

Where Currents Meet:

The Offshore Interface Between Corruption, Offshore Finance Centres and Economic Development

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1 Introduction

The connections between development, corruption and the increasingly globalized financial system are not yet fully understood. In this paper we explore what we call the offshore interface, consisting of tax havens and Offshore Finance Centres (OFCs), which lies between the 'developed countries' and LDCs. We explore the idea that the existence of the offshore interface facilitates, and may even encourage, corruption onshore.

Research on the potential relationship between corruption and offshore finance is highly problematic given the illegitimacy of corruption, and the secrecy and confidentiality of offshore financial activities. OFC customers, even legitimate ones such as transnational corporations, demand a wall of secrecy between themselves and their revenue authorities, governments and sometimes their own families. Additionally, two further aspects can hinder data collection. First, OFCs attempt continually to portray themselves in the best possible light, and second, financial services are based on the fragile notion of 'confidence'. Thus, major financial players promote the respectability of their own OFC with the support of the host government. This leads to a reluctance to reveal information about offshore activities, resulting in a lack of international comparative data. These measurement problems are similar to researching the so-called 'black' or hidden economy, so that estimates of size are often no more than 'best guesses'.¹

We begin by examining the operation of offshore centres, and then discuss private banking, capital flight and the nature of the offshore interface. Finally, we consider the impact on economic development of the linkage between the offshore interface and corruption.

2 Offshore Centres

2.1 The uses of offshore centres

An OFC is defined as:

a centre that hosts financial activities that are separated from major regulating units (states) by geography and/or by legislation. This may

¹ For example, US government estimates of illegal funds going offshore in 1983 ranged from \$US 9 billion to over \$US 50 billion (Picciotto, 1992: 127).

Table 1 Main offshore financial centres

Caribbean & South Atlantic	Europe, Middle East, Africa	Asia-Pacific
Anguilla	Andorra	Cook Islands
Antigua	Bahrain	Hong Kong
Bahamas	Channel Islands	Labuan
Barbados	Cyprus	Marshall Islands
Belize	Gibraltar	Nauru
Bermuda	Isle of Man	Philippines
British Virgin Islands	Liberia	Singapore
Cayman Islands	Liechtenstein	Vanuatu
Costa Rica	Luxembourg	Western Samoa
Dominica	Malta	
Grenada	Monaco	
Montserrat	Netherlands	
Netherlands Antilles	Switzerland	
Nevis & St.Kitts	United Arab Emirates	
Panama		
St. Lucia		
St. Vincent		
Turks & Caicos Islands		

Source author

be a physical separation, as in an island territory, or (a legal separation) within a city such as London or the New York International Banking Facilities.

(Hampton 1994: 237)

As Table 1 illustrates, OFCs are often located in small places: inland or mountain enclaves (Liechtenstein, Andorra), coastal enclaves (Monaco), or most commonly, in small islands. Although there is some confusion with tax havens, OFCs can be defined as sites hosting a range of economic activities (private and wholesale banking, offshore trusts and funds, holding companies, captive insurance and shipping registers), whereas tax havens are based upon tax differentials with other countries.

Offshore centres have become internationally prominent since the 1960s although some centres (e.g. Switzerland, Monaco and the Lebanon) existed before this. Bank deposits in tax havens increased from an estimated \$US 11 billion in 1968 to \$US 385 billion in 1978 (OECD 1987). Difficulties of estimation notwithstanding², by 1991 estimates of the total size of the global offshore business had risen to over one trillion US dollars (Kochen 1991).

Despite the lack of published data due to OFC secrecy, it is possible to produce partial tabulations that attempt to characterize offshore centres. The following tables use three categories of OFC: functional, notional and compound. A functional OFC can be defined as the place where financial activities physically take place, where full branches of banks, plus other financial services such as fund

² There is special difficulty with double counting. If we add up the published OFCs' bank deposits, the total would be misleading given the amount of inter-bank lending so that the same initial deposit could appear on the books of several banks across the world. Additionally, the money held in offshore trusts is even

harder to estimate as trust managers do not have to publish figures. In Jersey, for example, official bank deposits totalled £64.9 billion by year end 1994, but OFC respondents suggested that the size of the Jersey trust business was approximately two to three times larger at £130-190 billion.

management, trust companies etc. are sited. Functional OFCs employ a significant proportion of local labour (over 12 per cent of the labour force), and OFC activities contribute over 25 per cent of GDP (Table 2).

