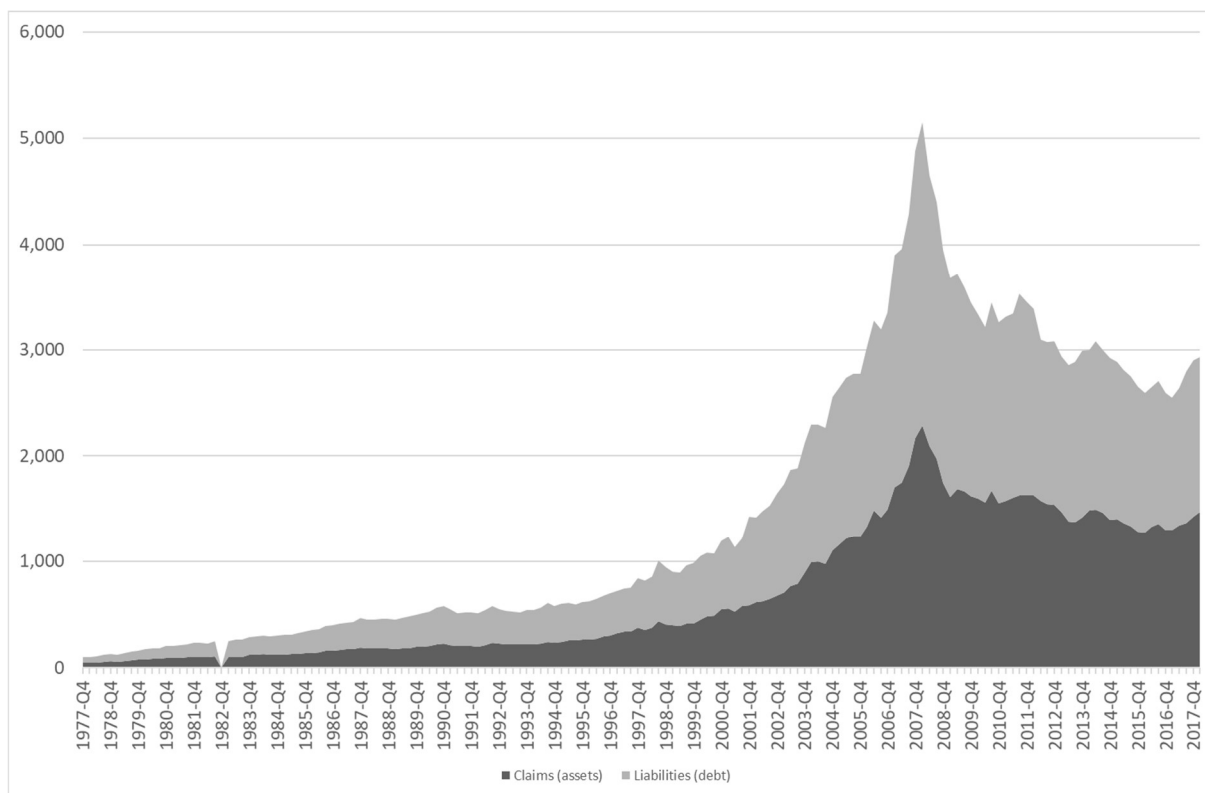
¹⁶ See appendix 1 for details.

¹⁷ Author's interview with former banker, London, September 2017, with tax lawyer, London, October 2017.

¹⁸ Author's interview with former tax lawyer, London, September 2017; with tax activist, Oxford, September 2017; author's telephone interview with tax expert, September 2017, with offshore expert, October 2018.

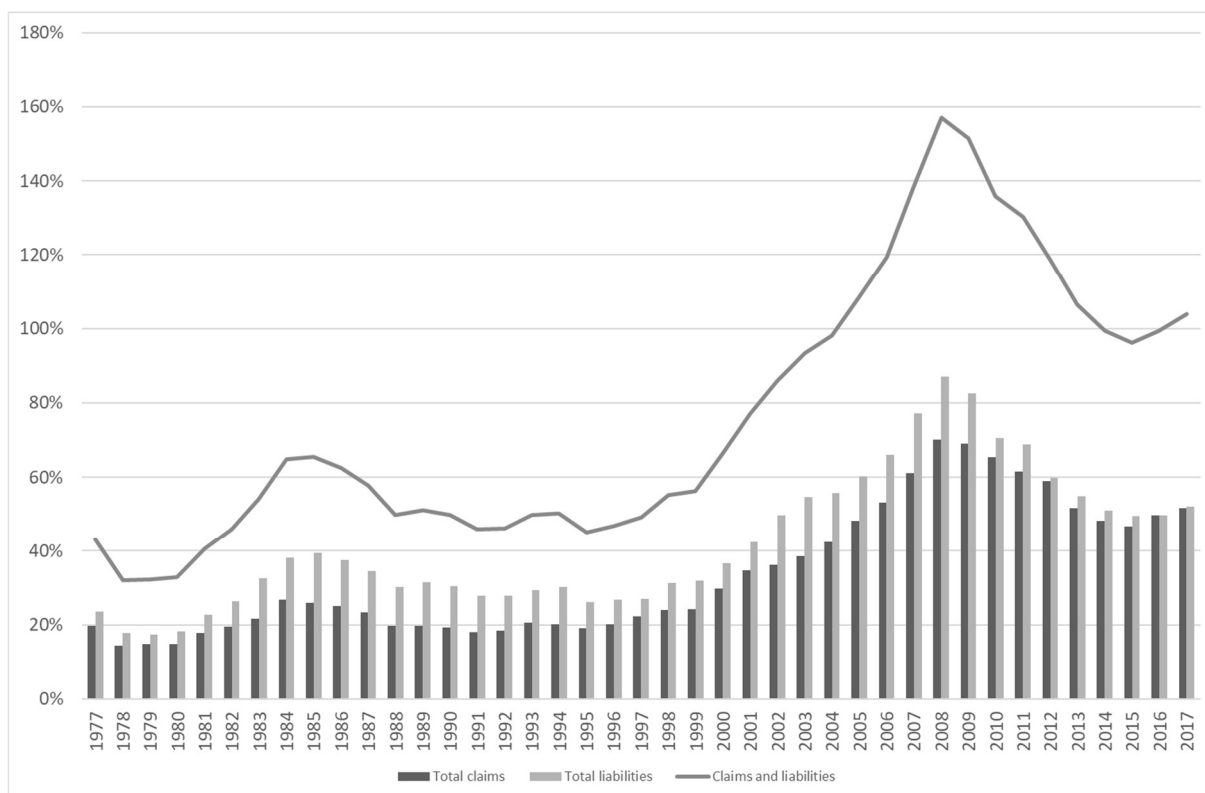
¹⁹ In the BIS statistics, this is denominated as 'all sectors', see appendix 1 for details.

Figure 3-1. Uses of offshore financial services (in US dollar billion, quarterly)



Source: BIS locational banking statistics

Figure 3-2. Uses of offshore financial services (percentage of GDP, annually)

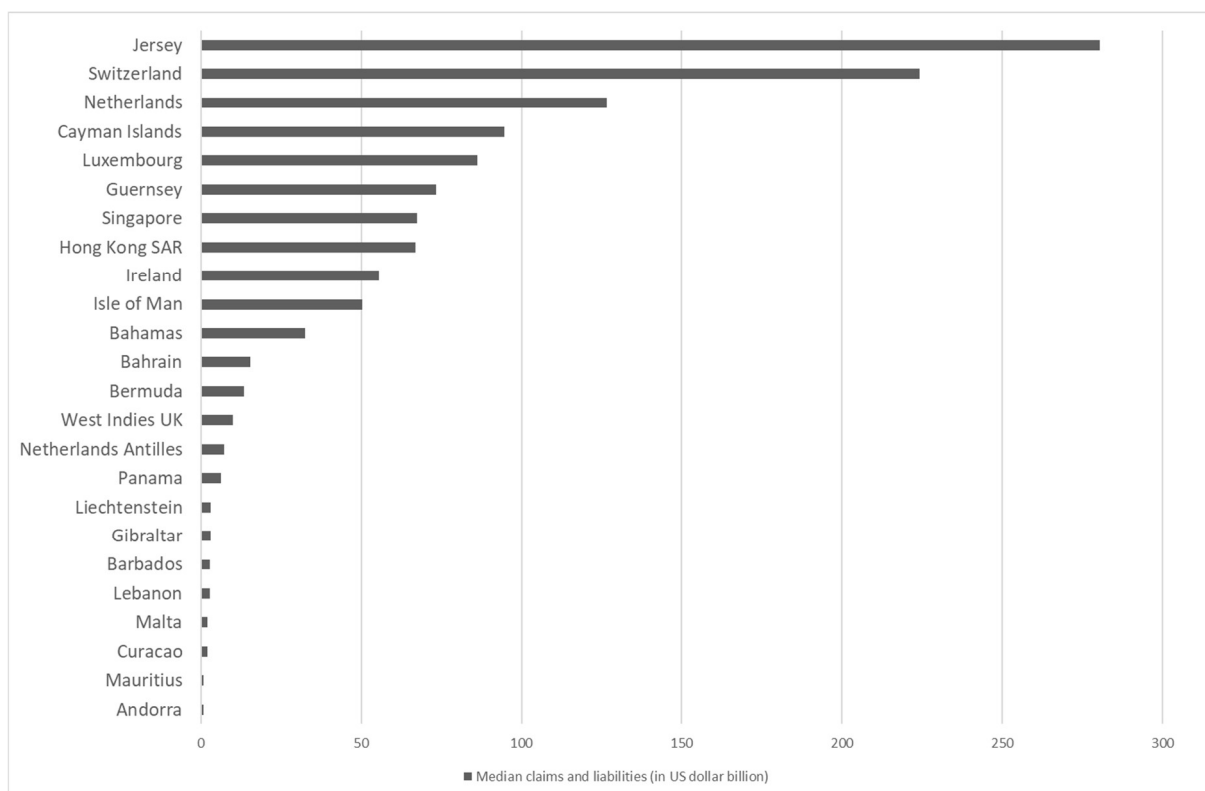


Source: BIS locational banking statistics, World Bank, own calculations

Figure 3.1 depicts this extent in absolute numbers of all claims and liabilities, figure 3.2 relative to GDP. To assess the effect of offshore finance on the state's power to finance its politics, we must add both sides of the balance sheet up since, from the perspective of the state, offshore assets and debt affect its power differently, but collectively. Offshore assets and debt both influence the government's tax revenue through tax planning and its monetary policy through expanding or limiting the amount of offshore money created. If we hence take British demand for offshore financial services together, it developed from US\$102 billion in 1977 to US\$2.9 trillion in 2018. The demand peaked at US\$5.1 trillion in 2008. Expressed in GDP this means that British demand for offshore services equalled 43 per cent of GDP in 1977, reached 157 per cent at its peak in 2008 and since then sunk to 104 per cent of GDP. The demand for offshore financial services experienced the strongest growth between 2001 and 2008. In those nine years, it grew by 320 per cent. The growth rate prior to the Financial Crisis was stronger than the decline afterwards, Britain's demand for offshore financial services fell by 43 per cent between 2008 and 2017. As a result, Britain's uses of offshore financial services today are still higher than at any time prior to 2006.

Figure 3.3 shows where the offshoring of British economic actors takes place. In declining order, the five most popular offshore centres for British economic actors are Jersey, Switzerland, the Netherlands, the Cayman Islands and Luxembourg. Except for the Cayman Islands, the important offshore centres used by British firms and individuals are all European.

Figure 3-3. Prominent offshore financial centres



Source: BIS locational banking statistics

The next section explores what the overall level of demand tells us about offshore money creation, tax planning and money laundering specifically.

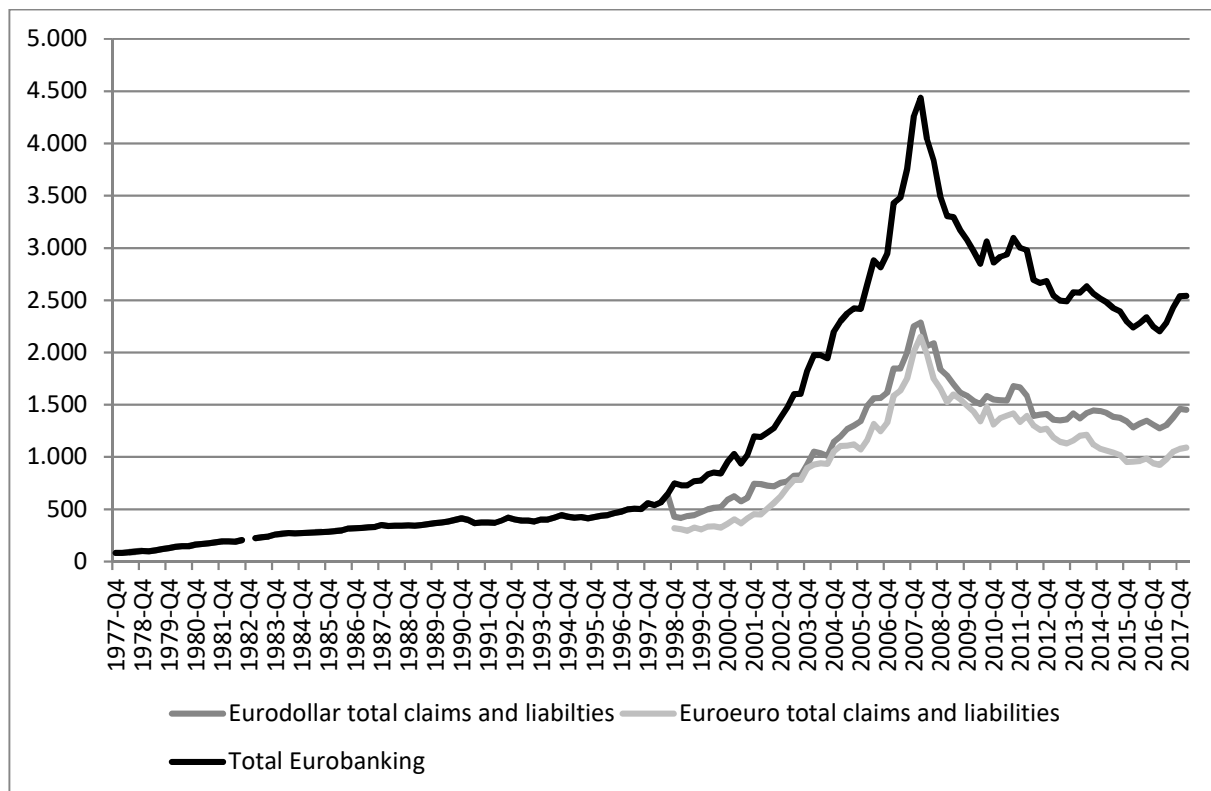
Money creation

In chapter 2, I introduced offshore money creation as an act whereby banks lend money between non-resident actors in a currency foreign to the jurisdiction in which the transaction takes place. Historically, these transactions came to be known as the Euromarkets. Theoretically, every internationally traded currency in the world can be created in the Euromarkets. In practice, it is mostly US dollar that is so created. In the case of Britain, however, it is almost equally often euros. The Euromarkets in Britain are Eurodollar and Euroeuro markets. Irrespective of denomination, there are globally no statistics covering offshore money creation. That is, it is statistically impossible to distinguish offshore from onshore currencies. Offshore money creation is invisible. To make the invisible visible, I proceed in two steps. I first determine the onshore currency mix of cross-border transactions between British banks and the rest of the world. I then apply this currency mix to the scope of offshoring assessed above.²⁰

²⁰ See appendix 1.

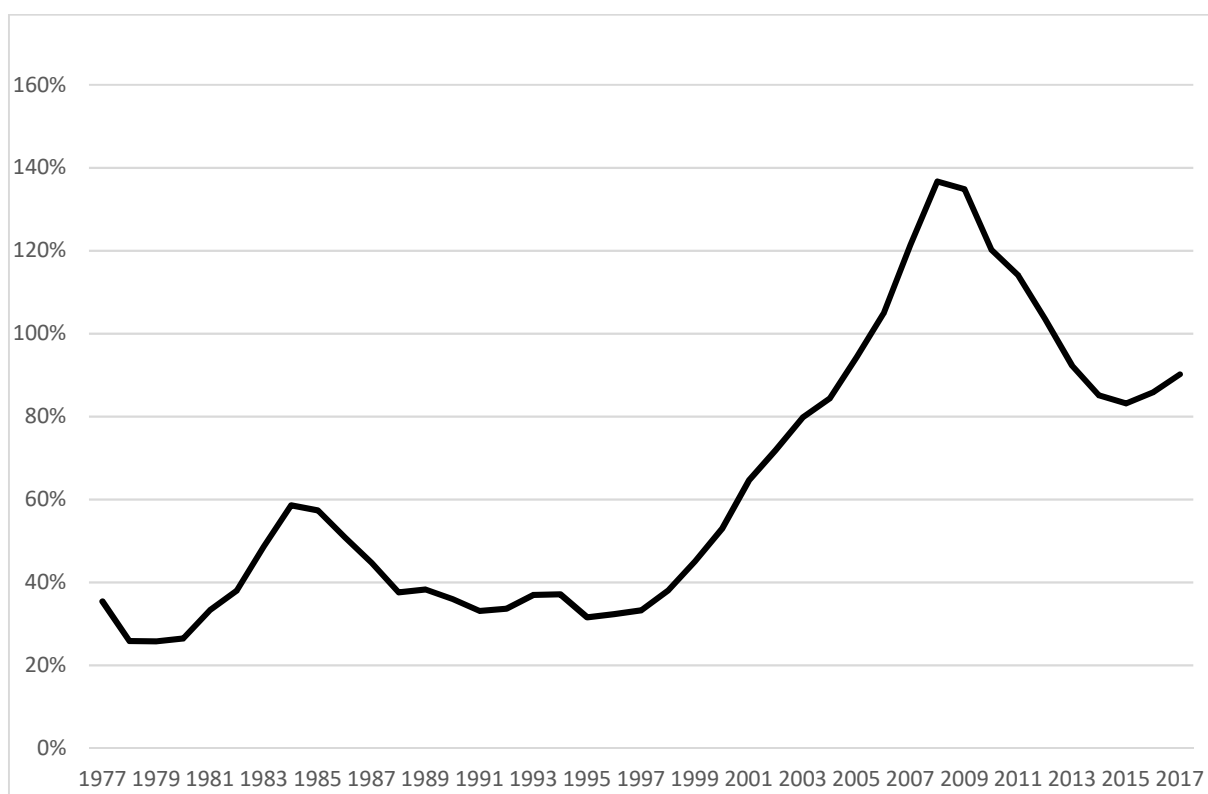
According to BIS data, the onshore currency mix developed as follows. Between 1977 and 1997, the US dollar accounted for 70 to 90 per cent of all cross-border transactions. However, in 1998, the year of the introduction of the euro, the proportion of US-dollar-denominated transaction plummeted to 45 per cent. The euro went from zero to about 34 per cent that same year. From then onwards, the US dollar and the euro together account for about 80 per cent of all cross-border transactions with the US dollar making up 50 and the euro 30 per cent of the total. Applying this currency mix to Britain's overall exposure to offshore financial services provides a sense of its exposure to the Euromarkets. Figures 3.4 and 3.5 depict this exposure in absolute numbers and as a ratio of GDP respectively.

Figure 3-4. Total exposure to Eurobanking (in US dollar billion, quarterly)



Source: BIS locational banking statistics

Figure 3-5. Total Eurobanking exposure (percentage of GDP, annually)



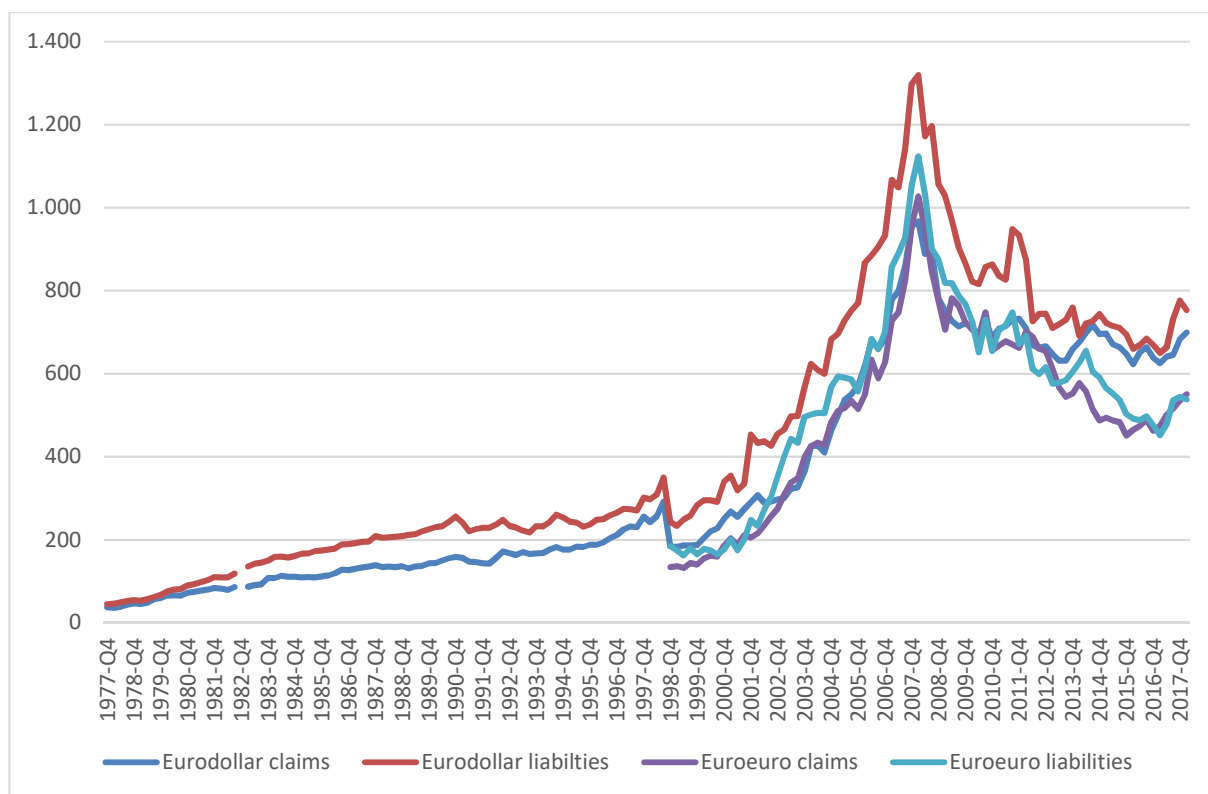
Source: BIS locational banking statistics, World Bank, own calculations

In the two decades between 1977 and 1997, Britain's exposure to the Eurodollar grew from US\$82 billion to US\$558 billion. Between 1998 and the Financial Crisis in 2007-2009 the exposure to the Eurodollar grew exponentially from US\$427 billion to US\$2.3 trillion. In the same time the exposure to the Euroeuro increased from US\$319 billion to US\$ 2.1 trillion. Taken together British exposure to offshore banking increased six-fold in absolute terms from US\$756 billion to US\$4.4 trillion and more than three-fold in terms of GDP from 38 to 137 per cent. In the decade after the Financial Crisis, Britain's exposure to the Euromarkets halved from US\$4.4 trillion in 2008 to US\$2.2 trillion in 2016. That means the exposure declined from 137 per cent to 90 per cent of GDP.

Turning to the demand for offshore money creation by British economic actors, I differentiate in figure 3.6 between claims (i.e. assets held offshore) and liabilities (i.e. debt held offshore). Here the offshore liabilities are of interest, for they measure the amount of US dollar and euro created by offshore banks through lending them to British economic actors. That is, for now the interesting slopes in figure 3.6 are the red (Eurodollar liabilities) and light blue (Euroeuro liabilities) ones. Two observations stand out. First, Eurodollar debt increased from US\$243 billion in 1998 to US\$1.2 trillion in 2008. This is a substantial expansion of Eurodollar money supply by offshore banks on behalf of British economic actors. Second, we can see that

liabilities outweigh claims, in both currencies, although the difference is starker for Eurodollar than for Euroeuro. It means that Britain is a net-borrower in both offshore currencies. The central role of Britain for the Euromarkets becomes even more distinct if we examine its role as a supplier of offshore services to the rest of the world.

Figure 3-6. Euromarket claims and liabilities (in US dollar billion, quarterly)



Source: BIS locational banking statistics

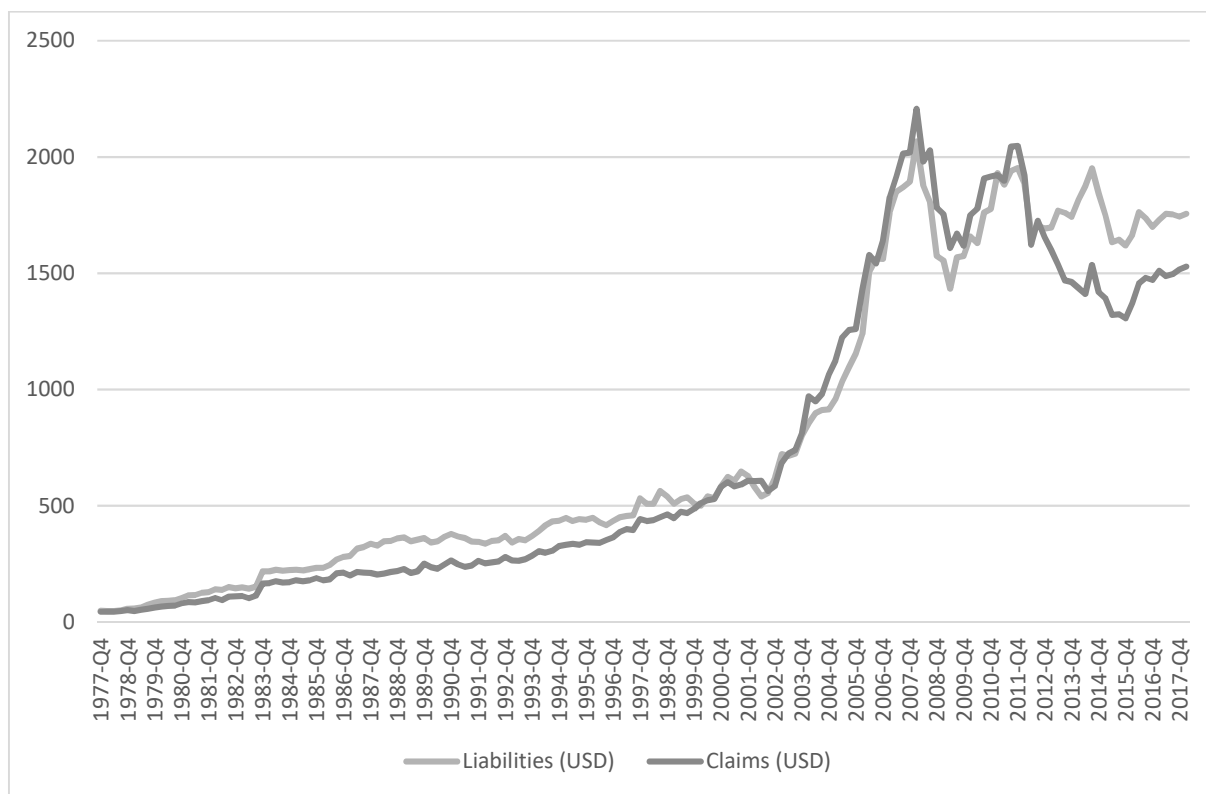
Britain is, what Garcia-Bernardo and colleagues (2017) call a ‘conduit’ offshore financial centre. Conduit offshore centres are intermediary centres between the location of the investor and the final recipient of the investment. According to Garcia-Bernardo et al. (2017) investments are routed through conduit offshore centres for tax purposes. Next to tax, however, there are other reasons to route investments through Britain. Most importantly, these reasons include the British legal system, which counts as the world’s most developed legal framework to deal with international trade and investment issues, as well as the size and internationalisation of Britain’s banks.²¹ Especially large and complex financial instruments can only be issued in New York or London.²² However, not all services that the City of London offers are offshore. To differentiate between offshore and onshore, I analyse transactions between British banks

²¹ Author’s interview with tax lawyer, London, July 2017.

²² Author’s interview with lawyer specialising in British banking law, Mexico City, November 2015.

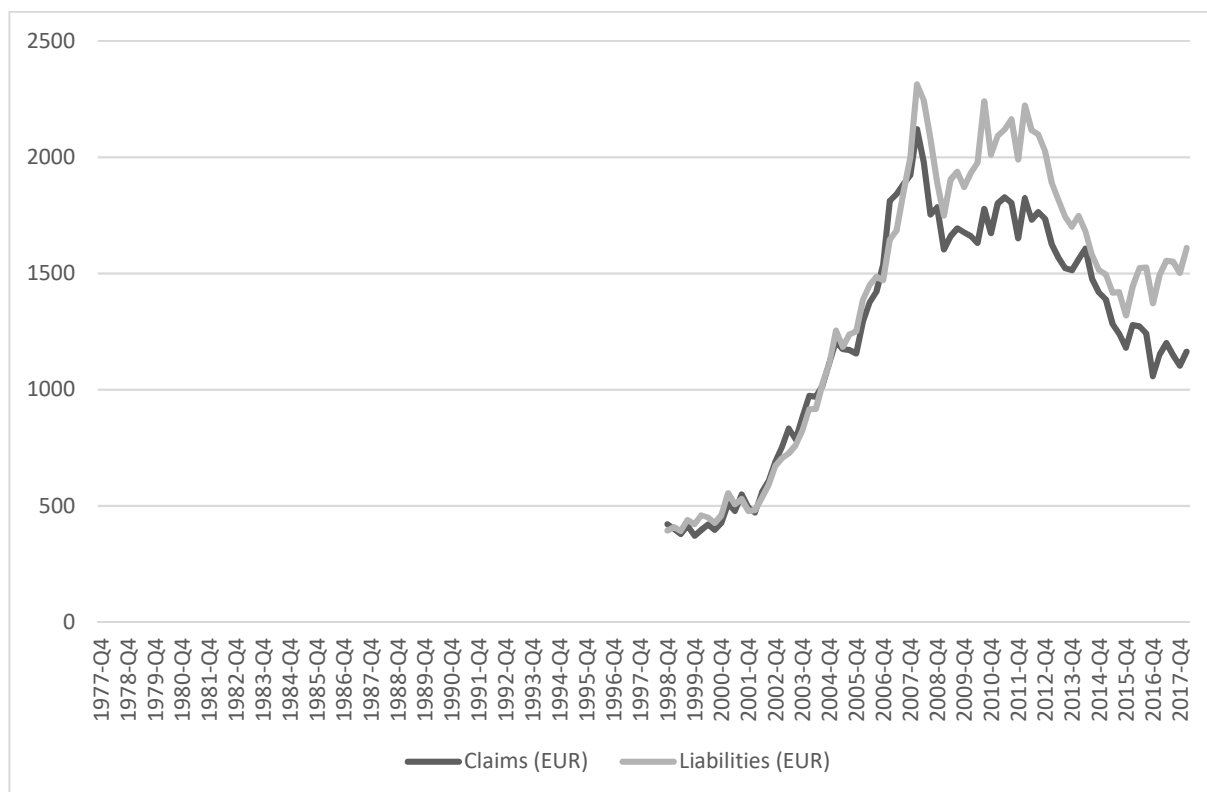
denominated in US dollar and euro with countries other than the United States (in case of the Eurodollar) and the Eurozone (in case of the Euroeuro). Figures 3.7 and 3.8 respectively depict all Eurodollar and Euroeuro transactions between Britain and the rest of the world. At least up until the financial crisis claims and liabilities are closely aligned, reflecting the conduit nature of British offshore services as money flows in and out in nearly the same amount.

Figure 3- 7. Britain as US dollar offshore centre (in US dollar billion, quarterly)



Source: BIS locational banking statistics

Figure 3- 8. Britain as euro offshore centre (in US dollar billion, quarterly)



Source: BIS locational banking statistics

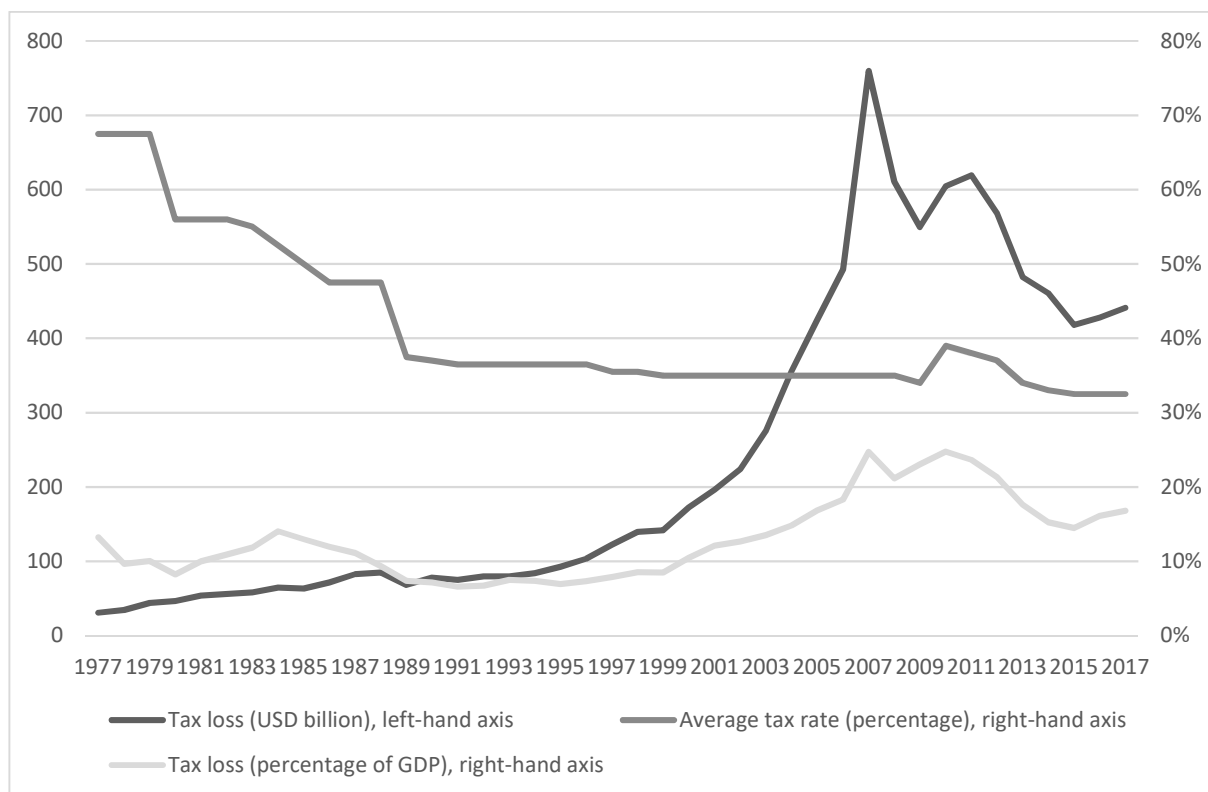
However, it is only the claims – the debt of foreigners towards Britain – that constitute offshore money creation. The interesting slopes regarding British offshore money creation are thus the blue and purple ones in figure 3.6 above. We see again for both currencies a strong growth from the early 2000s up until the Financial Crisis. Between 1998 and 2008, Euroeuro lending increases from US\$394 billion in 1 to US\$2.3 trillion; Eurodollar lending from US\$447 billion to US\$2.2 trillion. The Euroeuro and the Eurodollar are equally important for British offshore banking. Regarding the Eurodollar, the offshore money created by Britain is nearly twice the amount of that created for Britain by other offshore banks. Taking supply and demand together, thanks to British and other offshore banks, the Eurodollar supply increased from US\$690 billion in 1998 to US\$3.4 trillion in 2008. In particular, the stark increase of Eurodollar creation in the early 2000s is striking as it falls into a time where the US Federal Reserve aimed at tightening the US dollar money supply. In particular between 2004 and 2006, the US central bank raised the federal funds rate from one to 5.4 per cent (Snider 2018b). Yet, British and other offshore financial institutions continued to expand the Eurodollar supply undisturbed by US monetary policy. The independence between US monetary policy and the creation of Eurodollar confirms that the US dollar and the Eurodollar are indeed two separate monies (see chapter 2).

Tax planning

Of all the dimensions of the offshore phenomenon, tax planning has received the largest attention among the British public. The issue became one of national interest in 2013 with the House of Commons' public hearing of senior managers of Starbucks, Amazon and Google regarding their offshore tax planning strategies (Committee of Public Accounts 2013; Hodge 2016). The hearing was followed by public protests against 'tax dodging' multinationals in 2014 (Rawlinson 2014). In response to the increased public pressure, the British government introduced a diverted profits tax, popularly called the 'Google tax' in 2015. The new corporate tax aims at curbing the most harmful tax haven arrangements of multinational firms (HMRC 2014). Yet, the *Panama Papers*, the *Paradise Papers* and other offshore leaks between 2015 and 2017 raised the question of how effective and genuine the government's approach to offshore tax planning was (see Guardian 2016, 2017; Telegraph 2016, 2017).

Despite the public and policy attention to offshore tax planning, there is no quantitative data available on the related loss for Britain's tax coffers. Her Majesty's Revenue and Customs (HMRC), the British tax authorities, publishes annual data on the so-called tax gap. The tax gap is the difference between the theoretically possible and the actual amount of tax collected (HMRC 2018b). Yet, due to the estimation method chosen, HMRC's tax gap largely misses out on the loss related to offshore tax planning (see CIOT 2018; Brooks 2014, chap. 1). To provide a sense of the scope of offshore tax planning, I therefore draw again on BIS locational banking statistics. As discussed in appendix 1, the estimate assumes that all offshore assets are undeclared and, if onshore, would be taxed at the full applicable tax rate. Since income taxation in Britain is, as in most countries, a complicated affair with different rates depending on the type and volume of income, I facilitate the estimate by working with an average tax rate. That is, I assume that firms and individuals who use offshore financial services are in income bands to which the upper tax rates apply. I then calculate the average of the annual corporate and personal income tax rates for the years 1977 to 2017. In line with changes in the law, the average income tax rate decreases from 68 per cent in the late 1970s to 33 per cent in 2017. In a second step, I apply this annual average tax rate to the annual stocks of offshore financial assets. With this approach, I arrive at the estimated annual tax loss pictured in figure 3.9.

Figure 3- 9. Estimated tax loss



Source: BIS locational banking statistics, World Bank, HMRC, own calculations

The tax loss first increases from US\$31 billion or 13 per cent of GDP in 1977 to US\$604 billion or 25 per cent of GDP in 2010. From this peak, the tax loss declines to US\$441 billion or 17 per cent of GDP in 2017. As a point of reference for evaluating this loss, compare it with the overall British tax revenue. In the years 2000 to 2015, tax revenue (including social security contributions) remained, with the exception of some years, steady at around 33 per cent of GDP (OECD 2017c). That is, the tax loss due to offshoring oscillates between half and two thirds of the overall tax revenue collected in terms of GDP. Comparing figures 3.9 and 3.1, it becomes evident that the tax loss in absolute terms closely follows the development of offshore assets between 1977 and 2017. It grows sharply prior to the Financial Crisis and drops afterwards. The tax loss as a percentage of GDP describes a flatter slope, though. The combined effects of a declining average tax rate (falling from 68 per cent in 1977 to 33 per cent in 2017) and constant growth of GDP explain the flatter slope. In addition, we can see that the decline in the tax rate does not lead to a decline in assets held offshore. According to an interviewee, inheritance tax and offshore money creation explain the conundrum: ‘It is inheritance tax. The wealthy put their wealth into trusts offshore to avoid inheritance tax. It is also the banks who book assets

offshore to back up their offshore debt, but really it is about inheritance tax.’^{23,24} This account is in accordance with the findings of Alstadsæter, Johannesen, and Zucman (2018) and Tørsløv, Wier, and Zucman (2018) who find that individual wealth drives offshoring more than corporate profit shifting does. Overall, the analysis reveals that the tax loss related to offshore tax planning is smaller in terms of GDP than Britain’s exposure to offshore banking. It also suggests that the scope of offshore banking and offshore tax planning are causally related. The higher the volume of offshore bank transactions, the higher the amount of tax revenue lost. The same link appears intuitive in the case of money laundering, to which the analysis now turns.

Money laundering

As an integral part of offshore banking, I analyse money laundering in Britain from the demand and the supply side. On the demand side, there is remarkably little evidence of British public or private actors using offshore financial centres to launder money. This ostensible restraint stands out in comparison to the three other case studies. Indeed, according to Transparency International’s corruption perception index, Britain is among the world’s ten least corrupt countries (Transparency International 2017). Where the predicate crime is limited, there is a limited need to launder money offshore. Yet, interviewees pointed out that for offshore money laundering from tax evasion, the empirical data is less clear. It is impossible to determine how much of the above-discussed offshore tax planning is illegal, and how much is legal. It is known, however, that usually individuals evade tax, not firms. Corporations have the necessary legal and accountancy advice to keep tax planning activities legal.²⁵ The *Panama Papers* and *Paradise Papers* leaks revealed that a number of public figures, including Queen Elisabeth II, the former Prime Minister David Cameron and prominent party donors, mostly of the Conservative Party and the United Kingdom Independence Party (UKIP), hold offshore accounts. Those offshore accounts have been reported as being legal (Guardian 2016, 2017). In consequence, repatriating that money into the onshore economy would not constitute money laundering. However, as different interviewees pointed out, HMRC has never brought the underlying structures to the courts. Instead, HMRC opens criminal investigations into individuals and if these investigations reach the conclusion of tax evasion, the authorities reach

²³ Author’s telephone interview with offshore expert, October 2018.

²⁴ With 40 per cent inheritance tax on all wealth above £325,000–900,000, the tax base and rate for inheritance in Britain is higher than in most countries. Yet, there are important exceptions, at times amounting to a full exemption. Inheritance tax also applies to shares in or ownership of businesses (HMRC 2018a).

²⁵ Author’s interview with corporate tax lawyer, London, September 2017 and with tax lawyer, London, September 2017.

a deal with those individuals about the level of the fine and the repayment of taxes due.²⁶ Interviewees had different assessments why HMRC is reluctant to bring the offshore schemes to the courts. One saw it as the result of a policy focusing on maximising the tax revenue in the short-term by recovering payments and at the same time avoiding lengthy litigation processes.²⁷ Another saw it as the result of a deliberate strategy of HMRC to maintain a situation where offshore tax planning structures are neither clearly legal nor illegal.²⁸

On the other side of the coin, the supply of offshore services, the state of affairs is not much clearer. There is a long list of money laundering scandals involving the City of London. For kleptocrats from all over the world, for Russian oligarchs or for Pakistani and Chinese fleeing capital, London's financial and real estate markets are the destination of choice (see Sharman 2017, chap. 4; NCA 2018). In a report from 2018, Britain's National Crime Agency (NCA) observes that 'given the volume of financial transactions transiting the UK, there is a realistic possibility the scale of money laundering impacting the UK annually is in the hundreds of billions of pounds' (NCA 2018, 23). However, it is impossible to determine which share of this potential sum is related to London's offshore services and which to its international onshore activities. Yet, the large scandals in recent years were all part of banks' business with non-residents and US-dollar-denominated. They were part of London's Eurodollar business. For example, the 'Russian Laundromat', a global money laundering scheme uncovered in 2014 by a consortium of investigative journalists, helped wealthy Russians to move US\$20.8 billion out of Russia (OCCRP 2014). The scheme involved 96 countries, but London was central to it for most shell companies were registered there (Harding 2017; Milne 2018). Indeed, the NCA finds that British companies and trusts are 'used extensively to launder money', because they are easy to open and appear to be legitimate businesses (NCA 2018, 38). In addition, the report finds that 'a small number' of corrupt lawyers, accountants, bankers as well as trust and company providers increase the threat of money laundering through London's financial sector and that foreign exchange markets are particularly vulnerable (NCA 2018, 23–39). These revelations indicate that money laundering in Britain relates to non-residents bringing their money to or channelling it through London. The transactions are often denominated in US dollar. Therefore, it appears plausible that a substantial part of the overall money laundering that takes place is London relates to Britain's supply of offshore financial services. In

²⁶ Author's interview with corporate tax lawyer, London, October 2017. author's interview with tax lawyer, London, September 2017; author's telephone interview with employee of civil society organisation, October 2017.