Notional OFCs are where 'shell' or brass-plate offices of banks make book entries of financial transactions. However, their employment and GDP data is fragmented and incomplete, so that all we can note is a nominal contribution to both (under 3 per cent and under 10 per cent respectively).

Compound OFCs host a mixture of functional and notional activities. This category includes centres (e.g. the Bahamas) that have an increasing number of shell offices that eventually become fully operational branches. Such OFCs employ a smaller proportion of the local labour force than functional OFCs (3-10 per cent) and contribute an estimated 10-24 per cent of GDP (Table 3).

The overall lack of data on OFCs means that this statistical information is indicative rather than authoritative, but it does give a sense of the relative scales of the main OFCs. When this partial information is combined with the estimated total size of offshore business (over one trillion US Dollars) it provides some idea of the significance of offshore finance in the global economy.

At present three regional economic blocs seem to be forming: the EU, NAFTA and Asia-Pacific. Each bloc has a global financial centre within it; the cities of London, New York and Tokyo, the 'three-legged stool' of world finance (Hamilton 1986: 111). Each of these centres has a group of satellite OFCs around it servicing its catchment areas. When deposits are attracted to an OFC, they are then passed through to the deeper capital markets in the global centres, acting as a 'turntable' for funds (Johns 1983: 225). However, this relationship is somewhat different in the Asia-Pacific region, where Tokyo has a different activity base from New York and London, such that Hong Kong and Singapore act more like regional centres than normal OFCs.

Offshore finance has been seen as a development option by two types of LDC: first, middle-to-higher

Table 2 Functional OFCs, 1994

	Licensed Banks	Banks (real presence)	Number employed in OFC	Percentage of labour force	Assets (A) or Liabilities (L) \$US millions	OFC est. contrib to GDP	Offshore Companies	Captive Insurance Companies ^a
Bermuda	3	3	2,600 (1992)	15%	8,832 L	30% (1992)	7,297	1,357
Isle of Man	61	na	5,800	18%	19,650 L	35%	4,180 (1992)	141
Guernsey	73	54	5,000	16%	63,300 L	56%	14,000	280
Jersey	76	67	8,000	20%	97,437 L	54%	29,259	0

Sources Hampton, 1996

Notes a. Captive insurance is where a wholly owned subsidiary company is used to insure particular risks of its parent company, e.g. oil tanker fleets.

Table 3 Compound OFCs

	Licensed Banks	Banks (real presence)	Number employed in OFC	Percentage of labour force	Assets (A) or Liabilities (L) \$US millions	OFC est. contribution to GDP	Offshore Companies	Captive Insurance Companies
The Bahamas	396	177	3,330	3%	200,000 L (1993)	16% (1994)	12,600 (1993)	30 (1993)
Bahrain	47 (1993)	na	na	na	65,000 A (1994)	na	na	na
Barbados	16	na	na	na	2,500 L	na	794	236
British Virgin Islands	8 (1993)	na	na	4%	255,000 A	23%	100,000 (1993)	35
Cayman Islands	534	78	1,600	10%	427,000 L	na	29,298	378
Cyprus	19	19	1,500 (1992)	na	920 L	17% (1992)	13,000	9
Gibraltar	29	na	na	na	3,750 L	na	4,000	na
Netherlands Antilles	37 (1993)	na	na	8%	6,000 A	12.8%	30,000	na
Vanuatu	100	na	386 (1994)	na	5,000 A (1988)	10% (1993)	900 (1993)	25 (1993)

Sources Hampton, 1996.