²⁷ Author's interview with corporate tax lawyer, London, October 2017.

²⁸ Author's telephone interview with employee of civil society organisation, October 2017.

consequence, it appears likely that an increase in offshore money laundering accompanies an increase in Euromarket business.

In sum, the data leaves little doubt that offshore finance plays an important role in the British economy. In terms of scope, offshore banking is the most substantial part of Britain's exposure to, and provision of, offshore services. Tax planning and money laundering appear to be a function of offshore banking. Next to the central role of offshore banking, three phenomena stand out: first, the strong growth of the exposure to, and supply of, offshore financial services in the run up to the Financial Crisis; second the extraordinary important role of Jersey as compared to other offshore financial centres; and third the alleged importance of inheritance over income tax in explaining private tax planning. An explanation of these three observations are important building blocks towards an understanding on how the observed scope and pattern of offshore finance affect the power of the British state to unite resources to finance its politics. The following section now turns to these contemporary queries by looking back at the historical development of banking and taxation as a reflection of the institutional association of rule's struggle over how to fund the state.

2 The British state from the money view

Seen from the money view, the British state was an early developer. By the time the dust of the 1688 Glorious Revolution had settled, a first cycle of money, tax and debt was running smoothly: with the introduction of the land tax in 1692, the landed classes accepted to contribute to financing war efforts by tolerating a direct tax on their wealth. With the foundation of the Bank of England in 1694, the English government was able, as the first in Europe, to make its debt permanent. With the merger of the kingdoms of England and Scotland in 1707, the pound sterling became the common currency of Great Britain. As a result, in the late 17th, early 18th century, Britain was the first European state to raise revenue successfully from a combination of debt and tax (Bonney 1999). The historical analysis of the institutional association of rule and its struggles over how to finance the state hence starts in the late 17th century.

The institutional association of rule

After 1688, the combination of two innovations was deeply consequential for the shape and development of the county's association of rule: the Bill of Rights and the Bank of England. The Bill of Rights limited the power of the monarch by ascribing the right to make laws and levy taxes to Parliament. The Bank of England, established as a private bank in 1694, initially mobilised the financial means of about 1300 financiers. They lent, for the first time collectively and governed by parliamentary law, £1.2 million at an interest rate of eight per cent to the

government of King William III and Queen Mary II (Vogl 2015, chap. 4, loc 1632). Before 1694, the Crown had also borrowed from financiers, but individually and under a legal framework that the monarch could change at will. Therefore, the Crown could default on a creditor and then turn to another for borrowing again. Once lending became collective and governed by legal statutes, however, the risk of default decreased significantly. For the same people who were members of Parliament were also among the 1300 financiers of the Bank of England, creating ‘a virtual identity of borrow and lender’ as Macdonald (2003, 371) observes. The financiers had thus no difficulty ensuring that the government repaid its debt. Lending to the government had become a safe bet. So safe, that the financiers were now willing to make it permanent: they lent the government money to service the debt. Moreover, they did so at a historically low price (Cain and Hopkins 2015, chap. 1; Macdonald 2003, chap. 6). In return, the financiers received a set of lucrative privileges: First, the Bank of England held a monopoly for serving the government. Second, between 1694 and 1825 the Bank also had the exclusive right to operate as a joint-stock company, providing it with an advantage in mobilising funds from the wealthy. This limitation of competition created lucrative rents for the bank’s stockholders, which – importantly – included William and Mary (Bank of England 2018; Calomiris and Haber 2014, chap. 4).

Besides creating further wealth for its financiers, the Bank of England knew how to use these privileges. Unlike the notes of other commercial banks, those created by the Bank of England soon traded in the City of London like cash and hence the bank of England succeeded in creating a monopoly on the issuance of banknotes. It became the first European bank to introduce successfully the use of banknotes.²⁹ This success was possible because the law allowed the Bank of England to represent its ‘capital’ in form of banknotes, which the government used to settle its liabilities thereby providing the notes with legitimacy. Furthermore, the Bank was allowed to issue notes beyond the amount lent to the government up to its nominal ‘capital’ paid in by its stockholders (Macdonald 2003, 172; Collins 1988, 11). In short, the Bank of England was the first private bank to create sovereign credit-money.

The foundation of the Bank of England led to a merger of the ‘interests of commerce and statecraft’, to use Ingham’s (2004, 125) words, and thus became a site of shared power between the royal government and its financiers. Yet, the coalescence between the government and its financiers was not all peace and harmony. For one, it raised the suspicion of contemporary observers who decried the entanglement of public and private power (Vogl 2015, chap. 4). Furthermore, its hybrid nature as a public institution and a joint-stock company inevitably

²⁹ The Royal Bank of Sweden tried the same about six decades earlier but failed.

created tensions between the interests of the state and that of the financiers. For instance, as a public institution, the Bank of England was supposed to be responsive to the government's financing needs. Yet, as a joint stock company, the Bank of England was accountable to its stockholders only (Vogl 2015, chap. 4). One reason that the coalition between the government and its financiers held, despite this inherent tension, was their agreement on how to spend the money created by the Bank of England: to wage war (Cain and Hopkins 2015, chap. 1; Calomiris and Haber 2014, chap. 4). The other reason for the enduring of the coalition was the close personal relationships between the government and its financiers. That is, in the 17th and early 18th century, the institutional association of rule, i.e. the state, consisted of the king-in-parliament and the propertied classes.

However, to understand fully the shape of the institutional association of rule, we must consider it in the context of British capitalism and parliamentarism. British capitalist enterprise developed in four different but interacting pillars: agriculture, commerce and finance as well as industry (Cain and Hopkins 2015, chap. 1). These pillars are not merely different sectors of the British capitalist economy. Rather, they reflect different chronologies, cultures and geographies. Agrarian capitalism and its related landed wealth preceded the development of commercial and financial capitalism, which in turn developed before the Industrial Revolution created significant industrial capital. The culture and values of the landed elite dominated that of all subsequently emerging pillars of British capitalism: landownership became the single most important signifier of belonging to the institutional association of rule (Scott 1991, chap. 6). Furthermore, agrarian capitalism was the basis of the rural elites, while commercial, financial and industrial capitalism had its base in London and the industrial cities of the north. It is hence unsurprising that the respective capital owners had often contradictory interests with regards to economic and international politics (Macdonald 2003, chap. 4; Daunton 2007, chap. 14). The landed elite preferred isolationist international policies. In their view, expensive wars led to an increase in money and military men and hence to an increase of royal power. The financial, commercial and industrialist capitalists, on the other hand, were interested in imperial expansion and therefore willing to employ their liquid wealth to finance the government via debt. Eventually, however, by significantly decreasing the tax on land in the 1730s, the government under Robert Walpole could convince the landed elite of the perks of national debt (Macdonald 2003, chaps 4–6). As a result, the dividing line was no longer between landed and finance capital over whether and how to fund the state, but between 'gentlemanly and industrial capital', to put it in Cain and Hopkin's (2015, 41) terms. Gentlemanly capitalists derived their wealth from rents, not from hard work. As members of the leisure class, they had time for politics in London. They served as government ministers and occupied the leading positions at

the Bank of England. They considered their privileges the legitimate return for their service to the country (Scott 1991, chap. 3). Gentlemanly capitalists were closer to power – personally and geographically – than their industrialist counterparts in the north. The industrialists became part of the association of rule at arm’s length (Cain and Hopkins 2015, chaps 1–2; Macdonald 2003, chap. 6; Scott 1991, chap. 6). Nevertheless, to maintain the social structure in the higher echelons of society, the traditional landowners co-opted newly arising wealth into their value system through inter-marriage and the elite education system (Scott 1991, chap. 3). They had first done so with financial and commercial capital and now attempted the same with the industrialists. As Mayer (1981, 81) observes, ‘the ... nobilization of the obeisant bourgeoisie was far more pervasive than the bourgeoisification of the imperious nobility.’ Despite the rise of new forms of wealth, the relationship between the king-in-parliament and the propertied classes continued to be so close that it was difficult to distinguish meaningfully between a political and an economic elite (Cain and Hopkins 2015, chap. 1). Underneath this continued closeness lay the landed elites’ co-optation strategy.

Yet, the rise of new forms of wealth was not the only pressure on the institutional association of rule to transform over time. The evolution of parliamentarism was equally consequential. As discussed above, from the early 18th to the mid-19th century, the government’s lenders – the propertied classes – were identical with the parliamentarians who decided over government spending and servicing of the national debt. The lower classes, excluded from the franchise and democratic decision-making, had to pay for servicing the debt via excise duties and other indirect taxes. By the end of the century, however, the Napoleonic wars had become so expensive that financing them through borrowing alone was unsustainable (see below). Now the wealthy had to contribute to the war effort via direct taxation too. Yet, the principle for direct taxation remained the same as that for government debt: the franchise restricted by property led to the identity of the taxpayer and the taxman. This way, the propertied classes could ensure their taxes were spent in their interest – on defence, imperial expansion and debt service. They could also ensure that once the war was fought, debt would be repaid and direct taxes lowered (Macdonald 2003, chap. 6 and 8). This system of public finance reached its peak with Britain’s triumph over Napoleon in 1815. However, from the mid-19th century onwards, the idea of universal suffrage, made popular by the American and French revolutions a century earlier, took hold in Britain. Successive electoral reforms between 1832 and 1918 extended the franchise to the entire adult population. Yet, it would be wrong to think that the arrival of universal suffrage meant that the institutional association of rule became all-inclusive.

With the Glorious Revolution in 1688, the landowners had rejected absolutism in favour of a self-proclaimed ‘enlightened aristocracy’, to use the words of Daunton (2007, 461). The enlightened aristocracy valued political stability and consent within their small and familial circle of power (Daunton 2007, chap. 14). To a considerable degree, their strategy of co-optation and elite reproduction through a closed educational system was successful in fending off a substantial broadening of the institutional association of rule over time. Granted, the nature of the underlying wealth transformed since the late 17th century from land, to money, to shares, to high-income jobs in the City, yet to this day the dominance of the moneyed classes in British economy, society and politics remains significant (Clark and Cummins 2014; Scott 1991, chap. 6).

Nevertheless, mass democracy had, of course, far-reaching consequences for the politics of the institutional association of rule. Two of them are particularly relevant in the context of this analysis. First, although the moneyed classes still dominate the British state, membership in the institutional association of rule is no longer limited to the wealthy. It has become porous towards new members that have not gone through Britain’s elite educational institutions and are thus more difficult to co-opt into the culture and values of the moneyed classes. In combination with the broadening of the electorate, this means that the notion of privilege in return for public services has lost legitimacy (see Jones 2015). Second, mass democracy severed the identity of the taxpayer with the taxman and changed that of the lender with the borrower. That is, it altered the 200-year-old formula for financing the British state through debt, indirect taxes and an occasional direct contribution by the wealthy in case of war. These two consequences of mass democracy have important implications for the nature of contemporary banking and taxation and the move towards offshoring in the early 20th century as the following two sections demonstrate.

Banking

The history of banking in Britain starts with the Bank of England once more. As discussed above, the foundation of the Bank of England established a permanent sovereign debt and created a site of shared power between the government and its financiers. The Bank of England turned out to be a smooth mechanism for the institutional association of rule to unite the resources to finance its politics, in particular war and imperial expansion. *En passant*, it also helped to increase further the riches of the bank’s wealthy stockholders. Yet, for a long time, the Bank of England was not – as we expect from central banks today – a mechanism to maintain financial stability and to ensure liquidity in the money markets. Given its *raison d’être* as a government’s bank, it did not bind together the individual small goldsmith banks in London

and the country banks in rural England into a banking system. As a result, the individual banks were instable and inefficient. The country's enormous success to outspend France during the Napoleonic wars was independent from the fact that the British banks were among the most unstable in Europe and beyond. In addition, the fact that the Bank of England was a government's bank meant that all the available credit went to the government, starving the productive sector of financing. The Industrial Revolution happened despite, not because of the nature of British banking (Calomiris and Haber 2014, chap. 5).

However, as the industrialists accumulated more wealth from their entrepreneurial activity, they started to buy land – often in form of real estate in London – and landowners started to invest into company stocks. The process of entanglement of landed and industrial capital provided an opening for the industrialists into the association of rule. Yet, lacking gentlemanly lifestyle and demeanour, they remained outside its most inner circle (Cain and Hopkins 2015, chap. 1; Scott 1991, chap. 4). Nevertheless, the influence they had was enough to modify the association's interests around the Bank of England. With successive reforms throughout the 19th century, the Bank of England morphed from a government's bank into a modern central bank. In 1826, the government allowed banks *outside* of London to take on the form of join-stock companies, creating competition (but just not too much) around the mobilisation of stockholders. In 1833, the Bank of England became the sole issuer of the pound as legal tender, giving it the official role of a monetary authority. In 1843, it became a bankers' bank clearing financial transactions between multiple parties. Finally, in 1847, it became the lender of last resort to the entire domestic banking system (Mehrling 2011, chap. 1; Collins 1988, chaps 1–2). These reforms turned the Bank of England into a central bank – though still fully under private ownership – and invigorated the British banking system, allowing sterling to become the world's reserve currency. The small banks consolidated or disappeared and by 1870, the banking system was more stable and provided more liquidity to the productive sectors than at any point in the preceding decades (Calomiris and Haber 2014, chap. 5).

Yet, the smooth sailing did not last for long. In 1873, a financial crisis hit Britain and although it emanated from the outside with defaults in Vienna and elsewhere, the crisis revealed that the pound's international role had a domestic price. The conundrum was to ensure convertibility of the pound into gold – a precondition for being a world reserve currency – while avoiding to act as a lender of last resort to the sterling indebted world – a responsibility not aligned with the interests of the bank's stockholders (Mehrling 2016, 22–23). For the first part of the conundrum, the answer was logically easy, though politically potentially expensive. Given that the Bank of England cannot increase the volume of gold, the only way to ensure convertibility was to limit the money supply domestically through limited government spending

and through tight control of the currency by the Bank of England (Cain and Hopkins 2015). For the second part of the conundrum, how to lend to the world without acting as a lender of last resort, even Bagehot was shy of an answer (Mehrling 2011, chap. 1). This second part of the conundrum remained unsolved until the turmoil in world politics between 1914 and 1945 displaced sterling as a world reserve currency and the question did not pose itself any longer. I will return to the displacement of sterling later.

For now, in the late 19th century, the future of the currency appeared bright – internationally and at home. As the City was at once small and outward looking, it was well placed to connect the wealthy's fortunes with international banking. The close personal relationships within elite circles London meant that bankers could gain the confidence of the well-to-dos. As a result, the wealthy began to entrust the financiers with their private wealth (Cain and Hopkins 2015, chap. 1). One reflection of this development was the professionalization of trusts as a means for estate planning during that time. The trust was a popular instrument to keep the diversifying estate together over generations. It also made ownership invisible, a welcome instrument to keep assets safe in face of the extension of the franchise and the related growing distance between the taxman and the taxpayers. Landowners had used trusts already to manage and pass on their fortunes since the Middle Ages, yet the system was informal and based on kinship between the settlor and the trustees (Harrington 2012, 2016a, chaps 1 & 4). Institutionalising trusts in the second half of the 19th century made private banking a growing business for the financiers. Even better still, it allowed them to mobilise resources for their banks without having to employ their own means. This manner of asset mobilisation gave London-based banks an important competitive advantage over the joint-stock banks setup in the provinces after the banking reforms in the earlier decades of the 19th century. The structure of Britain's banking system reflected the distance in the association of rule between, on the one hand, the landed and finance capitalists in London and, on the other hand, industry in the provinces. The provincial banks served the banking needs of the population and industry. The City amassed the fortunes of the country's well-to-dos to finance sovereign debt and the international distribution of manufactured goods (Cain and Hopkins 2015, chap. 1; Calomiris and Haber 2014, chap. 5). In other words, the City banks connected managing private wealth with providing credit, at home and abroad.

Between 1870 and 1914, then, the Bank of England was no longer the sole big wig in town. Rather, the whole banking sector in London and beyond worked smoothly and was consistent with the interests of the institutional association of rule. Banking, commerce and related services – insurance, accounting, legal advice, entrepôt services etc. – grew and served Britain's international ambitions, colonial and otherwise. The growing financial and service

sector created what Cain and Hopkins (2015, 501) term ‘invisible earnings.’ Unlike manufacturing and trade, the products and processes generated by the financial sector were largely invisible to those outside of it. The resulting invisible influence and income was a good match with gentlemanly culture. Invisibility soothed the financiers’ growing discomfort with the industrialists’ class warfare and the extension of the franchise (Cain and Hopkins 2015, chap. 5 and 18).

In sum, three characteristics marked British banking in the long 18th century: division, invisibility and dominance. The division ran between banks in London and outside of it. It reflected the conflict between financial and industrial capital, the former interested in conditions that furthered empire and international trade, the latter in conditions that furthered industrial production. Invisibility of the products, processes and incomes generated in the financial service sector, was the financial capitalists’ trump card. They could enjoy their liquid wealth discretely, and their seeming detachment from the class warfare that was poisoning the relationship between workers and entrepreneurs made them seem fit for public office and for acting in the national interest. Finally, the political dominance of finance capital within the association of rule ensured the state’s commitment to sterling as a world reserve currency and hence a commitment to convertibility. The Bank of England acted as the custodian of these interests transforming them – as a private institution with a public mandate – into a perceived national interest (Cain and Hopkins 2015, chap. 4; Burn 1999). A consequence of the commitment to convertibility was that, whenever sterling was under pressure, the government had to cut spending. Inside the association of rule, this commitment tilted power towards the financiers and taxpayers and away from government.

Yet, change was coming. The two world wars, the financial crisis and depression in the interwar years as well as the post-war Labour government fundamentally displaced this state of affairs. Although Britain was victorious in the wars, the empire was coming apart, its public finances were in shambles, and the United States had successfully contested Britain’s international and monetary leadership. Moreover, the surprise win for the Labour Party in the general election in 1945 flushed people into Parliament and government positions who had thus far been outside the institutional association of rule. The extended role of the government in politics and the economy during the wars had tilted the power relationship within the association of rule in favour of the government. Again, the fates and fortunes of the Bank of England reflect the shift: in 1946, Clement Attlee’s Labour government nationalised the central bank. In hindsight, the nationalisation of the Bank of England can be dismissed as inconsequential (cf. Dellepiane-Avellaneda 2013; Burn 1999). The Bank’s operations and personnel remained largely unchanged. Nevertheless, at the time, finance capitalists read the nationalisation of the

Bank of England as a signal of the shifting power balance within the state. The cross-party consensus around full employment as a new national policy goal competed with the traditional commitment to convertibility of sterling further supported this reading (Macdonald 2003, chap. 9). So, when sterling came under pressure in 1957, the government aimed to stabilise the currency as in the past. Yet, this time, the measures were not limited to spending cuts. They also included a restriction on the use of sterling to finance trade outside the sterling area, credit limitations and other measures. These restrictions cut off the funding sources of London's merchant and overseas banks (Calomiris and Haber 2014, chap. 5; Burn 1999). The government's measures meant that the financiers could no longer be sure about their dominance in the institutionalised association of rule. To preserve their business, influence and wealth, they needed an option B.

Well connected with the upper classes at home and in the colonies, bankers knew that since the 1920s, the wealthy had begun to incorporate trusts in Jersey.³⁰ This trend gathered momentum with the onset of decolonisation in the 1950s. Former colonists decided to settle in Jersey rather than to move back to the homeland.³¹ Jersey had everything the wealthy elite historically considered its privilege: sterling, low taxes, gentlemanly discreteness and a smack of empire. By the late 1950s to early 1960s, 70 per cent of bank deposits in Jersey belonged to non-residents. To collect those assets, London's merchant and overseas banks opened branches on the island. In the decade between 1950 and 1960, the number of banks there increased from seven to 30 (Hampton 1996b). Once there, the banks were able to create money against these assets. They could then lend this money on to their headquarters back in London because the credit restrictions did not apply in Jersey (Hampton 1996a). The permissive tax environment made that business profitable.³² The merchant and overseas banks had discovered the beauty of offshore. Next to offshore private banking and intra-bank financing, the banks that had moved offshore came across a third new line of business. As the financiers registered the increasing price for and decreasing success of maintaining sterling convertibility, it became clear that if the City of London were to have a future as an international banking centre, this future lay in the US dollar. The financiers now aimed to decouple, as much as possible, the fate of the City of London from that of sterling (Burn 1999). Thus some financiers returned to a business first pioneered in the 1920s, but that was then aborted because of international political turbulences: taking non-resident US dollar deposits and lending those deposits on to international business

³⁰ This development was not limited to Jersey it took place in a similar fashion in other Channel Islands. However, as the data in section two demonstrates today Jersey is Britain's most important offshore centre hence the discussion here focuses on it.

³¹ Author's telephone interview with former economic advisor to the government of Jersey, October 2018.

³² Author's telephone interview with former economic advisor to the government of Jersey, October 2018.

partners (Burn 1999). Now, in the 1950s, international politics was less turbulent and the amount of US dollar flowing into London was at a historical high. The merchant and overseas banks, and later the join-stock banks, seized the opportunity (Helleiner 1994, chap. 4).

The Bank of England, interested in restoring the international role of the City, did what it could to support that business. For instance, it allowed the banks to keep two separate books, one ‘onshore’ book for its domestic activities and one ‘offshore’ book for its non-resident services (Palan 1998; O’Malley 2015). This accounting technique turned the 19th century invisible nature of banking into an explicit policy. It also reinforced the traditional division between domestic and international banking. Onshore banking remained under national and international restrictions, while offshore banking was, thanks to being among non-residents and denominated in a foreign currency, largely unregulated. With this setup, the banks could now create money offshore. Even better, way ahead of the end of dollar-gold convertibility in 1971, offshore money creation was free from the restraints of convertibility. That is, offshore banks could create fiat money – a privilege that had been, since 1694, exclusively the central banks’ (Snider 2018a, pt. 6). Consequently, the Eurodollar market grew and developed offshoots into other markets and places. Nevertheless, the Bank of England remained, as Green (2016, 444) puts it, the ‘epistemic authority’ of the Euromarkets. From the beginning, the transactions between non-residents in a foreign currency involved technical details that the participating banks had to clear with the Bank of England. In addition, despite nationalisation, the revolving door between the City banks and the Bank of England kept moving. Therefore, the Bank of England had now two potentially contradictory goals: ensuring financial stability while preserving the banking sector’s freedom from government interference (Burn 1999; O’Malley 2015). One expression of this double-faced mission was that the Bank of England guarded its Eurodollar knowledge, keeping the Treasury and the government in the dark about the newly developing markets (Burn 1999). Another expression was that the Bank was not concerned about the Euromarkets’ potential contradictions with government policy. The Bank was only concerned about a potential call on its dollar reserves in particular since American banks, attracted by the Eurodollar business, began to move into London. The Bank of England faced its 19th century conundrum again: how to lend to the world without acting as a lender of last resort. Only this time, it was about a foreign currency. The Bank’s answer was not to impose reserve requirements on the banks participating in the Euromarkets. The reasoning went that reserve requirements indicated the possibility for bailout in case the Eurodollar business would go awry – an impression that the Bank of England was, just as in Bagehot’s days, adamant to avoid. Offshore internationalised the creation of US dollar, but not the Bank of England’s role as lender of last resort (Burn 1999; Green 2016).

Throughout the 1960s to 1980s, the Euromarkets gathered further pace with the deutschmark joining the Euromarkets (see chapter 4). In fact, the offshore credit markets worked so smoothly that by the end of the 1960s and early 1970s, even British public sector agencies started to borrow offshore (Green 2016). The interests of the financiers and the government merged again. Moreover, the financial capitalists regained within the association of rule some of the dominance that they had enjoyed vis-à-vis industrial capital and the government prior to 1931. Yet, the British financiers were now dealing in US dollar and thus their influence was, even if tacitly, at the discretion of American banks and the US government (Green 2016). Thatcher's 'Big Bang' in 1986 further strengthened the position of international financiers who now bought many of the traditional British banks (Tooze 2018, chap. 3). Prominent examples include S.G Warburg, which was bought by Swiss Bank and Morgan Grenfell, acquired by Deutsche Bank. Deutsche had long tried to increase its initial five per cent share in Morgan Grenfell to tap into British know-how of investment banking. Yet, to no avail. Morgan Grenfell's majority shareholders rejected the offer. The situation only changed, as one participant in the takeover remembers 'when, in the wake of deregulation, the [British] banks ... were exposed to free market forces' (Historische Gesellschaft der Deutschen Bank 2017, 59). It were the American banks, however, who moved into London most forcefully. Morgan Stanley, Goldman Sachs, Citibank and others were all buying British banks. By the early 2000s, none of the largest ten merchant banks pre-Big Bank was still British-owned (Augar 2008, 309). The City is now foreign-owned and British-staffed (Augar 2008). The consequences for the British state cannot be understated: for the first time since the end of the 17th century, the financial elite was distinct from the political one. Yet, the Bank of England, the government and Parliament remained firmly in the hands of the British moneyed classes. Now an internationalised financial capitalist class negotiated with the British moneyed classes, government and taxpayers over how to finance the British state. Yet, their interest in that state was, of course, marginal. Moreover, opening up to international finance also meant that with the overall increase of inflowing money, the amount of illicit money grew too. Yet, the government and the financial sector (including the Bank of England) largely took the approach of see no evil, hear no evil, speak no evil – the predicate crime was committed in foreign lands and hence did not appear to be Britain's problem (J. C Sharman 2017, chap. 4). In addition, the foreigner's wealth stored in London was a welcome asset for the credit-creating machinery in the City of London.

With the Blair government coming into office in 1997, the introduction of the euro in 11 continental European countries, and China's growing hunger for Eurodollar, offshore money creation in London got a further, unprecedented boost. The New Labour government signalled

its support through further financial liberalisation and transferring the right to set interest rates from the Treasury back to the Bank of England (Dellepiane-Avellaneda 2013). In combination with previous reforms, these measures made financial transactions possible in the City of London that made bankers at Wall Street look dreamy-eyed towards the east (Tooze 2018, chap. 3): Britain's supply of offshore money doubled in the space of one year between 1998 and 1999 and then continued to grow exponentially in the following decade (see graph 3.4 above). Again, it is probable that the overall increase of US dollar in the British financial system included US dollar of criminal origin. The Eurosystem with its interlocking markets for money and derivatives immaculately provided US dollar liquidity for the entire world economy (Snider 2018a, pt. 6), legal or otherwise. Yet, with the rise of the international anti-kleptocracy regime, Prime Minister Blair's and later Cameron's commitment to development, the illicit sources of funds became more politically contested. The government passed laws to root out 'dirty' money, but the implementation of these laws was wanting (J. C Sharman 2017, chap. 4). Either way, in the late 1990s, early 2000s the Eurosystem worked so well that it made, according to hedge fund manager Eric Townsend (2018a, pt. 7), 'everything look shiny and wonderful, rainbows and unicorns.' As a result of this financial wonder-world, the Eurodollar exposure of European banks grew to about half of their overall foreign currency exposure in the decade between 1997 and 2007. Banks from Britain, the European Union and Switzerland accumulated a collective on-balance sheet exposure of more than US\$8 trillion (Goldberg, Kennedy, and Miu 2010, 4). They refinanced about three quarters of that exposure through inter-bank lending and the rest through a combination of money market funds, central bank funding and foreign exchange swaps. That is to say, the non-American banks created US dollar but lacked, contrary to the early days of the Eurosystem, a corresponding source of retail US dollar deposits (Goldberg, Kennedy, and Miu 2010, 4). Dependent on funding sources from the wholesale market, the European Eurobanks quickly ran dry when these markets suddenly froze up in 2008. The banks lost their ability to create fiat offshore money from one moment to the next (Snider 2018a, pt. 6).

Now a lender of last resort would have been handy. Yet, the Bank of England and the Federal Reserve had both declined that role. Bagehot's decedents on both sides of the Atlantic were still shy for an answer of how to lend to the world without acting as a lender of last resort. The second-best option, then, appeared to be a central bank currency swap between the Federal Reserve and European central banks in combination with a decade of quantitative easing. These measures established the Fed and – through the swaps also the Bank of England – as money dealers, activities usually done by commercial banks (Mehrling 2011). These measures stabilised British offshore money creation at the level of 2006 in terms of GDP (see graph 3.7

above). However, the lack of any sustained growth in Eurodollar credit beyond the level of 2006 in over a decade left the global economy struggling with a shortage of Eurodollar (Snider 2018a). The Financial Crisis revealed that creating offshore money in the absence of a lender of last resort is dysfunctional. The decade after the Financial Crisis reveal that offshore money creation has nevertheless become indispensable.

From the 1950s onwards, offshore money creation had become a part of the British cycle of money, tax and debt. From the 1980s to 2007, it had even become a dominant part of that cycle, but since the Financial Crisis it started to wobble. What offshore finance means for the tax part of that cycle is the subject of the next section.

Taxation

In the late 17th to the late 18th century, the Crown was unsuccessful in coaxing the landed and moneyed classes into paying direct taxes. The wealthy understood that a meaningful income tax would enhance the Crown's power. Moreover, a direct form of tax would have meant to value the wealth they owned. The propertied classes preferred to keep that value private. If they were to contribute to financing the state, they would do so, as discussed above, by extending credit. Yet, financing the state via debt, would have been impossible without anything to show up on the credit column of the government's balance sheet. Luckily for William and Mary, in the late 17th century, England's international trade was flourishing, not least because of preferential terms of trade through colonialization. Indirect taxation of the traded goods through tariffs and excise duties raised sufficient revenue to make the government a credible borrower (O'Brien and Hunt 1999).

Yet, by the end of the 18th century with the French revolution and the Napoleonic wars, this approach to financing the state had reached its limits. If the institutional association of rule was to defend its political freedom domestically and internationally, the propertied classes had to contribute to the government's revenue in a direct manner. Therefore, in 1799, Prime Minister Pitt the Younger was the first political leader in Europe to introduce an income tax. He did not do it lightly. Pitt himself, called the tax 'repugnant' (cited in Brooks 2014, 34), echoing the sentiment of his fellow well-to-dos. In their view, the tax broke their natural privilege to go untaxed and to keep the value of their property private (Macdonald 2003, chap. 7; Brooks 2014, chap. 2). What made the tax acceptable, though, was the identity between the taxman and the taxed. Against this background, Pitt's promise to repeal the tax after the war was credible. The wealthy considered the tax a temporary nuisance and most of them paid. By the end of the war the government mobilised 36-times more revenue than in the previous two centuries (O'Brien and Hunt 1999). Nevertheless, Pitt kept his word and Parliament repealed

the tax after the victory against the French. The state was to be financed again by debt and indirect taxation.

By the mid-19th century, the division between landed and commercial wealth that marked banking in Britain became also visible in tax matters. The financial and commercial elite (this time siding with the industrialists) promoted free trade to expand Britain's role in international trade. It advocated for the reduction of tariffs and excise duties – aware that this meant the government needed another source of income. As in banking matters, the financial and commercial elites proved to be dominant. By the 1880s, the government reduced tariffs and duties while reintroducing the income tax, this time for good. Yet, William Gladstone, then Prime Minister, was aware that the design of the tax would matter to make it legitimate with all parts of the propertied classes. He set out to negotiate what would become known as the Gladstonian fiscal constitution (Daunton 2007).

The main purpose of the fiscal constitution was to remove the conflict over taxation from parliamentary politics. Gladstone's formula for compromise rested on three principles: consent, balance and neutrality. Consent between the different propertied classes was reached through aligning the right to vote with the threshold for income tax; through ensuring that every group had to contribute to the tax, irrespective of the source of their income; through spending the resulting revenue on the goals of all propertied classes – defence, serving interest payments, free trade and imperial expansion; and through a collaborative process between the tax administration and the taxpayer, even at the expense of tax evasion (Daunton 2002, chap. 1). To uphold that consensus, a balanced and general budget was important. That is, revenue was not allocated to a predetermined policy. Rather, the Treasury secretly determined how the revenue should be spent and revealed the budget to the Parliament only shortly before the vote to avoid undue influence of one group of taxpayers at the expense of another. Parliamentary approval of the budget, therefore, became an expression of confidence in the government. This approach was supposed to limit overspending and to direct surpluses into debt service (Daunton 2002, chap. 1). The approach of a secretly developed, general and balance budget was also predicated on political neutral administrative officers who enjoyed independence from the Chancellor and who earned their legitimacy through technical and legal knowledge of tax and budgetary rules (Brooks 2014, chap. 2).

Gladstone's compromise between the different propertied classes was as much a result of skilful statecraft as it was a result of favourable circumstances. Since the 1840s, the British economy was growing; tax revenue thus increased without a raise in tax rates. Compared to the 18th century, the government had a limited need for resources. There were fewer wars since 1815 and the Crown did not maintain a standing army. Moreover, parts of the costs for defence,

free trade and imperial expansion were successfully pushed onto the colonies and a substantial demand for civilian spending was yet to emerge (Daunton 2002, chap. 1 and 14). Either way, the Gladstonian fiscal constitution successfully patched up the division within in the propertied classes over taxation. It also successfully ratcheted up the government's coffers. By 1906 revenue from direct taxation surpassed that from indirect taxes (Brooks 2014, chap. 2).

While the wealthy classes were divided over the usefulness of an income tax, they were united in their attempt to avoid it. Gladstone's emphasis on consensus meant that rather than establishing a high number of general rules that Parliament needed to deliberate, the tax administration challenged individual taxpayers in case of conflict in the courts. As a result, tax law became highly specific and fragmented (Daunton 2002, chap. 1). This legal setup in turn provided a breeding ground for the politics of the invisible: using loopholes in the law, the wealthy transferred their income abroad, where it was outside the tax net. This was particularly easy for those capitalists whose income was invisible, too. Despite the possibilities, however, cross-border tax avoidance was still rare. Tax rates were too low to arrange systematically a person's wealth with a view on the tax bill (Brooks 2014, chap. 2; Daunton 2002, chap. 1). Gladstone's fiscal constitution was by and large solid. Yet, by the late 19th, early 20th century, three developments began to merge that would fundamentally displace Gladstonian finance: mass democracy, mass warfare and mass welfare.

By 1918 suffrage had become universal. Yet, the expansion of the franchise did not immediately change the institutional association of rule. It took until the Labour Party's victory in 1945 for the change in the electoral system to translate into a parliamentary majority that recruited its members from outside the traditional institutional association of rule. Nevertheless, the extension of suffrage in the late 19th century towards a larger proportion of the male population, did change the government's discourse about public spending. From the 1890s onwards, unions and the Labour Party advocated for a redistribution of wealth via taxation and for easing the plight of the working classes via the establishment of a welfare state. The welfare state, Labour advocated, should be financed from tax, not contributory insurance schemes, which the party considered regressive. Two decades later, in the run up to World War I, the discourse about taxation changed further, as the government intended to shift to progressive taxation. The intended reforms were partially an expression of a drive towards more equality. It was, however, also an expression of the drive to cast a wider tax net: progression allows taxing more people. Rhetorically, the government stuck to Gladstone's ideal of a consensual, balanced and neutral income tax system, binding politicians to a certain degree to follow words with deeds (Daunton 2002, chaps 1 & 14). With the changes in discourse and policies, a new dividing line emerged. This time it ran between the propertied and the working classes. The

wealthy elites continued to favour a government that spent on defence, imperial expansion and debt service. The lower classes, to the contrary, envisioned a larger role for the government, one that provided education, health, transportation and other public services (Macdonald 2003, chap. 8). Given economic growth, the lower classes had also more to contribute to the state's revenue than in the past. Though mitigated through progression, they paid income tax and – as in the past – even more through indirect taxes. The new dividing line between capital and labour reinforced the existing one between the moneyed classes in London and the industrialists in the provinces. Unlike the finance capitalists, the industrialists often supported the workers' call for a welfare state. Industrialists saw it as a means to ease their conflicts with an increasingly organised working class. Lloyd George's 'People's budget' in 1906, then, included an hitherto unheard-of level of spending on social welfare financed by increased taxes on the wealthy (Daunton 2002, chap. 1). It signalled to the financial capitalists that mass democracy meant a tectonic shift in British tax politics.

As the years 1914 to 1918 went on to prove, the same held true for mass warfare. The cost of war led to a doubling of income tax revenue in 1914 compared to the previous years (Daunton 2002, chap. 1). By the end of the war in 1918, the standard income tax rate reached 30 percent and the surcharge for the very wealthy stood at 22.5 percent. In addition, the government levied an excess profit duty of 80 percent (Brooks 2014, chap. 2). The wealthy paid, assuming that, as in the past, this level of direct taxation was a momentary nuisance to finance the war. Yet, the extension of the franchise had dissolved the 18th and 19th century quasi-identity between the taxman and the taxpayer. When the war was over, the pile of national debt was enormous, and the economy was riddled by a depression. Prudently, but somewhat unexpectedly, the government did not bring down the tax rates for the wealthy. To the contrary, the 40 percent of tax revenue that the government spent to service war debt that was held by the country's most wealthy, triggered a debate questioning the legitimacy of the rentier class (Daunton 2002, chap. 2). It became clear that, concerning taxation, after World War I, the propertied classes had lost their dominance in the institutional association of rule. The consequences were noticeable. The share of national income owned by the wealthy decreased, that of wage earners increased proportionally (Macdonald 2003, chap. 9; Daunton 2002, chap. 2). Yet, the well-to-dos were reluctant to abandon a part of their wealth and influence meekly. Instead, they resorted to the politics of the invisible, went offshore and set out to recreate their pre-1914 world.

The politics of the invisible was noticed, though. In the 1920s, the Labour politician Hugh Dalton complained in the House of Commons that the 'rich are not only getting richer, but ... some of them have gone to Jersey' (quoted in Sabine 2006, 183). Indeed, Jersey emerged as a

tax haven for British wealthy individuals during that time. Unlike the British mainland, the Channel Island had no personal income tax until 1928 and even then, its rates were substantially lower than Britain's. Income tax rates in Jersey reached their peak at 20 percent in 1948, compared to the 45 percent collected on the mainland. Jersey did also not levy taxes on corporate income, capital gains and gifts. Most importantly, it had no estate duty tax (Hampton 1996b). The latter made the island particularly attractive as a location for trusts holding private wealth set up to manage inheritance.³³ Nevertheless, then Chancellor Winston Churchill shrugged off Dalton's complaints adjudging that a man is free 'to arrange his affairs as not to attract taxes enforced by the Crown as far as he can legitimately do so within the law' (quoted in Sabine 2006, 183). Yet, it was not only individuals moving their wealth offshore; corporations did so too. As a result, in the 1930s, the government passed its first anti-avoidance laws (Brooks 2014, chap. 2). Yet, the genie was out of the bottle. The wealthy and firms had discovered offshore as a way to preserve their wealth and keep it invisible, obscuring the true scope of inequality in a country whose citizenry grew impatient with the privileges of the well-to-dos.

From the perspective of tax, World War II and its aftermath replayed the same motives again only starting from a higher level: increase tax rates during the war, keep them up afterwards and spend an important amount of the post-war tax revenue on debt service. Yet, the landslide victory of the Labour Party under Clement Attlee in 1945 changed the game. At least rhetorically, the government set out to extinguish the rentier, to paraphrase John Maynard Keynes, through taxation and the nationalisation of key industries (Daunton 2002, chap. 7). Besides setting tax rates on income of up to 80 per cent³⁴ Attlee's Chancellor of the Exchequer, Hugh Gaitskell, also created a set of defensive laws protecting Britain's corporate tax base against abuse. The Tory governments following Attlee in the 1950s upheld these defensive measures (Brooks 2014, chap. 2). Likewise, they were committed to the welfare state, including high tax rates and spending on public services (Cain and Hopkins 2015, chap. 26). At close inspection, this so-called 'post-war consensus', however, turned out to be a party consensus more than a consensus across the institutional association of rule.

The use of offshore trusts and other means of tax avoidance accelerated during the 1950s and 1960s. The money retreating from the mainland to Jersey and other dependent territories merged with that from British expatriates returning from their posts with the onset of decolonisation in the late 1950s. Moreover, as discussed above, these assets made up such a

³³ Author's telephone interview with tax expert, October 2018.

³⁴ The effective rates were never this high as the allowances were generous.

substantial amount that it was worthwhile for Britain's banks to move offshore too and collect the deposits (Hampton 1996b). From then onwards, offshoring only grew aided by three important government policy choices. First, Margaret Thatcher abandoned capital controls which tremendously increased the capital flows internationally, including between the British mainland and the by now well-established offshore financial centres. More cross-border capital flows meant more opportunities to avoid taxation through offshore arrangements (Brooks 2014, chap. 2). Second, the Thatcher and Major governments changed the structure of taxation by initiating a shift away from direct to indirect taxation and by introducing tax breaks on personal savings and private welfare schemes (Daunton 2002, chap. 1). The reforms were, however, revenue neutral (see fig. 3.9 above). That is, Thatcher's tax reform did not lead to a shift of power away from the government towards the financiers and taxpayers. Rather, it constituted a shift of power within the group of taxpayers in favour of those with higher incomes. Third, the New Labour governments dismantled the defensive measures that Attlee and successors had built around the British corporate tax base. As a result, industrial-scale tax planning for multinational corporations became commonplace and uncontroversial within the institutional association of rule. This is exemplified by the fact that the British government rents public buildings from private companies which are incorporated in Jersey, Bermuda and elsewhere in the offshore world (Brooks 2014, chap. 9). The Labour governments' new attitude towards offshoring recalibrated the power between the government, financiers and taxpayers once more. The financiers, free to use offshore within a legally welcoming context, profited from the shift in two ways. For one, they could profit personally and professionally from tax-reduced offshore transactions. Moreover, the offshore practices that were once an exit of the propertied classes from a tax system that no longer aligned with their interests had become an intrinsic part of that order again. The gain in power for the financiers, however, was not at the detriment of that of the government. The government had intentionally established a legal framework that allowed for corporate offshore tax and regulatory arbitrage.³⁵ Moreover, despite the stark increase of absolute revenue loss due to offshoring, the tax revenue to GDP ratio had a lightly positive slope. Economic growth and other taxpayers picked up the slack caused by a drop of corporate and high-income tax rates. As with the Thatcher reforms, the New Labour policies resulted in a redistribution of power within the group of taxpayers.

3 Offshore finance and state power in Britain

Against the background of the preceding analyses in sections, I can now evaluate how offshore finance affects the power of the British state. The scope of offshoring and the influence these

³⁵ Author's interview with tax lawyer, London, June 2017.

markets have had on the institutional association of rule are impressive. These findings suggest that their effect on power to unite resources to finance the state's politics are important too. However, these they do not tell us anything about the nature of these effects. The interviewees, as reported above, were of two minds regarding this question.

One group understood offshore finance as a serendipitous development that helped the City of London to maintain its historically important role. Tax evasion and money laundering are merely negative side effects because of badly written laws. Offshore markets are separate from but regulated by the state. In this perspective, offshore finance leaves, despite its scope and transformative forces, the power of the state untouched. The second group argued that actors within the City of London had actively developed offshore financial services with the support of the government. Therefore, offshore finance is an expression of the power of the state, which has been, in the view of some, captured by financial interests.

Analysing the British state from the money view reveals the strong points and the shortcomings of both perspectives. In Britain there is, in-line with the second group's reasoning, indeed no antagonism between offshore finance and the state. The financiers developed offshore financial services in full sight of the Bank of England and the Treasury. These offshore services were initially geared towards Britain's own elite, not foreigners. Yet, to speak of corporate capture would be to misinterpret the nature of the British state. As the historical institutionalist analysis has detailed, the propertied classes were a constitutive part of the British state throughout the timeframe covered here. When their dominance in the institutional association of rule came under pressure – from the outside through the rise of the US dollar and from the inside through mass democracy – they reached for time-tested approaches to defend their position: co-opting contenders and the politics of the invisible.