Notes Data for Netherlands Antilles and BVI 1988; Barbados, the Cayman Islands and the Bahamas 1992; Cyprus, Gibraltar & Vanuatu 1993; unless otherwise indicated.

income LDCs, particularly the NICs and near-NICs of Asia (Hong Kong, Singapore and South Korea, the cities of Bangkok and Taipei, and Malaysia's Labuan island) and, second, small island economies and territories located in the Caribbean (the Bahamas, the Netherlands Antilles), the Pacific (Vanuatu), the India Ocean (Mauritius) or around the edge of Europe (the Channel Islands, Gibraltar, Malta).

2.2 Private banking, capital flight and the offshore interface

Arguably the most significant OFC activity in the 1990s is now offshore banking, specifically the rapid growth area of 'international private banking' encompassing bank accounts, trust and offshore companies. This can be attributed to two connected trends: the changing international financial environment on the supply side, and rising demand for private banking. First, in the late 1980s the syndicated loans business (Eurocurrency markets) and wholesale banking slowed down, reflecting rising real interest rates and the so-called Third World debt crisis. Many international banks thus returned to private banking for 'high net wealth' individuals and pursued them aggressively to replace declining wholesale loan activities with fee-based private banking.

Second, global demand for private banking facilities has increased. In 1990 the number of wealthy individuals worldwide (with investible private wealth of over \$US 1 million each) was estimated by Citicorp at around eight million, and this figure appears to be growing (OFM 1990: 10). The increase in demand comes from regions undergoing rapid industrialization with concomitant wealth creation such as South East and East Asia and areas threatened by increasing political instability, the so-called 'new world disorder' of the 1990s. For example, the break-up of the former Soviet Union led to spectacular capital flight which in 1994 was haemorrhaging at a rate of an estimated \$US 1 billion per month (Burns 1994).

Elsewhere, elites in many LDCs had long placed assets offshore, but there appears to have been a

recent acceleration of such capital flight. Examples, include the offshore fortunes of Haiti's 'Baby Doc' Duvalier, estimated at \$US 300-900 million, the Philippines' President Marcos with an alleged \$US 2-10 billion (Naylor 1987; Robinson 1994), and many others including Latin American cases where funds flowed to Caribbean OFCs and then onwards to Florida real estate.³

More recently, Russian assets held externally in Western banks totalled around \$US 18 billion in 1993 (approximately doubling from 1992), of which around \$US 4.4 billion is held in London (Tett 1994). Russian use of the Cyprus OFC for 'brass plate' offshore companies, bank accounts and offshore branches of Russian banks appears to be increasing. The problem for Western banks is how much of this flight capital is criminal in origin, derived from increasing 'Mafianization' and corruption within the former Soviet economy and being laundered through OFCs.

Capital flight is widespread and has a large technical literature⁴ but it depends on a fundamental need for secrecy in the recipient centre, the OFC. Users of international private banking often blatantly disregard the law concerning offshore bank accounts in their own country and OFC firms use devious (ingenious) methods to retain customers in sensitive locations such as Israel, South Africa (before the mid-1990s) or the Russian Federation in the 1990s. An illuminating example of this is a technique employed to disguise the correspondence from an OFC bank to a private customer using plain, handwritten envelopes with an ordinary postage stamp rather than a normal business style envelope and machine-franked postmark. The disguised letter or account statement is then sent by private bag to the OFC bank's head office in a large capital city for mailing so that the correspondence appears to be a private letter and does not bear the postmark of a known OFC.⁵

Capital flight and international private banking are connected to the large external debt of certain LDCs, but there are two competing explanations for this phenomenon: what Boyce 1992 dubs the 'Baker-banker' orthodoxy of the Western banks and

³ Recent estimates suggest a private banking market in Latin America alone of over \$US 450 billion of investible assets (Timewell, 1995: 58).

⁴ For example, see Boyce 1992 and Nyatepe-Coo 1993.

⁵ Information derived from a personal interview.

the IMF and a critical view. In the first view, significant external debt is due to LDC governments' economic mismanagement (including exchange rate overvaluation and inflationary policies). The relationship between capital flight and international private banking is thus indirect, that flight being a symptom of the LDCs crisis as money flees to more economically 'rational' locations. In contrast, Diaz-Alejandro (1984) takes a critical view and argues that Western banks set out deliberately to attract international private banking (that is capital flight), and that capital flight is partly the result of the increasingly globalized financial system. Similarly, Boyce (1992) uses the metaphor of the 'revolving door' to analyse capital flight from the Philippines, arguing that capital flight and external debt are explicitly and intimately interconnected.