In terms of co-opting contenders, after 1945, the Labour Party and the international financiers were the main two target groups to be integrated into the elite's traditional values of privilege in return for public service and the pre-eminence of the interests of the City within the larger set of national political interests. The Tory leadership was traditionally part of the propertied classes and as such part of the elite-recreating system of inheritance, inter-marriage and education. In the first post-war decades, the Labour leadership was made up of people from outside the propertied classes. Yet, by the time of the Blair government in 1997, this was no longer the case. The Labour prime minister personally has been recruited from the moneyed elite. Though his successor Gordon Brown had a different background, his policies shaped by the values of privilege through service. Furthermore, he accepted the centrality of the City's interests as a constraint to his policy proposals. It appears that in the timeframe of half a century, the core of the institutional association of rule was successful to convey their values on the

former contenders from the Labour Party. The international financiers, coming in droves to London attracted by the Euromarkets and a permissive regulatory environment, were a different ballgame, though. Their co-optation was fast and blatant (Augar 2008). By buying British banks, the new owners became members of the institutional association of rule, that is, part of the British state. Naturally, it was easy to convince the international financiers of the pre-eminence of the City's interests. The notion of privilege through public service did not affect the international financiers. They did not consider their income a privilege, nor did they have the right or ambition to take public office. That is, the traditional core of the institutional association of rule was successful in conveying their values to the Labour Party leadership and partially also to the international financiers.

This mixed success was enough to transform the politics of the invisible. Responding to the demands from the City, the Blair and Brown governments extended the possibilities for offshore money creation and tax planning, framing these services as a means of efficiency. If the activities in the Euromarkets and the related tax planning were not ruled to be illegal, the politics of the invisible was now presentable within the economic and political elites. As such, offshore financial services contributed to the state's ability to unite resources to finance its politics. Running the Eurosystem from London allowed Britain to play a larger global role than its actual political or economic weight would suggest. The Eurosystem helped to finance the British state via debt, either directly through lending in the Euromarkets itself (Green 2016) or indirectly through institutional investors invested in both the Euromarkets and British sovereign debt (Macdonald 2003 epilogue). It also enhanced the role of the Bank of England as the epistemic authority of the Euromarkets (Green 2016). Moreover, the Eurobusiness created large incomes and thus contributed to the government's tax revenue despite falling nominal and effective tax rates. Yet, thanks to the invisible nature of the Euromarkets, much of this income remained invisible too. Many of the top-level bankers received, for instance, their bonus payments right into offshore bank accounts (Brooks 2014, chap. 6). In short, all went smoothly – until it did not. By 2007, the Eurosystem had become so big that when it froze the Bank of England's 1950s principle of 'no reserves means no bailout' appeared anachronistic at best. Thanks to the size and centrality of the Eurosystem and the European banks in that system, the British taxpayers were on the hook. The bailout was expensive: By 2010, the total amount taxpayers had to shoulder was £124 billion, their theoretical exposure (should all banks in government possession fail) £512 billion (National Audit Office 2010). Moreover, the Bank of England had to rely on the Federal Reserve to provide US dollars (Goldberg, Kennedy, and Miu 2010). Finally, the bailout and the subsequent policies of austerity became a long-term liability to the state's ability to finance its welfare state politics. Presented with the choice of continuing

to finance the welfare state at post-war levels or to service debt, the institutional association of rule prioritised the latter and used quantitative easing to prop-up the former. According to Alston (2018) this choice left 20 per cent of Britain's population struggling with poverty.

Over the course of the past 100 years, offshore finance has altered the nature of the British state. Starting out as a phenomenon serving the interests of the institutional association of rule, it became a part of it. Offshore finance initially enhanced the state's power to finance its politics domestically and internationally. Once the Euromarkets faltered, offshore finance developed destructive forces from within the state. How these forces will play out in the long-term, is yet an open question.

IV Germany: The tax state and its adversaries

If Britain is the inventor of offshore finance, Germany is, according to conventional wisdom, among offshore finance's prime victims. The country has a large and open economy and shares a border with three globally important offshore financial centres: Switzerland, the Netherlands and Luxembourg. Moreover, Germany is a classical high tax country, with significant rates for private and corporate income as well as for indirect taxes. Following the literature, we would hence expect it to be at the receiving end of offshore financial services with a considerable effect of offshore financial services on the state's ability to unite resources to finance its politics.

Indeed, the analysis below demonstrates that offshore finance plays an important role in the German economy. Yet, the data also shows that Germany is, contrary to conventional wisdom, not exclusively at the receiving end of offshore financial services. Rather, with its considerable historical and contemporary engagement in the Euromarkets, Germany has been one of the major facilitators of offshore money creation. On the other hand, with regards to tax planning and money laundering, the state faces a considerable loss in tax revenue and the cover up of serious political and economic crimes. The question of how offshore finance affects the power of the German state is a genuinely open one. The empirical data in conjunction with the historical institutionalist analysis suggests that the state has explicitly and implicitly supported the development and uses of offshore financial services for its own political gains. If Britain is the inventor of offshore finance, Germany is its catalyst.

1 The uses and abuses of offshore finance

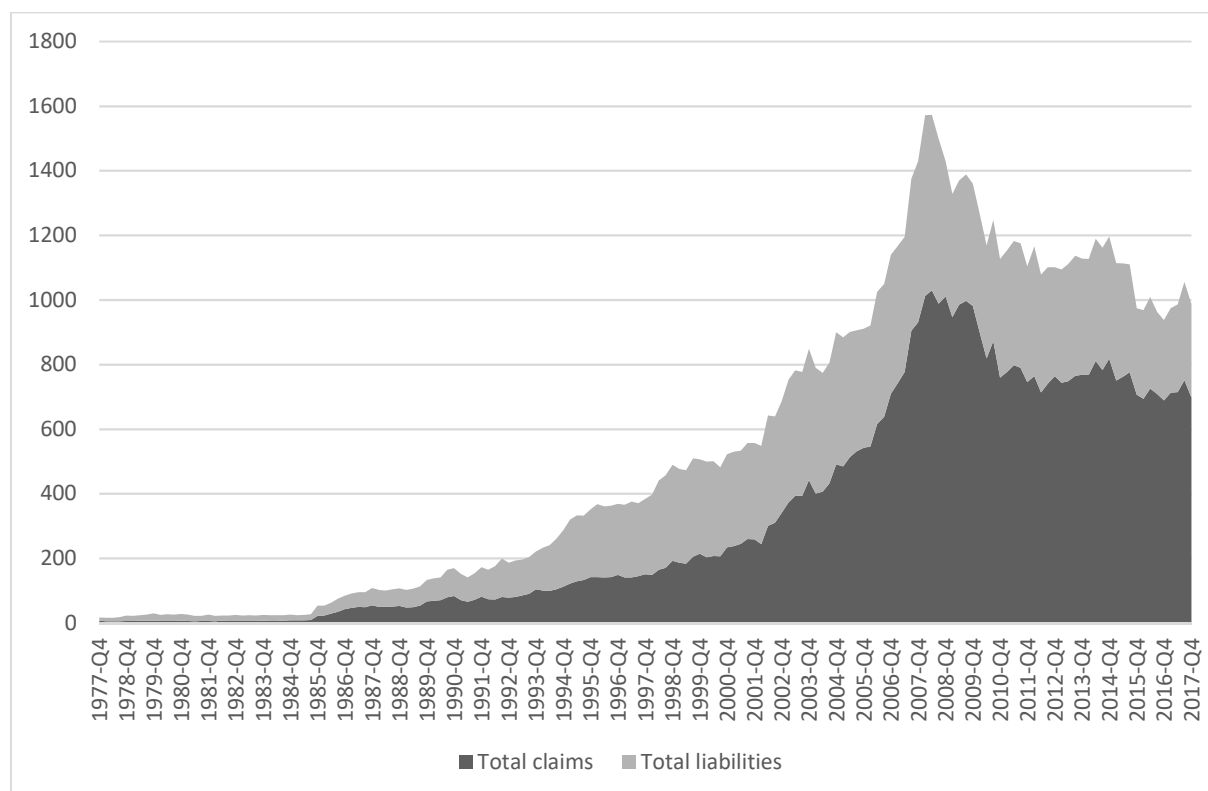
The German state is adamant about the importance of tax secrecy and other forms of guarding the financial privacy of individuals and firms. This attitude has earned the country a spot among the world's ten most secretive jurisdictions (Tax Justice Network 2018c). As in the British case, the German case study therefore relies exclusively on BIS locational banking statistics and qualitative data from participant interviews.

The interviewees – although addressing the offshore phenomenon from different viewpoints – came to a coherent conclusion. They were all convinced that since the late 1950s, early 1960s there has been a large demand for offshore financial services offered by neighbouring offshore centres. German corporations and individuals use these services for three prime reasons: to plan taxes, legally and illegally, to hide their money from law enforcement more generally and to circumvent strict German regulations of all sorts. However, most

interviewees also indicated that compared to international standards, German tax advisers and firms appear to exercise a certain restraint with regards to the aggressiveness of their tax planning structures. Finally, most of them were also convinced that with recent unilateral, European and multilateral changes in the law, in Germany the heydays of offshoring have passed.

Figures 4.1 and 4.2 show the overall scope of offshoring between 1977 and 2017, according to BIS data.

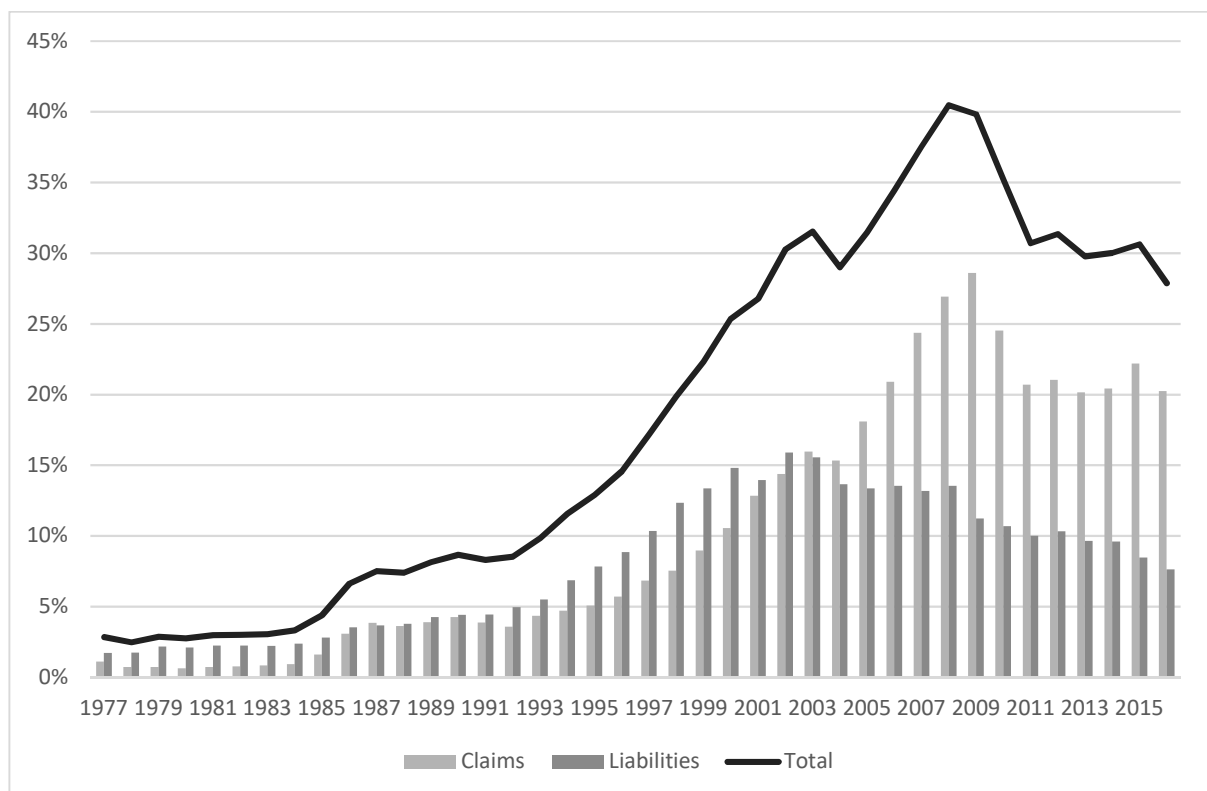
Figure 4-1. Uses of offshore financial services (in US dollar billion, quarterly)



Source: BIS locational banking statistics

During that time, offshore claims and liabilities together grew from US\$12 billion, or about three per cent of GDP, in 1977 to US\$638 billion, or about 28 per cent of GDP, in 2016. Offshoring started to grow considerably from the early 1990s onwards and then even more during the 2000s. It peaked in 2008, at the height of the Financial Crisis, at US\$884 billion or about 40 per cent of GDP. From 2009 onwards, offshoring declines.

Figure 4-2. Uses of offshore financial services (percentage of GDP, annually)

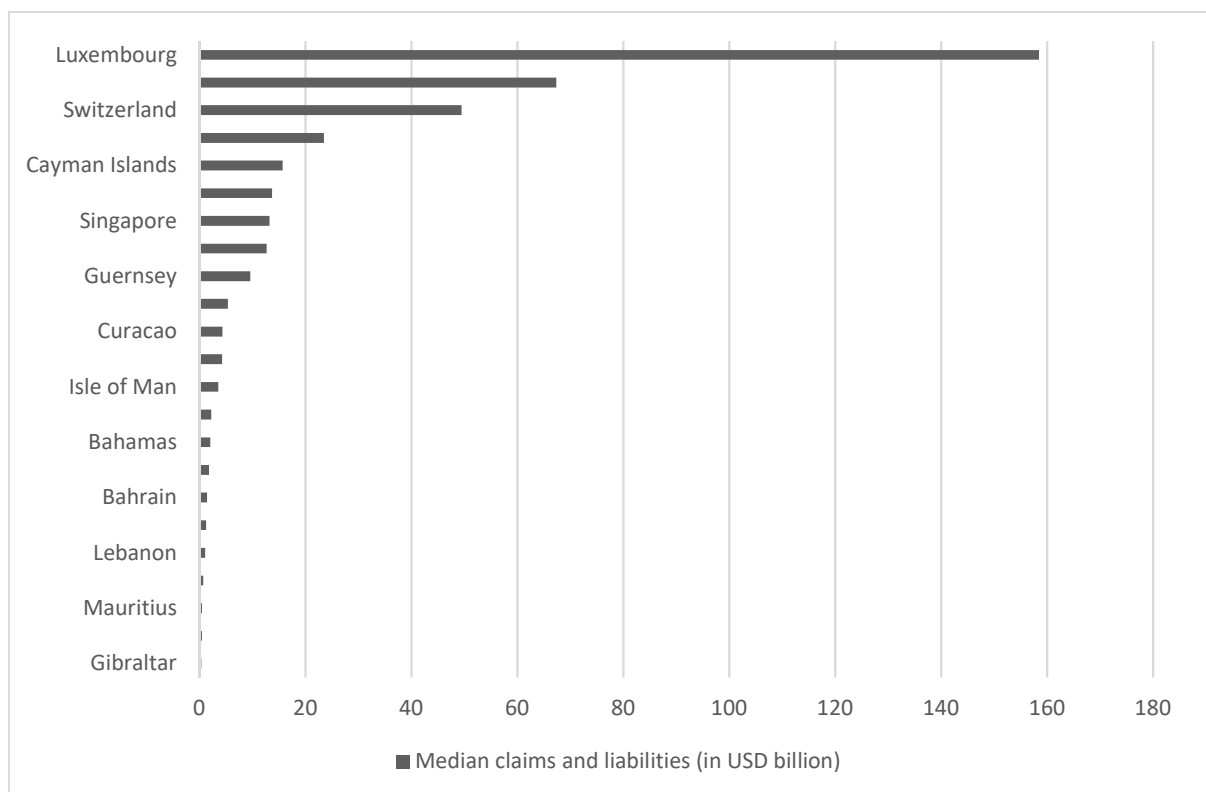


Sources: BIS locational banking statistics, World Bank, own calculations

However, it is notable that the growth rates in the 1990s and 2000s were much stronger than the rates of decline after the Financial Crisis. So, while offshoring may indeed have passed its zenith, as the interviewees claimed, it is by no means history. Analysing the two sides of the balance sheet separately, we can see in figure 4.2 that until 1990 both sides – claims and liabilities – develop in parallel and have roughly the same volume. In the early 1990s the development of offshore claims and liabilities separates. Liabilities outgrow claims and Germany becomes, for the decade from 1991 to 2001 a net borrower in the offshore markets. However, from 2001 onwards, offshore claims grow so significantly, in some years at a rate of three per cent of GDP, that the relationship reverses and Germany becomes, by far, a net lender in the offshore markets. Offshore claims peak in 2008 at over one trillion US dollar. With the Financial Crisis the growth of offshore lending comes to a sudden stop. Yet, while the following decade sees a significant decline in offshore lending, the claims that Germans hold towards offshore financial centres remains higher in 2017 than at any time prior to 2006. Offshore liabilities grow too between 2001 and 2008. Yet, they do so at more moderate rates before the Financial Crisis, just as they shrink more moderately thereafter. At the peak in 2008 offshore liabilities account for a little more than half of offshore claims.

Figure 4.3 shows where the offshore lending and borrowing by German individuals and firms takes place. In decreasing order, the top five offshore financial centres, measured as median stock of offshore claims and liabilities between 1977 and 2017, are Luxembourg, the Netherlands, Switzerland, Ireland and the Cayman Islands.

Figure 4-3. Prominent offshore financial centres

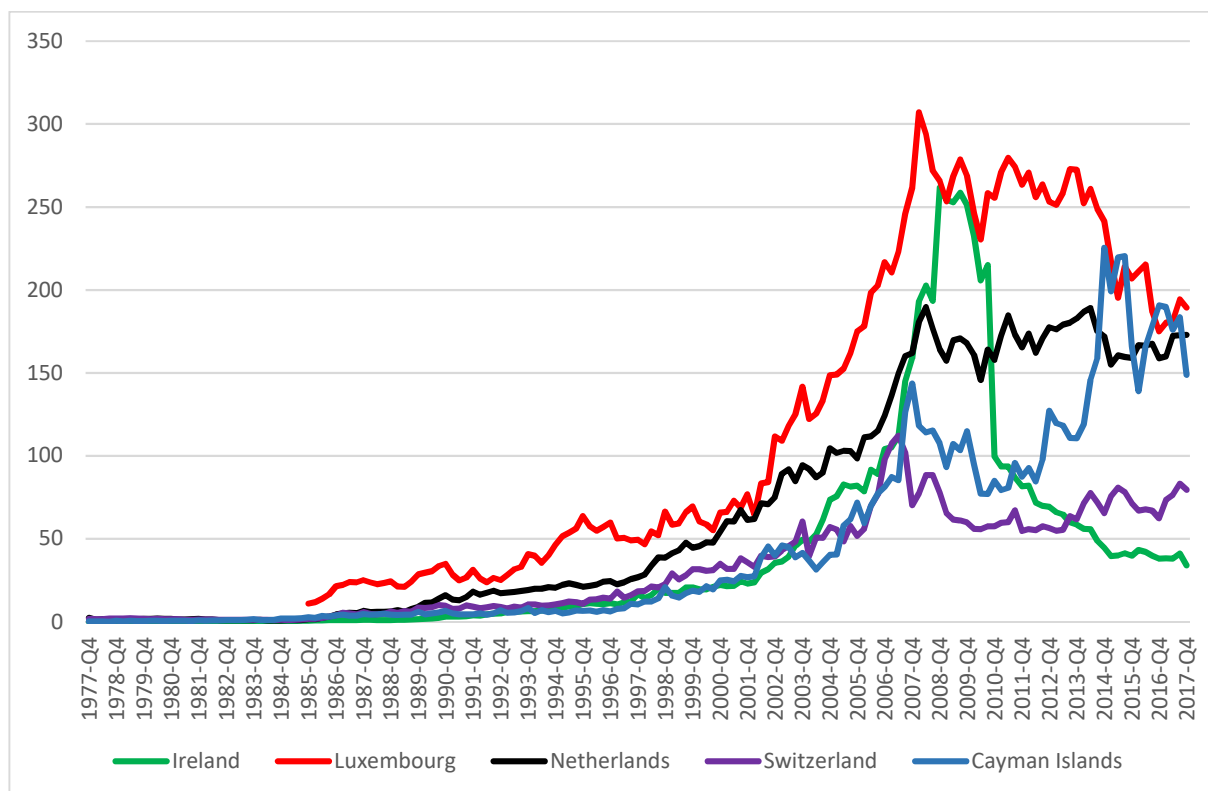


Source: BIS locational banking statistics

This finding echoes both, interview results and the literature arguing that individuals and firms usually use close-by offshore centres (Blanco and Rogers 2014; Haberly and Wójcik 2015a; Alstadsæter, Johannesen, and Zucman 2018). Two observations stand out: firstly, the importance of Luxembourg – with flows more than two times larger than the Netherlands and even three times larger than Switzerland. Secondly, the Cayman Islands is the only non-European offshore financial centre among the top five.

From its first appearance in the BIS statistics in the mid-1980s, Luxembourg accounts for about half of all of Germany’s offshore claims. As other centres, particularly Ireland and the Netherlands embark on a strong growth path in the early 2000s, Luxembourg’s market share drops, but it remains the unchallenged largest offshore centre used by German economic actors (see figure 4.4).

Figure 4-4. Top five offshore financial centres (claims in US dollar billion, quarterly)



Source: BIS locational banking statistics

Luxembourg is one of the world's most important offshore financial centres (Zucman 2015). It hosts, after the United States, the second largest investment fund industry and is the Eurozone's most important centre for private banking and wealth management. While Luxembourg offers its offshore services to clients from around the world, its focus has long been on Germany (Tax Justice Network 2018b). A member of the German imperial customs union from 1834 to 1919, the Grand Duchy of Luxembourg has long had strong ties with Germany. However, after being occupied by Germany during World War I, Luxembourg turned to Belgium. The two countries entered into a monetary union in 1922. As an effect of that union, Luxembourg had no central bank between 1922 and the introduction of the Euro in 1999. That meant that, unlike in Germany, there were no reserve requirements for banks in Luxembourg. Hence many German banks, first among them Deutsche Bank, opened subsidiaries in the tiny neighbouring country to circumvent German banking regulation. In 1963, Deutsche Bank was also central in bringing the first ever issuance of a Eurobond to Luxembourg. Having handled this issuance successfully, the Grand Duchy became, after the City of London, one of the prime locations for listing Eurobonds (Röper 1970; Roulot 2013; O'Malley 2015). Following on from its Euromarket activity in the 1960s and 70s, Luxembourg developed into the important offshore centre that it is today (Roulot 2013; Fichtner 2016).

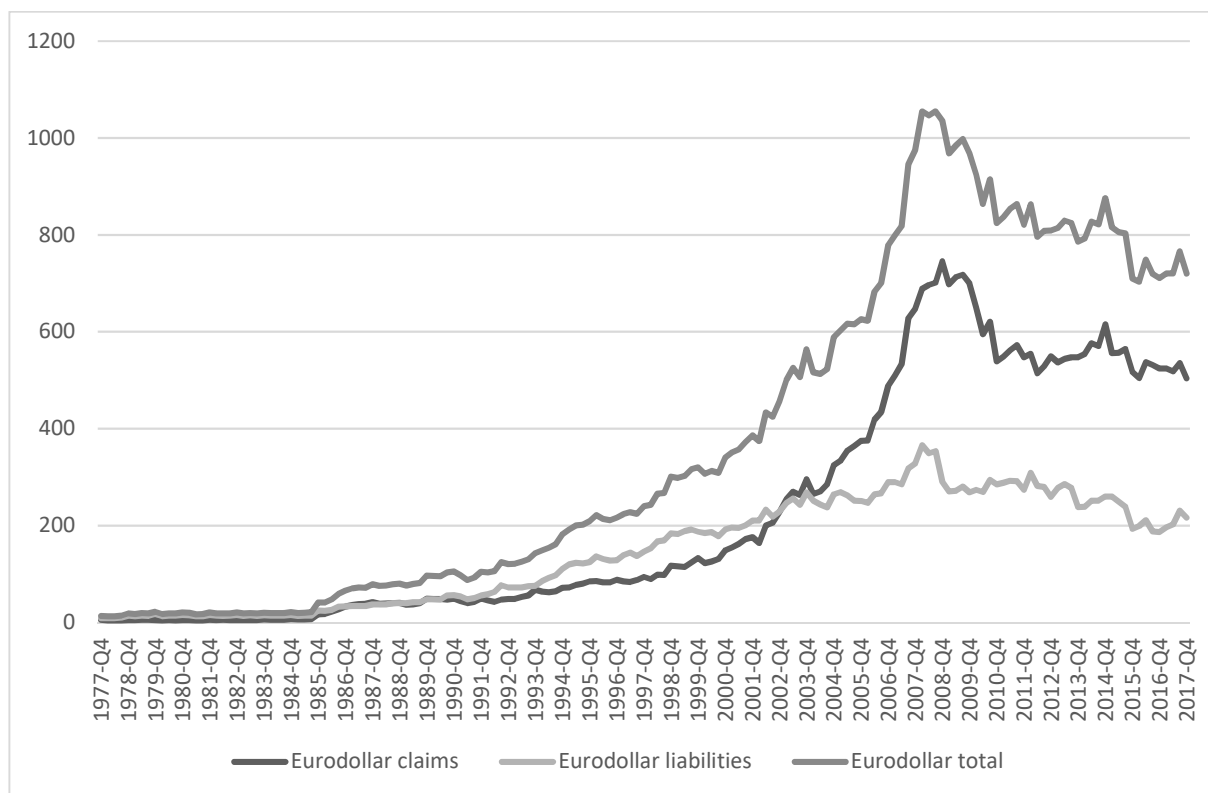
The Cayman Islands, on the other hand, is the American equivalent to Luxembourg. Operating under British common law, the Cayman Islands is an important financial centre mediating financial flows between the United States and the rest of the world, in particular the United Kingdom. It has developed into an important hub for the US American investment fund industry and multinational corporations (Haberly and Wójcik 2015b; Fichtner 2016). That is, in the selection of the top five offshore financial centres used by German actors, Luxembourg and the Cayman Islands are offshore centres acting mainly as banking hubs, while Switzerland, the Netherlands³⁶ and Ireland are more classical tax havens (Zucman 2015; Fichtner 2016). Grouped together, from 1977 to 2017, the flows between Germany and Luxembourg and Cayman Islands exceed the flows between Germany and Switzerland, the Netherlands and Ireland by 20 per cent. This means, Germans use offshore banking centres more than they use offshore tax havens. While the conceptual and statistical distinction is more clear-cut than the messy reality where banking centres are used for tax planning and tax havens for offshore money creation, the finding nevertheless suggests that in Germany offshore money creation may play a more important role than is commonly recognised in academic and policy circles. The next section analyses offshore money creation in more detail.

Money creation

The Euromarkets are at the core of offshore money creation that is outside of any regulatory framework. To get an idea about the importance of offshore money creation for Germany, I estimate the country's Eurodollar exposure – the share of US-dollar-denominated borrowing and lending in the overall offshore activity – as discussed in the appendix. According to this estimate Germany's exposure to the Eurodollar developed as shown in figure 4.5.

³⁶ For a more detailed description of the Netherlands as offshore tax haven, see chapter 6.

Figure 4-5. Total exposure to Eurobanking (in US dollar billion, quarterly)



Source: BIS locational banking statistics

From the perspective of the state, offshore claims and liabilities have different, but combined effects on state power. Considering claims and liabilities together, Germany's Eurodollar exposure amounted to US\$13.6 billion in 1977. In the following four decades it grew to US\$720 billion in 2017. Expressed in GDP, Germany's activity in the Euromarkets increased from two per cent of GDP in 1977 to 20 per cent in 2016. It peaked at 28 per cent of GDP in the years 2008 and 2009. The growth of Eurodollar exposure was particularly stark from the late 1990s to 2008. During this decade, the exposure grew at a rate of three per cent annually. In comparison, during this time, the German economy grew at an average rate of 1.6 per cent a year (World Bank 2018). Clearly, Eurodollar banking is a substantial part of Germany's offshore activity.

Analysing the two sides of the balance sheet separately, we can see that German Eurodollar claims increased hundredfold between 1977 and 2017 from US\$5 billion to US\$503 billion. Compared with Germany's overall offshore claims, Eurodollar claims accounted for 76 per cent of all offshore claims in 1977 and slightly dropped to 72 per cent by 2017. Eurodollar liabilities, on the other hand, grew from US\$8.5 billion in 1977 to US\$216 billion in 2017. Compared to overall offshore liabilities, Eurodollar liabilities started out with an 82 per cent share in 1977 and fell from there to 75 per cent in 2017. That is, Eurodollar claims increased

considerably more than Eurodollar liabilities, reflecting Germany's status as a net lender in the offshore markets. Most importantly, however, the data shows that, largely overlooked by the interviewees, Eurodollar banking is an important reason for German economic actors to go offshore.

Tax planning

Unlike Eurodollar banking, offshore tax planning – both illegally and legally – was very much at the forefront of the interviewees' minds. Despite the apparent size of the phenomenon, the German Finance Ministry never attempted to quantify the amount of taxes lost due to offshore tax planning. Given the decentralised nature of the tax administration such an estimate is difficult to attempt.³⁷ Yet, as in the British case, I provide a rough estimate of the potential tax loss based on the estimates of the level of offshore demand presented above.³⁸

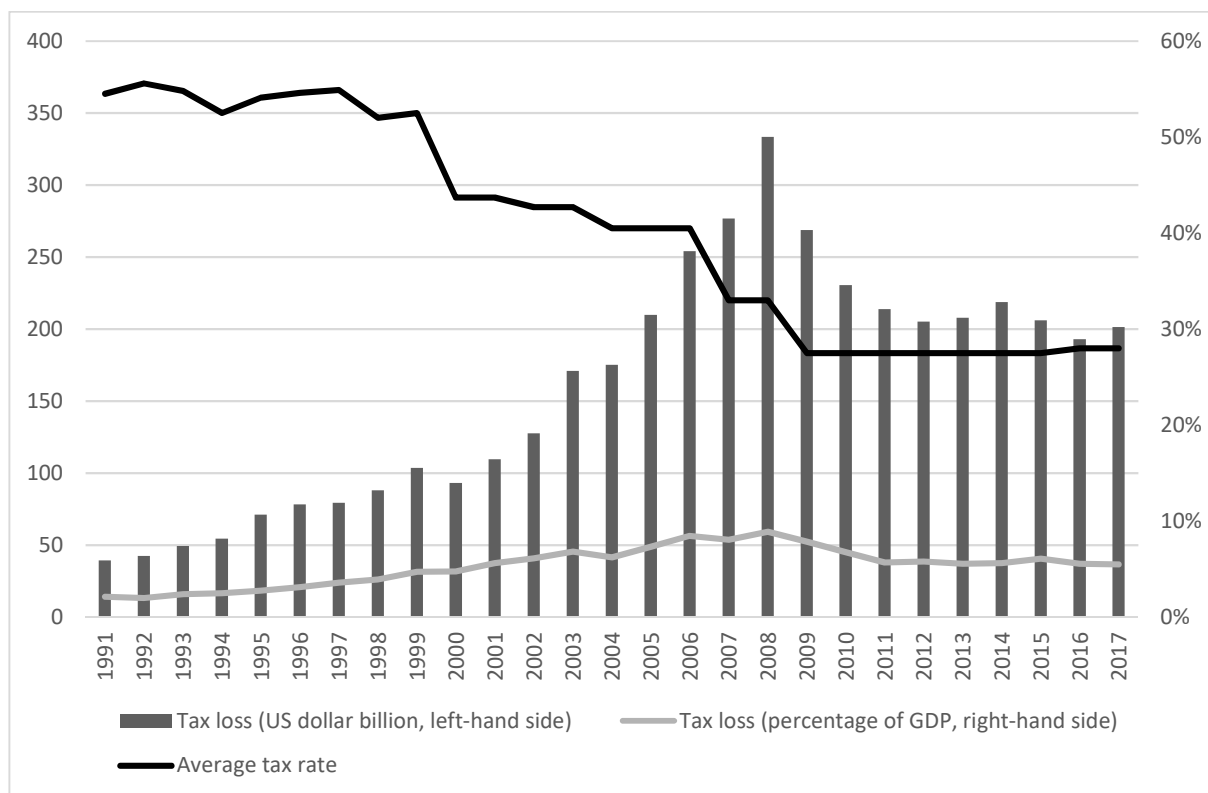
According to the BIS data, offshore assets held by German economic actors amounted in 1991³⁹ to US\$70 billion and in 2017 to US\$697 billion. Since the BIS data does not allow distinguishing between individuals and corporate offshore assets, I work as in the case of Britain with a middle value between the two rates. I estimate the related tax loss by assuming that all these assets are not taxed in Germany and would be taxed at the full income tax rate if onshore. Personal income tax rates are a complicated matter in Germany. For the sake of simplicity, I assume that individuals who hold money offshore are in an income bracket that makes them liable to the top rate. This rate decreased between 1991 and 2017 from 53 to 42 per cent. The corporate tax rate, on the other hand, decreased from about 56 per cent in 1991 to roughly 30 per cent in 2017. I adjust the tax rates on a yearly basis following the change in the law. Based on these assumptions, the German state missed out, as figure 4.6 demonstrates, on US\$39 billion in 1991 (two per cent of GDP). Peaking in 2008 with US\$ 333 billion (nine per cent of GDP), it decreased to US\$201 billion (five per cent of GDP) in 2017.

³⁷ Author's interview with employee of the ministry of finance, March 2018.

³⁸ See appendix 1 for details.

³⁹ The estimate starts with 1991 to cover the data for re-unified Germany. All BIS data before 1991 exclusively covers West Germany.

Figure 4-6. Estimated tax loss



Source: BIS locational banking statistics, World Bank, CESifo

It is important to keep in mind here that the numbers are supposed to provide a sense of how much German individuals and corporations use offshore services for tax planning purposes. The claim is not to provide a precise estimate. Nevertheless, the considerable increase up to 2008 and then the moderate decrease afterwards stands out as an observation. Three factors may explain that drop. First, the Financial Crisis led wealthy Germans to seek financial safety at home. They repatriated some of their internationally mobile capital into saving banks. For instance, the savings bank of Hamburg, the largest of Germany’s savings banks, had an increase of deposits of €500 million in the four weeks between September and October 2008 alone (Seifert 2008). Next to the Financial Crisis, the decrease of income tax rate post 2006 automatically leads to a decrease in the tax loss estimate. Finally, governments between 2006 and today took law enforcement measures to curb offshore tax planning. Almost all interviewees pointed to a resulting significant decrease in private offshore evasion between 2007 and 2010 – 2015. During that time, deposits in Switzerland dropped from US\$6.6 billion in 2007 to about US\$800 million in 2015 (Swiss National Bank n.d.). The numbers of the development of German fiduciary funds in Switzerland support the interpretation that this decrease is related to changes in German tax politics. Alstadsæter et al. (2018) argue, that the drop could be related to a shifting of assets to other offshore centres. However, the interviewees

did not mention any offshore centres to replace the private deposits in Switzerland and Luxembourg. Likewise, an employee of a Swiss investment fund claimed

*'If there is a +49 on my display, I don't even pick up the phone anymore. Serving German clients is to have one foot in prison [laughs]. I mean, we rather serve clients in Latin America or Asia.'*⁴⁰

For Germany, the drop in offshore assets held by individuals in Switzerland appears genuine. The available data analysed in the previous two sections underlines the interviewees' sense that offshore finance plays an important role in Germany. This holds true even more for offshore banking than tax planning. It hence stands to reason that offshore banking services are also used to launder money from a range of predicate crimes. The next section turns to these abuses of offshore finance.

Money laundering

If the numbers on tax planning had to be taken with a pinch of salt, reliable data on offshore money laundering simply does not exist. In Germany, court sentences and fines related to money laundering trials are not published, neither is the amount of frozen assets. Germany's financial regulator, the Federal Financial Supervisory Authority (BaFin), has little in-house resources. Auditing and monitoring anti-money laundering provisions are largely outsourced to private firms. Hence there are no public statistics on the matter (Tax Justice Network 2018a).

Yet, three of the largest scandals in the history of post-war Germany demonstrate how central offshore financial services have been in the shadow world of German economics and politics. These scandals are the 2016 Panama Papers leak, uncovering countless instances of tax fraud and money laundering via offshore shell companies, the 2006 Siemens corruption scandal and Chancellor Helmut Kohl's slush funds (1973-1996), doubtless the largest political crime since 1948. All three scandals are well-documented. I briefly discuss each of them with a view on the use of offshore financial services.

In 2016 two journalists at the *Süddeutsche Zeitung*, Bastian Obermayer and Frederik Obermaier, received secret records of 214.000 offshore companies set up with the help of the Panamanian law firm Mossack Fonseca. The leaked data exposed that the estimated US\$552 billion that Germans held offshore in 2007 alone was not there because of their sheer cleverness. It was offshore because German banks systematically advised their rich clients to put it there

⁴⁰ Author's telephone interview with employee at Swiss investment fund, March 2017. +49 is the German country code.

(Obermayer and Obermaier 2016).⁴¹ The documents leaked to the *Süddeutsche Zeitung* revealed more, however. Next to setting up and managing offshore companies on behalf of their clients, German banks also held accounts owned by shell companies. These accounts were opened by Mossack Fonseca on behalf of its clients. The leaked internal communication of Mossack Fonseca employees suggests that the German banks did not always know or systematically check who the beneficial owner of a specific shell company was – breaching anti-money laundering law. The data further suggests that larger German banks acted as correspondent banks for smaller financial institutions that were allegedly involved in money laundering. According to the data, more than 20 German banks did business with Mossack Fonseca, among them Germany’s largest commercial banks such as Deutsche Bank and Commerzbank, but, also several *Landesbanken*. That is, publicly owned banks helped their clients to evade taxes in Germany. Commerzbank and the *Landesbanken* required government bailouts during the Financial Crisis. Afterwards the affected *Landesbanken* liquidated their offshore business (Obermayer and Obermaier 2016).

The Panama Papers also provided additional insight into the 2006-2009 Siemens corruption scandal, the largest publicly prosecuted corporate corruption scandal in Germany. Siemens is a large German electrical engineering firm and central part of the German industrial landscape since its foundation in the mid-19th century. The scandal erupted after the public prosecutor in Munich, where Siemens’s headquarters are, received an anonymous letter accusing the corporation of running a large system of slush funds for bribing foreign officials. In the course of the ensuing investigation, Siemens was suspected to have paid, between 2001 and 2007, bribes to foreign officials, totalling US\$1.4 billion (Berghoff 2018). In a plea bargain, Siemens admitted to only five breaches of US law, but not to the allegation of bribery. Nevertheless, the corporation agreed to a record fine of US\$1.6 billion. Due to the plea bargain many of the corrupt payments were never investigated in full and the actual mechanics behind them remained hidden from public sight (Berghoff 2018). The leaked Mossack Fonseca files obtained by Obermayer and Obermaier (2016) shed some light onto the bribery practices of Siemens subsidiaries in Latin America. The CEOs of different regional and national offices in Latin America would siphon off money from official Siemens accounts and pooled them in the accounts of a shell company, Gillard Management, setup by Mossack Fonseca. The shell company held accounts in Switzerland, Singapore and Panama, into which the pooled slush funds were paid. Out of these accounts the managers of the different Latin American branches of Siemens could make payments, usually to ‘advisors’ and other middle men who would then

⁴¹ Also, author’s interviews with tax expert, Berlin, February 2016; with employee of the Ministry of Finance, Berlin, March 2017.

hand the money to the foreign officials (Obermayer and Obermaier 2016). These practices were standard in different divisions of Siemens during the 1980s and 1990s. In those years, none of this was illegal in Germany. Rather, until 1999 companies could deduct bribes from their taxes if paid to foreign officials and until 2002 if paid to foreign businessmen. Yet, between 1998 and 2002 foreign corruption was successively outlawed, but Siemens's practices changed little and slowly (Berghoff 2018). When the prosecutions in 2006 finally started, the managers in Latin America became nervous, first restructuring and then dissolving the shell companies they held with Mossack Fonseca and the related bank accounts (Obermayer and Obermaier 2016).

Next to the Panama Papers, a recent investigation by *Der Spiegel* und public broadcaster *Das Erste* revealed how offshore structures also played a central role in the illegal party donation system that had financed Kohl's ascendance to power⁴² (Dettmer and Röbel 2017; Lamby and Koch 2017). The slush funds had been initially setup by Germany's first post-war Chancellor Konrad Adenauer and his supporters from the country's largest corporations. In 1954, Adenauer and industrial magnates set up an association, the *Staatsbürgerliche Vereinigung* (civic union), which pooled donations from these magnates and then acted as the official donor of that money to the conservative Christian Democratic Union (CDU) and the liberal Free Democratic Party (FDP). That same year, parliament passed a law that made donations to parties and charities tax deductible. Through pooling the money at the *Staatsbürgerliche Vereinigung*, the actual donors could remain anonymous, while still receiving tax deductions. However, four years later, in 1958, the constitutional court outlawed this practice, because it undermined the constitutional rule of transparent accountability of party finances. In response to this ruling, the *Staatsbürgerliche Vereinigung* setup, over the coming decades, a sophisticated offshore structure to ensure the anonymity of donors and avoid having to declare the funds. This structure included research institutions with the legal form of a foundation headquartered in Liechtenstein with bank accounts in Switzerland. The *Staatsbürgerliche Vereinigung* made payments for fake research projects to these institutions in Liechtenstein into their Swiss bank accounts. From there the money would be transferred in cash to an anonymous bank account in Switzerland owned initially by two members of the CDU's treasury and close aides of Helmut Kohl. From this bank account, the money would be transferred to a trust account in a Luxembourg subsidiary of a German private bank. The bank transferred the money internally to its German bank account and from there Kohl's aides would withdraw the money in cash and deposit it in the CDU's official bank account. All related

⁴² Parts of the slush fund system was revealed in the 1980s under the parliamentary and judiciary investigation of the Flick affair (Kilz and Preuss 1983). Another part of the system was revealed in the late 1990s as part of the CDU party donation scandal (see von Arnim 2000). The new investigations now show that the two scandals were part of one system that was built around the ascendance of Helmut Kohl to power.

documentation was stored in an anonymous safe in Switzerland (Dettmer and Röbel 2017). On their part the industrialist donors had also come up with an ingenious money-laundering-cum-tax-fraud system. They would donate large sums to a catholic missionary congregation in Sankt Augustin near Bonn. The congregation would provide receipts for these large sums to the firms who could deduce it from their tax liabilities. Subsequently the congregation would pay back the larger share of the money to the firms and donate the smaller share to the *Staatsbürgerliche Vereinigung* (Lamby and Koch 2017). When the corporate tax fraud scheme raised the suspicion of the tax authorities in the late 1970s, Kohl's aides in the party treasury became nervous. To obscure all traces to the CDU and to them personally, the aides set up another foundation in Lichtenstein, called Norfolk, which now became the owner of a new bank account in Switzerland and the lease holder of the safe with all the documentation. However, they also made sure that from 1980 onwards the *Staatsbürgerliche Vereinigung* would no longer donate to the party. The association was liquidated ten years later and its remaining money was channelled into the offshore system which was by now mainly operated by Helmut Kohl's two aides (Dettmer and Röbel 2017).

The so hidden and laundered slush funds helped finance the ascendance of Helmut Kohl to power from his election as party chairman in 1973 until the end of his 16-year chancellorship in 1998. In 1971 he had lost out against his opponent Barschel in the competition for the chairmanship. Two years later, Barschel was politically damaged after he had lost the general election. The slush funds sweetened his decision not to run for the chairmanship again with payments amounting to DM1.7 million. The slush funds allowed Kohl and his supporters to fund campaigns and create loyalists in the party's often financially strained state chapters. There is no evidence that the industrialists' donations were related to direct favours for the companies. Yet, it is unlikely they came for free. Two details emerged in an investigation into a part of the slush fund system in the 1980s. After having paid out Barschel, one of the donors, Kurt Biedenkopf, at that time the chief executive officer of the large chemicals firm Henkel, became general secretary of the CDU once Kohl had won the chairmanship. The other donor, Flick, a coal and steel magnate at the very core of the slush fund system, requested a tax exception from the ministry of finance when he sold his shares of the car company Daimler to the Deutsche Bank. The exception was granted (Kilz and Preuss 1983; Historische Gesellschaft der Deutschen Bank 2017). In 1999, the whole system came apart. Kohl's two aides who ran the offshore system were caught in relation to an illegal cash donation by an arms dealer. Kohl publicly admitted having known about illegal donations of DM3 million and claimed to be ignorant about the slush fund system. According to the investigations, between 1973 and 1998, the slush funds had provided him with over DM200 million in addition to the party's official

finances (Dettmer and Röbel 2017; Lamby and Koch 2017). Although it is impossible to determine the actual volume of money laundered through offshore financial centres, the three largest scandals of post-war Germany suggest that offshore finance plays a central role in political and economic crimes committed in Germany.

Overall, the empirical data echoes the findings from the interviews. There is indeed a considerable demand for offshore financial services in Germany, both for legal and illegal purposes. However, the data also adds two important points of nuance to the interview results. To begin with, the demand for offshore financial services is driven by individuals and banks rather than by firms in search for tax gains. Next, the data demonstrates that the demand for offshore financial services never declined to the levels it had before the mid-1980s. That is, in the short-term perspective, offshoring has passed its peak. In the longer view, however, offshore's contemporary decline is smaller than its past growth. In this general picture, three observations stand out: the large scope of individual tax evasion, the relative restraint of corporate tax planning and the steep increase in offshore money creation between 1998 and 2007. The following historical-institutionalist analysis explains this pattern of offshore uses and the drivers behind it.

2 The German state from the money view

From the money view, the formation of the German state markedly differed from the British experience (see chapter 3). At the time when England, Wales and Scotland had a shared cycle of money, tax and debt in 1707, the 25 small states that would once become Germany ran on six different currencies with a 119 different coins and 117 different sorts of paper money (Ullmann 2005). It was with the foundation of three successive institutions – the *Zollverein* (a customs union between the different states) in 1833, the German Empire in 1870/71 and *Reichsbank* in 1876, that Germany developed a cycle of money, tax and debt comparable to that of Britain. Consequently, the analysis of the institutional association of rule and its struggles over how to finance the state starts in the German case in the late 19th century, about two hundred years later than in the British one. Moreover, unlike in Britain, the institutional association of rule undergoes fundamental changes throughout the five regimes covered in this analysis: The German Empire (1870/71-1918), the Weimar Republic (1918-1933), National Socialist Germany (1933-1945), the Bonn Republic (1949-1991) and the Berlin Republic (1991 to today).

The institutional association of rule

The foundation of the German Empire in January 1871 was the unification of 25 previously independent states. The individual states of the German Empire had already developed elements of modern statehood, in particular tax systems and a small but functioning cycle of money, tax and debt. When the individual states were unified into a federal nation state, the individual tax systems continued to exist separately, complemented simply by a federal level of tax rules (Ullmann 2005). On the monetary side, the development was more centralised. Five years after the empire's foundation, the 33 state-level banks of issue (*so-called Notenbanken*) were merged into one central bank, the *Reichsbank*, now issuing the new single currency, the Mark. The new currency was backed up with the gold from French war reparations following its defeat in the Franco-Prussian war of 1870/71 stored in the war chest in Berlin-Spandau (Wagner 1902). More than the central bank, however, it was the establishment of three commercial banks in the empire's early years – Deutsche Bank (1870), Commerzbank (1870), and Dresdner Bank (1872) – that would fundamentally shape the institutional association of rule. The history of Deutsche Bank is the exemplar of the unification, from the mid-19th century onwards, of corporate and financial capital into a money elite and its close but separate relationship with Germany's *Funktionseelite*, an elite of public and clerical functionaries (see below).

The purpose of establishing Deutsche Bank in 1870 was to finance industrialisation and, with the idea of imperial expansion in mind, foreign trade thus far handled by international banks (Gall 1995). The relationship between Deutsche Bank and the government was strategically closely knit from the beginning. Georg Siemens, one of the bank's founders, went to great lengths to establish a relationship with the Emperor and finally met William II in person on a trip to the Middle East in 1898. Three years later, Siemens was handled as a candidate for Minister of Finance. Although Siemens declined, he maintained close ties with the Emperor. Besides politics, Georg Siemens also had close personal ties with Germany's industrialising enterprises. He was the second cousin of Walter von Siemens, founder of the electrical company Siemens. After initially focusing Deutsche Bank's business on commercial banking, it was Georg Siemens who moved the bank into universal banking and with it into the large-scale financing of industrial enterprises. Siemens and other electrical companies were among the earliest recipients of credit from Deutsche Bank (Gall 1995). They were soon joined by other industrialising sectors such as coal and steel mining. As part of financing industry, Deutsche Bank became a shareholder in their client companies. In turn, important clients became members of the bank's supervisory board. The inter-locking boards of commercial banks and large corporations became a hallmark of German banking. The industrialisation process and the

development of universal banking in Germany hence mutually reinforced the building up of cartelised industries and big banks (Gall 1995; Gerschenkron 1979).

The resulting close financial and power relationships between corporations and banks created a money elite of bankers and entrepreneurs that was separate from the country's *Funktionseelite*. German sociologists consider the *Funktionseelite* a political class that consists of government representatives, high rank civil servants, judges, scholars, clerics and functionaries of other important institutions (see Rebenstorf 1995; Kaina 2004; Berghoff and Köhler 2007). It expanded over time to also include parliamentarians, union leaders and leading figures in the media (Kaina 2004). Throughout the time covered in this analysis, the *Funktionseelite* has been largely replaced with each regime change (Schäfers 2004). The money elite, to the contrary, has been stable across time and regimes. The wealthy classes today are largely dominated by the same business-owning families as in 1871 and the same banks as then still dominate the German banking system (Berghoff and Köhler 2007; Bartels 2017). Together, the money elite and the *Funktionseelite* make up Germany's institutional association of rule. The interplay between a stable money elite and a changing elite of functionaries shaped the struggle over how to finance the state and with it, Germany's bank and tax systems.

Banking

The banking reflects the relationship between the state, its financiers and the taxpayers (see chapter 2). From the early days of the empire until today, this relationship has been marked by the stability of the money elite and the strong but fundamentally changing nature of the *Funktionseelite*. The stability Germany's banking institutions reflect the stability of the money elite, the constant negotiation within the institutional association over how to finance the state's belligerent or socio-economic ambitions reflects the constant change in the elite of functionaries.

The founding of Deutsche Bank, Commerzbank and Dresdner Bank in the early 1870s complemented the pre-existing two pillars of Germany's banking system: the savings and cooperative banks on the local level and the *Landesbanken* on the regional level. Savings and cooperative banks started to emerge in the early to mid-19th century. They were a local response to rural poverty caused, among others, by a lack of access to credit for farmers and craftsmen. Around 1830, regional public *Landesbanken* started to emerge. They were mandated to settle the accounts between the savings banks and to provide finance to the state governments through issuing bonds. The fourth pillar of the imperial banking system, next to the commercial banks, the savings and cooperative banks and the *Landesbanken*, was from 1875 onwards the central bank on the federal level. That year a new banking law transformed the Prussian state bank into

the *Reichsbank*, which was subordinated directly to the Chancellor. Together, these four pillars of the German banking system determined how money was created in the empire: local savings and cooperative banks created the money for financing small businesses, farmers trades craftsman. Regional *Landesbanken* backed the local money creation up and provided funding for state governments. Large private banks created money for industrial corporations. The *Reichsbank* backed up the *Landesbanken* and the big commercial banks. The imperial banking system created competition between the locally and regionally organised savings and cooperative banks as well as between the large commercial banks. As a result, from the early days of empire, access to credit was affordable for most economic actors. In addition, the banking system stabilised the financial system along ownership structures. The publicly-owned savings banks and *Landesbanken* were to be, in times of crises, bailed out by the taxpayer. The privately-owned commercial and cooperative banks had no such guarantees but could rely on the *Reichsbank* as a lender of last resort. In its basic features, the German banking system today is still the same.

With this setup, the imperial system was able to serve the needs of almost all economic actors ranging from private individuals, over farmers, to small firms, big corporations and the state governments. Strongly differing from the role of the Bank of England, the *Reichsbank* was not established to finance the government. Reparations from France, defeated in the Franco-Prussian war in 1870/71, were used to repay the debt of the empire's predecessor states. Therefore, at its foundation, the German Empire was debt free (Ullmann 2005) and the federal government's spending needs were still limited. Thanks to French gold, the war chest in Berlin-Spandau was full (Wagner 1902) and spending on civilian causes – including much of Chancellor Bismarck's famous foundations of the welfare state – was mostly upon the states (Ullmann 2005). Reflecting the interests of the money elite, the privately-owned *Reichsbank's* raison d'être was rather to act as a currency watchdog and a bankers' bank (Deutsche Bundesbank 2016). In other words, the banking system of the German Empire did not institutionalise an answer to the question of how to finance the state. This question had to be negotiated between the money elite and the *Funktionselite* throughout the course of the five German regimes.

During the German Empire (1870/71-1918) the question of how to finance the state became most virulent with World War I. The Industrial Revolution had brought with it the possibility of industrial-scale warfare. If the scale of human suffering surpassed the imagination of contemporaries, so did the actual economic costs of modern warfare. Germany's war chest in Berlin-Spandau appeared to be full by the standards of the old times only. In the new times, it turned out, the gold in Spandau was good for financing mere two days of fighting (Macdonald

2003, 414). Therefore, the German Empire needed to mobilise resources quickly. Given that the country was excluded from international financial markets after the outbreak of the war, the only possible source was domestic borrowing. Issuing eight war bonds between 1914 and 1918, William II raised US\$27 billion from small savers, wealthy individuals and corporations (Macdonald 2003, 407). The financiers saw the war and its expansionary goals as being aligned with their own interests to expand beyond the confines of the empire. However, knowing about the risks of war, they preferred lending over financing the war via tax. William II was so adamant not to tax the money elite that tax receipts actually declined during the war. As a result, Germany paid the costs of war 100 per cent out of debt and inflation. By the end of the war, the money supply had multiplied by six and the *Reichsbank* directly held a fifth of the government's debt (Macdonald 2003, chap. 9). War financing turned Germany into a quintessential debt state.

Faced with defeat abroad in September 1918 and a revolution at home in November of that year, Emperor William II abdicated and fled into exile. The November Revolution was the preliminary climax of a class struggle between the growing working and the money classes over the distribution of the wealth created throughout the Industrial Revolution and the burden of World War I. It cumulated in the proclamation of the Weimar Republic (1918-1933) by a social democrat and a socialist. During the Weimar Republic the question of how to finance the state posed itself with renewed vigour because of a combination of costs to the government: domestic debt accumulated during the war, social costs of a growing welfare state and – although less than often claimed in the German public discourse – war reparations. Despite this accumulation of public costs, the money elite remained unwilling to contribute to the state via taxation, not least because it disliked the young republic. So, the government, in cooperation with the *Reichsbank*, chose to inflate the debt away and to submit public finances to a course of austerity. Between 1918 and 1925 German debt decreased from 179 billion to 6.8 billion mark (Macdonald 2003). The chosen policies hit the working class badly. The small savers, who had invested their savings into government war bonds, lost their savings and felt the consequences of cuts in welfare programs at the same time. Worse still, with the inflation and the banking crisis of the 1920s, the cycle of money, tax and debt broke down entirely. The money elite, on the other hand, owned much of their wealth in form of land and real estate and were hence less affected by inflation. The cash that they still held was transferred abroad (Macdonald 2003; Winkler 2005). The German public only regained trust into an official tender currency when, in reform of 1923/24, the mark was replaced with the *Reichsmark* (RM), which was pegged to the US dollar at a fixed rate (Deutsche Bundesbank 2016). The US dollar became a benchmark currency in Germany.

The National Socialist dictatorship (1933-1945) found yet another answer to the question of how to finance the central government and its belligerent ambitions. It turned Germany into a tax, debt and predator state. To begin with, the banks and corporations were largely in line with the Hitler government's economic policies – not least because the government-funded recovery and remilitarisation flushed money into the pockets of the large industrial conglomerates. The close relationship between the government and its corporate creditors found its expression in the *Mefo-Wechsel*, bills of exchange between the government, the large banks and business conglomerates. The *Mefo-Wechsel* allowed the National Socialist government to debt-finance arms production (Deutsche Bundesbank 2016).

However, there was also suspicion between Hitler's *Funktionseelite* and the money elite. The banks and corporations watched warily as the role of the state in the economy grew. The National Socialists, on their part, took issue in the concentration of power in the hands of the privately-owned banks. This position vis-à-vis the banks was motivated by anti-Semitism as many bankers were Jews. But the attempt to break up the big banks was likewise an attempt by the National Socialist *Funktionseelite* to wrestle power from the money elite. Too dependent on corporate creditors, though, the National Socialists did not manage to break up the big banks (James 2004). The government's dependency on corporate creditors was rooted in the fact that the general population was in no mood to extend credit to the state. The memories of being duped by the government over its war lending after 1918 were still fresh. Therefore, the government placed government bills directly with the public-owned savings banks that had been forced into line. The small saver became, without knowing it, a creditor again. Finally, the National Socialist dictatorship financed an important amount of its war of aggression through forced extraction: occupied territories in eastern Europe had to supply raw materials and slave labour, western countries were taxed, forced to use overvalued paper money or, like Greece, to provide forced credits (Macdonald 2003).

When Germany lost the war in May 1945, it did so again with a pile of public debt. Much of Europe was destroyed and Germany, too, was in tatters. Again, the politics of debt had broken the circle of money, tax and debt. People resorted to barter. In addition, the growing tensions between the capitalist Western Allies and the socialist Soviet Union over the terms of occupation, stoked the fire of class warfare again. Under military rule the Western occupying forces, the United States, Britain and France, introduced in June 1948 the *Deutsche Mark* (D-Mark). The currency reform wiped out West Germany's public debt and re-established the circle of money, tax, and debt – again through pegging the new currency to the US Dollar. A few months earlier, in March 1948, the Allies had already established West Germany's new central bank. The new constitution, founding the Bonn Republic (1949-1989), was passed over

a year later on 8 May 1949. Note the chronology: The Western Allies introduced a currency and a central bank, *before* a new German state was founded. Recognising the priority of the Allies to establish the bank before the state leads Vogl (2015, loc. 2380) to term the Bonn Republic an ‘economic society’, in which the liberalised economy is not supposed to limit the power of the state, but to legitimate it in the first place. The local savings banks and the *Landesbanken* emerged from the upheaval largely untouched. The big banks and the newly independent *Bundesbank* were back in business by 1957. With the old banking system, the old question of how to fund the state sprung up again too.

This time, the question posed itself against the background of a state that was physically destroyed, morally and financially bankrupt and that faced the mounting regime competition between the capitalist western powers and the socialist Soviet Union. The competition between capitalism and socialism mirrored the unsolved class conflict within German society. As a result, social spending rose considerably and with it government debt, particularly in the years between 1969 and 1982 (Ullmann 2017). During the 1980s social spending and sovereign debt slowed down considerably, but the expansionary policies of the 1960s and 1970s had given the renewed question of how to finance the state an old answer: public debt.

Yet, throughout the Bonn Republic and until the end of the 1990s, the powerful and independent *Bundesbank* managed public debt in a conservative manner, focusing on long-term bonds (Trampusch 2015). That conservative outlook did, however, not apply when providing credit to others. With the economic recovery of the country, the *Bundesbank*, awash in US Dollar, pursued, in the words of Röper (1970, 456), a ‘rigorous money exporting policy.’ This policy included the direct participation of the *Bundesbank* in the Euromarkets by placing parts its US dollar reserves there. Moreover, the *Bundesbank* subsidised the about 40 German banks participating in that market by providing them with currency swaps at below market rates (Röper 1970). By the mid-1960s, this policy had turned Germany into the principal provider of Eurodollars to US banks. The large US banks borrowed US dollar from German banks and lent them on to US corporations for importing goods from Germany. The lending and borrowing between German and US banks in Eurodollar created a recycling mechanism for the abundance of US dollar circulating in the international economy. This, in turn, reduced the US balance-of-payment deficit – an effect welcomed in Washington, DC (Dickens 2005). Furthermore, in 1964 the German government introduced a 25 per cent coupon tax. The tax would not apply, however, to income from bonds denominated in D-Mark issued by non-residents. As a result, by the mid-1960s a Euro-D-Mark market had developed which adhered to the same principles as the Eurodollar market only that the issues were denominated in D-Mark. The first Euro-D-Mark bond issue was an offering for Argentina, with Deutsche Bank as the lead manager.

Deutsche soon developed into Germany's largest Eurodollar bank. Other banks that competed for leading syndicated Euro-D-Mark bond issuances were Dresdner Bank, Commerzbank and Westdeutsche, the *Landesbank* of North Rhine-Westphalia (O'Malley 2015, chap. 1). That is, from the beginnings of German engagement in the Euromarkets, some of the government owned *Landesbanken* were involved in offshore banking too.

The stability of the banking system throughout the previous regimes restricted the ability of German banks to grow their business domestically. The Euromarkets were the opportunity to do so internationally. By 1966, Euro-D-Mark bonds made up a quarter of all primary issuances. Two years later, in 1968, the *Bundesbank* initiated a committee to regulate bond issues. Part of the regulations was that all Euro-D-Mark bond issues would have to be done with a German lead manager so that the *Bundesbank* could keep control over the currency. These regulations were also in the interest of the German banks as it kept foreign competitors at bay (Moore 2004). Led by Deutsche Bank, German banks setup subsidiaries in Luxembourg which was about to established itself as an offshore financial centre. In particular Deutsche Bank was determined to make Luxembourg the main centre for the Euro-D-Mark market, the way London was the uncontested centre for Eurodollar business (Büschgen 1995).

However, as inflation rose in the US in the late 1960s, the German government became concerned that recycling US dollars would mean to recycle US inflation too. In addition, German corporations had started to borrow in the Eurodollar markets which reinforce the inflow of US dollar into the German financial system, putting the fixed exchange rate under pressure. In response to these developments, the government started to advocate for a regulation of the Euromarkets. The *Bundesbank* urged their US counterparts to setup reserve requirements for US banks borrowing in the Euromarkets. Additionally, Germany promoted in Europe introducing capital controls on corporate borrowing in the Euromarkets and a floating of the D-Mark against the US Dollar (Farnsworth 1971). Likewise, throughout the 1970s and 1980s, the *Bundesbank* kept a conservative outlook on short-term debt instruments such as credit derivatives or floating rate notes, many of which were pioneered in the Euromarkets. The *Bundesbank* regulated these instruments more strongly than its US American and British counterparts (Moore 2004). As a result of these measures, the Eurodollar market lost its anchor in the official dollar reserves of Germany (Dickens 2005). Moreover, the German banks' engagement in the Euromarkets was, though substantial, constrained compared to what the future would hold, as figure 4.5 above shows (see also Bundesbank 1997; Büschgen 1995). Nevertheless, the stakes involved in the Eurodollar business were already high during the 1970s and 1980s.

Domestic demand for Eurodollar bonds and other financial products, however, remained limited. Corporate financing – true to its 19th century roots – was still mainly based on either own (family) resources or traditional bank borrowing (Bundesbank 1997; Büschgen 1995). The borrowers of the German banks in the Euromarkets came hence from elsewhere. In the 1970s, they came from Latin America, Africa and the Middle East. In the 1980s customers from the Eastern Bloc joined the ranks. By the early 1980s, Deutsche Bank was the largest lender for supranational issues and the second largest for lending related to public investment projects (Büschgen 1995). Now the *Bundesbank's* conservative outlook was not so convenient for Deutsche Bank anymore. Echoing the politics of the invisible, in 1982, the central bank and Germany's big banks came, in Büschgen's (1995, 684) words, to the 'gentlemen's agreement' that such instruments could be traded only in US dollar. From that year onwards, Deutsche Bank became active in the Eurodollar derivatives market geared towards corporate lenders in Latin America, Africa, but also in the United States and at home. With such an exposure, the Latin American debt crisis in the early 1980s and the breakdown of the Eastern bloc at the end of the decade were fully felt on Deutsche's balance sheets. Yet, although Deutsche Bank was the biggest, it was not the only German bank operating in the Euromarket. Publicly-owned *Landesbanken* were also lead managers of Euroloans.

The 1990s were politically and economically determined by German reunification. After a first euphoria, by the mid-1990s public debt ballooned in tandem with unemployment rates. The costs of unification surpassed even the estimates of pessimist observers (Burret, Feld, and Köhler 2013). The conservative-liberal coalition had to go on a borrowing spree, while the *Bundesbank* and the money elite, watching worrisome the inflation indicators, pushed for austerity measures. Cut backs in social spending were severe and by the end of the 1990s, West Germans feared for their welfare state, while East Germans were still waiting for the 'blooming scenery' Chancellor Kohl (1990) had promised in July 1990. The combination of growing government expenses and political discontent led to an unlikely combination of forces that would allow Deutsche Bank and some *Landesbanken* to get a hitherto unseen exposure to the Euromarkets.

In 1998, Germans voted Chancellor Kohl out and a coalition of the Social Democratic Party (SPD) and the Green Party into government. With the first progressive government in power since the end of the war, the old question of how to finance the state came back with urgency. The context of the question was radically different from when it was last posed in the 1950s. For one, with German reunification the system competition had ended, but the subsequent economic repression and ballooning unemployment, had severely strained the public coffers. Furthermore, in 1999, Germany was a founding member of the Euro, a single

currency of 11, later 19, European states. A year before the Euro became the official means of payment, the ECB was established in Frankfurt as the watchdog of the new Euro currency. The introduction of the Euro and the founding of the ECB had weakened the *Bundesbank's* power. Hans Eichel, the new German finance minister, seized the opportunity to weaken the central bank further with regards to managing public debt. The new government needed money to implement the policy changes they envisaged and the *Bundesbank's* traditional conservatism towards short-term debt was unhelpful in this regard. The law governing the role of the *Bundesbank*, written by the Allies in 1948, put the German central bank outside the control of the legislative and the executive. Trying to influence the central bank's policy was hence no option for Eichel. Rather, the government established a publicly owned private liability company that would henceforth replace the *Bundesbank* as the manager of sovereign debt. The new Federal Finance Agency immediately moved to substitute the *Bundesbank's* conservative debt strategy with a market-based funding approach, including short-term debt and the use of instruments such as interest rate swaps and other derivatives (Trampusch 2015). Likewise, the municipalities and states, which had to bear the brunt of the costs of unemployment benefits, were severely stripped of revenue. Refinancing themselves at the money markets appeared like a good solution to their conundrum (Trampusch and Spies 2015). The *Landesbanken* were happy to issue debt on their states' and communes' behalf. Their domestic business model was not particularly profitable, and the state guarantees allowed them to refinance themselves at the international markets under good conditions.⁴³ The big commercial banks did not like the *Landesbank* on their turf. They saw the state guarantees as an unfair advantage of the *Landesbanken* and initiated proceedings against them with the European Commission. The Commission decided in favour of the commercial banks. To help the *Landesbanken* adjust to the new competitive framework, the federal government gave them an adjustment period of three years. Knowing that they would soon have to refinance themselves at worse terms, the *Landesbanken* leveraged up in particular at the Euromarkets. The so mobilised funds were then invested on in foreign assets. This business was mainly done through Ireland.⁴⁴ Between 1998 and 2008, bearer bond refinancing of the *Landesbanken* taken together developed from about €310 billion to €475 billion (Hüfner 2010). These numbers cannot be fully compared with the Eurodollar exposure pictured in figure 4.5 as there is no currency breakdown for the *Landesbanken* statistic. A large part of these bearer bonds were Eurobonds. That is, next to

⁴³ Author's interview with banker, Berlin, February 2017.

⁴⁴ Author's telephone interview with offshore expert, August 2018.

Deutsche Bank, the *Landesbanken* account for the steep increase in Eurodollar exposure between 1998 and 2007.⁴⁵

Once the foreign investments of the *Landesbanken* turned out to be toxic assets and were downgraded in the course of the Financial Crisis, the leverage of the *Landesbanken* became untenable. In consequence, the federal government merged two *Landesbanken* and bailed out three others. Subsequently, the *Landesbanken* retreated from the Euromarkets, as the strong decline in transactions with Irelands in figure 4.4 reflects. That is, post-2007 Deutsche Bank, historically the German leader in the Euromarkets sustained its Eurodollar business throughout the Financial Crisis as more or less the only relevant German bank.⁴⁶ The relative stability of transactions between Germany and Luxembourg in figure 4.4 is again indicative of that development.

Offshore money creation had become a lucrative, but risky business for a select number of German banks. Driven by the export-orientation of the German economy and the related US dollar overhang, particularly in the 1960s and 1970s, Germany played an enabling role in the development of the Euromarkets. However, the limited debt issuance by the federal government and German corporations in combination with a stricter regulatory environment has prevented offshore money creation to become a substantial element of Germany's cycle of money, tax and debt. The next section analyses what offshore finance means for the tax part of that cycle.

Taxation

The nature of the institutional association of rule also shaped the German tax system. As with banking, taxation has been marked by the stability of the money elite and the changing nature of the *Funktionseelite* throughout the five regimes between 19th century imperial Germany and today. With the notable exception of the Weimar Republic, the money elite has had, throughout modern Germany's history, a basic willingness to contribute to the state if that meant to safeguard its own privileged position. The founding moment of this basic willingness to contribute was Germany's aborted March Revolution of 1848. Just as the French forerunner in 1789, the revolution started as tax revolts. Siding with the revolutionaries, the Prussian national assembly decided for a tax boycott to bring down the monarchy. Yet, the boycott found little support among the bourgeoisie. The wealthy opted to pay taxes rather than to risk a full-fledged revolution (Ullmann 2005). The different answers given to the class struggle underlying Germany's altering political regimes reflects the continuous change in the *Funktionseelite*. Class warfare started with industrialisation in the mid-19th century, coined the Weimar Republic and

⁴⁵ Author's interview with banker, Munich, November 2018.

⁴⁶ Author's interview with banker, Munich, November 2018.

peaked with the cold war. The class struggle expressed itself in demands of the working classes to participate politically and economically in the institutional association of rule. Throughout time, the money elite was, as established during the failed March Revolution, willing to pay for some of the economical demands to keep the political ones at bay (Schmidt 2012). The inclination to pay tax rather than to share power reflects the stability of the money elite. For the state to stay legitimate, the changing *Funktionselite* had to mediate successfully between the working classes and the money elite over the collection and distribution of tax revenue.

Contrary to the bank system that emerged in conjunction with the German Empire in 1870/71, the German tax state emerged earlier and from the level of the individual states. For instance, in 1820 a new law on government debt was passed in Prussia, obliging the otherwise absolutist monarchy to convene a national assembly should it wish to issue debt. In response, William III of Prussia went at length to avoid sovereign debt: he mobilised revenue through indirect taxation and through state-owned railroad companies. Moreover, he ruled by the principle of the frugal state, avoiding expenses where possible. However, already in the early 19th century, policy-makers and scholars criticised the regressive nature of indirect taxation. Over time, the weighing of frugality versus tax justice mounted in a convergence of the political and scholarly debate around the notion of a principle of performance: those who have more should contribute more, and who contributes more should get more in return. The principle of performance linked the income with the expenses side of nascent imperial tax system (Ullmann 2005). The strong role of the individual states in tax policies, the weighing of frugality versus tax justice and the principle of performance are all still echoing in Germany's contemporary tax system.

Within the first decade of the German Empire, Saxony was the first state to introduce a progressive general income tax. Prussia followed suit in 1893 (Ullmann 2005). The decision on how to respond to the mounting pressures from the working classes for more participation in the empire's growing wealth came, however, from the federal level. Between 1876 and 1914 Chancellor Otto von Bismarck initiated, in response to the increasing influence of social democracy, a health, occupational accident and old age insurance system (Schmidt 2012). This system also embraced the 'principle of performance': the higher the pay, the higher the contributions and the higher the benefits in the insurance case. Furthermore, the old age insurance established the sharing of contributions between employer and employee. The principle of shared contributions is later extended to all pillars of the social insurance system. Shared contributions are still a hallmark of the contemporary social insurance system. It reflects, on the one hand, the basic willingness of the money elite to contribute. On the other

hand, it means that the pacification of class warfare became a corporate cost, not a direct reduction of the money elite's private wealth via taxation.

By 1914, the income tax systems of the different states had converged, and the tax became the most important source of government revenue. Yet, as the income tax spread, so did resistance towards it. As income taxes presuppose the correct declaration of income by taxpayers and their willingness to contribute was reaching its limits, the government became more vulnerable to tax evasion. In response, Saxony and some of the southern states developed strong tax enforcement capacities. Prussia, on the other hand, staying true to its leitmotif of the frugal state, considered a specialised tax administration too expensive. It opted for strong laws in combination with weak law enforcement, an emphasis on privacy of the individual taxpayer and general leniency towards the mistakes the layman may make in their tax declaration (Ullmann 2005). In other words, Prussia became complicit in tax evasion. At the eve of World War I, taxes made up 64 per cent of public revenue, fees 27 and debt eight per cent (Ullmann 2005). As discussed above, anxious not to further alienate the money elite, the Emperor decided to finance the war via debt.

The Weimar Republic, following the defeated German Empire in 1918, therefore had broken public finances from day one. Unemployment and the impoverishment of large parts of the population, caused by the war and the renegeing of government debt, gave class warfare an hitherto unknown fierceness (Schmidt 2012). Yet, the strained financial situation during the early Weimar years did not provide much leeway to extend social welfare programs. The new *Funktionseelite*, broader than the old imperial one because of the introduction of universal suffrage and the unionisation of the working class, tried to put the young republic on financially solid ground. The first finance minister, Matthias Erzberger, a centrist, centralised tax administration and legislation in order to reform it. This reform included top rates of 65 per cent on income and wealth. The new tax system would prove to be more durable than the Weimar Republic itself. The high tax rates on the wealthy were short-lived though. They did not survive the resistance of the money elite, which expressed itself in capital flight and tax evasion justified as opposition against an unpopular democratic and, in its beginnings, left-leaning republic (Ullmann 2005). Nevertheless, the tax revenue generated through the reform and the relative economic recovery between 1924-1928 allowed the conservative government to pacify the class struggle by introducing unemployment insurance. After that short respite, however, renewed economic recession led the government on a course of austerity. The gains made by the working classes throughout the Weimar Republic were largely lost again (Schmidt 2012).

Despite the social, political and economic upheaval that followed the years of National Socialist Germany (1933-1945), the tax and social security systems remained largely

unchanged. The social insurance system provided little opportunity for political exploitation and the new National Socialist *Funktionseelite* recognised early on that the money elite was – as during the German Empire and the Weimar Republic – unwilling to fund an expansion of the state via taxation. However, the National Socialist government tried to improve the tax morale of the population by framing tax payments as a devotion to the German nation. Moreover, in line with the regime’s anti-Semitic ideology, the Hitler government systematically looted the Jews. In the fiscal year 1938/39 alone, the forcibly extracted resources amounted to five per cent of the regime’s revenue. The expropriation of the Jews was possible, among others, by the centralisation of the tax administration as introduced by Erzberger in the 1920s (Ullmann 2005). During the occupation, the United States was thus adamant to return Germany to a federalised tax system. Tax administrations were again fragmented and are – to this day – accountable to the state, not the federal level. Consequently, the states must finance the tax administration and law enforcement. Yet, they must pass on much of the recovered revenue to the central government. State government have thus incentives for strong laws combined with weak enforcement (Tax Justice Network 2018a) – a strategy already well known to the Prussians.

After World War II, taxation and class struggle in the Bonn Republic (1949-1991) stood under the sign of regime competition between the capitalist western and the socialist eastern blocks. The money elite in West Germany was wary of socialism across the border. The threat of an economic system that might jeopardise their property rights, motivated the money elite to contribute to the West German state via tax payments and social security contributions. However, true to the principle of performance, their contribution was knit to an expectation of economic state support. The 1950s to mid-1970s were hence marked by an unprecedented expansion of the state and its expenses. During these years the principle willingness of the money elite to contribute to the state, the legacy of the National Socialist notion of taxation as a contribution to the nation and the constitutional setup of West Germany as an economic society merged. Taken together, they made the notion of the tax state part of Germany’s post-war national identity.⁴⁷ However, with the oil shocks in the mid-1970s, the expansionary policies came under pressure. Therefore, starting in the 1980s and taking up speed with the end of the regime competition in 1989, the 1990s and early 2000s saw a gradual, but significant change in the tax system of the Berlin Republic (1991 until today).

Successive tax reforms separated the corporate and capital income tax assessment from the personal one. Corporate and capital income tax thereby changed from a progressive to a flat rate tax with lower rates than in the past (Bach 2016; Ullmann 2017). These reforms allow the

⁴⁷ Author’s interview with civil society organisation, Berlin, March 2017, with tax expert, Berlin, February 2015.

money elite to hold their private wealth as corporate wealth and be hence taxed at lower rates than people with wage income (Bach 2016). The money elite was also successful in avoiding wealth and inheritance taxes by arguing that these taxes would threaten the survival of family-owned businesses, the backbone of Germany's economy.⁴⁸ Compared to the post-war years, the proportion of corporate tax as percentage of GDP about halved (Corneo 2004).⁴⁹ The government's revenue is now mostly funded by social security contributions (38 per cent), followed by taxes from personal income, profits and gains (27 per cent). Consumption taxes are the third most important source of tax revenue (28 per cent). Taxes on corporate income contribute only five per cent (OECD 2017a). However, the tax reforms did little to relieve the pressure of progressive personal income taxation on those with high incomes in the middle classes. Unable to break the public consensus that all classes are supposed to contribute according to their means, the conservative governments provided their upper middle income and wealthy voters with a back door: the politics of the invisible.⁵⁰ From the 1950s until well into the early 2000s, successive conservative governments, in Prussian fashion, actively turned a blind eye to individual tax evasion via offshoring. In the words of one interviewee:

*'Using offshore finance for minimising personal taxes was a mass phenomenon and at least the conservative parties did not want to alienate their voters by outlawing offshore financial services. The motivation to address the issue was probably also chocked off by the fact that the CDU used the offshore system itself to hide their illegal party finances.'*⁵¹

The reforms maintained the identity of Germany as a tax state, yet on the individual level resistance to personal income tax was high. Offshore tax evasion culminated around 2007 at the estimated annual personal income tax loss of US\$199 million (see above). The change to that state of affairs came – as has been the case historically – from the state level. In 2006, the tax administration of North-Rhine Westphalia actively started to work against the federal level's politics of the invisible. It bought leaked data from banks in Liechtenstein, Switzerland and Luxembourg to investigate individual tax evasion. These so-called CD-purchases (the first leaked data sets were stored on a compact disc) revealed the identities of tax cheating wealthy Germans. The CD-purchases were soon followed by public leaks, including the *Panama*

⁴⁸ Author's interview with member of parliament, Berlin, January 2017; with tax expert, Berlin, February 2017; with civil society organisation, Berlin, March 2017.

⁴⁹ Author's interview with civil society organisation, Berlin, March 2017.

⁵⁰ Author's interview with civil society organisation, Berlin, March 2017; with tax lawyer, Berlin, January 2017.

⁵¹ Author's interview with tax lawyer, Berlin, January 2017.

Papers. Together, the CD-purchases and leaks pressured offshore banks and their tax evading clients into coming clean. The leaks delegitimised the large-scale mass tax evasion via offshoring.⁵² A wave of voluntary self-declarations ensued, flushing between 2010 and 2014 over four billion Euro into the state's coffers (Seibel 2014). In addition, the government started to tighten the laws around voluntary self-declarations and financial transparency.⁵³ At the same time, the money elite entered a generational transition. The large fortunes accumulated after World War II are now handed to the next generation. In the process of inheritance offshore structures complicate matters. As one wealth manager put it:

*'The heirs just don't want to bother with the offshore accounts. They fear waking up in the morning, learning from the newspaper that their money is involved in some illegal structure. They don't want to worry. They just want to get rid of all the structures.'*⁵⁴

A tax lawyer confirms:

*'It is mostly elderly people who come to us, hoping to fix their tax affairs so that they can handover clean money to the next generation.'*⁵⁵

In combination, the public scandals, the legal changes and the inheritance question have led to a paradigm shift about offshore tax evasion, explaining the dip in fiduciary funds held in Switzerland (Swiss National Bank n.d.).

As the quantitative analysis above demonstrated individuals use offshore finance for tax planning purposes more extensively than corporations. Yet, this does not mean that corporations do not practice offshoring. Tørsløv et al. (2018) estimate that in Germany profit-shifting brought the corporate tax rate down from 30 per cent nominally to 11 per cent effectively. This number obscures, however, that the effective tax rate did not drop for all sorts of corporations equally. Since profit-shifting is mainly done by multinational corporations, most local firms still pay the 30 per cent corporate tax rate. This means the effective corporate income tax for multinationals firms is well below 11 per cent. It also means, however, that a good proportion of German corporations pay their tax.

The reason for the relative constraint of corporations when it comes to offshore tax planning can be found in the success of the money elite – the coalition of corporate owners and bankers – to influence the onshore corporate tax rate environment in their interest. No other

⁵² Author's interview with tax lawyer, Berlin, January 2017.

⁵³ Interview civil society organisation, Berlin, March 2017; with tax lawyer, Berlin, January 2017, with staff at the finance ministry, Berlin, March 2017.

⁵⁴ Author's telephone interview wealth manager, January 2017.

⁵⁵ Author's interview with tax lawyer, Berlin, January 2017.

group of tax payers has seen such a radical reduction of their tax burden since the beginning of the Berlin Republic. Yet, again true to the principle of performance, the lower contribution to the state's tax revenue also meant that the state became less lenient with regards to offshore tax planning. Throughout the 1990s and 2000s the German government has passed unilateral defensive laws against aggressive tax planning and signed up to such laws on the European and international level. However, in the context of the OECD BEPS process, the strong link between the money and *Funktionseiliten* showed again. Defensive of their own multinational corporations, the German government practiced the old strategy of committing to strong rules, while neglecting their enforcement and emphasizing the privacy of the individual corporate taxpayer. Germany is, for instance, the only European state that will not publicise the results of the now legally required county-by-country reporting of corporate annual results.⁵⁶ That institutional association of rule keeps a backdoor open for being complicit in tax evasion. What these findings mean for how offshore finance affects the power of the state to finance its politics is the subject of the following section.

3 Offshore finance and state power in Germany

The German state has actively shaped its relationship with offshore finance. It laid the ground for offshore money creation by German banks and allowed, for a long time, offshore tax planning to flourish. Certain parts of the *Funktionseilite* even used offshore financial services to launder money. The relationship between offshore finance and the German state is hence not an antagonistic one. Yet, the fact that the German state called, as the sorcerer's apprentice did, the spirits itself, does not automatically mean that it commands them. The question is whether the German state, understood as the institutional association of rule made up of the money elite and the *Funktionseilite*, is in control of the offshoring it allowed its economic actors to engage in.

From the German Empire through to today, the German banking system was able to create the money needed to finance capitalist expansion. However, the stable and regulated nature of the banking system limited the ability of the commercial and *Landesbanken* to expand their business. In the 1960s, following the lead of Deutsche Bank, the commercial and publicly-owned *Landesbanken* became important players in the Eurodollar markets. Their participation in offshore money creation was initially facilitated by the decision of the *Bundesbank* to recycle its US dollar overhang in the Euromarkets. The effect of the resulting exposure to the Eurodollar

⁵⁶ Author's interview with employee of OECD, Paris, July 2017; with civil society organisation, Berlin, January 2017.

markets on the power of the German state changed overtime. We can broadly distinguish three phases.

The first phase lasted from 1960 to 1998. During that time, German banks profited from offshore money creation. The *Bundesbank* regulated that activity such that Euromarket exposure would not undermine its monetary policy. Therefore, the power of the state to finance its politics was unaffected, the balance-of-payments surplus lessened. Offshore money creation was aligned with the state's interests. The second phase lasted from 1998 to the 2007-2009 Financial Crisis. This phase was marked by financial deregulation and the introduction of the Euro. Taken together, these two events significantly increased the exposure of Deutsche Bank and the *Landesbanken* to the Euromarkets. As the pre-eminent D-Mark bank, Deutsche used the monetary union to position itself as the world's largest foreign exchange trader, which provided the means to engage fully in the Euromarkets. The *Bundesbank* was aware of these developments. It did not blink.⁵⁷ From the perspective of the institutional association of rule, offshore money creation became a means to keep liberalisation and internationalisation outside the German banking system, while still catering to the interests of Germany's big banks and export industry. Yet, once the Euromarkets froze in 2007, it became clear that offshore money creation is a risky business. The German Eurobanks transmitted international fragilities into the otherwise conservative and stable German domestic banking system. The entire system was on the brink. The response to the crisis made the German state dependent on support from the Federal Reserve (see chapter 2). It also cost about a quarter of German GDP (Hüfner 2010). During this second phase, offshore money creation, the state had to put up a lot of political and economic capital to retain control over offshore finance. Tensions between the *Funktionselite* and the money elite mounted. In response to the Financial Crisis, the *Landesbanken* withdrew from the Euromarkets and Deutsche Bank's engagement became largely limited to the on-balance sheet transactions. Yet, Deutsche Bank remains important to finance the export industry's international business in Eurodollars. In the absence of alternatives to the Eurodollar, Germany did not come off the system after the crisis. The impact of the continued exposure to the Euromarkets on state power in the contemporary phase is yet an open one.

Moving to offshore tax planning, it is important to consider that, historically, the German state found various ways to finance itself. The money elite was willing to pay tax to preserve the existing order. Yet, it was much less willing, particularly compared to its British counterparts, to pay tax to wage war. War had to be paid for by other means. Therefore, the German Empire and National Socialist Germany were to a considerable extent predator states,

⁵⁷ Author's interview with banker, Munich, November 2018; with offshore finance expert, August 2018.

forcibly extracting resources from other countries through invasion and from their own population through repression and terror. In addition, modern Germany has been from the late 19th century until today, a social security state. The state owns most elements of the social insurance system and contributions, directly deduced at source, are by law shared between employers and employees. Social security contributions are often lumped together with general tax payments, in the public discourse as much as in economic statistics. However, from the money perspective, the differences are profound. For the government social security contributions mean that revenue is directly linked to specific expenses. Social security contributions limit the discretionary spending power of the state. For the money elite, shared social security contributions are a means to pacify the class struggle in form of corporate expenses, not in form of a direct reduction of their personal wealth. The success of this model of public finance is reflected in the fact that today income inequality is at the level of 1913 (Bartels 2017), while the intensity of class warfare is not. As social security contributions are difficult to evade offshore, the government fenced off one important source of its income from offshoring.

Since the early days of the Bonn Republic, offshore tax planning, individual and corporate, has been an expression of how the *Funktionselite* did – or did not – accommodate the money elite’s interest to lower its tax burden. On the side of individuals, we can distinguish two separate phases. First, between the beginning of the Bonn Republic and the late 1990s, the state implicitly allowed them to minimise taxes offshore. This leniency was an expression of the close relationship between the money elite and the conservative *Funktionselite* in the early post-war years and from 1982 until 1998. In addition, it is possible that this *Funktionselite* under the Adenauer and Kohl governments had no interest in regulating offshore financial services as it was using it for its own purposes. Yet, with the beginning of the second phase in the late 1990s, offshore tax evasion became so pervasive that it threatened the notion of Germany as a tax state. Successive governments on the state and the federal level set out to curb it, apparently successfully.

Corporate tax planning, on the other hand, has been restricted in its aggressiveness and scope. Though corporate financing diversified in the past decades, corporate financing through own (family) capital and bank borrowing is still dominant compared to market financing. Consequently, it is rare for German corporations to access credit directly in the Euromarkets. Additionally, the German tax code is defensive against aggressive tax planning. Together, corporate financing and defensive laws limit the flows to offshore financial centres that could be used to optimise the corporate tax bill. Moreover, as an intrinsic and stable part of the association of rule, the money elite successfully aligned tax reforms since the late 1990s with

their interests. Moreover, true to the ‘principle of performance’, paying (relatively) high tax rates comes with returns in form of economic subsidies and other government support. Overall, in Germany, the incentive structure is set against large-scale corporate offshoring. That does not mean, however, that German corporations do not go offshore. Yet, if they do so, it is often explicitly to avoid taxation. Offshore tax planning for the sake of offshore tax planning has considerable transaction costs, though. These costs must be carefully weighed against the benefits of remaining onshore.