However, we can go further than Boyce's 'revolving door' to consider how offshore finance and capital flight are related to the emerging global system. This developing relationship is what I have called the 'offshore interface' and is wider than just the location of flight capital. OFCs are places of convergence of many capital currents. The offshore interface is where what Roberts (1994) calls 'fictitious capital' or wholesale banking meets 'furtive capital' (private banking and capital flight/retail banking). In addition, it is also a global-local interface: between the developed countries and LDCs, and between corrupt transactions and legitimate ones.

Roberts (1994) identifies the paradox of offshore finance as being both at the margin and at the centre of global capitalism. Given that many OFCs are not independent nation states this paradox is also borne out by their somewhat peculiar relationship with a nearby large power. As dependencies they are both 'within and without' the mainland, having some local autonomy, but linked to the large onshore state. This peculiar relationship partly creates the offshore interface, but is itself open to penetration by internationally mobile financial capital - that is international banks (Hampton 1996). This offshore interface then attracts flight capital often associated with 'onshore' corruption.

Thus, the development requirements of certain small economies and the uneven global financial topography (especially regulatory and fiscal) have

been exploited by international financial capital. The phenomenal 1960s growth of the 'offshore' Eurocurrency markets initially centred in London created a massive pool of unregulated, highly mobile private capital. OPEC funds, swollen by the early 1970s oil price rises, in combination with low real interest rates created excess systemic liquidity which the international banks attempted to mop up by extensive loans to LDCs. These developments were facilitated by significant technical advances in telecommunications and computer power that enabled the rapid transfer of funds from centre to centre across the globe.

A significant proportion of these international loans to LDCs were creamed off corruptly through rent-seeking activities by local elites in the form of over-payments, bribes etc. The funds thus obtained were then transferred into banks located in the offshore interface, ironically often to 'private banking' branches of the very same international banks that had issued the international loan to the LDC country in the first place.

The offshore interface means that an extremely fine distinction exists between various OFC activities, particularly between legal and illegal, as both types require strict secrecy and are subject to low taxation. Thus, it provides a continual potential for abuse by individuals, corporations and the state, although what may be perceived as abuse in one country may be a legitimate business activity elsewhere. This ethical relativism is illustrated by the offshore industry's use of catch-all euphemisms such as 'private banking' or 'asset protection'.

Offshore 'private banking' facilities can also be used for money laundering, although the older functional centres appear more selective in their clientele. As centres 'gentrify', funds of questionable origin tend to move to less selective, newer OFCs (usually notional centres). Alternatively, there may be a layering of shell companies (as in the 'Baby Doc' Duvalier case) to hide the real origin of certain funds, acting as a further interface between legality and illegality.

Governments in developed countries have also used the offshore interface (offshore bank accounts and companies) as money boxes for their security services' covert operations in LDCs and elsewhere to

supply funds to foreign governments, opposition parties or terrorist groups (e.g. the well-documented CIA's dirty wars in Central and Latin America).⁶ Although national security is a sensitive issue for governments, this continuing use of OFCs for clandestine purposes may explain governments' apparent willingness to ignore nearby OFCs, or more generally to tolerate the existence of the offshore interface.

Jersey is a good example of the offshore interface in action. As an OFC with a high level of bank secrecy, the island is open to various abuses including flows from onshore corruption and drug proceeds. Some interview respondents within the OFC sector seriously questioned the island's reputable image and the efficiency of the OFC's regulation: 'Jersey overstates that it is a clean OFC'; 'Jersey is a prostitute ... [and] welcomes money with open arms'; 'It is extremely naive to think that Jersey is not targeted by international financial criminals'; 'It is a potential back door for hot money'.