In sum, offshore money creation, money laundering and tax planning have become a substantial part of the Bonn and Berlin republics. Yet, in most circumstances it remained within the control of the institutional association of rule. Individual offshore tax planning aligned with the state’s interests. In addition, income from social security and therefore funding for welfare state policies was largely safeguarded from the politics of offshore finance. Once individual tax planning became fiscally and politically expensive, it was successfully reined in by the state. Corporate tax planning is comparatively restraint, for corporate offshore debt issuance was limited and onshore taxation favourable. The important exception to this overall picture was the Euromarket exposure of the *Landesbanken* and Deutsche Bank pre-2007. The crisis response was politically and economically expensive. It strained the hitherto close relationship between the money and the *Funktionselite*. Post-2009, the *Landesbanken* retreated from the Euromarkets. Yet, the export-orientation of Germany’s economy does not allow for a full retreat from the Euromarkets. The Eurodollar exposure is now concentrated almost exclusively in Deutsche Bank. With its crisis response, the German state reigned in offshore money creation. Yet, in the current setup, the question is for how long.

V Brazil: Inflation and Eurodollar dependency

With this chapter, I leave Europe, the cradle of offshore financial services, and turn to Latin American, one of the regions supposedly hardly hit by their availability (see Zucman 2013a). I start with Brazil, the region's largest economy. Brazil is, despite phases of profound growth, still a developing economy. Moreover, Brazil faces important governance problems, in particular regarding corruption. Even though Brazil is, contrary to the other countries, removed from major offshore centres, it therefore comes as no surprise that offshore financial services have a deep impact upon the power of the state to unite the resources to finance its politics. The nature of this impact changes over time but is always driven by Brazilians' use of offshore banking services, rather than tax planning.

The chapter is structured in the same way as the previous ones. It first establishes empirically the scope and patten of the demand for offshore financial services in Brazil. Unlike in the other countries, however, there is domestic quantitative data on offshoring available. By law every Brazilian corporation and individual with external assets worth US\$100 thousand or more is required to report these assets. Since 2007, the *Banco Central do Brasil* has made that data publicly available as part of the annual Brazilian capital abroad (CBE) survey.⁵⁸ This allows us to triangulate and complement the BIS data with quantitative and qualitative data form national sources. In the second step, the chapter provides an historically embedded analysis of the Brazilian state from the money view. It then brings the two previous analyses together and determines how offshore finance affects the power of the Brazilian state to unite resources to finance its politics.

1 The uses and abuses of offshore finance

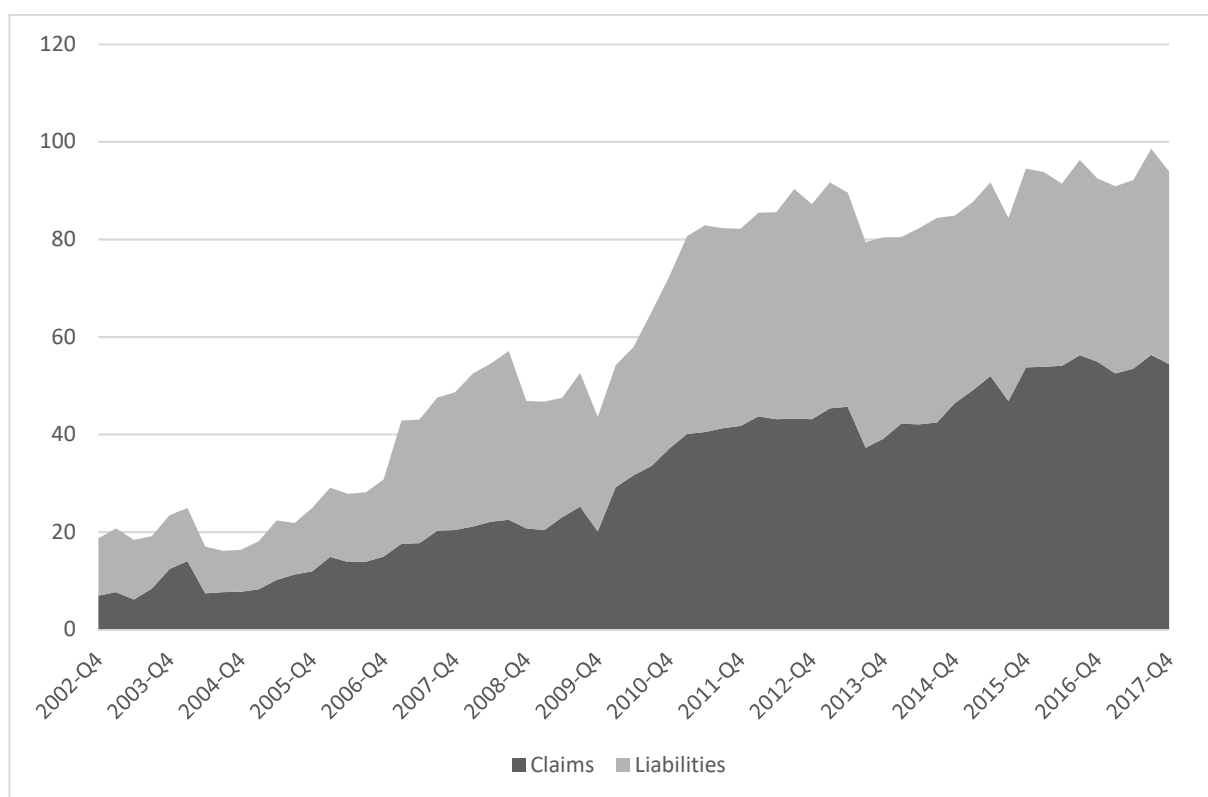
Again, as in the German case, the interview results all pointed into the same direction. According to the interviewees, offshore finance plays a central role in Brazil's political economy. This central role, they argue, commenced with wealthy Brazilians' flight in safe assets in response to historically high levels of inflation in combination with exchange controls. If you were to protect your money in US dollar, you had to do it illegally and offshore. Inflation has been reined in compared to the past. Exchange controls have been largely abandoned since. Yet, offshore financial services remain part and parcel of money laundering from all sorts of

⁵⁸ See appendix 1 for details.

financial crimes committed by Brazilian individuals and corporations. Next to the abuses of offshore financial services, there are, according to the interviewees, also legal reasons for economic actors to go offshore. The most important of which is access to US-dollar-denominated credit. Tax planning is another important reason to go offshore, but the Brazilian tax authorities are described as powerful and able to rein in excesses. The interviewees estimate that the illegal uses of offshore finance match or even exceed the legal uses discussed in the two sections above.⁵⁹

Figures 5.1 and 5.2 show the overall scope of Brazilian demand for offshore financial services based on BIS data.

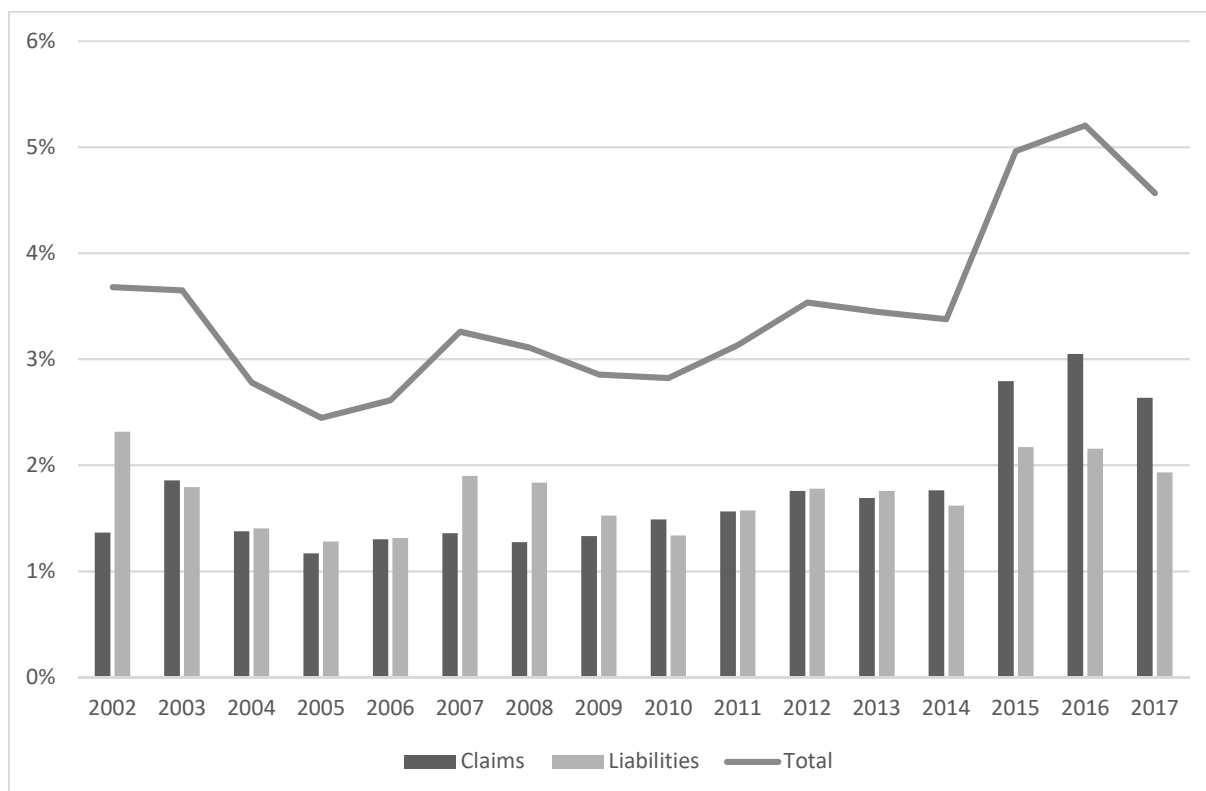
Figure 5-1. Uses of offshore financial services (in US dollar billion, quarterly)



Source: BIS locational banking statistics

⁵⁹ Author's interviews with anti-money laundering expert, defence lawyer and representatives of civil society organisations, São Paulo and Rio de Janeiro, April 2017.

Figure 5-2. Uses of offshore financial services (percentage of GDP, annually)

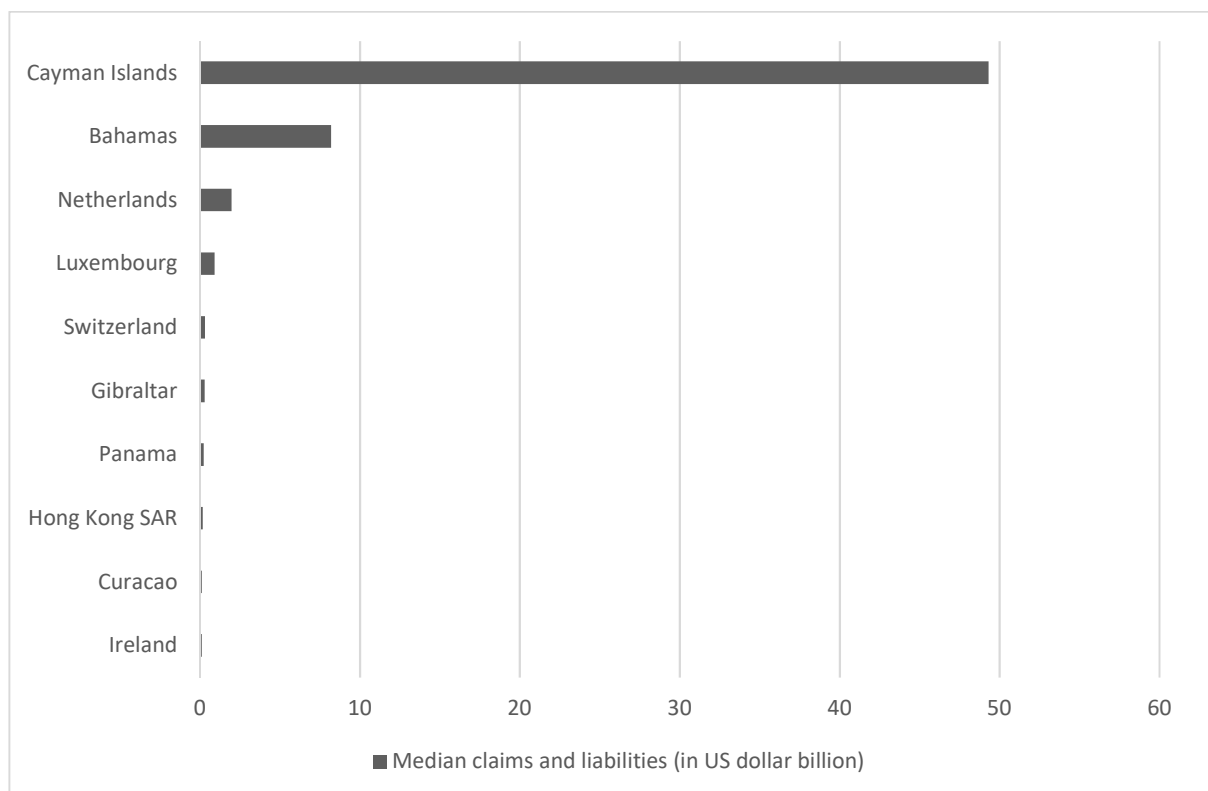


Source: BIS locational banking statistics, World Bank, own calculations

According to this data, offshore assets continuously grew from about US\$7 billion in 2002 to US\$20 billion in 2007 and then to US\$54 billion in 2017. This corresponds to a growth from one to three per cent of GDP in the same time frame. The CBE survey reports for 2007 offshore assets of US\$98 billion in 2007 to US\$269 billion in 2016. This corresponds to seven per cent of GDP in 2007 and 15 percent in 2016 (Banco Central do Brasil 2017). That is, due to off-balance sheet transactions and other measures that make offshore transactions invisible (see chapter 1), the BIS data underreports offshore assets by a factor of five. CBE survey also disaggregated offshore assets by asset class, revealing that foreign direct investment, in equity and debt, is by far the most important and the fastest growing offshore asset held by Brazilians.

In terms of where these offshore investments go, the offshore financial centre most popular with Brazilian economic actors is according to both data sources, by far the Cayman Islands (figure 5.3 below). The Bahamas and the Netherlands follow with a long distance according to BIS data. The CBE survey reports a similar picture but registers after the Cayman Islands, again with a long distance, the British Virgin Islands as number two, closely followed by the Netherlands (Banco Central do Brasil 2017). Indeed, analysed the other way around, according to IMF investment data, Fichtner finds (2016) Brazil as is the Cayman Island’s fourth largest investor.

Figure 5-3. Popular offshore centres



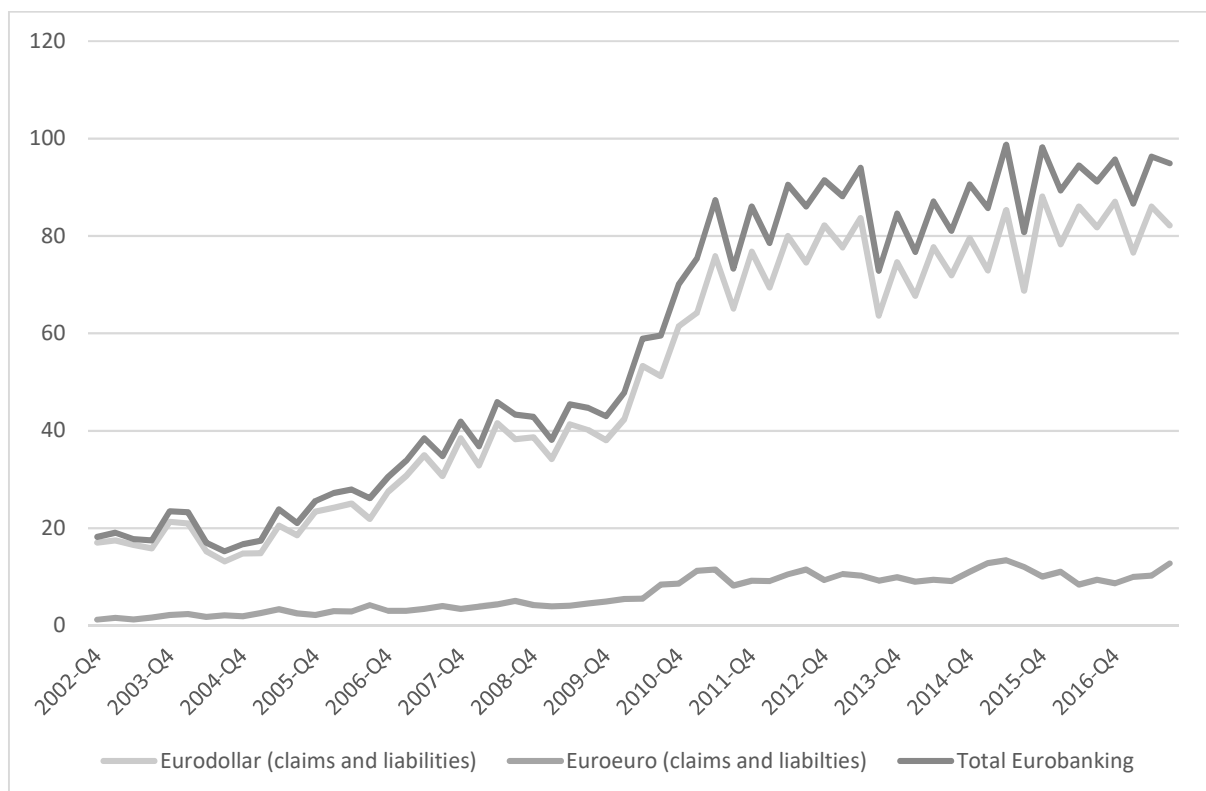
Source: BIS locational banking statistics

In sum, as of 2016, Brazilians are holding legally obtained and declared offshore assets, mostly in the Cayman Islands, and mostly in form of direct investment in equity and debt instruments. These offshore assets are, according to the CBE survey data, worth US\$269 billion or 15 per cent of GDP. As significant as these offshore assets are, they are only part of the picture as they leave out offshore debt. In the next two sections I hence combine the CBS data with data from the BIS locational banking statistics to estimate Brazil's Eurodollar exposure. A detailed discussion of the estimation method and its assumptions and limitations is provided in appendix 1. In the following section, I summarise the most important findings.

Money creation

According to the BIS data, Brazilian Eurodollar claims developed from US\$6.1 billion in 2002 to US\$47.4 billion in 2016. In the same timeframe Eurodollar liabilities developed from US\$11.6 billion to US\$37.8 billion. Most of the time Eurodollar liabilities slightly exceed Eurodollar claims (see figure 5.4). That is, Brazilian economic actors use offshore financial services more to access credit than to invest or protect their money. The relationship reverses during the Financial Crisis and the recent Brazilian recession. Here Eurodollar claims exceed Eurodollar liabilities.

Figure 5-4. Total exposure to Eurobanking (in US dollar billion, quarterly)



Source: BIS locational banking statistics

As explained in chapter 3, from the perspective of state power, offshore claims and liabilities affect the power of the state differently, but collectively. In combination, Eurodollar claims and liabilities range from US\$17 billion in 2002 to US\$82 billion in 2017, equalling 4-5 per cent of GDP. These numbers alone document a considerable exposure to the Eurodollar system, but as mentioned above, BIS data systematically underestimates the true size of the offshore phenomenon. The Brazilian case now provides the unique opportunity, due to the availability of CBE survey data, to come to a more realistic quantitative estimate of Eurodollar exposure.

To do so, I apply the ratio of US-dollar-denominated offshore transactions and the ratio between claims and liabilities from the BIS statistics to the CBE data for the year 2016, the last year where data is available in both sets. According to the BIS, out of all offshore claims in that year 80 per cent were denominated in Eurodollar. The CBE survey, on the other hand, records for 2016 offshore claims of US\$269 billion across all currencies. Applying the BIS ratio of 80 per cent to the CBE reported offshore claims means that US\$215 billion of offshore claims are denominated in Eurodollar. Moving on to the other side of the balance sheet, the BIS data reports that in 2016 Eurodollar liabilities amounted to US\$35 billion, claims to US\$54 billion. That is, the liabilities amounted to 65 per cent of the claims. Applying this ratio to the CBS data means that the estimated Eurodollar liabilities amount to US\$139 billion (65 per cent of US\$215 billion). As in the previous estimate, I add claims and liabilities to come to an estimate of overall

Eurodollar exposure which amounts to US\$381 billion or 21 per cent of GDP in 2016. This result is four times more than the BIS statistics suggest and appears to be in line with the claim of interviewees working in foreign exchange markets that the Eurodollar market is the largest international funding market for Brazilian firms.⁶⁰ Table 5.1 below summarised the two different estimates of Brazil’s Eurodollar exposure.

Table 5-1. Different estimates of Eurodollar exposure

2016		
	BIS LBS data	BIS LBS & CBE data
Eurodollar claims	US\$47 billion	US\$215 billion
Eurodollar liabilities	US\$35 billion	US\$166 billion
GDP Ratio	5 per cent	21 per cent

Source: Banco Central do Brasil, BIS locational banking statistics, World Bank, own calculations

Tax planning

After having estimated Brazil’s exposure to the Eurodollar markets, I now move to the taxman’s potential loss due to offshore tax planning. Under the assumption that all offshore assets go untaxed and would be taxed at the full nominal rates if moved onshore, the potential tax loss from offshore tax planning is the amount of offshore assets multiplied by the onshore income tax rate. For simplicity reasons, I apply an average tax rate between the personal and the corporate income tax.⁶¹ In Brazil the income tax rates remained stable 2002 to 2016 at 34 per cent for corporate and 27.5 per cent for personal income. Based on these assumptions and the BIS data, the tax loss for the Brazilian government ranges between US\$2 billion or 0.4 per cent of GDP in 2002 and US\$17 billion or one per cent of GDP in 2016.

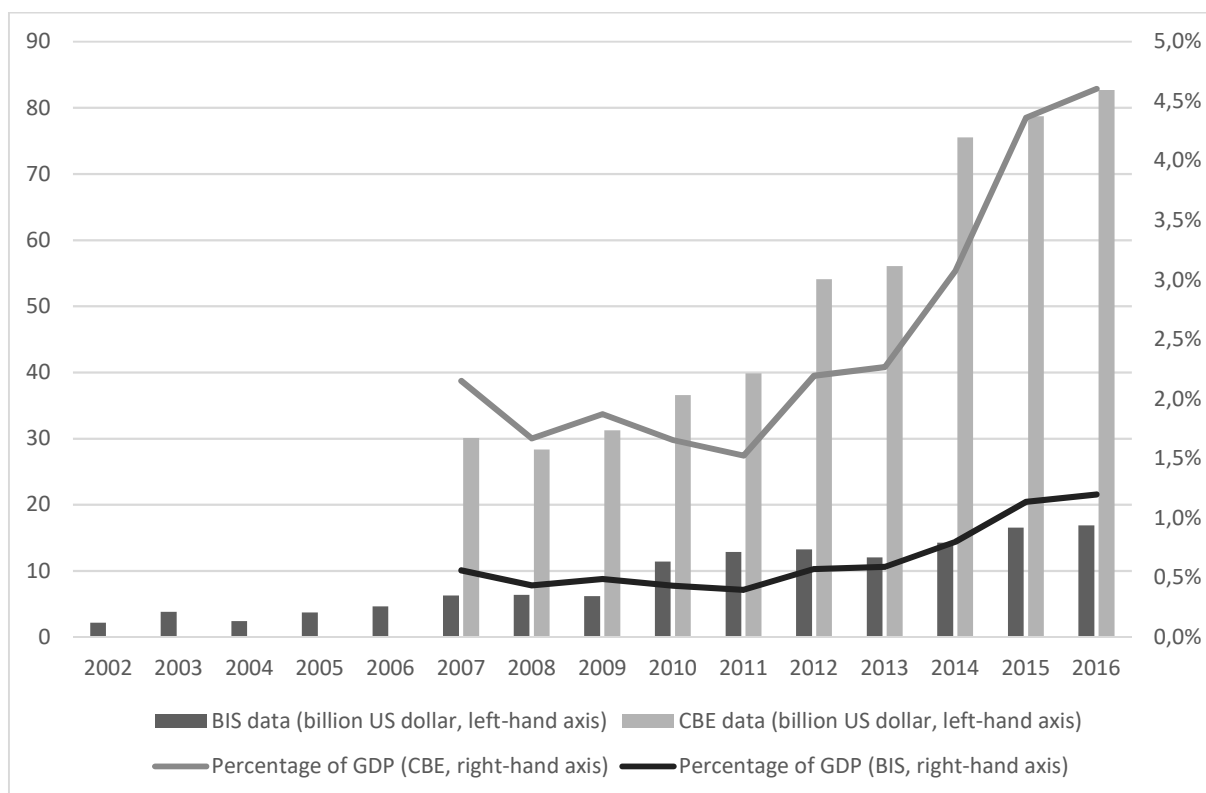
As discussed above, the CBE data reports five times more offshore assets than the BIS. The related tax loss based on this data would amount to US\$30 billion or two per cent of GDP in and US\$63 billion or five per cent of GDP in 2016. However, given that the assets are declared it is likely that they have been taxed at the capital gains tax of 22.5 per cent. If we consider that some of the assets are already taxed, the potential tax loss amounts to the difference of the offshore and the onshore tax rate (roughly 8 per cent). In this case, the potential

⁶⁰ Author’s telephone interview with financial analyst, May 2017; author’s interview with banker, Rio de Janeiro, April 2017.

⁶¹ See appendix 1 for details.

tax loss is similar to the estimate based on BIS data. It ranges between 0.5 to one per cent of GDP. Figure 5.5 compares the two estimates.

Figure 5-5. Estimated tax loss



Source: BIS locational banking statistics, Banco Central do Brasil, World Bank, own calculations

This estimate covers tax planning through offshoring assets only. Yet, as interviewees reported, Brazilian corporations also use offshore debt to plan their taxes. Here, it is even harder to come to conclusive estimates, not least because offshore credit is particularly strongly concentrated in Brazil's oil, gas and mining sectors, who indeed need foreign borrowers to help finance their operations. That means, it is very likely that all those corporations active in the offshore debt markets structure their debt issuances in a tax efficient manner. The following quote from a Brazilian corporate tax lawyer describes a classical scheme:

[W]e get pre-export finance from the group so instead of going to the bank market, we get credit from our group, which is based in Luxembourg. [...] Luxembourg is, since 2011, no longer considered a tax haven in Brazil anymore, so [...] our withholding tax rate for any sort of business we have with Luxembourg is 15 per cent. If Luxembourg were considered a tax haven, we should pay withholding taxes of 25 per cent. The group has money to finance itself – that is why we get money from our [group]. So, it is easier for us to make the export processes. The money that we get, we consider as a debt, so

*these are expenses to the company. So, from the tax perspective, those expenses are deductible. [...] The money that we pay as an interest for the group it should be taxed in Luxembourg, but as we have a very huge income tax loss there it doesn't have any sort of impact. [...]*⁶²

However, as noted, it is unlikely that these issues are done with the exclusive purpose to avoid taxation in Brazil and Luxembourg. The extractive industries need considerable pre-financing. That is, it is impossible to distinguish between ‘proper debt’, issued to finance operations and ‘artificial debt’ issued to avoid taxation in Brazil and hence to estimate the Brazilian tax loss related to this practice of tax planning. If it is challenging to estimate the scope of legal uses of offshore banking and tax planning, it is impossible to do so for the illegal uses. Therefore, as in the previous cases, the following discussion of offshore money laundering is exclusively based on qualitative data.

Money laundering

Again, compared to the other cases, the Brazilian case provides additional data sources. Next to the interviews, the information that emerged from the official investigation into the *Lava Jato* corruption scandal in past years provides comprehensive insights into the role of offshore financial services in money laundering from corruption and other illicit activities.

As in other countries, ownership of offshore companies, bank accounts and assets is legal in Brazil if they are reported to the relevant authorities. Hence, ownership in itself does not indicate any wrong-doing. However, against the background of strict capital controls in Brazil between the 1930s and 1970s, offshore financial accounts were widely used to circumvent those regulations; that is, for illegal purposes. Capital controls included the prohibition to hold capital abroad or to exchange it into foreign currency (cf. Goldfajn and Minella 2005). To hedge against inflation and other risks, particularly during times of hyperinflation, well-off Brazilian individuals and corporations routinely used offshore accounts. The offshore transactions were often facilitated by *doleiros*, money traders who would illegally exchange domestic currency into US dollar.⁶³ Since the liberalisation of capital controls in the 1990s, many of these offshore accounts have been regularised. Nevertheless, for those actors seeking to hide ill-gotten gains or evade taxes, collaboration with *doleiros* and the use of offshore accounts is still the bread and butter of their illicit financial transactions. Investigations into the recent corruption scandal, the so-called *Operação Lava Jato* (Operation Car Wash) started off with a *doleiro* and soon moved on to the offshore world.

⁶² Author's telephone interview with corporate tax lawyer, Rio de Janeiro, April 2017.

⁶³ Author's interview with defence lawyer, São Paulo, April 2017.

Operação Lava Jato started in March 2014 with an investigation into a corruption scheme involving a cartel of big Brazilian construction companies, the majority-state-owned oil company Petrobras and an illegal party financing system. By April 2017, the *Lava Jato* investigation had, in one interviewee's words, gone 'through 35 stages, each with a different corruption scheme, some extremely complex, some extremely simple; but in nearly every stage, offshore played an essential role.'⁶⁴ The investigations show that particularly offshore banks and offshore shell companies were an essential part of the corruption scheme.⁶⁵

Offshore banks were a necessary element in the graft to process the large financial flows. The case of the construction corporation Odebrecht, one member of the cartel, reflects the actual volumes involved. Between 2001 and 2016, the construction firm dispersed US\$788 million in bribes, out of which US\$348 million went to politicians and political parties in Brazil and across 11 countries in Latin America and Lusophone Africa (Capers and Weissmann 2016). Given the large amounts and globally dispersed beneficiaries involved, Odebrecht needed a trusted bank. The company's 'Structured Operations Department', exclusively responsible for handling bribes, chose an Austrian bank in Antigua. When this bank faced liquidity troubles, the head of Structured Operations simply bought the bank to ensure that Odebrecht's payments remained hidden (M. Smith, Valle, and Schmidt 2017). Next to Antigua, Odebrecht worked with banks in New York, Belize, Panama and the British Virgin Islands. Odebrecht's offshore network included 33 different banks and more than 70 bank accounts in Antigua alone (Capers and Weissmann 2016). Also, often the middle men's bank account and even that of the final beneficiary of the bribe was also held offshore: 'Just today', one interviewee told me, 'there was a plea bargain of the marketing director of the last presidential campaign of the PT (*Partido dos Trabalhadores*), the Workers' Party. He testified that Odebrecht paid his salary offshore for ten years.'⁶⁶

Offshore shell companies, on the other hand, were used to get the money undetected into and out of Brazil. The shell companies were used to forge documentation of fictitious imports of fictitious products to justify money flows between the bribing corporation and the bank account of middle men, who would then pass on the money (after deducing their own share) to the final beneficiary of the bribe. Often, the money would pass through three or four layers of offshore structures.⁶⁷ To get the money back into Brazil, according to a defence lawyer, the final beneficiary

⁶⁴ Author's telephone interview with a senior investigator, April 2017.

⁶⁵ Author's telephone interview with civil society organisation, April 2017.

⁶⁶ Author's interview with anti-money laundering expert, São Paulo, April 2017.

⁶⁷ Author's telephone interview with senior investigator, April 2017. See also: Pacheco, 2017; Capers & Weissmann, 2016.

*would have a company in Brazil which has a partner that is not really a partner, usually the maid, who holds one per cent of the company and the other partner, an offshore company, holds 99 per cent. And this offshore company would make an investment in Brazil, which is not taxable and then you have the money here. For instance, in one of my cases in Rio [de Janeiro], this company bought famous paintings and art objects.*⁶⁸

‘But,’ the lawyer pointed out, ‘these days in Brazil we only talk about *Lava Jato* and Odebrecht, but in almost all my cases on big tax fraud, about 90 per cent of the time there was an offshore structure involved.’⁶⁹ Abusing offshore financial services is part and parcel of corruption, tax evasion and other financial crimes committed by Brazilian corporations and individuals. The quantitative volume of the money involved remains invisible. But the extent to which offshore finance facilitates crime in Brazil has been dragged to the light of day and into the public debate through the *Lava Jato* investigations.

The empirical evidence suggests that offshore financial services do indeed play an important role in Brazil’s political economy, as established by the interviews. The data also proposes that in the case of Brazil, access to credit via the Eurodollar system is the most important use of offshore financial services, followed by the abuses of offshore secrecy in relation to money laundering from corruption and other crimes. Offshore tax planning, on the other hand, is also relevant but less significant than offshore banking. After having established the scope and pattern of the uses and abuses of offshore financial services by Brazilian corporations and wealthy individuals, the next section now turns to the analysis of the Brazilian state from the money view.

2 The Brazilian state from the money view

From the money view, the Brazilian state has been characterised between its independence in 1821 and the monetary reform in 1994 by short-lived cycles of money, tax and debt. This fragile nature of the cycle of money, tax and debt reflects the long-standing tensions between an urban ruling elite and an oligarchic rural economic elite in a continental country. This tension marked the country’s institutional association of rule more strongly than the different regimes – monarchy, autocracy, military dictatorship and democracy – through which Brazilian politics was organised from independence until today.

⁶⁸ Author’s interview with defence lawyer, São Paulo, April 2017

⁶⁹ Author’s interview with defence lawyer, São Paulo, April 2017.

The institutional association of rule

On 9 April 2015, Márcio Martins de Oliveira entered the Brazilian Congress with a box full of rats.⁷⁰ He made his way to the Parliamentary Committee of Inquiry (CPI) which was investigating the *Lava Jato* scandal. The day Martins de Oliveira headed towards the CPI, it was to hear the testimony of João Vaccari Neto, the treasurer of the PT. Neto was accused of money laundering and bribery. At that point in time, he was one of the 110 people the judicial investigation had accused of corruption, money laundering and other financial crimes. Over 50 of the accused were members or former members of Congress. When the treasurer entered the room of the CPI, Martins de Oliveira released the rats, wreaking chaos among the deputies. After long minutes of disorder, armed security forces finally arrested Martins de Oliveira and seized the animals (Passarinho, Calgaro, and Salomão 2015b; Pacheco 2017; Sotero 2018). One deputy later lamented: ‘[This was an] action that testifies against the parliament, the armed circus shows the level we are at. Those who complain about the low acceptance of the government, should look at the acceptance of the parliament; it is even worse’ (Cited in Passarinho, Calgaro, & Salomão, 2015).

Márcio Martins de Oliveira is not alone with his discontent. Brazil’s political institutions face a severe crisis of confidence. In 2013, 35 per cent of the population said they disapprove of the work of then-President Dilma Rousseff. By 2017, the disapproval rate for her successor, Michel Temer, stood at a staggering 91 per cent. Brazilians’ dissatisfaction seems to be a far cry from the time when, in 2009, president Luiz Inácio Lula da Silva, after the discovery of large oil reserves, famously declared that ‘God is Brazilian’ (see Phillips 2009) and his approval rate stood at an all-time high of 87 per cent (Latinobarómetro 2017).

Yet, the following historical-institutionalist analysis demonstrates that, despite the changing enchantment of Brazilians’ with their presidency, the country’s political institutions and the underlying institutional association of rule are remarkably stable over time and across regimes (monarchy, autocracy, military dictatorship and democracy). Despite its stability, the institutional association of rule between the country’s economic and political elites has not been a comfortable one. Now as then, the economic elite did not intend to share power with its political leaders; it aimed to rule through them⁷¹ as Brazil’s peculiar independence in 1822 shows.

Brazil is the only colony in history whose independence had been declared by a family member of the colonising power’s royal court (Skidmore 2010). In 1821, Dom Pedro, who

⁷⁰ It later turned out that the rodents were hamsters and mice, not rats. But the news first reported it as rats see: Passarinho, Calgaro, and Salomão (2015b).

⁷¹ Author’s interview with defence lawyer, São Paulo, April 2017, author’s telephone interview with tax lawyer, Rio de Janeiro, April 2017, see also: Calomiris and Haber (2014).

resided as prince regent in Rio de Janeiro since 1807, received order from the Portuguese crown to return to Lisbon. The order was against the prince's will and when a petition from local elites reached him with a request to stay, Dom Pedro seized the opportunity. He declared Brazil an independent monarchy and himself Emperor. Yet, the relationship between the urban monarch and the rural planter-merchant elite was not as cosy as the episode of independence suggests. The provincial oligarchs, spread out across Brazil's vast coast line, sought independence from Portugal but had no intention to upset the prevailing social order. They did not mean to share their power and wealth with the new Emperor, nor to mobilise the masses to overthrow him. Dom Pedro, for his part, aimed to build a centralised state with the planter-merchant class contributing to its revenue. Neither side could win the power struggle and so the constitution of 1824 presented a compromise between the urban monarch and the rural oligarchs. The merchant-planter oligarchy was represented, nearly exclusively, in parliament. Parliament had the right to tax, spend, go into debt and regulate how the national debt would be paid for. The monarch, in turn, had the right to dismiss parliament, should he disagree with its fiscal policies. However, dissolving parliament entailed, of course, the risk to create even more opposition towards the Emperor's fiscal plans (Calomiris and Haber 2014, chaps 12–13).

Unsurprisingly, the oligarchs' parliament was in favour of government spending that would support their sugar, coffee and mining industries, while keeping tax on capital and private wealth low. Spending was financed through international borrowing, particularly from the British, in return for the country's mineral wealth. In addition, Dom Pedro relied on an institution that his father had founded when Brazil was still under Portuguese rule: *Banco do Brasil*. The bank had the right to issue legal-tender paper money and it helped finance the government by buying government debt with money that it created in the first place. However, without tax revenue to speak of, the cycle of money, tax and debt could not get going. Rather, both debt and inflation quickly spiralled out of control, sealing Dom Pedro's political fate. Seven years after independence, the planter-merchant oligarchy in the parliament revoked *Banco do Brasil's* licence to print money and removed Dom Pedro from power (Skidmore 2010; Calomiris and Haber 2014, chap. 12). Dom Pedro had not succeeded in establishing sovereign money.

The conflict between Brazil's small and wealthy elite and the government over how to finance the state remained the common theme across Brazil's modern history well into the 20th century. Irrespective of regime type all successive Brazilian governments faced the same trilemma: do not tax and stay a weak central power in a continental country; or strengthen the state by taxing the wealthy elite and lose their political support; or finance the inevitable deficits of the state via inflation and risk popular discontent (Calomiris and Haber 2014, chaps 12–13).

Most governments went for the last option. As a result, Brazil developed in the past 200 years average inflation rates that were among the world's highest (Calomiris and Haber 2014, 390). The respective governments dealt with the resulting popular discontent by a combination of measures, including highly exclusive decision-making processes, focusing economic policies on keeping unemployment down or outright repression. As tax revenues remained repressed throughout that time, the governments coaxed the wealthy elite and foreigners into providing credit by keeping interest rates high. Consequently, interest rates, just as inflation rates, were among the highest in the world. By the early 1990s, the longstanding cycle of low tax, high inflation, high debt and even higher interest rates had gotten out of control, with inflation peaking at 1430 per cent per year (Averbug 2002).

It was in 1993 that a team of economists around the newly appointed finance minister Fernando Henrique Cardoso understood the problem underlying Brazil's past predicament: Brazil had no trusted means to account for and settle debt, including tax debt, domestically. Between 1942 and 1994, the country had eight different currencies, most of which did not even last for a decade. Cardoso's aides devised a currency reform. They split, for a time of transition, the two functions of money: means of payment and unit of account. The then official currency, the *cruzeiro real*, remained the means of payment, while a newly introduced virtual currency, the *unidade real de valor* (URV), became the new unit of account. Brazil's central bank, the *Banco Central do Brasil*, determined daily the exchange rate between the two. After prices expressed in URV had nominally stabilised, making Brazilians trust in the currency reform, the two functions were merged again and the new currency, the Brazilian real (R\$), was floated in the summer of 1994 (Averbug 2002). 25 years on, the Brazilian Real is the longest serving currency in modern Brazil.

As is to be expected from Ingham's theory of money (see chapter 2), the debt-to-GDP ratio increased significantly after the currency reform, particularly from 1995 onwards. Importantly, this growth was driven by domestic issuance. External public debt, to the contrary, fell from 18 per cent of GDP in 1994 to one per cent in 2005. Domestic public debt, on the other hand, rose from 18 per cent in 1994 to 49 per cent of GDP in 2005 (Ferreira and Bonomo 2006). Before the introduction of the Brazilian real, external debt usually outpaced domestic debt. With the currency reform and the steady growth of tax income, domestic financiers were finally willing to lend to the government (Ferreira and Bonomo 2006). Brazil's circle of money, tax and debt was running.

Brazil's longstanding problems with (hyper)inflation can be interpreted as an expression of the conflict between the urban ruler and the rural oligarchy over how to finance the state. The running circle of money, tax and debt testifies for a less contentious relationship within the

institutional association of rule since the mid-1990s. Yet, Brazil's contemporary relationship between the executive and the legislative still echoes the old conflict between the urban rulers and the rural oligarchy. The 1988 constitution grants the President far reaching powers, but every law must eventually pass Congress. The Brazilian Congress is constituted of more than 20 parties, which are more loosely knit groupings than ideologically coherent platforms. As a result, the loyalty of members of parliament rests rather with their constituencies than with their party (Mello and Spektor 2014). The ordinary Brazilian is mostly not part of these constituencies. They are dominated by the successors of the rural planter oligarchy: agribusiness and powerful corporate interests from other sectors.⁷² Consequently, presidents must negotiate legislative proposals with individual lawmakers rather than having a stable majority or coalition that votes along with their suggested initiatives. Tax incentives or attractive contracts for large corporations in the parliamentarians' constituencies are bargaining chips in the negotiation (Mello and Spektor 2014).

The political decision-making process in contemporary Brazil is still marked by the economic elite's desire to rule through the state rather than be ruled by it. The establishment of a sovereign money in the mid-1990s, on the other hand, has tightened the relationship between the government and its domestic financiers. The next section discusses the historical development and contemporary shape of this relationship in more detail.

Banking

The fate of the *Banco do Brazil*, one of the country's most important banks, mirrors the continuity and change of the relationship between the government and its financiers. Essentially, the *Banco do Brasil* has throughout Brazilian modern history had three incarnations. In its first incarnation, *Banco do Brazil* was founded by the father of Dom Pedro II in 1808, as noted above. The purpose of the bank was to help finance the build-up of the Brazilian kingdom's military and administrative infrastructure. As the banks' creation of money was not backed up by tax revenue or real economic activity inflation quickly went through the roof. By the late 1820s, it had eaten up all the shareholders' proceeds. Unwilling to fund the government any longer, its financiers, the oligarchy represented in parliament, concluded the bank in 1829. In the following two decades, Brazil's banking system remained miniscule. With government expenditures twice the tax revenue, international financiers had to be found to finance the state and its politics (Calomiris and Haber 2014, chap. 12; Skidmore 2010).

⁷² Author's interviews with former banker, São Paulo, April 2017, anti-money laundering expert, São Paulo, April 2017, defence lawyer, São Paulo, April 2017.

In its second incarnation, the *Banco do Brasil* was resurrected in 1850, when the government won the upper hand in the struggle over funding the state through money creation. It merged two privately owned banks into the now majoritarian state-owned *Banco do Brasil*. To soothe the shareholders of the merged private banks, the government endowed the *Banco do Brasil* with far reaching privileges. The privileges included the monopoly to issue notes and favourable reserve requirements, earning the private shareholders attractive rents. The power to create money, however, had clearly moved to the government. The government also forced four regional banks to become branches of the *Banco do Brasil*, further centralising the governments' monetary power. Yet, as in the past, the banking system outside the *Banco do Brasil* remained small and affordable credit to the private sector scarce. By the late 19th century, the ailing Emperor had difficulties to defend the monarchy against republican pressures. He tried to turn the *Banco do Brasil* from an instrument to fund the government into an instrument to maintain the support of rural-planter oligarchy. After the abolishment of slavery in 1888, the oligarchy needed money. Through the *Banco do Brasil* Dom Pedro II provided it in form of government-subsidised credit. This policy indeed provided cheap credit to the rural-planter oligarchy and, as a side effect, expanded the Brazilian banking system. However, it did not save the Emperor. In 1889, the military forced Dom Pedro II into exile, ending the Brazilian empire (Calomiris and Haber 2014, chaps 12–13). The following decade of intermediary military rule put the banking system and the relationship between the government and its financiers into turmoil again. The military government maintained the Emperors strategy to buy political support from the economic elite through subsidized credit. Yet, unbacked by meaningful tax revenue on the left-hand side of the government's balance sheet, the credit boom gave rise to a bank run. The collapse of the banking system in 1900 took with it the *Banco do Brasil* and many other banks.

The third incarnation of the *Banco do Brasil* had a beginning similar to the second one. The republican government of 1906 nationalised a large private bank and turned it into another *Banco do Brasil*. As its two predecessors, the *Banco do Brasil* was a commercial bank with the government acting as a majority shareholder. Yet, there were important differences in the mandate and use of the new *Banco do Brasil*. To begin with, the bank was not allowed to issue notes or to act as a universal bank. Most importantly, however, the government aligned the use of the *Banco do Brasil* closely with the interests of the coffee growers, Brazil's largest economic sector at the time. The *Banco do Brasil* helped propping up the coffee sector when it came under pressure because of falling international coffee prices. As a result, the rural-planter oligarchy started to favour a larger state (Maxfield 2001; Skidmore 2010; Calomiris and Haber 2014, chaps 12–13). This third incarnation of the *Banco do Brasil* survived the 1930 military coup

that brought Getúlio Vargas to power. Vargas, as authoritarian ruler from 1930-1945 and as democratically elected president from 1950 to 1954, left important imprints on Brazil's bank system. As his predecessors, he used the *Banco do Brasil* to forge a political coalition with the economic elite. As the coffee business declined and the industrial sector rose in Brazil's economy, the beneficiaries of the *Banco do Brasil* changed. Vargas used the bank to finance industrialisation and a growing welfare state that would appeal to urban industrial workers. Vargas also turned the *Caixa Econômica Federal* into a government-backed system of saving banks. The *Caixa Econômica Federal* supplied his government with further funds, mobilised from the growing Brazilian working class. Moreover, in his second term, Vargas also laid the foundations for the *Banco Nacional de Desenvolvimento Econômico e Social* (BNDES), the government-owned development bank. Backed by tax money, the BNDES was provided cheap credit to selected, large companies that provided employment. The BNDES was used, both during Vargas' reign and under military rule, to keep popular discontent in check by funding employment-supporting policies that went along with repression. Vargas also attempted to create, next to the *Banco do Brasil*, the saving banks and the BNDES a fourth pillar of the banking system: the central bank. However, the rural-planter oligarchy and later the São Paulo industrialist elite, who were among *Banco do Brasil's* shareholders, successfully resisted that move. The conflict between the financiers and the government over the foundation of an independent central bank would span more than half a century. Until the mid-1990s, Brazil saw successive governments attempt unsuccessfully to establish a central bank (Maxfield 2001; Musacchio Farias and Lazzarini 2014; Calomiris and Haber 2014, chaps 12–13).

The three government-backed or government-owned banks *Banco do Brasil*, *Caixa Econômica Federal* and the BNDES are still today the bedrock of Brazil's banking system. They are the central tool of the government to implement monetary, industrial and redistributive policies.⁷³ Under the Cardoso government in the mid-1990s, Brazil would also finally establish a central bank, the *Banco Central do Brasil*. Since Cardoso all successive governments upheld the central bank's independence and hence supported policies to bring down Brazil's historically high levels of inflation (Maxfield 2001; Boito 2007; Mello and Spektor 2014).

Brazil's historically grown strained relationship between the government and the economic elites created four legacies that help explain the contemporary use of offshore financial services: a small banking system, high inflation rates, high interest rates and government-owned banks as policy tools. All four legacies led the government and the private sector to turn regularly to international creditors. In line with the general global development,

⁷³ Author's interview with former banker, São Paulo, April 2017; author's interview with BNDES staff, Rio de Janeiro, April 2017.

Brazil's international debt was first denominated in pound sterling and then, after the World Wars, the US dollar.

Interestingly, there is little economic research on what drives the issuing of US-dollar-denominated debt, besides interest rate differentials (McCauley, McGuire, and Sushko 2015b). However, interest rates can explain only why Brazilian economic actors tap into international financial markets. They do not explain issuance in Euromarkets. Here, the legacy of Brazil's defunct cycle of money, tax and debt plays an important role. Brazil's prolonged periods of inflation and hyper-inflation led to a shallow banking system with little appetite for lending to the private sector. If at all, corporations had only access to expensive, short-term credit. Moreover, they faced the risk that, on the other side of their balance sheet, assets, particularly in form of cash, quickly lost value. To protect their assets, corporations, but also wealthy individuals, engaged in innovative financial transactions, particularly in daily repurchase (repo) agreements. They used offshore accounts to deposit US dollar, because Brazilian banks were, due to capital controls, not allowed to offer US-dollar-denominated deposits (Calomiris and Haber 2014, chap. 13). By the mid-1960s, tapping into the Eurodollar markets did not seem far off for Brazilian corporations. They already had US-dollar deposits offshore and were used to financial innovation. It appeared natural to issue debt offshore, too. Yet, at that time, it was not mainly corporations, which needed access to credit, but even more so the government. The need for money was met at the Euromarkets. Investors seeking to recycle their petrodollars considered Brazil, due to its rapid growth, increasing levels of industrialisation, and political stability under the military dictatorship a creditworthy country. In that decade, the Brazilian government could borrow in London at negative real rates of interest (E. Cardoso and Fishlow 1989; Skidmore 2010). And so they did, in the words of Rocha (2002, 6), 'embark on a gigantic borrowing spree on world-capital markets, contracting loans particularly from ... banks – rather than, as in the past, from governments or semi-official lending institutions – to drive development.' It is history that the dream of cheap international debt ended in the 1980s. Brazil, alongside the entire Latin American continent, sank into a debt crisis. What did not end, however, at least not in the longer run, is Brazil's engagement in the Euromarkets. The Brazilian government was indeed excluded from international financial markets during the 1980s, but the private sector could borrow in the Euromarkets from the early 1990s onwards. As a result, there were two fundamental changes in Brazil's engagement in the Eurodollar system compared to the pre-crisis period. First, the government withdrew significantly from those markets, having changed the way it organised its access to US dollar. It moved from issuing debt in the Eurodollar markets to issuing debt domestically in combination with building up US dollar reserves. This move was made possible by the successful introduction of the Brazilian real and

the resulting willingness of domestic financiers to lend to the government. It was also made possible by an export-oriented development and increasing oil revenues leading to an increase in US dollar reserves. Second, unlike the government, corporations now moved forcefully into the Euromarkets. Private sector borrowing gained momentum in the early 2000s and after the Financial Crisis as was demonstrated in the previous section. What developed since the 1990s, against the backdrop of a proper sovereign money, was an institutionalised division of labour between the domestic and the offshore banking system with regards to long-term credit. The domestic banking system provided long-term credit nearly exclusively to the government. The offshore markets provided long-term credit to Brazil's corporate sector.⁷⁴

Besides these domestic reasons, the banking regulation and litigation laws in the United States are an important set of motivations, why Brazilian corporates issue dollar-denominated debt in Europe, particularly in London and Luxembourg, rather than directly in the United States. US American banking regulation is so demanding on corporations that it excludes most Brazilian firms from issuing in the U.S. markets. According to interviewees, even more deterring than banking regulations is US American litigation law.⁷⁵ In the words of one interviewee:

*[T]o comply with all the rules when dealing with the American authorities, it really is a nightmare for the lawyers. And when talking with the management of the companies [...] they know that if anything goes wrong, we will be prosecuted in the US and next time we visit Disneyland or New York, we cannot.*⁷⁶

However, next to avoiding US banking regulations and litigation laws, the Eurodollar system has even more perquisites for creditors. The Eurodollar system provides them with access to exactly those US investors, which they have no access to in the US American market. Particularly since the Financial Crisis, institutional investors from the United States are under pressure to find viable investments in a low interest rate, high liquidity financial environment. Searching beyond the US market, they invest in emerging economies, prime among them China and Brazil.⁷⁷ Moreover, issuing bonds offshore in the Eurodollar market is an effective and widely used tool among Brazilian corporations for tax planning via intracompany loans.⁷⁸ In line with these findings, the BIS reports that Brazilian intracompany loans co-move with offshore dollar debt issuance (McCauley, McGuire, and Sushko 2015a). The next section now

⁷⁴ Author's interview with banker, Rio de Janeiro, April 2017.

⁷⁵ Author's telephone interview with investment banker, May 2017; with tax lawyer, London, June 2017; with tax lawyer, Mexico City, November 2015.

⁷⁶ Author's interview with banker, Rio de Janeiro, April 2017.

⁷⁷ Author's interview with banker, Rio de Janeiro, April 2017; author's telephone interview with investment banker, May 2017.

⁷⁸ Author's telephone interview with corporate tax lawyer, April 2017.

turns to the question of how the historical development of the tax system shaped the pattern of contemporary offshore tax planning.

Taxation

The tax system reflects the relationship between the state and its taxpayers. This relationship is today less contentious in Brazil than in the past. Again, the introduction of the Brazilian real in 1994 was an important turning point. With the establishment of sovereign money, the government's tax receipts increased remarkably. Between 1993 and 1994 it rose from R\$3.6 million to R\$102 million, a nearly thirtyfold increase (Ferreira and Bonomo 2006). The tax-to-GDP rate also grew steadily from 21 per cent in 1992 to 32 per cent in 2015, peaking at about 35 per cent in 2007. Since then, it has oscillated around the OECD average of about 32 per cent (OECD 2016). By the mid-1990s, Brazil had become a tax state comparable to that of OECD countries.

However, the Brazilian tax state was a long time in the making. The high concentration of wealth and power in the hands of Brazil's rural oligarchy made taxation a difficult affair. Yet, two regimes managed to gain the upper hand in the struggle between the rural-planter elite and the urban rulers over how to finance the state: the autocratic *Estado Novo* under Getúlio Vargas, lasting from 1937 to 1945, and the military regime under different governments, lasting from 1964 to 1985. Vargas's main goal was to strengthen the central government. The financial crash of 1929 and the Great Depression provided the opportunity for Vargas to do so. The rural coffee growers and early industrialists needed financial support from the government and could finally be won over to support a larger state. Vargas was particularly adamant to regain fiscal power from the federal states. The federal states had successfully increased their share of government revenues between the end of Imperial Brazil and during the First Republic (Goldsmith 1986). Building-up an administration run by technocrats and relying on the military to maintain stability, Vargas succeeded in the 15 years of his autocratic reign to centralise taxation (Skidmore 2010). About three decades later, the military regime (1964-1985) attempted the next tax reform, betting on Vargas's strategy: centralising tax collection, professionalising tax administration and insulating the tax authority from political struggles between the urban rulers and the rural wealthy elite. As a result, the *Secretaria da Receita Federal* (RFB) became one of the best organised parts of the Brazilian administration (Weyland 1998). Another important result of the 1965 tax reform was the introduction of the VAT, split between the state and the federal levels (Longo 1994; Melo, Barrientos, and Canuto Coelho 2014). Together with Canada, Brazil was one of the first countries in the world to introduce a dual VAT. The dual VAT was an efficient way to appease the states while broadening the

central government's tax base. Introducing a general consumption tax finally included the large poor population into the rank of tax payers. The military government was also clever in other ways. As corporations became ever better in avoiding taxation under the condition of inflation by pushing their payments into the future, the RFB indexed tax payments to inflation and introduced a pay-as-you-go tax structure. Helped by Brazil's 'economic miracle' between 1968 and 1973, with average annual growth rates around ten per cent, these measures flushed money into the government's pockets. Brazil's tax revenue increased from about six per cent in 1963 to nearly ten per cent in the early 1970s (Weyland 1998).

During the time spanning the autocratic regime of Getúlio Vargas to the military regime, Brazil's economy transformed from agrarian to industrialised. Consequently, the institutional association of rule between the government and the rural oligarchy extended to now also include industrialists, mostly based in São Paulo. In addition, Vargas and his administration created a government-directed, corporatist social organisation. The aim was to address questions of social welfare for the growing number of urban workers and avoid class warfare (Skidmore 2010). As a result, the tax system as developed under Vargas and the military regime was determined by different social groups' special interests. The question of how to finance the state through taxation became one that was less about who must pay how much. Instead, it was about who was capable of negotiating exceptions or tax breaks for its own social group. By the mid-1970s, tax breaks for different business sectors amounted to 65 per cent of corporate income tax revenue or to about 13 per cent of the federal government's revenue. This number excludes the loss of corporate income tax through tax evasion, which was also widespread (Weyland 1998). By the mid-1970s, the private sector had, essentially, stopped paying tax. After half a century, the tax state that Vargas and the military had built reached its limits. However, the Eurodollar fuelled debt state could gloss over the fiscal problems and spared the military regime to pay the political price for properly taxing the wealthy or cut spending on the urban workers. A decade later, by the mid-1980s, high inflation, low growth and the fiscal and debt crises reflected that the institutional association of rule had not found a sustainable agreement of how to finance the state. The wealthy were unwilling to pay either through tax or debt. As the state disintegrated, it took with it the military regime.

With the 1988 constitution, Brazil returned to democracy. The constitution was an integrative moment for Brazil's otherwise hugely divided society. Different groups of society were consulted in the constitutional processes. As a result, the Brazilian constitution contains a long list of positive social and economic rights.⁷⁹ Moreover, the constitution contains detailed

⁷⁹ Author's telephone interview with tax lawyer, São Paulo, April 2017.

text on types of taxes, on taxing competences and how tax revenue is shared between the different levels of government. This time around, it is the municipalities which regained a significant share of tax revenue (Longo 1994).

Yet, despite the inclusive nature of the constitutional process and the devolution of taxing power, the contemporary Brazilian tax system is in five dimensions a continuation of the past. First, since the mid-1990s, when the introduction of the Brazilian real successfully closed the cycle of money, tax and debt in Brazil, the country's tax revenue has increased significantly. In terms of revenue, Brazil is Latin America's most successful tax state, comparable to those of the OECD. All democratically elected governments have effectively extracted money from the tax payers. However, as in the past, this success is not rooted in the economic elites' voluntary contribution towards the Brazilian tax state. Rather, the democratic governments have found a way to tax the growing middle classes and the country's poor. In 2014, the Brazilian lower and middle classes collectively contributed about three quarters of the tax revenue. Taxes on corporate income, profits and property, on the other hand roughly contributed the remaining quarter (OECD 2015). Second, onshore tax avoidance and evasion expresses that the economic elite remains unwilling to subordinate itself to the state's fiscal power. A common way for corporations to avoid the taxman is to use the intricacies of the Brazilian tax law. Corporations often appeal to the Supreme Court to clarify a specific clause. The appeal can take between ten and twenty years to be addressed by the Court. This way, a corporation can legally postpone paying taxes. By the time the case is addressed the tax debt might have expired by limitation, the law might have changed in your favour or inflation, still comparably high in Brazil, might have devalued the tax debt.⁸⁰ The poor, the majority of Brazil's population, also tried to get away from the taxman. The easiest way to do so is informality. However, unlike curbing corporate tax avoidance, the government succeeded in reducing informality – and with it tax avoidance from about 46 per cent of the labour force in 1999 to 37 per cent in 2013 (A. Cardoso 2016). Third, although social spending towards the poor, for instance with the social cash program *Bolsa Família*, has grown to historically unprecedented levels, the old practice of government support for corporations through subsidised credit continues unabated (Melo, Barrientos, and Canuto Coelho 2014). Knowingly, Brazilians' have come to call these subsidies *Bolsa Empresario* (Leahy 2015). The fourth reminiscence of the past in contemporary taxation is the sheer amount of tax privileges and taxes that are earmarked for specific sectors.⁸¹ In the words of Mello and Spektor (2014, 106)

⁸⁰ Author's interview with defence lawyer, São Paulo, April 2017.

⁸¹ Author's interview with banker, Rio de Janeiro, April 2017.

'Legislators and the president alike regularly raise taxes not so they can invest in better public services but so they can replenish the war chests they use to please the special interest groups that help them stay in power. With government spending benefiting thin slices of the electorate rather than the majority of Brazilians, the discrepancy between revenue and the quality and extent of public services is enormous.'

The fifth and final legacy of the past relationship between the government and its taxpayers is Brazil's strong tax administration. Brazilians call the RFB *o leão*, the lion, and it is considered an attractive place to work for tax lawyers and accountants. The RFB is one of the technically most modern tax administrations in the world. Moreover, the strong institutional insulation from other government agencies protects the RFB's work from the politics of patronage that marks other political institutions.⁸²

Against the background of the evolution and contemporary shape of taxation, we can see why in Brazil offshore banking is more important than offshore tax planning. The bank system has institutionalised a division of labour between the domestic and the international level. Domestically, taxpayer backed banking serves to subsidise Brazil's large business conglomerates. Internationally, the Eurosystem creates the money necessary to finance the public and private sectors. Taxation, to the contrary, provides ample opportunity for the different powerful parts of the ruling association to meet their interests onshore in terms of tax exemptions and revenue spending. Moreover, the resulting tax mix, which is heavily skewed towards indirect taxes and social security insurance run by the state and taxed at source, does not lend itself easily to offshore tax minimisation. The offshore tax planning estimated in section one, therefore, is mainly a consequence of offshore money creation. Once the money is created offshore through debt, it needs to be repatriated to Brazil. This repatriation happens in the most tax efficient manner through offshore inter-company loans or tax free 'foreign' direct investment. Nevertheless, offshore tax planning, just as offshore banking affects the power of the Brazilian state. The next section assesses how.

3 Offshore finance and state power in Brazil

In the previous two sections, I discussed the scope of Brazilian uses and abuses of offshore finance. Offshore finance plays an important role in Brazil's political economy. The shape of the bank system has made Eurodollar banking a central element of Brazilian money creation. The close but strained relationship between the country's wealthy elite made offshoring also

⁸² Author's telephone interview with corporate lawyer, Rio de Janeiro, April 2017; author's telephone interview with tax lawyer, São Paulo, April 2017, author's telephone interview public investigator in the Lava Jato scandal, Rio de Janeiro, April 2017. Author's interview with former banker, Rio de Janeiro, April 2017.

attractive for individuals to hold US dollar at a time of capital controls and to avoid or evade taxation. Offshore financial services are also used to hide the dirty underbelly of the close but strained relationship between the political and economic elite. They play an important role in managing and laundering money flows from corruption and other criminal proceeds. These uses and abuses of offshore finance by Brazilians raise the question whether the Brazilian state is trying to rein in offshore finance, whether it is complicit in it or whether it actively supports the use of offshore financial services. The following analysis demonstrates that the Brazilian government does all three of these things.

In chapter 2, I established theoretically the qualitative difference between the US dollar and the Eurodollar. The Eurodollar, I argued, is money that is created offshore and that remains, at every level of the hierarchy, ‘near money’. That is, Eurodollar cannot be monetised. Nevertheless, up until the Financial Crisis, the two moneys were traded as if they were on the same level in the money hierarchy. Once it became clear in 2007-2008 that this is not the case, European banks retreated from offshore money creation. Non-bank financial institutions, such as institutional funds and asset managers, took up some of the slack by providing offshore credit to emerging markets economies (Kreicher and McCauley 2016; Snider 2017a). In this chapter, I demonstrated empirically that Brazil has been a recipient of that post-crisis offshore credit, but also had a significant Eurodollar exposure in the past. In sum, Brazil’s Eurodollar exposure can be divided into three stages: a first phase, from about the mid-1960s to the 1980s, when the Brazilian government borrowed from Eurobanks; a second phase, from about the mid-1990s to 2007, when the Brazilian private sector borrowed from Eurobanks; and a third phase from 2009 until today, when the Brazilian private sector borrows from non-financial institutions. In the following, I discuss how this past and present Eurodollar exposure affects the relationship between offshore finance and the Brazilian state.

During the first phase, successive Brazilian governments were short of tax revenue and domestic creditors, so issuing debt offshore was a convenient way to finance their developmental ambitions. For about two decades, offshore money creation by Eurobanks appeared to be a good replacement for onshore money creation. The offshore money fulfilled its purpose: it financed production. Yet, in the 1980s, Brazil’s engagement with the Eurodollar ended in a debt crisis that led to a ‘lost decade’ in terms of growth and development. Nevertheless, since the crisis was a sovereign debt crisis, the Brazilian government could still decide how to deal with the situation. It decided to default on its international debt. Subsequently, it put a sustained effort into establishing the Brazilian real as a trusted sovereign money. The success of this currency reform finally allowed the government to shift its debt from the Euromarkets to domestic creditors. This strategy lessened the possibility of external

interference into Brazil's fiscal and monetary affairs and reduced the government's exchange rate risks, both so forcefully experienced during the debt crisis (Ban 2012; Ferreira and Bonomo 2006).

However, during Brazil's recovery, the global role of the US dollar only increased. Although the government could reduce its exposure to the US dollar, Brazilian corporations, if they wanted to be part of the global economy, needed access to it. Yet, with regards to private sector credit, the Brazilian banking system was still shallow and expansive. It could neither provide sufficient and affordable domestic credit nor US-dollar-denominated credit to allow for capitalist expansion (Calomiris and Haber 2014). With the financial support of the BNDES and hence ultimately the Brazilian taxpayer, large Brazilian corporations thus turned to the Eurodollar system for credit (Musacchio Farias and Lazzarini 2014). In this second phase of Eurodollar exposure, the government's support for the private sector's exposure to the Eurodollar system via the state-owned development bank was an explicit policy choice. It was seen as an effective way for Brazilian corporations to access funding at lower interest rates than at home.⁸³ During this second phase, the private sector borrowed from the very same banks the Brazilian government had defaulted on a few years earlier. Compared to the first phase, the government's ability to influence the relationship with offshore finance was now one level further removed as the creditor and the borrower were now outside the government's immediate influence. Nevertheless, for more than 15 years, the production of offshore credit money appeared to replace onshore credit money just fine. Brazil's industrial production and domestic income grew at unprecedented levels. Other than subsidizing offshore credit, there was little need for the government to intervene. The government's abstinence changed fundamentally with the Financial Crisis. Brazil was confronted with a considerable US dollar gap and related liquidity issues. However, the Brazilian central bank found a successful response. A combination of capital controls and swap lines with the Federal Reserve helped to effectively cover Brazil's US dollar gap during the crisis (Allen 2013; Chamon and Garcia 2016). Consequentially, the country got off relatively lightly. The Financial Crisis had limited negative effects on Brazil.⁸⁴

And so, the third phase of Brazil's exposure to Eurodollar credit began with an ostensible head start. In 2009, dollar credit was still short in the United States, but Eurodollar credit was again flowing freely to Brazil. These flows were mainly driven by investors in search for yield

⁸³ Author's interview with BNDES employee, Rio de Janeiro, April 2017. Author's interview with financial market expert, Rio de Janeiro, April 2017.

⁸⁴ Author's interview with financial sector expert, Rio de Janeiro, April 2017.

in a low-interest environment.⁸⁵ The Brazilian private sector happily borrowed as the example of Petrobras, the partially state-owned oil company, shows. In 2009, Petrobras became the largest net issuer of Eurobonds in the world. With two issuances of US\$8 billion and US\$6 billion between 2009 and 2014, the oil company became one of the most indebted corporations globally (McCauley, McGuire, and Sushko 2015b). In 2016 alone, the Brazilian private sector collectively received US\$166 billion Eurodollar-denominated credit (see section 1 above). Yet, unlike in the previous two phases, offshore money creation no longer led to enhanced production and growth. Quite to the contrary, the Brazilian economy experienced its worst recession in decades. The country's GDP growth fell from its peak in 2010 at 7.5 per cent to -3.8 per cent in 2015 (World Bank 2017). Likewise, between 2010 and 2016 the Brazilian real halved its value from 1.7\$R to 3.4\$R per one US\$ (BIS 2018a).

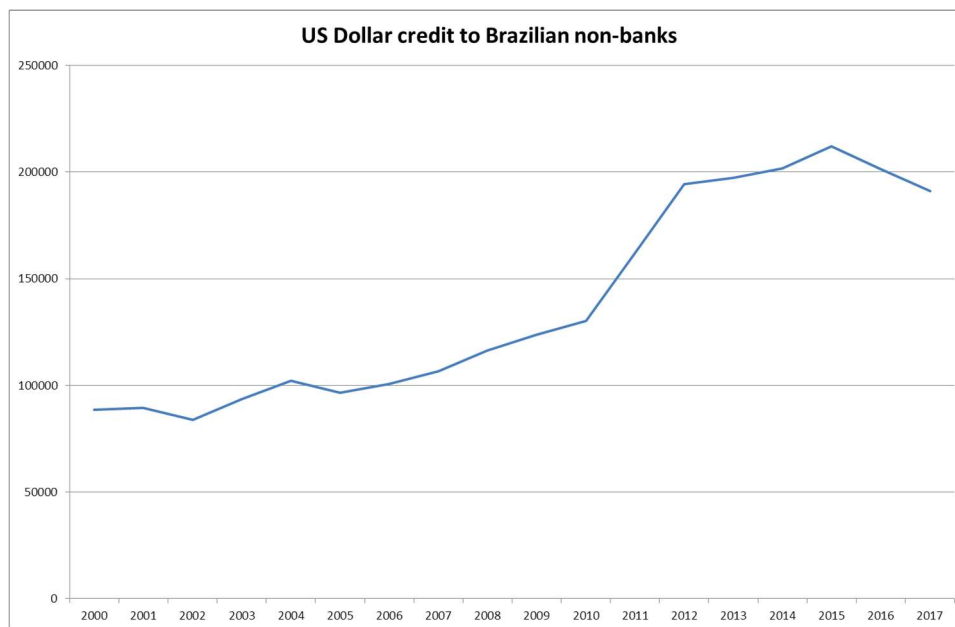
The reason why Brazil's access to credit did not translate into capitalist expansion is a contested topic. The *Banco Central do Brasil* interpreted the events as a result of the announcement of monetary tightening by the Federal Reserve in 2013. Consequently, the central bank set out to defend its currency and the private sector's access to Eurodollar. Between 2013 and 2014, the central bank drew on its reserves and started providing US dollar swaps that were settled in Brazilian real. The program amounted to more than US\$90 billion or about a quarter of Brazil's total foreign reserves (Chamon, Garcia, and Souza 2015). In practice, the program essentially amounted to a subsidy to Brazilian banks to allow them to borrow more cheaply in the Euromarkets to then lend on to the Brazilian private sector (Snider 2017). Going through the banking system was necessary for the government because it is politically inconvenient to support private sector borrowers directly. Being one level removed from the borrower in the Euromarket started to show its price. Despite these efforts, the Brazilian economy did not recover. According to Jeffrey Snider (2017), it could not, because the *Banco Central do Brasil's* measures to bring down the price for offshore credit cannot make up for the shortage of offshore money creation since European banks retreated from the Euromarkets in 2009. The *Banco Central do Brasil's* and Jeffrey Snider's interpretations differ on whether the price or the volume of Eurodollar is the problem. They agree, however, that at the heart of the matter lies liquidity.

Figure 5.6 below shows US dollar credit to Brazilian corporations. Note that these numbers, collected by the BIS as part of their global liquidity indicators, do neither distinguish between the type of borrower (government or private sector) nor between onshore US-dollar and Eurodollar. However, for the case of Brazil we do know that today most of the borrowing

⁸⁵ Author's interview with financial market expert, Mexico City, November 2015. Author's telephone interview with investment banker, May 2017. See also (McCauley, McGuire, and Sushko 2015b)

is done by the private sector and most of US-dollar credit is Eurodollar credit (see above). The BIS numbers are thus a good indicator as to whether a shortage of Eurodollar credit since the Financial Crisis lies at the heart of Brazil's contemporary predicament.

Figure 5-6. US dollar credit to Brazilian non-banks



Source: BIS Global Liquidity Indicator

According to these figures, access to US dollar credit increased constantly from 2000 to 2015. In 2015 it peaked at US\$212 billion. The volume of US-dollar credit then came down slightly in 2016 and 2017 to US\$191 billion, which is still way above the pre-crisis level, which ranged between US\$89 billion and US\$102 billion in the years 2000 to 2006 (BIS 2018b). Liquidity is not Brazil's problem.

If the Brazilian private sector had uninterrupted access to US dollar funding but the Brazilian economy is not growing, it prompts the question where all that money goes. On a theoretical basis, we can answer this question if we take the difference between volume and monieness of the Eurodollar seriously (see chapter 2). With the Financial Crisis the creation of offshore money moved from European banks to non-bank financial institutions, such as funds and asset managers (Kreicher and McCauley 2016; McCauley, McGuire, and Sushko 2015b). Through licencing and banking regulations, states have direct influence over banks. Non-bank financial institutions are, by comparison, less regulated and hence further outside the reach of the state. That means that since the Financial Crisis, the creditors in the Euromarkets changed. Through this change the system retreated further into the shadows. In the logic of Ingham (2004) and Mehrling (2012), this means that Eurodollar credit moved further down in the money hierarchy. Being now even further removed from any authority that could guarantee the

Eurodollar's validity than before the crisis, it appears that it can no longer be transferred into a form of 'near money' that is high enough in the hierarchy to be accepted as payment and credit in the real economy. As a result, the credit remains stuck in the lowest echelons of the hierarchy in form of speculative financial products that no longer contribute to production and economic development. In the case of Brazil, offshore money creation without the state has lost its potency.

These developments have important consequences for the Brazilian state. In phase three of its exposure to the Eurodollar market, it has lost all influence over the creation and use of offshore money. In the first phase, the state had room to manoeuvre to respond to the debt crisis with a fundamental restructuring of its own finances. In the second phase, the state was removed from directly influencing events around the Eurodollar system as it no longer engaged in it directly. Nonetheless, the state actively supported the private sector in going offshore via the state-owned development bank BNDES. For more than 15 years, this policy worked in favour of the Brazilian economy. It came to a halt with the Financial Crisis. In the short run, the Brazilian government managed the resulting effects on two fronts. Domestically, it continued to support the private sector via the banking system. Internationally, it collaborated with the Federal Reserve to narrow the country's dollar gap through currency swaps (Allen 2013). That is, unlike in phase one, when the government faced a crisis related to the Eurodollar system, in phase three it did not create an onshore alternative to offshore private sector credit. Brazil's banking system is still shallow and expensive and the institutionalised division of labour of domestic banks lending short-term and international banks lending long-term is still in place. The government's support of the private sector via the domestic banking system exposes Brazilian banks even further to the now purely speculative Eurodollar currency. In phase one, the government had responded to the predicaments of offshore money creation with domestic money creation. In phase three, the government decided to expose its banking system even more to offshore money creation. The *Banco Central do Brasil's* measures may well turn out to worsen Brazil's economic situation in the years to come (Snider 2017).

In short, across the three phases, the Brazilian state's relationship with offshore finance is a close but changing affair. The relationship depends on the nature of the borrower (government vs. private sector), the nature of the creditor (banks vs. non-bank financial institutions) and the resulting monieness of the Eurodollar. In the case of Brazil, the relationship with offshore finance deepened throughout these three phases. Yet, the ability of the state to influence it decreased.

Unlike offshore banking, the scope of offshore tax planning in Brazil is limited. Part of the explanation for this limited scope is the nature of Brazil's tax system. It provides the

economic elites with ample exemptions and advantages. Moreover, taxation is strongly based on consumption taxes and government organised social security contributions. Both types of taxes are evaded through informality, rather than offshoring. Another part of the explanation is, however, that from the mid-1990s onwards, the RFB has created thorough domestic defensive laws. When it comes to offshore tax planning, *o leão* bares its teeth.

Brazil's defence against harmful tax competition started in 1994 with the introduction of withholding taxes on source-based income in Brazil and regulations that limit the payment of royalties. The withholding tax rate is at 15 per cent,⁸⁶ unless the income is passive, and its beneficiary is resident in a tax haven (as to the tax authority's black list). In this case, the withholding tax rate increases to 25 per cent. Besides enforcing higher tax rates for residents of tax haven countries, the withholding tax also increases the transaction costs of cross-border flows such that it may make shifting money solely for tax purposes less attractive. Two years later, in 1996, Congress introduced CFC rules, which are among the most stringent in the world. The purpose of the CFC rules was to increase tax income, regardless of the reason for why corporations may be offshore. The following year the Brazilian government added rules with regards to transfer pricing. Brazil is famous for deviating both from the OECD and the US approach to transfer pricing. Rather than working with the arm's length principle, requiring comparable prices which are often difficult to come by, the RFB works with maximum values for import prices and minimum values for export prices. This system is easier to navigate for the Brazilian tax administration. In addition, because it is so different from what the rest of the world does, it increases the transaction costs for shifting profits through transfer pricing. Finally, in 2010, the RFB complemented the framework by adding thin capitalisation rules (Estellita and Silva Bastos 2015; Falcao 2012; Rigoni 2014; Valerdi 2017). The purpose of thin capitalisation rules is to limit the amount of debt that is deductible from a corporation's tax debt, one of the more commonly used routes for offshore tax planning. A legacy of Brazil's extensive capital controls is the extensive reporting requirement for international capital flows. This data, in combination with the advanced tax and banking technology, help enforcing the laws and regulations.⁸⁷ For instance, the CBE survey data, facilitated the *Lava Jato* investigations.⁸⁸ That is, the Brazilian tax administration has come up with effective domestic measures to curb base erosion and profit shifting by orienting the tax regime towards a source-oriented tax system and modern technology (Estellita and Silva Bastos 2015; Rigoni 2014). Nevertheless, there are ways for corporate tax advisers to circumvent the rules and regulations legally. The best way to

⁸⁶ Services are subject to 25 per cent.

⁸⁷ Author's interview with defence lawyer, São Paulo, April 2017.

⁸⁸ Author's telephone interview with investigator, Rio de Janeiro, April 2017.

do so is through the network of Brazil's double tax agreements, commonly called 'treaty shopping'.

Therefore, Brazil was, as a non-member, actively involved in the OECD BEPS process and stated implementing a considerable part of the agreement. Most importantly, Brazil committed to create a register of beneficial ownership, to be published from 2018 onwards on the RFB's website. If this commitment will indeed be enforced, it would not only affect tax planning. Much more far reaching, it would expose all offshore companies and bank accounts of Brazilian politicians and would hence increase the scrutiny of why they hold wealth offshore.⁸⁹ Brazil's engagement with the OECD BEPS process continued despite two important points of contention. For one, the country still refuses to join the arm's length standard. Furthermore, Brazil begrudged the OECD's support for policies that were aligned with the interest of its member states, e.g. resident-based taxation, rather than balancing the different positions of the G20 member countries (Rigoni 2014).

With regards to taxing international economic activity, the Brazilian state has – at least from the legal perspective – fundamentally different approach than when it comes to taxing domestically. The RFB shows its power and expertise. Yet, in practice, the state is often complicit in offshore tax planning. For instance, the state-owned development bank BNDES holds minority shares in several Brazilian multi-national corporations that have extensive offshore structures. Moreover, according to an interviewee, the central bank even encouraged BNDES itself to open a branch in the Cayman Islands, for 'efficiency reasons. The BNDES decided to go to London instead.'⁹⁰ The Brazilian state has the power to curb offshore tax planning. It may not always decide to use it, though.

⁸⁹ Author's interview with defence lawyer, São Paulo, April 2017.

⁹⁰ Author's interview with banker, Rio de Janeiro, April 2017.

VI Mexico: Power without plenty

Mexico is the last of the four case studies considered in this thesis. The causes that the literature identifies as explanatory factors of which countries are affected by offshore finance – size, economic openness, level of development, geographical proximity to offshore financial centres and governance – are present in the Mexican case in a pronounced manner. It is a large country, geographically and economically. Mexico is Latin America's second largest economy and among its most open ones. In 2015, for instance, Mexico's gross domestic product (GDP) was US\$1.14 trillion and its currency, the Mexican peso, was the most traded emerging market currency in the world. It was overtaken by the Chinese renminbi only in 2016 (Cota 2015). Despite its economic weight, though, Mexico is also a developing country and one with endemic problems of crime and corruption. Finally, Mexico is located closely to the Caribbean, one of the world's largest offshore hubs. Given Mexico's characteristics, we would expect its economic actors to make ample use of offshore financial services. Puzzlingly, the empirical evidence presented in this chapter suggests otherwise. According to the data, Mexican firms and individuals make little use of offshore financial services. With this finding, Mexico is the most counterintuitive of the four case studies. This chapter presents the evidence Mexican firms and individuals' demand for offshore financial services. It explains why the demand is limited. Finally, the chapter discusses, as the previous case studies have done, what we can learn from the results regarding the question of how offshore finance affects the ability of the state to unite resources to finance its politics.

1 The uses and abuses of offshore finance

Of the four case studies, quantitative data is scarcest for Mexico. The quantitative analysis of offshoring by Mexican economic actors is exclusively based, like those of Britain and Germany, on BIS locational banking statistics. The quantitative data is again complemented by the data collected through participant interviews (see chapter 1 and appendix 1). As in the previous cases, the interview results and the quantitative data are strikingly consistent.

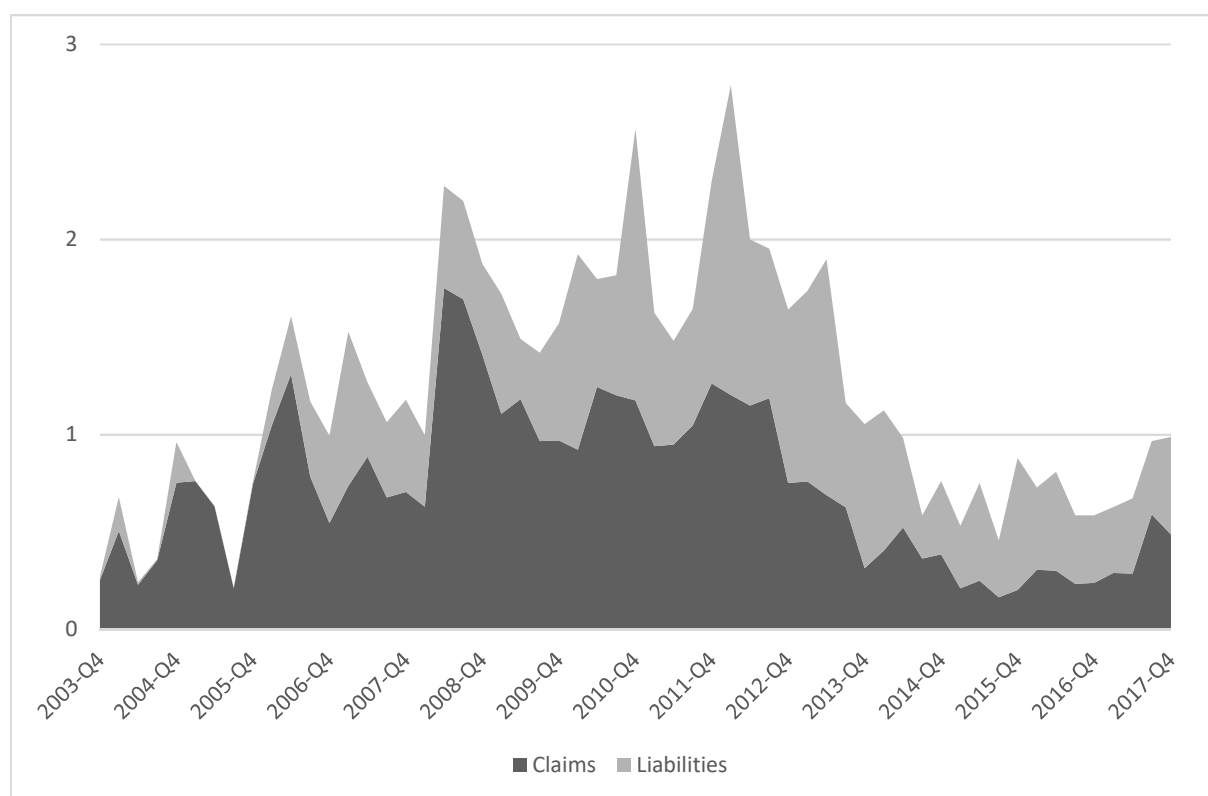
Asked about the extent of offshore finance in Mexico, all interviewees were convinced that only a small number of Mexicans use offshore services. The users of offshore financial services are foremost the country's seven largest banks, the eight largest business conglomerates (and their owners) and PEMEX, the state-owned oil and gas company. Everyone else lacks the sophistication or sees no need to go offshore.⁹¹ An interviewee from the *Banco*

⁹¹ Author's interview with financial lawyer, Mexico City, November 2015.

de México, the central bank, confirmed: ‘Mexican corporations’ cash, to the best of our knowledge, resides locally or is invested sometimes in some offshore centre, but that is a very small part of it.’ Interviewees also pointed out that in Mexico, with its history of financial crises and its volatile currency, going offshore usually serves to hedge against risks while avoiding taxation at the same time. A currency swap, for instance, is structured to simultaneously avoid taxation. It becomes impossible to distinguish the two motivations for the transaction: financial gain and tax avoidance.⁹²

The analysis of the BIS data provides a similar picture as the interviewees. Figures 6.1 and 6.2 below depict the overall scope of offshoring in Mexico between 2003 and 2017 in US dollar and as a percentage of GDP.

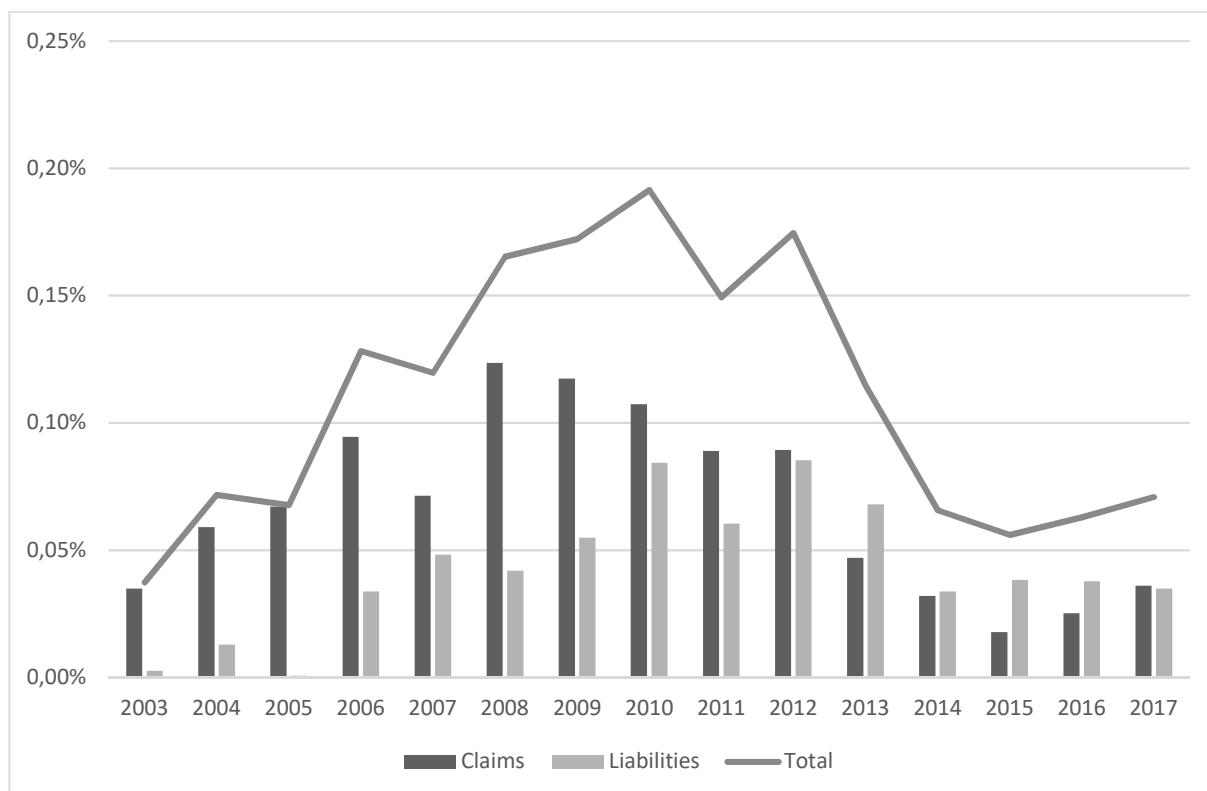
Figure 6-1. Uses of offshore financial services (in US dollar billion, quarterly)



Source: BIS locational banking statistics

⁹² Author’s interview with former employee of tax authorities, Mexico City, November 2015.