Not surprisingly, respondents who were government employees talked in terms of Jersey being 'responsible', 'sensible' or taking the 'quality road'. However, since the 1980s a variety of court cases have highlighted how the Jersey OFC has been abused. The 'Baby Doc' Duvalier case illustrated the offshore interface being abused by a member of the LDC elite. What follows is a speculative reconstruction based on various pieces of evidence.

The first stage, once Duvalier had corruptly obtained funds in Haiti (such as cash payments for fictitious 'services', cheques paid to himself and his family etc.) he set up various offshore 'private' bank accounts. Many of these were in Switzerland, an estimated \$US 370 million held there alone (Ferguson 1987: 131). Second, under instruction, a London firm of solicitors formed a Jersey offshore company, Boncardo Limited, with nominee directors in Sark (another small Channel Island) to mask the true 'beneficial owner', that is, Duvalier himself. Next, instructions were passed via Boncardo Limited to set up company bank accounts in various offshore banks in Jersey and elsewhere including BNP, Lloyds, Hong Kong and Shanghai, and the

Royal Trust Bank. Finally, Duvalier, now in exile in a French villa, obtained Boncardo company cheque books for its accounts held at various banks, enabling him to spend his corrupt gains. Meanwhile, the new Haitian government had started to track down Duvalier's illegal offshore fortune. In the process, its lawyers discovered £77,400 in one Boncardo Limited account in BNP. This eventually led to a case in the Royal Court of Jersey in July 1988 and a judicial award against the Duvalier family of \$US 120 million. However, the coup in Haiti in September 1988 led to a pro-Duvalier government and the case was not followed through.⁷

Secrecy, low taxes and political stability attract legitimate business to OFCs, but they are also conditions sought by illegal business. This raises the question of whether such abuses can be stopped effectively given this overlap of attraction. The proportion of OFC business originating from illegal sources is unknown, so it is difficult to evaluate examples like the above as representative or anomalous. A defence often used by the offshore industry is that abuses happen even in reputable finance centres like London and New York, since once money is in the international payments system it is very hard to track. Thus money from an illegal source, or corrupt payment, once paid into a bank in a less regulated jurisdiction such as the Turks and Caicos Islands, can ultimately be transferred to a 'reputable' OFC such as Jersey. In practice, the route taken would involve a chain of OFCs and onshore finance centres, possibly using several trusts and offshore companies. This defence places the onus on the international regulatory system and can be used to justify relative inaction both in the OFC and by the international banks themselves.

3 Impact on Economic Development

The growth of the offshore interface may bring certain negative developmental consequences: by undermining the legitimacy of states, reducing development possibilities and transforming economic activities to rentier ones. First, it may contribute to the possibility of corruption becoming

⁶ For example, see Bloch and Fitzgerald 1983 and Naylor 1987.

⁷ Sources include Robinson 1994 and various articles in the *Jersey Weekly Post*.

seen as a 'normal' activity which undermines local laws in LDCs (Nyatepe-Coo 1993; Watts 1994). The blurring of lines between the corrupt and the normal is also apparent in the developed countries in the 1990s - for example, in the events surrounding the fall of the Berlusconi government in Italy, the Belgian arms scandal, or cases of business malfeasance in the UK. More subtly, as Will Hutton argues, the emergence of the offshore interface and an increasing global economy, by facilitating rapid movements of capital, may be contributing to a more generalized weakening of the credibility and legitimacy of public agencies and social institutions.

The burgeoning international marketplace - destabilizing currency flows, using offshore havens to avoid tax - is hostile to expressions of common and public interest. Private interests have too easily slipped the national leash and have used the ungoverned world beyond national frontiers to undermine what they regard as tiresome, inefficient and bureaucratic efforts to assert the moral and social dimension in human affairs.

(Hutton 1995: 26)

Similarly, Bennett argues that the growth of the informal sector and capital flight in Guyana and Jamaica was

the rejection of the moral and legal authority of the government on the part of a broad cross-section of society in both countries ... a major breakdown in state authority. Many of those whose activities would normally have fallen within the context of the formal sector simply chose to ignore the formal state apparatus and its rules and regulations.

(Bennett 1995: 240-241)

Bennett argues that the increased growth of market forces enforced by international financial agencies weakens the regulatory capacity of states and allows privileged groups to secure advantages corruptly and deposit their ill-gotten gains offshore.