Figure 6-2. Uses of offshore financial services (percentage of GDP)

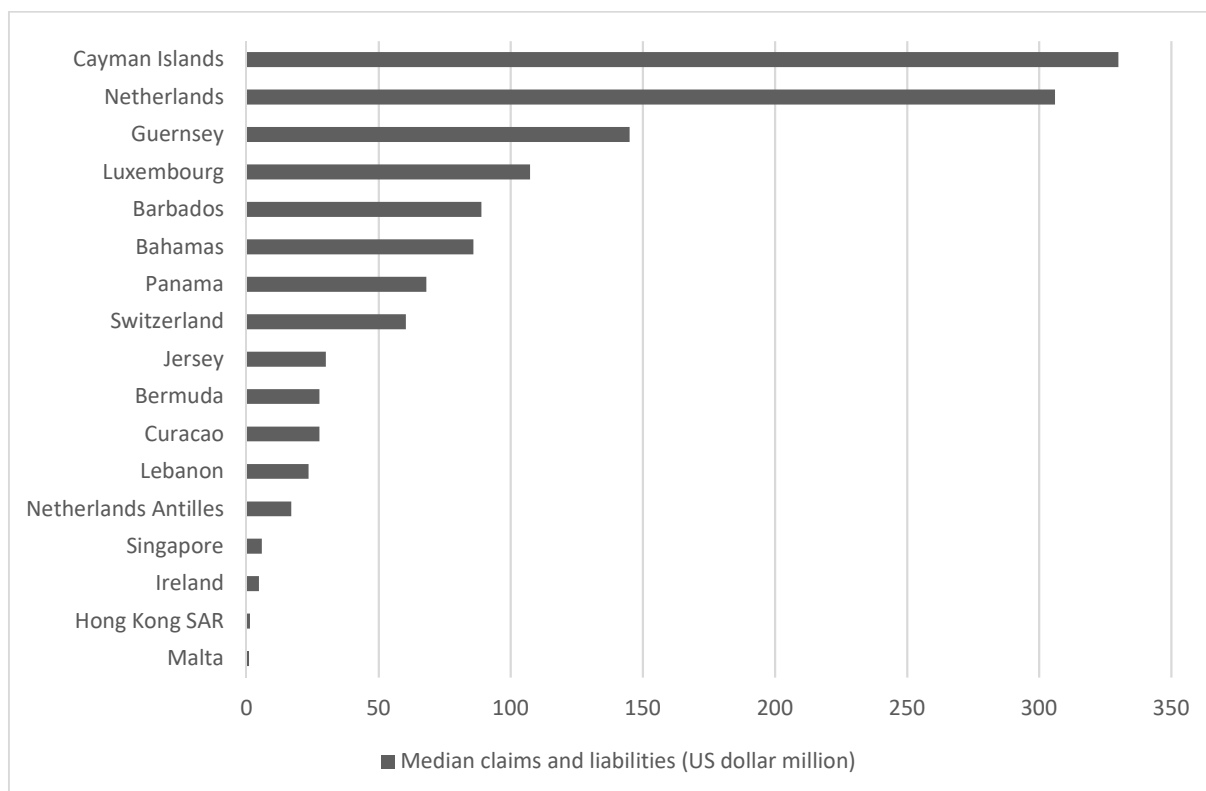


Source: BIS locational banking statistics, World Bank, own calculations

Mexico's demand for offshore financial services as total of claims and liabilities develops from US\$272 million in 2003 (0,04 per cent of GDP) to US\$988 million in 2017 (0,07 per cent of GDP). It peaks at US\$2.8 billion (0,17 per cent of GDP) in 2012. That means, Mexican demand for offshore services is by magnitudes lower than in Brazil and even more so compared to Germany and Britain. This is true in relation to the size of Mexico's economy and in absolute terms. Furthermore, the flows are volatile from quarter to quarter (see figure 6.1). What we can see here are mostly individual transactions. The interviewee from the central bank could even recall the banks responsible for each of the larger transactions.⁹³ Figures 6.1 and 6.2 also demonstrate that offshore assets are larger than offshore claims (except for the years 2014 to 2017). The numbers support the interviewees' claim that if Mexicans do go offshore it is to hedge against risks rather than to issue debt.

⁹³ Author's interview with employee of central bank, Mexico City, November 2015.

Figure 6-3. Prominent offshore financial centres



Source: BIS locational banking statistics

Figure 6.3 shows where these transactions take place. The two most important offshore centres are the Cayman Islands and the Netherlands, followed at a distance by Guernsey and other European and Caribbean offshore centres. In contrast to what the literature suggests (cf. Blanco and Rogers 2014; Haberly and Wójcik 2015b), Mexican economic actors do not necessarily prefer nearby Caribbean offshore centres, but also use European ones. Another notable observation is that interviewees usually mentioned Switzerland and the Netherlands as important offshore centres. While the Netherlands are indeed a popular offshore centre, Switzerland is used much less than the interviewees suggested. This difference may be a hint towards the illegal uses of Swiss offshore financial services and are analysed further below in the context of money laundering. The Netherlands is, on the other hand, Mexico's second biggest investment partner (IMF 2016), 'both, in substance and in form' as a corporate lawyer put it. In substance, the Dutch are among Mexico's ten largest trading partners and with the trading real investment flows in the same direction. In form, the Netherlands is also one of the most prominent offshore financial centres used to structure investment from and into Europe in a tax efficient manner (Garcia-Bernardo et al. 2017). And indeed, the Netherlands account for 25 per cent of Mexican outward investment. A number that appears disproportionately high in comparison to the real economic relations between the two countries. Mexican investors

channel their equity investments into Europe, mostly to Germany and Spain, through holdings in the Netherlands. These holdings give them, as one tax lawyer put it, an ‘excellent exit strategy’ to sell shares without paying tax for the proceeds in either Mexico or the final destination country of the investment.⁹⁴ Yet, unfortunately, the FDI data cannot tell us how much of the pie is real investment into the Netherlands and how much of it is virtual investment that ends up in Germany or Spain. Summing up the uses of offshore finance by Mexican economic actors one interviewee said:

*You know, a lot more money is probably parked in apartments in Miami than it is in Jersey or Bahamas. The destination is the United States, or Spain ... if I were to look at where the money is, it is there.*⁹⁵

This insight brings us to a question that is particularly relevant for the Mexican case study: the role of United States’ sub-national offshore financial centres. With no income tax on individuals and trusts, a very low state estate tax, no inheritance and no gift tax, Florida is certainly a low-tax jurisdiction. However, it is not an offshore financial centre according to the concept discussed in chapter 2. The favourable tax laws are not exclusively provided to non-residents, but also to United States citizens (no ring-fencing). Furthermore, Florida is not among the country’s secrecy jurisdictions. According to the financial secrecy index these are Delaware, Nevada and Wyoming (Tax Justice Network 2018d). These US offshore financial centers have not been mentioned in the interviews at all and hence there is neither quantitative nor qualitative data on their importance for Mexican firms and individuals. Finally, with a good three-hour flight from Mexico City, the wealthy indeed spend time in their Miami apartments.⁹⁶ The Miami holiday home for rich Mexicans is the equivalent to the Swiss Chalet for rich Germans. The line between capital flight and offshoring can be a fine one. Although the overall level of offshoring is comparatively low in Mexico, to understand the relationship between offshore finance and state power, it is nevertheless helpful to analyse the role of offshore money creation and tax planning in more detail.

Offshore money creation and tax planning

As in the previous cases, I estimate Mexico’s exposure to the Eurodollar – the core of offshore money creation – by first determining the share of US dollar-denominated cross-border

⁹⁴ Author’s interview with tax lawyer, Mexico City, November 2015.

⁹⁵ Author’s interview with economist, Mexico City, November 2015.

⁹⁶ Author’s interview with economist, Mexico City, November 2015.

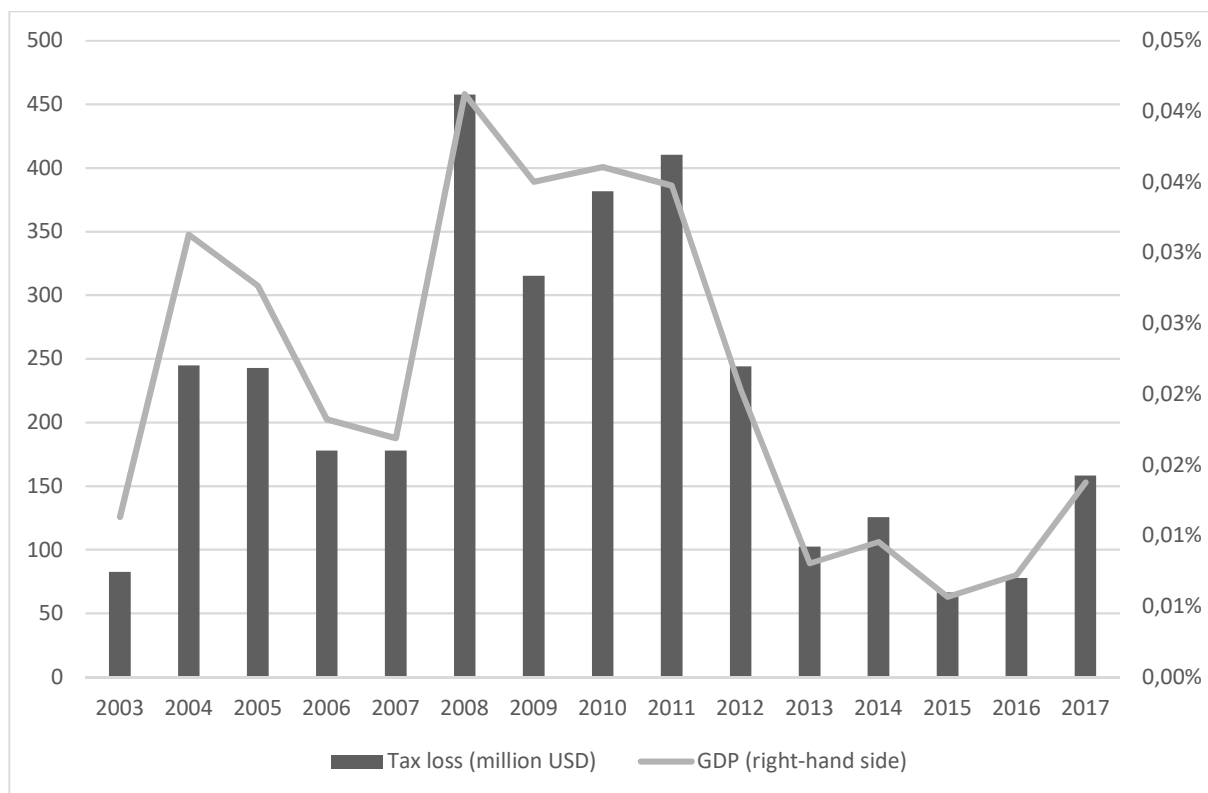
transactions between Mexican banks and the rest of the world and then, in a second step, applying this share to transactions between Mexican institutions and offshore financial centres.⁹⁷

According to the BIS data, all most all money that Mexican firms and individuals hold outside Mexico are denominated in US-dollar-denominated. The range varies between 90 and 99 per cent. That means, almost all money held offshore are Eurodollar. Eurodollar exposure is not substantially different from overall offshore demand. Moreover, as discussed above, in most years holding assets offshore outpaces the issuance of offshore debt. That means, during the timeframe covered here, Mexican economic actors draw rarely on money created offshore.

Logically, the limited overall demand of offshore financial services, whether in the Euromarkets or outside of them, means that offshore tax planning must be limited too. It depends on money crossing borders, whether in form of real economic activity or as an artificially created money flow simply for the purpose of saving tax. With the limited flows to offshore financial centres therefore come limited opportunities for Mexican firms and individuals to plan taxes there. Assuming, as in the previous cases, that all offshore money is undeclared, but would be taxed at the full average tax rate of 32.5 per cent if onshore, the loss for Mexican tax revenue develops as depicted in figure 6.4.

⁹⁷ See appendix 1 for details.

Figure 6-4. Estimated tax loss



Source: BIS locational banking statistics, World Bank, own calculations

Between 2003 and 2017, the tax loss related to offshore finance ranged from a minimum of US\$66 (0.01 per cent of GDP) to a maximum of US\$458 million (0.04 per cent of GDP) annually. In a country with a large proportion of the population living in poverty and lacking basic services, this is no trivial amount. Yet, it is hardly a fatal blow to the Mexican tax state. The numbers and interview results regarding offshore money creation and tax planning are clear: offshore finance plays a limited role in Mexico. However, these estimates cannot tell us anything about *illegal* offshore assets, about the abuses of offshore finance. The next section discusses these illegal uses of offshore finance by Mexican firms and individuals based on qualitative data.

Money laundering

Interestingly, and in stark contrast to Brazil, the interviewees maintained their claim about the limited uses of offshore finance even regarding money laundering. They argue that Mexican criminals use the onshore informal economy rather than offshore financial services for money laundering purposes. Informality coupled with the low inclusion of Mexican households into the financial sector, creates a largely cash-based economy (Del Angel 2016). The use of cash,

internationally going down, is on the rise in Mexico (FATF and GAFILAT 2018). This creates formidable spaces for onshore money laundering. For instance, paying workers without a bank account in cash is a cheap and efficient way for firms to keep financial flows below the state's radar. Although the Mexican authorities are well-aware of these money laundering schemes and have highly developed systems to detect them, law enforcement is wanting (FATF and GAFILAT 2018). That is, Mexican criminals employ classical onshore money laundering schemes such as 'cuckoo smurfing', succinctly described by a former employee of HSBC Bank:

My experience was ... that all these criminal networks ... have singular persons involved in these money laundering systems. They pay, for example, a cleaning lady ... and her only job is to go daily to a different branch of HSBC to make a deposit of 500 pesos. ... They collect 1,000 cleaning ladies doing that daily to different accounts. The owners of the accounts are ... the sons or nephews of the main capos and outside of Mexico. Maybe he is in England, studying in Oxford, or in Harvard and they ...make the shift of transactions of thousands, of millions of dollars to other branches of HSBC.⁹⁸

Although there is no publicly available data to quantify illegal offshore uses, the data of the Swiss National Bank on fiduciary funds can help to test the plausibility of the interview results. As noted above, there is a notable difference between what the interviewees said and what the data showed regarding the importance of Switzerland as a popular offshore financial centre. Interviewees usually mentioned Switzerland as one of the most important offshore financial centres, while the data demonstrates that other centres are far more important. One reason for the discrepancy of these numbers with the interviewees' impression could be transactions that are off-balance sheet which do not show up in the BIS statistics. Fiduciary fund and trusts that make offshore money invisible. (see chapter 1). Unlike fiduciary deposits, trusts are not allowed under Mexican law. Famously, Switzerland is globally the prime location for fiduciary funds (Zucman 2013b). For a criminal who wants to hide her money while still being able to invest it, a Swiss fiduciary deposit account is the way to go. Interestingly, the Swiss National Bank publishes an annual breakdown of the country of origin of the fiduciary funds (Swiss National Bank n.d.). If criminal Mexicans were hiding their money in Switzerland, it is likely it would show in this data. According to the Swiss National Bank, Mexican fiduciary deposits developed from about US\$ 800.000 in 1987, peaked at US\$2.8 million in 2000 and then declined to US\$2.8 million in 2016 (Swiss National Bank n.d.). Again, these comparatively small. The data on fiduciary deposits suggest that it is unlikely that Mexican hide large amounts of money in

⁹⁸ Author's interview with financial sector expert, Mexico City, November 2017.

Switzerland. The discrepancy of the interviewees' perception of the role of Switzerland and its actual importance may reflect past scandals, however. For instance, in the early 1990s, Raúl Salinas, the brother of former President Carlos Salinas (1988-1994), transferred about US\$100 million to Switzerland and the United Kingdom. After the Mexican government could show that a large amount of this money were actually public funds, the Swiss government froze Raúl Salinas's accounts and handed back US\$74 million to the Mexican government (GAO 1998; Swissinfo 2008).

In sum, all available data – quantitative and qualitative – point to a limited use and abuse of offshore finance in Mexico. Mexicans deposit and lend money offshore on such a limited scale that it is unlikely to have any substantial effect on the Mexican's state ability to determine the sources of its revenues in line with its preferences. These findings for Mexico are in stark contrast with the findings of the literature on offshore finance and international taxation. They hence warrant explanation.

2 The Mexican state from the money view

From the money view, Mexico's modern statehood developed around the same time as that of Germany and Brazil. Mexico became independent from Spain in 1821, but it took another 50 years for the federal republic to stabilise, centralise and exert territorial control in a manner that justifies speaking of Mexico as a modern state. In the first half of the nineteenth century, Mexico saw 75 presidents come and go. The governments had no tax revenue to speak of, and after repeatedly defaulting on their debt, they were excluded from international capital markets (Centeno 2002; Maurer and Gomberg 2004; Calomiris and Haber 2014, chaps 10–11). It was President José Porfirio Díaz who finally sustained Mexico's accumulated debt and by extension his grip on power. He was also able to create a small cycle of money, tax and debt thanks to Mexico's silver resources. In the absence of sovereign money, the precious metal helped to create a trusted means to account for and settle debt. The analysis of Mexico's institutional association of rule and its struggles over how to finance the state therefore starts in the late 19th century. Mexico's political order undergoes dramatic changes from José Porfirio Díaz autocratic reign (1877 to 1911), known in Mexico as the *Porfiriato*; through a revolution (1910-1920); to the dictatorship of the *Partido Revolucionario Institucional* (PRI)⁹⁹ (1928-1997); and most recently the process of democratisation since then. Like in Brazil, despite these fundamental regime changes, the institutional association of rule remains impressively stable over time.

⁹⁹ The party was first named Partido Nacional Revolucionario, then Partido de la Revolución Mexicana and since 1946 trades under the current name of Partido Revolucionario Institucional.

The institutional association of rule

From the money view, President José Porfirio Díaz's major achievement, one that would shape the Mexican state for more than a century, was his partnership of interest with Mexico's financiers (Calomiris and Haber 2014). Díaz convinced the Mexican wealthy elite to lend to his government in return for rents that arose from direct involvement in policymaking, deliberate restrictions on competition and selective enforcement of property rights (Maurer and Gomberg 2004). Díaz's tax revenues, however, remained marginal. The bankers lent to the government despite its limited resources for repayment because of the sheer volume of the rent. According to Maurer and Gomberg (2004), the financiers broke even as long as the government did expropriate them via bank nationalisation and renegeing on debt payments less than twice a decade. With this arrangement, Díaz had found a formula to finance the state without taxing the wealthy. Yet it would not have been sustainable were it not for Mexico's mineral wealth.

The rents could offset tax revenue as a means of coxing the financiers into extending credit to the government. But the rents could not replace tax revenue as a step in the cycle of money creation through debt and tax. That is, it did not help to establish a sovereign money that allows for capital expansion (see chapter 2). Fortunately for Díaz and his government, Mexico's resources in precious metals meant that the country has had, for 400 years already, a trusted currency – silver. Silver coins were used as tax payments and as a means to account for and settle debt long before the *porfiriato*. However, the precious metal as currency reached its limits by the beginning of the 20th century when a drop in the price of silver brought Mexico's international creditors and investors to the scene. They feared for the repayment of their credits and the devaluation of their investment. In 1905, under pressure from the US government, Porfirio Díaz implemented a far-reaching and domestically contested currency reform. He limited the coin production, introduced paper money and put the country on the gold standard. With these measures Díaz successfully stabilised the value of the (silver) peso (Pessananti 2008; Sotelo 2008; Banco de México 2018). But he still lacked revenue to create a smooth cycle of money, tax and debt. Already earlier in his presidency, Díaz had sought to develop the oil industry to address the country's rising energy costs and to generate government income. In 1884, his government granted the owner of surface land the rights to subsurface petroleum resources to promote investment into the development of the industry. Unfortunately for Díaz, it took the US American and British investors a decade of exploration before they could profitably drill oil. By 1911, the time when Mexico emerged as one of the world's largest oil producers, Díaz reign had already ended (Haber, Maurer, and Razo 2003).

During the *Porfiriato*, the Mexican state, in the sense of an institutional association of rule, essentially constituted of the president, his closest allies and a handful of bankers and big

businesses (Carmagnani 1994; Aboites 2003; Knight 2013; Calomiris and Haber 2014, chaps 10–11). The rural poor and the urban middle classes, the overwhelming majority of Mexicans, were excluded from that association. But they had to pay, directly or indirectly, for the rents that sustained Díaz's partnership with the bankers (Calomiris and Haber 2014). The resulting problem of legitimacy was solved – or rather postponed – through coercion and violence (Centeno 2002; B. T. Smith 2014; Calomiris and Haber 2014, chaps 10–11). In November 1910, the educated middle classes joined forces with the rural poor in protest over Díaz's reign and took to the streets. Their protests ignited the Mexican Revolution, a 10-year armed struggle over political participation (Hamilton 1982). Through that struggle, members of Mexico's old elite seized power. Unlike Díaz and his allies, they acknowledged, however, that the new regime needed a popular base. They created a one-party system and co-opted popular movements – small farmers, organized workers, and unionized public employees – into the emerging PRI. The country's economic elites, in contrast, were not included in the PRI. Rather, the PRI corrupted big businesses individually and resurrected Díaz's partnership of interest with the bankers. As a result, the spheres of political and economic elites developed as separate but interrelated.¹⁰⁰ The glue that held them together was the same that connected the PRI with its popular base: a system of selective privilege and patronage. The government provided the economic elites with decision-making power, monopoly rents and tax exemptions in return for investment and access to credit. In the same vein, the party offered its popular base political influence, welfare programs, tax exemptions, social mobility and opportunities for personal enrichment in return for political loyalty (Knight 1990; Maurer and Gomberg 2004; Haber et al. 2008). The system of privilege and patronage ensured the PRI's quasi-total power from 1928 to 1997. During that time, the institutional association of rule consisted of the PRI, the financiers and the social movements the PRI had co-opted. However, after more than 50 years of successfully mitigating the conflicts between the interests of the financiers and the co-opted social movements, the PRI model of organising the state's finances through rents and debt met its limits in the financial crises of the 1980s and 1990s. In 1982, most Mexicans, excluded from the system of privilege and patronage, paid for the debt crisis with sharply rising inflation and unemployment. The 1982 debt crisis rang in Mexico's *década perdida* and the beginning of the end of the PRI's uncontested power. The austerity measures that the government introduced undermined the system of privilege and patronage and hence the party's link with its popular base. The party's response to the crisis laid the foundation for the currency crisis of the mid-1990s, sealing the PRI's fate. After 76 years of uninterrupted rain, the PRI had to concede defeat

¹⁰⁰ Author's interview with economist, Mexico City, November 2015.

in the presidential elections of July 2000 to the opposition candidate for the presidency, Vicente Fox. During Mexico's transition from a one- to a multi-party system, formal power in Mexico changed fundamentally (Camp 2015). Yet, the informal power networks between the government, the wealthy and the co-opted social movements, built through the system of privilege and patronage, persisted. Despite political competition, the relationship between the government and the citizens continued to be mediated by 'political brokers' as Selee (2011, 170) puts it. Political opinion- and decision-making remained a process of intermediation through private networks, rather than parties and parliament. Mexico's democracy is more clientelistic than representative. In other words, despite democratization the nature of the Mexican state changed little (Selee 2011). In the words of one interviewee:

Most Mexicans consider the state as something that is external to them. The state is a set of institutions which are controlled by a small group of people. That is, you have two options. Either you become part of the state controlling group, which is difficult, or you stay away from the state as far as possible.¹⁰¹

Consequently, as the subsequent two sections demonstrate, banking and tax institutions in contemporary democratic Mexico show the legacy of José Porfirio Díaz's and the PRI's approach of financing the state.

Banking

Porfirio Díaz certainly was the most influential president in the development of banking in modern Mexico. His 'crony banking system', as Calomiris and Haber (2014, 337) term it, proved successful. Though small, it was stable and provided the resources to finance Mexico's industrialisation. It also created significant revenue, both in the form of rents and cash, for Mexico's moneyed classes. It therefore created a tight relationship between the wealthy and the government. By the 1890s, Mexico, hitherto the chronic defaulter, had the best credit rating in Latin America (Knight 1990). An important step on the way from chronic defaulter to creditor darling was the foundation of the *Banco Nacional de México* (Banamex) in 1884. Banamex was the first national bank with the right to issue paper money, to act as the finance ministry's fiscal agent and to run the mint. Since the underlying bank law was co-written between the government and Mexican financiers, it also granted Banamex a monopoly of lending to the government by revoking the right of the states to issue bank charters. Through the foundation of Banamex, a semi-official bank, Díaz managed to successfully establish paper money as the

¹⁰¹ Author's interview with civil society organisation, Mexico City, November 2015.

main means of payment, including tax payment which was also collected through Banamex. The successful establishment of paper money allowed for capitalist expansion (Calomiris and Haber 2014, chaps 10–11; Banco de México 2018).

Yet, the Mexican revolution disrupted Díaz's cycle of money, rent and debt thoroughly. In need for money, every party to the conflict printed its own bills with the validity limited to the territory they controlled at any given point in time. With the military ups and downs of these groups, the validity of the paper money changed constantly, undermining the credibility of paper money among the population. In response, Mexicans resorted to what they trusted in: silver and US dollar. By 1916, even the government had given up on paper money and accepted only silver coins as tax payment. By law, workers had to be paid in precious metal, too (Cardenas and Manns 1987; Banco de México 2018). By the end of the revolution, the Mexican banking institutions and money creation was in shatters.

As noted above, after the revolution, the emerging PRI resurrected the partnership of interest in a move similar to Díaz's. It founded a bank that would bring together the government and Mexican financiers. In 1925, they founded *Banco de Mexico* (Banco de México 2018). Initially, the *Banco de Mexico* was the same mix between a commercial and a central bank as Banamex. However, with this setup, the re-introduction of paper money proved difficult. To address this problem, the PRI removed, in 1931, the *Banco de Mexico's* commercial powers and demonetized precious metal. Silver coins were no longer accepted as tax payment. With these measures, the PRI established a central bank and re-established the cycle of money, rent and debt. As under Díaz, the resulting banking system was small, but functional in terms of lending to the government (Calomiris and Haber 2014, chaps 10–11; Banco de México 2018). However, the system's smallness became a problem when, in 1938, the government decided to make good on one of the most radical promises of the 1917 constitution: to privatise the oil industry. The government expropriated all foreign petroleum firms and merged them into one large state-owned company, *Petróleos Mexicanos* or PEMEX for short. Next to PEMEX, other central industries were also nationalised – though in a less dramatic fashion. Through the continuous acquisition of stocks, the government became either a minority or a majority shareholder of firms in the railway, tourism, telecommunication and other sectors (MacLeod 2005). Initially, the nationalisation splashed money into the government's coffers. However, over time, inefficiencies in some of the state-owned companies became a strain to the budget (MacLeod 2005), all the while the costs for the system of patronage and privilege continued to rise. By the 1970s, debt began to outpace revenues. The government urgently needed more and cheaper money than the domestic banking system could provide (Calomiris and Haber 2014, chaps 10–11).

The PRI was lucky. Thanks to rising petroleum prices and new discoveries in the Mexican Gulf, government revenues were large enough to allow for borrowing in international financial markets (Haber and Musacchio 2013). Even more importantly, a banking reform in 1974 allowed Mexican banks to internationalise. The banks, first among them Banamex and Bancomer, used the deregulations to get involved in the Euromarkets. The participation in Eurodollar banking appeared to be a win-win situation between the banks and the government resembling an internationalised version of Díaz's partnership of interest. On the one hand, the government profited from Mexican banks' Euromarket activities. Having access to international interbank loans, the Mexican banks expanded their domestic lending activities; between 1977 and 1982 domestic credit increased at an average rate of 38 per cent annually. The banks extended these credits largely to the government and public corporations (Alvarez 2015). For instance, in September 1976 the Mexican government issued an US\$800 million Eurodollar loan. This was Mexico's largest loan in the Euromarkets thus far; and it was one of the largest loans issued by any market participant that year. According to the government, the intent of the loan was to invest in infrastructure development, including in the oil sector (The New York Times 1976). Only one year later, Mexico topped its record with a new largest-ever Eurodollar loan, this time valuing US\$1.2 billion. This loan came in addition to a separate Eurodollar loan issued by PEMEX the same year, seeking US\$300 million, but ending up oversubscribed with US\$350 million (Riding 1977). Again, the loans were sought to invest into infrastructure development. All in all, in the decade between 1970 and 1979, Mexican economic actors issued 322 Eurodollar loans valuing collectively US\$16 billion. Out of the US\$16 billion about a third included Mexican banks as intermediaries (Alvarez 2015). Mexican banks, on the other hand, also profited from the new arrangement by increasing their business. Best of all, however, interest rates in the Euromarkets were about 40 to 60 per cent lower than domestically. With a *de facto* fixed exchange rate (under a managed floating exchange rate regime), Mexican banks could borrow cheap internationally and lend on at higher prices domestically. In addition, in the Euromarkets the international branches of Mexican banks were not subject to reserve requirements (see chapter 2). The rents through arbitrage were steep (Alvarez 2015).

However, when oil prices collapsed in 1982, the Eurodollar bonanza came to sudden end. The Mexican government had to sign a moratorium and to negotiate a restructuring of its debt in return for a fierce domestic structural adjustment program. To avoid a collapse of the Mexican banking system, President José López Portillio (1976–1982) nationalised the banks. With the stroke of a pen, the long lasting partnership of interest between the government and Mexican financiers was finished (Calomiris and Haber 2014, chaps 10–11). Importantly, the negotiation between the Mexican government and the international creditors in 1982 entailed

keeping the interbank credit lines frozen at the pre-moratorium level. After several extensions of this agreement, in 1991, a newly created financial instrument was introduced. The so-called Floating Rate Privatization Note was a direct obligation of the Mexican government (Alvarez 2015). When President Carlos Salinas (1988–1994), intending to stem the withdrawal of the propertied classes from domestic credit markets, re-privatised the banks the same year, the holders of the Floating Rate Privatization Note could use it to purchase shares in Mexican banks. In addition, Salinas tried to revive the partnership of interest and offered the financiers unlimited insurance against any loss the banks may incur in the future. This offer proved so attractive that the bankers were willing to pay US\$12.4 billion, three times the book value of the banks, for the 18 banks on offer (Calomiris and Haber 2014, chaps 10–11). Facing little risk thanks to the government-bailout guarantee and the remaining access to the interbank market through the owners of the Floating Rate Privatization Note, Mexico's banks, in particular Banamex and Bancomer, were back in the Euromarket in the early 1990s. During that time, economic actors were starved for credit to finance the lucrative acquisition of the public companies that were privatised as part of the structural adjustment program. With the banks back in Eurodollar intermediation, Mexico's private sector moved from being a net creditor in 1990 to being a net borrower only one year later. The lending of Mexican banks in the Eurodeposit market alone increased from US\$321 million in the third quarter of 1994 to US\$2.7 billion in the last quarter of 1994 (Antzoulatos 2002). However, unlike in the 1970s, this time the intermediation was mainly between Mexican banks and the Mexican private sector. The banks channelled US dollar liquidity into Mexican corporations, even if they had mainly peso denominated assets. When the peso collapsed in December 1994, nearly halving in value against the US dollar, Mexican firms' US-dollar-denominated loans doubled in value in the space of a few days. The firms could not serve their debt, and as a result the banks collapsed. Only three years after the bank re-privatisation, the government of Ernesto Zedillo (1994–2000) nationalised the banks again, costing the country about 15 per cent of GDP. The bailout – which transferred money from Mexican taxpayers to bank stockholders, some of Mexico's wealthiest individuals – killed the relationship between the PRI and its popular base. The PRI lost power first on the local level in 1997 and then on the federal level in 2000. Bracing for the PRI's demise, Zedillo attempted to spur economic growth, for which he needed a new partnership with the bankers. As the relationship with the domestic financiers was ruined, Zedillo turned to foreigners. In 1996, for the first time since the *Porfiriato*, Zedillo allowed unrestricted foreign bank ownership. It took only a few years for the largest Mexican banks to be owned by foreign investors, particularly from the United States and Spain (Haber et al. 2008; Calomiris and Haber 2014, chaps 10–11).

The end of the partnership of interest between the Mexican government and its domestic financiers in the 1990s and the subsequent liberalisation of the financial sector, disrupted banking in Mexico more substantially than the revolution did. In 1991, foreign banks owned one per cent of assets; by 2013, that number had grown to 74 per cent. Mexico became the country with the most rapid and far-reaching penetration of foreign banks in the world (Haber and Musacchio 2013). According to Haber and Musacchio (2013), the entry of foreign banks made Mexico's banking system more stable, with access to credit for corporations and households more easy and cheap. Still, financial inclusion remains small in Mexico; only 39 per cent of adults have a bank account (CONAIF 2016). The system also remains highly concentrated with seven banks, five of which are foreign owned, accumulating 73 per cent of market share (Díaz-Infante 2013).

As the ownership of the banking system developed from domestic-owned to foreign-owned, the issuance of Mexican sovereign debt developed in the opposite direction. Before the Mexican financial crises, 70 to 80 per cent of debt was issued abroad. Today that amount is issued domestically. The ownership structure, though, did not change. Mexico's debt is still foreign owned, since most of it is held by the foreign-owned banks and their pension funds.¹⁰² The big change is that the debt is denominated in Mexican pesos, not in US dollar (Banco de México 2014). In other words, after three decades of offshoring debt with terrible consequences for Mexico's ordinary citizens, the government finally moved to create money onshore. Likewise, after the 1994–1995 peso crisis, the private sector became much more restrained in borrowing in US dollars. Hence, for a considerable period after Mexico's successive financial crises, there was limited demand for US dollar-denominated debt and thus no reason to search for investors offshore. After the 2007–2008 global financial crisis – which had severe effects on Mexico's economy but barely affected the banking system – the dynamic changed. Driven by US American investors' search for yield in the post-crisis, low interest-rate environment, Mexican private corporations found it easy to issue debt in international credit markets as the US American banks operating in Mexico could provide them with direct access to these markets.¹⁰³ Hence, an important contemporary reason for economic actors to go offshore, namely getting access to credit denominated in US dollar, is not present in Mexico the way it had been before the country's financial crises. Not engaging in offshore banking is a very recent phenomenon. Mexico's withdrawal from the offshore Euromarkets had, has demonstrated

¹⁰² Author's interview with central bank staff, Mexico City, November 2015; author's interview with economist, Mexico City, November 2015.

¹⁰³ Author's interview with financial sector expert, Mexico City, November 2015

above, consequences for offshore tax planning too. To get a better perspective on that side of the coin, the next section provides a historical perspective on taxation in Mexico.

Taxation

The reason for the limited demand of offshore tax planning services, on the other hand, are the result, as this section shows, of a longstanding, surprisingly stable history. As with banking, this history has its roots in the *porfiriato*. With the partnership of interest Porfirio Díaz's government (1877 to 1911) managed to set in motion a circle of money, rent and debt. The creation of rents allowed the government to go into debt and create sovereign money, while being able to rely on a currency that was – since centuries – backed by silver. However, that cycle would not have been sustainable if it were not for Mexico's oil resources. Already Díaz and his government aimed to develop the petroleum industry, but profitable drilling only started a couple of years into the revolution. From then onwards it grew significantly and with it grew tax revenue. In 1912, receipts from the oil sector accounted for less than one per cent of the government's total income. In 1917, the year of the new constitution, it made up five percent. Five years later, in 1922, the government's income depended to more than 30 per cent on oil (Haber, Maurer, and Razo 2003). Since then, the Mexican oil industry has experienced important changes. For instance, in the late 1920s, with the technology of the day, drilling companies could not keep up its previous levels of oil extraction and Mexico lost an important share of the international oil market. Once these problems were overcome, the PRI nationalised the oil industry in 1938. The 1970s, in turn, were a golden age for Mexico's petroleum industry with new findings in the Gulf of Mexico and roaring international oil prices. Despite these changes, what stayed the same in the long-run was the share of the oil sector in the government's revenue.¹⁰⁴ Since the early 1920s, the petroleum industry contributes on average about one third of the state's coffers (L. B. Hall 1995; Aboites 2003). Although not enough to finance the state, the taxes from oil created the basis for a tax system characterised by a low tax burden, in particular for capital (Haber et al. 2008). Post-revolution, the low tax burden allowed the PRI to avoid political conflict with its two power bases, since, in the words of Smith (2014, 261), 'the elites considered taxation as brazenness and peasants as another feudal load.' Thanks to oil revenue, the PRI could finance the state's politics through debt (Aboites 2003; Calomiris and Haber 2014, chaps 10–11). Nevertheless, not least in order to tax the oil sector, by the end of the 1940s, the PRI had developed a small, but modern tax system. Between the 1950s and the early 1980s, this system generated, on average, about two thirds of the tax revenues typical at that time in the rest of Latin America. Before the mid-1970s the state's revenue was constantly

¹⁰⁴ Author's interview with economist, Mexico City, November 2015.

less than 10 per cent of GDP. With Mexico's increasing income from oil revenues throughout the late 1970s and early 1980s the ratio increased to about 15 per cent of GDP. By the early 1970s, government expenses finally started to outpace revenues, and the government urgently needed to mobilise resources to sustain its debt (Calomiris and Haber 2014, chap. 11; B. T. Smith 2014). But in the system of patronage and privilege, taxing the wealthy or cutting expenditures for the popular base was politically unfeasible. The government decided to borrow at the Euromarket, that is, to create money offshore. As noted above, the engagement in the Euromarket fundamentally altered banking in Mexico by replacing domestic financiers with foreign ones. As for taxation, the system today still reflects the interests of the old association of rule as an evaluation of the contemporary tax structure shows.

According to the OECD (2017b), taxes on personal income make up a smaller proportion of tax revenue than in any other member state. Like in previous times, the wealthy elite is spared from contributing more significantly to the state's treasury (Sobarzo 2011). Likewise, social security contributions account for a much smaller share in the tax mix, expressing the association of rule's limited willingness to contribute to the welfare of the larger population.¹⁰⁵ Mexico's nearly entirely privatised health, pension and social security systems create much lower spending needs than either in the OECD or in other Latin American countries (OECD 2015). Next, consumption taxes make up about 39 per cent of the tax revenue. This share is lower than the Latin American average of more than 50 per cent (OECD 2015), but is an explicit attempt by the government to increase its revenue by taxing poor people in Mexico's informal economy.¹⁰⁶ Finally, the share of corporate incomes taxes is considerably higher than in the OECD world. Corporations contribute 20 per cent to the tax revenue, much more than their OECD peers. A high tax burden for corporations is common in developing countries, as these taxes are easier to collect than others (Genschel and Seelkopf 2016). Yet, the 20 per cent share of corporate tax revenue in Mexico must be seen against the background of a significantly lower overall tax burden than in any other OECD country. Mexico still has the OECD's lowest tax-to-GDP ratio. In 2016, its tax revenue amounted to 17 per cent of GDP compared to the OECD's average of 34 per cent and Latin American average of 22 per cent¹⁰⁷ (OECD 2015). That is, Mexican corporations contribute a larger share to a much smaller pie than corporations in other OECD countries. This setup reflects the above described fact that businesses were not part of the PRI's system of privilege and patronage but were corrupted individually. In contemporary Mexico, the high corporate tax rates are matched by equally high rates of corporate onshore tax

¹⁰⁵ Author's interview with tax expert at a civil society organisation, Mexico City, November 2015.

¹⁰⁶ Author's interview with tax expert at a civil society organisation, Mexico City, November 2015.

¹⁰⁷ Numbers for Latin America are from 2014.

avoidance. Businesses negotiate individual tax exemptions at the municipal and state levels¹⁰⁸ adding up to a considerable tax loss at the federal level (San Martín Reyna et al. 2016). That is, Mexico's contemporary tax institutions reflect the preference of the institutional association of rule: limited spending on the poor and a low tax burden for the wealthy. Within that agreement, however, the government has the capacity to enforce the rules.¹⁰⁹ For instance between 2004 and 2015, evasion of VAT has come down from 35 to 19 per cent of the possible tax revenue and evasion of income tax has dropped even more from 49 to 26 per cent (San Martín Reyna et al. 2016).

The contemporary shape of Mexico's tax institutions has two implications for the use of offshore financial services. First, Mexico's exceptionally low tax burden limits corporations and wealthy individuals' demand of to go offshore. Second, almost 40 per cent of tax revenue comes from consumption taxes. These taxes do not lend themselves to being evaded offshore (OECD 2017b). Rather, Mexicans dodge them through the country's large informal economy (ILO 2014; Buehn and Schneider 2016). In Mexico, it is the informal sector, not offshore financial centres, that help criminal and the wealthy to engage in the politics of the invisible. The informal economy provides similar opportunities as offshore financial services; only, it spares the cost and effort to hire the lawyers and accountants needed to go offshore. As in the past, Mexico's tax state is weak by design.

The ensuing shortage of tax revenue is offset, again as in previous times, by revenues from petroleum (Aboites 2003; Sobarzo 2011) and debt (Calomiris and Haber 2014, chaps 10–11). This approach to financing the Mexican state exposes public finances to the volatility of international debt and oil markets. Yet, it reflects the preferences of the still exclusive association of rule that is the Mexican state.

3 Offshore finance and state power in Mexico

Contemporary Mexico is a counterintuitive case regarding the effects of offshore finance on state power. The country exhibits all factors that are commonly associated with an important demand for offshore financial services – it is large, has an open economy, is located closely to important offshore financial centres and wrestles with problems of crime and corruption (see chapter 1). Yet, the empirical data discussed above shows that contemporary Mexico has little exposure to the Eurodollar market and tax avoidance and money laundering are done through the country's large informal economy. Mexican economic actors make little use of offshore financial services. The subsequent historical-institutionalist analysis could explain these

¹⁰⁸ Author's interview with tax lawyer, Mexico City, November 2015.

¹⁰⁹ Author's interview with tax auditor, Mexico City, November 2015.

surprising results. The country's limited exposure to the Eurodollar market is the result of domestic policies that responded to the experience of the financial crises in the 1980s and 1990s. The limited uses of offshore financial services for tax planning and money laundering, on the other hand, are due to an exclusive elite consensus that provides the wealthy and the criminals with onshore rents which are comparable to the rents created through offshoring – only they spare the actors the trouble to pay lawyers and accountants to setup sophisticated offshore structures. In sum, banking and taxation institutions in Mexico are shaped such that there is a limited demand for offshore financial services. In the absence of significant uses of offshore finance, their effect on state power is, naturally, limited too. Nevertheless, the Mexican case holds interesting insights for the thesis's question about the relationship between offshore finance and state power. In the following I discuss these insights with a view on the ability of the Mexican institutional association of rule to united resources to finance its politics.

The historical-institutionalist analysis above has shown that the Mexican state remains remarkably exclusive and remarkably stable over time. The debt-oriented development of Mexico's public finances has made, from José Porfirio Díaz's autocratic rain to today, the government dependent on the moneyed classes and natural resource revenue. The approach to coax the moneyed classes into lending to the government by providing them with rents through restricted competition, institutionalised an oligopolistic economy and a tight (though often strained) relationship between the government and its financiers. Yet, the financial crises of the 1980s and 1990s and the subsequent process of democratisation shook up the institutional association of rule: domestic financiers were replaced by international ones and debt denominated in peso rather than US dollar. In other words, the financial crises disrupted banking in Mexico more than it disrupted taxation (see below).

As in the Brazilian case, we can observe three different phases of Mexican exposure to the Eurodollar. In the first phase, the Mexican government and state-owned corporations borrowed extensively at the Eurodollar markets. This was possible mainly, because the Mexican central bank had allowed domestic banks to establish affiliates abroad (Alvarez 2015). The access to Eurodollar allowed Mexico to finance its economic development in the 1970s. Yet, as is well known, the borrowing ended in the 1982 financial crisis. In consequence, the Mexican government retreated from borrowing in the Eurodollar market. The government also nationalised the banks and hence ended the century old partnership of interest with domestic financiers. However, the banks and their owners moved back into the Eurodollar markets by the early 1990s. This time around, again similarly as in Brazil, the banks passed on the US-dollar denominated offshore credit to the Mexican private sector. In both these phases, Mexico's engagement with the Eurodollar market was an attempt to extend money creation and

finance infrastructure development by going offshore. The small banking system which was the result of the institutionalised partnership between domestic financiers and the government did not create enough money to allow for capitalist expansion. Two severe financial crises in the span of a decade was the price Mexico paid for offshore money creation. Politically, the 1982 crisis cost the government its relationship with the financiers and that of 1994 the backing of its popular base. As a result, the PRI's power, uncontested for 76 years, vanished. In the aftermath of the two financial crises, the Mexican government succeeded in on-shoring money creation. The government opened the Mexican banking sector to foreign banks which increased the possibility for domestic debt issuance for both, the government and the private sector. In addition, all newly issued debt, sovereign and corporate, was now denominated in Mexican peso.¹¹⁰ As a result, between 1994 and 2005 the money issued offshore was below US\$300 per year – the amount of a single issuance in the 1970s (without inflation adjustment). Leaving the Eurodollar markets behind increased the Mexican state's ability to conduct a monetary policy that was supportive of its politics.

However, with the onset of the third phase of Mexico's exposure to the Eurodollar in the aftermath of the Financial Crisis these gains in state autonomy are at stake. Between 2009 and 2012 offshore debt issuance started to increase, but then, from 2014 onwards it drops again. The increase in offshore debt between 2009 and 2012 was, according to the interviewees, driven by supply. International investors were in search for investment opportunities and, given the state of the US and European economy, emerging market investments appeared attractive. However, the government and economic experts remained wary of increased corporate sector leverage, denominated US dollar.¹¹¹ The state's response to the financial crises was to withdraw from the Euromarkets, something no other country studied in this thesis achieved. Abstaining from offshore money creation remains an explicit policy of the Mexican government (Webber 2001). Through US American banks, Mexico continues to create money onshore.

Likewise, Mexican tax planning is done at home. The reasons are to be found in Mexico's comparatively low tax burden on income and wealth, the large size of its informal economy and the limited flows of money to and from offshore centres since the withdrawal from the Euromarkets. Unlike offshore banking, the limited use of offshore tax planning has a long history. Mexican modern statehood emerged out of debt and political violence (Centeno 2002), not as usually attributed to the European state from external warfare and financing through taxation (Schumpeter 1991; Tilly 1990). If we conceive the state in Weber's terms as an

¹¹⁰ Author's interviews with central bank staff; with financial sector expert, Mexico City, November 2015.

¹¹¹ Author's interviews with central bank staff; with economists, with financial sector expert, Mexico City, November 2015.

association of rule, we can see that the Mexico's moneyed classes willingly financed both the debt and the violence in return for rents from restricted competition, selectively enforced property rights and natural resources. They were much less willing, though, to contribute to the state's finances via taxation. Historically, the Mexican tax state has been weak by design, not because of a lack of capacity. The same holds true today. The low overall tax burden in Mexico – it is still only at about 17 per cent of GDP (OECD 2017b) – is a reflection of political will. The government has shown that if need be it can fight onshore and offshore tax avoidance and evasion. The significant drop in VAT and personal income tax fraud and Mexico's early implementation of the OECD BEPS standards testify to the tax state's potential strength. Next to the nature of Mexico's tax system, the informal economy is an important factor in explaining the limited demand for offshore services. It allows criminals to launder their ill-gotten gains from tax evasion, corruption, or drug trafficking without too much risk of being detected. For the wealthy, the informal economy provides similar rents as offshore finance, but without having money to spend on accountants and lawyers to set up sophisticated offshore structures. At the same time, the informal economy provides a hideout for the poor population who feels – not unjustifiably – that Mexico's tax system is skewed too much against them.¹¹² Finally, with limited financial flows to and from offshore centres since Mexico's withdrawal from the Euromarkets, there are less opportunities for firms and individuals to use these flows as a means to plan taxes. The opportunities that do arise from in and outflow of FDI are used by large corporations, but do not sum up to a threat to Mexico's ability to determine its tax policies. For the relationship between offshore finance and the state, it matters that Porfirio Díaz forged a partnership with the bankers *before* establishing a modern tax system. This chronology laid the foundations for a modern state more deeply shaped by debt than by tax. Consequently, but counterintuitively, the structure of bank ownership has been more consequential for the level of using offshore financial services than formal democratization.

¹¹² Author's interview with tax expert in civil society organisation, Mexico City, November 2015.

VII Conclusion

Analysing the offshore phenomenon from the perspective of Britain, Germany, Brazil and Mexico has shown that offshore finance is, indeed, like a house of mirrors. Mexico's uses of offshore financial services are considerable smaller than what the literature would suggest. In Brazil both its economic development and the large-scale corruption would be impossible without offshore finance. Germany's substantial role in the Euromarkets often goes unnoticed. The size of Britain's demand and provision of offshore financial services may not surprise comparatively, but the absolute numbers are nevertheless dizzying. Nonetheless, coming at the offshore phenomenon from the combined perspective of the state, understood in Weber's (1994) terms as an institutional association of rule, and Ingham's (2004) notion of sovereign money, proved a useful guide through that house of mirrors. The perspective allowed recognition of the unique nature of the relationship between offshore finance and the state in each case. At the same time, it allowed identifying commonalities between them. For each country, it clarified how the intrinsic connection between tax and debt projects itself onto the offshore world. It highlighted how the state is involved with offshore finance, and who stands to win and who to lose from that involvement. Most importantly, it unveiled how across all cases offshore money creation was more consequential for the power of the state than was offshore tax planning. Offshore money creation affects the power of the state (and in the British case even its very nature) more deeply than recognised in academic and political debates.

This concluding chapter provides a summary of the commonalities and differences between the four cases. It then attempts a more generalised answer about how offshore finance affects the power of the state to finance its politics. The chapter ends with a discussion of the implications of the research results for studying offshore finance.

1 A structured comparison

The purpose of a case-study-driven enquiry into the relationship between offshore finance and the state was to account for the historical and geographical contingencies that shape this relationship. The purpose of analysing all four countries within a common framework was to allow for comparison and some degree of generalisation. This section starts the comparison by analysing the demand for offshore financial services across the four cases and discussing the reasons that account for the variations and similarities.

The scope and pattern of offshoring

Undoubtedly, Britain is the heartland of offshore finance. It invented offshore money creation, uses all sorts of offshore financial services abroad and provides offshore banking services to non-residents from across the world. This central role in the offshore world sets Britain apart from the other three countries. In Germany, Brazil and Mexico, economic actors mostly use offshore financial services offered elsewhere. The facet that is most comparable across all cases is, therefore, demand for offshore financial services. Since the longitudinal dimension of that data varies across the four cases, I discuss here the longest timeframe available for each case, focusing on the relation of the demand for offshoring to the size of the economy.

In the case of Britain, the demand for offshore financial services developed from 43 per cent of GDP in 1977 to a peak of 157 per cent in 2008. It then sunk from the Financial Crisis onwards, reaching 104 per cent of GDP in 2018. Even without considering the provision of offshore banking services, British demand of offshore financial services alone equals the size of the country's economy. Before the 2007-2009 Financial Crisis, it stood even at 1.5 times the national economy's size. Given the pre-eminence of the City of London in global finance, it hardly comes as a surprise that demand for offshore financial services in the other countries are a different ball game. Germany, the largest of the four economies, the overall demand for offshore financial services grew from three per cent of GDP in 1977 to 40 per cent at its peak in 2008. It then fell after the Financial Crisis to 28 per cent of GDP. Brazil's demand for offshore financial services ranges between four per cent in 2002 and five per cent in 2017. In Mexico offshore demand remains between 2003 and 2016 constantly below 0.2 per cent of GDP and is, therefore, negligible.

Despite this variance in the scope of offshore demand, there is an important commonality: for all four countries, the largest part of their offshore activities – somewhere between 70 and 99 per cent – takes place in the Euromarkets. For Britain this means offshore activities are denominated in Eurodollar or Euroeuro; for the other countries it means they are denominated in Eurodollars. It stands to reason that the Euromarkets drive offshoring. Intuitively, the numbers also suggest that the higher the scope of offshoring, the higher the related tax loss. In 2016, Britain lost tax revenue equivalent to an estimated 16, Germany six, Brazil one and Mexico 0.06 per cent of GDP. Overall, the tax loss closely follows the level of offshoring. The same appears true for offshore money laundering, though quantitative data is not reliable, and the full extent of the phenomenon remains obscure. Yet, even with regards to offshore money creation and tax planning, it is important to see the numbers for what they are. As the Mexican case demonstrated most clearly, the contemporary level of demand for offshore financial services as reflected in these numbers is a snapshot, not a static, universal fact. The Brazilian

case, on the other hand, highlighted that the estimates are potentially too low, for the BIS data does catch the face, but not the underbelly of offshore finance. In Brazil, the offshore assets reported to the *Banco Central do Brasil* (2017) were four to five times more than the BIS data suggests. However, since the data was reported to the central bank, it was also reported to the tax authorities and hence taxed. The Brazilian case suggests that we underestimate the offshore volume and overestimate, by assuming that everything that is offshore goes untaxed and would be taxed at the full rate if repatriated, its related tax loss.

From the perspective of state power, however, these quantitative intricacies are only of secondary importance. Granted, it does matter for the power of the state whether offshore demand is huge, as in the case of Britain, or minimal, as in the case of Mexico. However, the exact volume does not necessarily change the effect of that demand on the state's ability to unite resources. Take Germany and Brazil as examples. Brazil's demand for offshore financial services is smaller compared to the size of its economy than Germany's. Nevertheless, the effects are more pronounced in Brazil than in Germany. The thesis overall findings and the conclusions drawn are unlikely to change should more and better future data revise the scope of offshoring up or downwards.

There is one critical exception, however. As discussed in chapter 2, the notion of offshore finance is contested. One bone of contention is the question whether Britain and the United States should, or should not, be considered offshore financial centres, both as tax havens and banking hubs. If I were to include those two countries into the estimates, the numbers would change so fundamentally that the conclusions drawn here would probably no longer apply. However, including the United States and Britain into the concept of offshore finance would essentially mean that the international financial system as such is an offshore system. In that case, the value of offshore as a concept would be lost. It would no longer provide a mental short-cut for understanding a complex reality. It would simply be a different label for that reality. It would undermine the concept's ability to make the politics of the invisible visible.

Variance and similarity

Comparing Britain, Germany, Brazil and Mexico, we see that the scope of offshoring varies across time and space. Yet, the patterns of offshoring – most offshore transactions are Euromarket transaction and the level of tax planning and money laundering is a function of these transactions – are strikingly similar. This similarity is rather simple to explain. It is a matter of chronology.

In the 1920s British gentlemanly capitalists, building on the infrastructure of empire, set out to preserve offshore the influence that they began to lose onshore. For the first time since

the late 17th century, gentlemanly capitalists had lost absolute control over state finances. They were still the state's main financiers, but they had to compromise over the level and spending of tax with an emboldened government as well as with an enlarged and diversified body of taxpayers. To protect the basis of their influence – property – the financiers resorted to a politics of the invisible. Except land, most of their wealth and earnings was invisible by nature (Cain and Hopkins 2015). The trust then helped to obscure ownership even of land and industrial plants, usually visible from afar. The trust also helped to move wealth offshore without having to relocate the assets physically (Harrington 2016b). Once the assets were offshore, British banks, starved for credit in the post-war years, followed suit (Hampton 1996b). By that point, the financiers had also understood that to maintain their supremacy in financing international trade, they must bet their future on the US dollar, not the stumbling pound sterling. Resourcefully, British financiers came up with an accounting technique that allowed them to create US dollar offshore (Burn 1999; O'Malley 2015). These Euromarkets soon grew so strongly that from the mid-20th century onwards, the Eurodollar was the key reason to go offshore, with tax planning and money laundering tagged on to the ever-growing offshore banking business. Germany, Brazil and Mexico simply followed suit a trail that the British moneyed classes had established. Yet, their paths to offshore were premised on the unique genealogy of each state as seen from the money view.

For British financiers, the Euromarkets were a source of income that seemed to grow endlessly. The Euromarkets got boosts about once a decade: the development of Eurobonds in the early 1960s, the recycling of petro-dollars in the early 1970s, the financial deregulations in the late 1980s and again in the late 1990s, the introduction of the euro currency in the same decade and the growing demand for Eurodollars from China in the early 2000s. There seemed to be, until the Financial Crisis in 2007-2009, no reason for banks in Britain to curtail the scope of their offshore services and, likewise, to seek Eurodollar financing in other offshore financial centres. Moreover, the Bank of England, the Euromarkets' epistemic authority (Green 2016), understood that anchoring the Euromarkets in the City of London retained Britain's influence in international trade and politics far beyond the country's actual political weight. The scope of offshore tax planning, on the other hand, was a function of the British financiers' loss of power in relation to the government and taxpayers. Mass democracy and mass warfare had tilted the power relationship such that the moneyed classes could no longer, as they have done in the previous 200 years, determine exclusively the level and nature of direct taxes and how the resulting resources would be spent. Consequently, they had to put up with high rates of income and wealth taxes as well as with a tax-financed welfare system that mitigated the class conflict through wealth redistribution.

In Germany, the scope of offshoring was equally driven by the Euromarkets and a loss of influence of the propertied classes over taxation and government spending in the wake of democratisation. However, the Bundesbank remained cautious towards offshore money creation. Initially, a few large German banks, notably Deutsche Bank, were allowed to participate in the Euromarkets. The full boost for Euromarket participation came only in the late 1990s. With the introduction of the euro, Deutsche Bank became the leading foreign exchange trader between euro and US dollar. In combination with a loss of power of the *Bundesbank* under the Schröder government in the late 1990s, Deutsche Bank started participating full-swing in offshore money creation; some more German banks joined the party in the early 2000s. The merrymaking came to an end with the 2007-2009 Financial Crisis, leaving behind Deutsche Bank as the only relevant German actor exposed to the Euromarkets. Offshore tax planning, though considerable at the individual level, remained restrained compared to Britain. The German propertied classes had lost, due to the arrival of mass democracy, some of their influence over tax policy and public spending the way their counterparts across the channel had. However, Germany's money elite had been influential enough to mitigate class conflict through a welfare system that is mainly based on co-financed insurance schemes. This limited the scope of offshore tax planning in three ways. First, the German welfare state is less redistributive than the British welfare state. A substantial share of its costs is borne by the working classes themselves and the employers' share constitutes a corporate cost that does not directly reduce the capital owner's private wealth. Second, the insurance-based welfare state limits the government's discretion over how to spend that money. Third, unlike taxes, German social security contributions can barely be avoided through offshoring. The insurance companies are publicly-owned and the contributions are directly deduced at source, not needing the cooperation of taxpayers to declare anything as in the case of other forms of taxes. In addition, law enforcement is strict. If German economic actors dodge social security contributions, they do it through informality, not offshoring.

In Brazil, the Eurosystem has become an intrinsic part of the country's cycle of money, tax and debt due to the strained relationship between the urban ruling and the rural economic elites that make up Brazil's institutional association of rule. Financing of large, employment-generating corporations publicly and privately owned, depends on offshore banking services. Offshore tax planning, on the other hand is less important. The Brazilian government has built a powerful tax administration. At the same time, the tax structure reflects, despite democratisation, still the preferences of the country's economic elite. As in Germany social security contributions are difficult to evade offshore and are mostly borne by the employers themselves. In addition, Brazil relies to a strong degree on indirect taxes, which again are

difficult to evade through offshore tax planning. Taken together, social security contribution and indirect taxation protect a considerable part of the government's tax revenue from offshoring.

Finally, in Mexico the scope for offshoring is limited for two reasons. For one, unlike any of the other countries, Mexico withdrew from Eurodollars already in the 1990s. Financing much of its development through Eurodollars in the 1970s and 1980s, the succession of two major financial crises taught the country's governments, financiers and taxpayers a painful lesson about these markets. Consequently, the government defaulted on its liabilities towards its international creditors, restructured its debt to be denominated in peso and opened the country's banking system to US American banks. As a result, if Mexican economic actors access US dollar credit, it is US dollar, not Eurodollar debt. In the relative absence of financial flows between Mexico and offshore financial centres, there is little to tag on for tax planning or money laundering purposes. Second, the Mexican propertied classes have retained their power over influencing tax levels and public spending. The welfare state in Mexico is minuscule compared to the other countries, including Brazil, and hence public spending is much lower too. There are no wealth taxes to speak of and generally a move from direct to indirect taxation. Moreover, the large Mexican informal sector allows wealthy elites, corporations and criminals, big and small, to evade taxes and launder money onshore. With so much rents to be had, there is little reason for anyone to bother going offshore.

In short, a country's path to offshoring depends on the perceived need of the wealthy classes to tap into the politics of the invisible. This in turn is a function of four domestic factors: the ability to make business from offshore money creation, the need to access US dollar credit as a means for capital accumulation in an internationalised economy, the institutionalised answer to class conflict and the current position of the financiers in the institutional association of rule relative to the past.

2 The effect of offshore finance on state power

Once the wealthy resort to the politics of the invisible via offshoring, the question arises how this affects the power of the state to unite the resources to finance its politics. Against the background of the theoretical framework, the question can be broken down into two: How does offshore finance affect the ability of the institutional association of rule to mobilise resources; and how does it affect institutional association of rule's ability to align the spending with its interests? Any answer to these questions must consider that the nature of the institutional association of rule differs across space and within one country across time. It must also consider

that offshore finance affects the power of the state through two channels: offshore banking (including money laundering) and offshore tax planning.

Offshore money creation

The Euromarkets allow banks to create money outside of the state's authority. As the case studies detailed, creating money offshore can have enhancing or limiting effects on state power, sometimes even simultaneously. Or, it can, as is the British case, lay the ground for altering the very nature of the state by opening up the institutional association of rule to foreign financiers. The effects of offshore money creation on state power again varies across cases and within cases across time. The crucial junctions when the relationship between offshore banking and state power fundamentally changed course were in all cases financial crises.

In Britain, up until the 2007-2009 Financial Crisis, offshore money creation affected the state's ability to finance itself directly and indirectly. Directly, the profits that banks made in the Euromarkets contributed to the government's coffers via taxation and employment in the City. Moreover, the government, especially at the local level, also got engaged in mobilising funds from the Euromarkets via debt (see Burn 1999; Green 2016). More importantly, however, offshore money creation enhanced British state power in an indirect way. The Euromarkets were instrumental in restoring the City's role as a leading financial centre next to New York. Britain's leading role in financing international trade and investment in Eurodollar rather than sterling spared the state the political price attached to a monetary policy that must balance domestic with international conditions. Unsurprisingly, the state actively drove the Eurodollar market making by British private banks. The setup of the Euromarkets was an expression, not a limitation to state power. As a result, Britain could exert a level of international influence that was well beyond its actual economic and political weight. Yet, even during times when the Euromarkets functioned undisturbed, they brought limitations to state power with them. Britain's power emanating from offshore money creation is at the discretion of the US government (see Burn 1999; Green 2016). Since the introduction of the euro in 1998 and Britain's decision to stay outside the currency union, it is also at the discretion of that of the Eurozone member states. Even more far-reaching, offshore money creation laid the ground for changing the very nature of the British state. The possibility to create offshore money in London made the City attractive for international banks. In combination with deregulations under Thatcher, the Euromarkets opened the institutional association of rule towards international financiers. In other words, the price for extending British state power via offshore money creation was high, but in the view of the institutional association of rule worth paying, not least because the payday was relegated to the future. That future arrived with the 2007-2009

Financial Crisis. The Euromarkets froze, European Banks began to tumble and then the first US American banks came down. Much of the consequences played out in the Square Mile. The response, both in nature and volume, limited the ability of the British state to finance its politics, in particular welfare politics.

In Germany, the relationship between offshore finance and state power was in some ways not unlike that in Britain. The banks that engaged in Euromarkets market making earned considerably, particularly compared to the limited profits they could make at home. As in Britain, the Euromarkets affected the ability of the state to finance its politics in direct but and limited ways through tax revenue generated and through funding local government via debt. Yet, there are important differences to the British experience. For one, the export-orientation of Germany industry created an interest in the Euromarkets beyond the financial sector. German corporations were actively seeking dollar-denominated trade financing from German banks active in the Euromarkets. On the other hand, Germany's exposure to the Euromarkets took place on a much smaller scale and outside the country, mostly in Luxembourg and London. Despite deregulations since the late 1990s, international financiers always remained outside the institutional association of rule. The Euromarkets never altered the nature of the state. This distance to the Euromarkets and its most important actors may also be because Germany was, compared to Britain anyway, a latecomer in large-scale offshore money creation. It became substantial only in the late 1990s with the introduction of the euro affording Deutsche Bank to develop a global quasi-monopoly for foreign exchange business between the euro and the US dollar.¹¹³ This strong position allowed Deutsche Bank to participate in the Euromarkets way beyond its European competitors. It was then also Deutsche Bank (and to a certain degree the *Landesbanken*) which made the German economy vulnerable to the Financial Crisis. Yet, given the smaller scope of offshore money creation and the fact that it happens outside the state, the political and economic consequences of the crisis were limited compared to Britain. As a result, Deutsche Bank, the only remaining Eurodollar bank in Germany, came out of the Financial Crisis economically weakened, but, paradoxically, politically unscathed. Likewise, the costs to prop-up the German banking system were substantial, but it did not undermine the state's ability to finance its politics. Therefore, despite the dysfunctionality of the Euromarkets since the Financial Crisis, the German government and financiers remain committed to it. Yet, like in the case of Britain, German state power emanating from the Euromarkets is at the discretion of US government's willingness to help in case of crises.

¹¹³ Author's interview with banker, Munich, November 2018.

In Latin America, the relationship between offshore finance and the state is of a different nature altogether. Brazil and Mexico historically both entered the Eurodollar markets in the 1960s and 1970s as borrowers. Importantly, governments (directly or through state-owned corporations), not the private sector, were the largest borrowers in the Euromarkets. The Eurodollar markets financed both countries' economic development. As such, the Euromarkets expanded the state's ability to finance its politics beyond what would have been possible with tax money alone. For both countries the reckoning of debt-financed, Eurodollar-denominated development came much earlier than for their European counterparts. The debt crisis in 1982 demonstrated the potential toxicity of the Euromarkets. In response, governments in Mexico and Brazil retreated from these markets, but allowed their private sectors (and newly privatised corporations) to continue borrowing offshore. For Mexico, this policy ended badly already in 1994. With the peso-crisis, the Mexican state finally turned its back to the Euromarkets. It restructured government and private sector debt towards peso and opened its banking system to US American banks. As a result, the dependency on the Eurodollar significantly decreased. If access to US dollar was needed, Mexican economic actors could now get it directly from New York. This path to the US dollar includes backing through the Fed's lender of last resort function in times of crisis. Consequently, Mexico's banking system was the one among the four cases that suffered the least from the 2007-2008 Financial Crisis.

Brazil, on the other hand, took a different course. Eurodollar lending of the Brazilian private sector was backed up by BNDES, Brazil's state-owned development bank. This arrangement was successful from the mid-1990s to 2007. For 15 years, the Euromarkets continued to finance Brazilian development, this time through the channel of corporate financing. With the Brazilian government's response to the 2007-2009 Financial Crisis, corporate dependency on Eurodollar had only grown. In consequence, the suppressed supply of Eurodollar since the crisis has hit the Brazilian economy hard. Brazil is, just as Britain and Germany, stuck with a system of offshore money creation that is at once dysfunctional and largely indispensable.

The four cases suggest that offshore money creation enhances the power of the state to finance its politics in the short- to mid-term. In the long-run, however, it potentially challenges this power to the core. To a considerable degree, this challenge to state power is independent of the scope of offshore money creation. Despite a smaller scope, Brazil's exposure to offshore money creation is undermining Brazilian state power more fundamentally than is the case for Germany. The challenge of state power emanating from offshore money creation is also irrespective of the country's position in the Euromarkets. Britain and Germany are market makers and were most of the time net-lenders, Mexico and Brazil were borrowers. Nevertheless,

Britain is arguably more fundamentally affected by offshore money creation than any of the other countries as the Eurodollar planted the seeds for altering the nature of the state itself. The challenges to state power that are associated with offshore money creation are a function of two variables, one domestic and one international.

The domestic variable is the role of the Euromarkets in a country's cycle of money, tax, and debt. The more substantial that role, the higher the effects of offshore money creation on state power. The international variable is the unsolved tension of creating global credit in a world without a global lender of last resort. Granted, the United States did act as a lender of last resort to the banking systems of Britain, Germany, Brazil and Mexico in the immediate aftermath of the crisis. Yet, it is unclear whether the United States is willing to do so next time and if, under which conditions. This uncertainty undermines market liquidity and so overtime, the Fed has become a 'dealer of last resort' (Mehrling 2011). This expanded role of the Federal Reserve and also the ECB has fundamentally altered the international financial system and central banking since the Financial Crisis. The political consequences are profound and visible beyond the four cases studied here (Tooze 2018).

Offshore tax planning

Offshore tax planning, I discussed above, followed offshore money creation. Yet its effects on state power are quite different as the analysis across the four cases has shown. The tax loss associated with offshore tax planning is certainly painful with regards to public services that remain unfinanced as a result. Nevertheless, the analysis confirmed Genschel's finding (2005) that offshore finance does not systematically undermine the state's ability to unite resources. This is all the more the case in countries like Germany and Brazil whose regulatory laws and social security systems mitigate the most harmful effects of offshore tax planning on state revenue. It is also the case in Mexico where the state has, next to tax and debt, oil rents as an additional source of income. The potential loss of 17 per cent of tax revenue in the case of Britain may be more problematic from a power perspective, but, as we have seen, the British government found other ways to mobilise tax revenue. The taxpayers that cannot or do not go offshore are picking up the bill. Offshore tax planning does not leave any of the case study countries without the means necessary to finance its politics. Rather, offshore tax planning leads, as has been established in the literature on international tax planning, to a redistribution of the tax burden (see Genschel 2005).

Moreover, offshore tax planning – both in its legal and illegal forms – happened in all cases at the discretion of the state. Offshore tax planning aligns with interest of the moneyed classes and the governments did – depending on whose interests it prioritised – limit or enhance

the space within which firms and wealthy individuals could plan taxes offshore. Even Mexico's government, hardly affected by it, decided to become an active part of the OECD's efforts to curb harmful tax competition. Each country took different defensive measures against offshore tax planning. For instance, Germany's defensive laws are stronger than Britain's. Yet, this is not the result of the inability of the British state to do it differently, but of the New Labour governments' willingness to go along with the interests of the institutional association of rule, still dominated by the monied classes, and abandon much of its defences against harmful tax optimisation. Finally, and counterintuitively, offshore tax planning can even extend the power of the government within the institutional association of rule. A precondition for that scenario is, however, that it remains invisible. It allows the government not to obscure that it sides with one group of taxpayers – the wealthy – over the other – the ordinary taxpayers. Offshore tax planning does not do away with the inescapability of prioritising one set of interests over another, yet it spares the government the political conflict over the chosen prioritisation and thus strengthens its position vis-à-vis both groups of taxpayers.

These findings contradict five of the central insights of the tax competition literature. As discussed in the introduction, this literature generally argues that developing countries are more affected by international tax competition (including offshore tax planning) than developed ones (Crivelli, De Mooij, and Keen 2015; Cobham and Janský 2017); large countries more than small ones (Genschel and Seelkopf 2016); open economies more than closed ones (Wibbels and Arce 2003); countries with high level of crime and corruption more than those with lower levels (Genschel and Seelkopf 2016); and countries which are geographically close to offshore financial centres more than those at a distance (Zucman 2013a; Blanco and Rogers 2014; Haberly and Wójcik 2015a). On these grounds, the two Latin American countries should be more affected by tax planning than the two European ones; Mexico should be more affected than Brazil and Germany more than Britain. Yet it is exactly the other way around. The Europeans are more affected than the Latin Americans, Britain more than Germany and Brazil more than Mexico. The reason lies, as the case studies demonstrated, in the shape of countries' banking and taxation institutions reflecting the underlying conflicts within the institutional association of rule.

3 Beyond the money view

The findings of the thesis on the relationship between offshore finance and state power have implications for how to study offshore finance. This last section, therefore, directs its sight into the future. It puts the findings of thesis into the context of existing scholarship, discussing the resulting agreements and contradictions.

Institutions matter...

According to conventional wisdom, offshore finance conditions state power. The argument goes that the higher the use of offshore financial services, the more limited the state's power to finance its politics (see Zucman 2013a; Tørsløv, Wier, and Zucman 2018). Now, the results of this thesis demonstrate that the reverse can be true too. The nature of state power conditions the level of offshore demand. This reversal of cause and effect is the reason why structural variables – size, economic openness, proximity to offshore financial centers and level of development – cannot explain the level of offshore demand in Britain, Germany, Brazil and Mexico. Institutions and politics, however, can.

That is, the results of the thesis support findings of the literature on international tax competition that account for institutions and domestic politics (see Swank 2003, 2016a). Voter opposition towards policies that benefit capital, the preferences of veto players in the legislative process, quality of governance and the level of public debt – these are among the domestic institutions the literature identified as influencing the effect of capital mobility on domestic tax policies (Basinger and Hallerberg 2004; Genschel and Seelkopf 2016; Swank 2016a). The case studies demonstrate that while these institutions do matter, they do so differently than thought hitherto.

Take voter preference or more generally regime type to begin with. Here, the literature argues that democratization leads to a preference of median voters for higher taxation on the wealthy (see Meltzer and Richard 1981; Genschel, Lieser, and Seelkopf 2016). The explanatory power of voter preference is particularly limited in the cases of Mexico and Brazil. Here, political institutions are formally democratic, but opinion- and decision-making are organized through private informal networks rather than parties and parliament. As a result, the effect cannot be observed. Yet, the influence of voter preference is also diluted in the case of Britain and Germany. Here, the politics of the invisible obscured the growing divergences between nominal and effective tax rates (see Zucman 2014; Tørsløv, Wier, and Zucman 2018). Consequently, it undermines the median voter's ability to build preferences based on real tax rates. In all countries, though to differing degrees, the exclusive nature of the institutionalized association of rule helped elites to find ways to align state financing with their interests rather than with that of the median voter. This observation echoes Tocqueville's (2002) insight that alongside universal franchise it is *wealth distribution* that conditions taxation and spending.

Next, all cases confirm veto players as important institutions. In all countries, the financiers were – except for certain times, e.g. early Weimar Germany and early post-war Britain – enduring veto players for all decisions related to the financing of the state. Likewise, sovereign debt is an important institution shaping the relationship between state power and

offshore finance. Yet, the case studies suggest that *ownership structure* and *currency denomination* have more explanatory power than does the volume of debt. Finally, the thesis suggests that governance plays its role too. The case of Germany confirms the literature's argument that criminals in well-governed countries go offshore (Genschel, Lierse, and Seelkopf 2016). In Britain, this seems to be less the case. Brazil, though facing similar governance problems, has much higher rates of offshoring than Mexico. In Mexico, bad governance, expressed in form of informality, *curbed* offshoring by creating onshore havens for tax planning and money laundering. The *degree of formality* of the economy appears to have more explanatory power than good governance as such.

Importantly, however, by its very nature, the literature on international taxation can only speak to a part of the phenomenon: offshore tax planning. Therefore, it overlooks the dovetailing nature of taxation and banking as captured in Ingham's (2004) concept of sovereign money that is created through a cycle of money, tax and debt. That cycle and the underlying power relationships shape public finances onshore and extends itself, bar the sovereign bit, to the offshore world. Onshore as offshore, every credit needs a (somewhat) corresponding asset. The literature's focus on offshore tax planning at the detriment of offshore banking led to a false understanding of the *raison d'être* of offshore finance. The thesis revealed that despite the distinct histories of offshore tax planning and offshore banking (see chapter 2), over time the latter has become an enabler for the former. Today, the main purpose of offshore finance is no longer to simply *shelter* the wealthy's and the multinational corporation's money. Its main purpose is to *create* that money in the first place. Offshore finance's potency lies in its ability to create global credit-money. The key currency that is created offshore is the Eurodollar. However, most political economists treat the Eurodollar system as a phenomenon of the past (see Helleiner 2011; Burn 1999; O'Malley 2015). Yet, the quantitative and qualitative data presented in this thesis suggests otherwise. The Euromarkets are a contemporary phenomenon. Their growth peaked with the 2007-2009 Financial Crisis, but they continued to be far more relevant in the decade after the Financial Crisis than in its alleged heydays between the 1960s and 1980s. That means, rather than speaking of a generalised notion of financial globalisation, we can now point to a specific mechanism that is at the core of the international financial system: offshore money creation.

Next to institutions, this study established that conceptualizing state power matters too. Approaching it from the perspective of Weber (1994) helped to uncover how the interests of different social groups shape taxation and banking and how this, in turn, affects the demand for offshore services. With a view on European history, scholars found that sovereign debt could turn into a central source of public finance only because the growing costs of external warfare

made general taxation both necessary and possible. By the beginning of the nineteenth century, European states could borrow at unprecedented levels because constant and significant tax revenues ensured the state's ability to repay and thus the creditor's willingness to lend (Schumpeter 1991; Tilly 1990; Macdonald 2003). The tax state precedes the debt state.

The historical development of Mexico's public finances, however, displayed that tax and sovereign debt can also institutionalize in reverse order. The state can go into debt before seizing significant amounts of tax revenue. This is possible if a third source of income, the combined rents of monopoly and oil, is large enough to offset the lack of tax revenue as collateral for the state's financiers. The sequencing matters. It institutionalized the relationship between the Mexican government and its financiers first and that with the taxpayers second. The government-banker relationship has always been more central to the financial survival of the Mexican state than the government-taxpayer relationship. The chronology of how taxation and banking institutions developed help explain why today Mexicans use offshore financial services sparsely. Yet, as the historical analysis demonstrated too, this has not always been the case. Between the 1970s and the 1990s, the Mexican public and private sectors did go offshore in a substantial manner to issue debt. The withdrawal from the Eurodollar markets in response to two severe financial crises shows the centrality of banking in determining the level of offshore demand in Mexico. The literature's focus on European states and their path to modernity may explain the emphasis on taxation at the detriment of sovereign debt as a defining element of the modern state.

... and so do false dichotomies

The thesis has explicitly taken a money view on the state. That is, the effect of offshore finance on the state was framed in terms of the institutional association of rule's ability to unite the means to finance its politics. Such a perspective largely neglects how offshore finance affects people outside of the institutional association of rule. Yet, what has filtered through in the case studies is that the more exclusive the association of rule, the higher the likelihood that the costs and benefits of offshoring are unequally distributed across different groups of society. Beyond state power, offshore finance thus has far reaching consequences for inequality and democracy. In all four cases the actual relationship between the state and offshore finance has been obscured by the politics of the invisible. The politics of the invisible undermines any debate about the full extent of inequality (see Alstadsæter, Johannesen, and Zucman 2018) and related fiscal and monetary policies.

Popular ways to capture the offshore world are a product of the politics of the invisible. The mainstream account of offshore finance alleges that there is something sinister about it.

The commonly used language around offshore finance reflects that well. There is talk of ‘dirty’ or ‘dark’ money that accumulates in shadow banks. There is a system of tax havens which are, according to Zucman (2015) a ‘scourge’ to the international economy. Thanks to the so created ‘Moneyland’, Bullough (2018) informs us, the ‘thieves and crooks now rule the world.’ These accounts create dichotomies: the notion of ‘dirty’ or ‘dark’ money implies an existence of ‘clean’ or ‘clear’ money; the notion of shadow banks implies that somewhere at the other end of the spectrum are respectable banks that do not dread the daylight; the scourge of tax havens implies that if we only closed them down, the international economy would somehow be free of trouble; the notion that offshore finance has led to crooks and thieves *now* ruling the world, evokes a better past, when upright men (there are rarely any women populating this better past) took care of the state’s affairs. As this thesis has shown, the dichotomy between an onshore world and an offshore world, if it ever existed, certainly ceased to exist when the volume of offshore created US dollar surpassed that of the onshore created US dollar in the late 1980s. False dichotomies are unhelpful in analytical and political terms. Take Brazil as an example. Without offshore finance Brazil’s ‘economic miracle’ (1968-1974) is unlikely to have happened. Likewise, without offshore finance the *Lava Jato* corruption scandal (since 2014) is unlikely to have developed its epic proportions. To govern offshore finance in the interest of the common good, those inherent tensions must be acknowledged. As the world economy outside the United States runs on the Eurodollar, and the Eurodollar is created offshore, we cannot ‘simply’ do away with it.

Moving forward, research on offshore finance must address the centrality of the Euromarkets not only as the seed of the phenomenon, but as a crucial constitutive element of it. Loved by bankers and tolerated by governments, the Euromarkets grew until they were, possibly, probably, bigger than the onshore financial system. If offshore is the new normal, it raises the empirical question about the true size of the Eurodollar system. It may well be, as the interviewees and other practitioners suggested, that our current macroeconomic and banking statistics capture the smaller piece of the pie. If that is the case, the current governance system – ranging from the OECD BEPS project to the BIS financial stability monitoring to national monetary policies – likewise focus their attention on the smaller piece of the pie. Offshore tax planning practices have become more visible in recent decades. The Eurodollar markets, on the other hand, remain largely invisible. Here too it is time to meet the politics of the invisible with attempts to transparency.

Appendix 1

1 List of offshore financial centres

In alphabetical order, based on BIS locational banking statistics (2017) and completed by European offshore financial centres as identified by Garcia-Bernardo et al. (2017)

Caribbean Offshore	Asian Offshore	European Offshore	Other Offshore	Complemented European Offshore¹¹⁴
Aruba	Hong Kong	Gibraltar	Bahrain	Cyprus
Bahamas	Macao	Guernsey	Lebanon	Ireland
Barbados	Singapore	Isle of Men	Samoa	Liechtenstein
Bermuda		Jersey	Vanuatu	Luxemburg
Cayman Islands				Malta
Netherlands Antilles				Switzerland
Panama				
West Indies United Kingdom				
Curacao				

2 Estimating overall demand for offshore financial services

It is not the purpose of the estimates presented in this thesis to contribute to the increasingly sophisticated debate about how to quantify the demand for offshore financial services (see Henry 2012; Zucman 2013a; Crivelli, De Mooij, and Keen 2015; Cobham and Janský 2017; Alstadsæter, Johannesen, and Zucman 2018; Tørsløv, Wier, and Zucman 2018). The purpose is to provide an indication of its overall scope to discuss how offshore finance affects state power. With this purpose in mind, the BIS locational banking statistics (BIS 2017) provide the most coherent, transparent and simple way to gauge that overall scope. They allow us to determine the cross-border flow of money between reporting institutions in the reporting country (i.e. Britain, Germany, Mexico and Brazil) and reporting institutions in counterparty countries (i.e. the countries listed above). Reporting institutions include banks, non-bank financial institutions, non-financial corporations and the non-financial sectors (i.e. government and households). I refer to all bank and financial sector institutions as banks in the thesis to

¹¹⁴ Garcia-Bernardo et al (2017) also include Monaco, but Monaco does not report to the BIS and is hence not included in my estimates.

facilitate the analysis. With this data, we can see the financial flows between, say, Germany and offshore banks. German claims towards offshore financial centres represent assets that German economic actors hold offshore. German liabilities towards offshore financial centres represent debt that German economic actors issued offshore. Offshore assets may be held offshore, for instance, to avoid taxation related to the ownership of or income on these assets would incur. Debt, on the other hand, may be issued offshore because in the country of residence, banks would or could not lend to the economic actor in need of money. However, offshore debt may also be used for intra-corporate financing and hence be used again to plan taxes. As a result, offshore claims and liabilities affect the power of the state differently, but collectively. The estimates of overall offshore demand are therefore presented in each case study as each side of the balance sheet separately and collectively.

The estimate approach to the overall offshore demand is the same for each country covered in this thesis. However, in the case of Brazil there is additional data available through the CBE survey for the years 2007 to 2017 (Banco Central do Brasil 2017). In January 2016, the Brazilian Congress passed an amnesty law allowing Brazilian individuals to regularise their legally obtained, but non-reported foreign assets that were in breach with Brazilian currency exchange and tax regulations. In response, Brazilian households reported an additional US\$54 billion to the central bank. Once integrated into the survey, this amount led to the marked growth of external assets between 2013 and 2014 (Banco Central do Brasil 2017). The amnesty coincided with Brazil's decision to join the OECD's automatic exchange of information regime. Lawyers advised individuals with undeclared external assets to come clean before the new regulation would take effect in October 2016. It is hence highly likely that the CBE survey now covers close to all legally obtained offshore assets.¹¹⁵ To keep the case studies comparable, I use the CBE survey data to triangulate the BIS locational banking statistics. For the estimate of Eurodollar exposure, I combine both data sets and for the estimate of the tax loss, I separately provide numbers based on the CBE survey and the BIS locational banking statistics.

3 Constructing an estimate for the exposure to the Euromarkets

To be considered a part of the Eurodollar system, a transaction must fulfil two conditions: it must be US-dollar-denominated, and it must happen between reporting institutions from the case study country and foreign financial institutions from outside the United States. The BIS locational statistics as described above do not allow to breakdown bilateral financial flows by currency. The estimate therefore needs to proceed in two steps. First, I use the BIS locational banking statistics data to determine the share of US-dollar-denominated cross-border

¹¹⁵ Author's interview with defence lawyer, São Paulo, April 2017.

transactions between the case study country and the rest of the world. Second, I apply this share to transactions between the case study country and offshore financial centres, again claims and liabilities separate and added up. I do this basic estimate in all case study countries. In the case of Britain and Brazil, I add an estimate of the Euroeuro. In Germany, the euro is the onshore currency and in Mexico it does not play any role whatsoever. I therefore discuss in these cases only the Eurodollar.

4 Constructing an estimate for tax loss

My estimate of the tax loss associated with offshoring is straight forward. I apply an average tax rate between corporate and individual income tax rates to the assets held offshore as reported to the BIS. This simple approach is, as are alternative approaches, based on three assumptions. The first assumption is that all money that is offshore is not taxed at all. This does not necessarily correspond to the reality. How well the assumption reflects reality may differ from country to country. In all cases tax lawyers maintained that it is more likely to be realistic in the case of individuals than in the case of corporations. The second assumption is that all money that is offshore would be taxed at the full applicable rate if onshore. Again, it is unlikely that this is the case as there are plenty onshore tax planning opportunities, including sub-national offshore centres. The third assumption is about the applicable tax rate. Given that different taxpayers (individuals and corporations) hold different asset classes offshore, it is difficult to determine which tax rate would apply onshore. Therefore, most estimates, including mine, work with an average tax rate. Taken together, estimates of tax loss related to offshoring tend to be biased towards overestimating the loss.

As with my overall estimate, I tried to keep the estimate of the tax loss simple and transparent. This meant not to build on existing more sophisticated approaches that also come with more methodological challenges. This includes in particular the work of Alstadsæter et al. (2018) which estimates the amount of money held offshore by individuals as a means to improve existing measurements of inequality. The study of Tørsløv et al. (2018), which estimates the amount of profit-shifting based on macroeconomic data from tax haven countries. And the work of Crivelli et al. (2015) as well as of Cobham and Janský (2017), which estimate profit-shifting via tax differentials between tax havens and high tax countries based on the International Monetary Fund (IMF) data.

5 Estimating money laundering

It is impossible to tell, based on the BIS data, which of the money that is reported to flow between reporting institutions is legal and which is illegal. In addition, other available data

estimating the amount of illicit funds is of questionable quality. Therefore, in all cases, my assessment of offshore money laundering exclusively builds on qualitative data based on interviews and primary sources such as government reports and newspaper articles. Conceptually, the thesis considers offshore money laundering a part of offshore banking.

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