In other cases, the offshore interface may contribute to political decay by intensifying anomalous or corrupt relationships between government and business. In Taiwan, for example, the dominant Kuomintang Party (KMT) is seen as one of the

island's largest industrial conglomerates with around seven holding companies controlling various activities from cement and petrochemicals to telecommunications. According to official figures, the KMT's registered assets totalled around £23 billion at the end of 1992 (Tyson 1994). In Vietnam, despite economic growth of around 9 per cent per annum in 1994, 'corruption has become a serious hindrance to economic development' (Hung Tran of Deutsche Bank Research, Frankfurt, cited by Montagnon 1995). Given the wall of secrecy, the Vietnamese elites' deposits cannot be tracked offshore to particular OFCs, but it is likely that the various sweeteners, 'fees' and commissions end up in the offshore interface.

Second, continuing corruption and consequent capital flight from the LDC can reduce development options since there is a continuous siphoning of resources away from the poorest in society and a widening gap between the wealthy elite and the urban (and rural) poor (Watts 1994).

Third, increasing corruption and capital flight are connected to a sea change in basic economic activity, away from productive uses of capital such as manufacturing, to rentier uses, both for the state and the individual (Murphy *et al.* 1993). For Nigeria, for example, Nyatepe-Coo (1993) and Watts (1994) draw an explicit link between its oil revenues, increasing corruption and massive capital flight, and note the oil producing companies' increasing connection to the international financial system from the 1970s. The offshore interface is an important mechanism of such connections.

As regards the OFC host country, there is the possibility of contagion and increasing corruption amongst its own residents. The 1985 imprisonment of the Chief Minister of the Turks and Caicos Islands and two other senior officials on drugs charges provides a good example of this contagion (Thorndike 1987). The opening up of a small jurisdiction to influential and well-endowed external agents may increase local opportunities for corruption and crime. New OFCs are typically less selective in the business accepted, compared with older OFCs. The shake-out of dubious and illegal operators from the more 'reputable' centres may pressurize them to use new OFCs that may not be tainted by known connections to money laundering. The

cases of certain Caribbean OFCs, including Anguilla, the Bahamas, the Cayman Islands, Montserrat and Panama confirm the contagious nature of large scale imported corruption (Walter 1985).

4 Conclusion

In the offshore interface, the connections between OFCs, corruption, capital flight and economic development are complex. This is only a preliminary account but certain points emerge for future examination. The rapid pace of change, especially that of increasing financial globalization, the deregulation of international finance since the late 1970s, and the arrival of new technologies have resulted in rapid capital flows through the offshore interface. Private banking in OFCs, underwritten by strict bank secrecy legislation, facilitates the easy movement of the gains from corrupt transactions, so that there appears to be an increasing synergy between the offshore interface, globalization and onshore corruption.

If this is so, what can be done? One immediate problem is the pivotal role of the international banks both as wholesale lenders to LDCs and private bankers for their wealthy elites. Arguably these roles are activated by flows of capital partly generated from rent-seeking, corrupt behaviour by elites

in certain countries. This ambivalent, pivotal role of international banks has created obstacles to the implementation of significant change. Such banks perceive the offshore interface as basically unproblematic, except that they might endorse some nominal offshore regulation.

From the point of view of governments in developed countries, in 1995 the OECD Task Force on Bribery, in cooperation with the Financial Action Task Force (set up in 1989 to combat increasing money-laundering) placed a new emphasis on what it calls 'inadequate governance' (read corruption) in LDCs and called for increasing transparency and democracy. However, the occupation of the moral high ground by the OECD is viewed as hypocritical by many LDCs. Moral outrage at the 'cancer of corruption' needs to be considered alongside the double standards of Western companies that routinely supply the bribes to win contracts in LDCs, thus prolonging rent-seeking behaviour.

Yet the growth of the offshore interface may be outpacing any attempts at regulation, whether by business or government. While this article has emphasized its role in fostering corruption, this is just one reason why there is an urgent need for further research on this elusive yet increasingly important phenomenon.

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