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ABSTRACT:

From 1998 Offshore Finance Centres (OFCs) faced complex, overlapping initiatives from the OECD, IMF, FATF and EU. This paper contends that OFCs faced unprecedented Rapid Complex Constant Change (RC^3) which had significant impacts on their host governments. The 'four spaces' concept – regulatory, fiscal, secrecy and political space – is used to analyse RC^3. Two aspects are examined: first, the impact of RC^3 on host governments; and, second, the degree of the hosts' control over the industry. A Jersey case study illustrates the contrast between official narratives of proactive government and alternative narratives of the OFC being driven by the international banks. Finally, lessons are suggested for host governments.

KEY WORDS: tax havens; financial services; globalisation; international finance; island economies; governance

INTRODUCTION.

Tax havens and offshore finance centres (OFCs) emerged in the early twentieth century[1] initially in the Caribbean and in Europe, and at present 70 tax havens (mostly in small islands) manage an estimated US $12 trillion (Tax Justice Network, 2005). Other estimates suggest that over a quarter of the world's money supply is now held offshore and possibly over one half of the gross value of world trade may be transacted through offshore centres. Although tax havens have existed since the 1920s, and OFCs since the 1960s[2], since around 1998 they have been faced by what could appear

to be an overwhelming tide of complex and wide-ranging initiatives from multi-lateral organisations including the OECD, the IMF, the G7's Financial Action Task Force (FATF) and Financial Stability Forum, and the European Union (EU). In addition, national governments including the US and UK have also launched initiatives against OFCs and commissioned enquiries and official reports. These various initiatives, whilst focused on particular aspects such as harmful tax competition (the OECD) or money-laundering (the FATF), are multi-layered and have some overlapping concerns.

The central argument of this paper is that for the first time in their history tax haven hosts are now facing what could be called RC^3 (Rapid Complex Constant Change). This paper argues that the RC^3 facing the OFCs has had a significant impact on the hosts including uncertainty and (questionable) decisions made under pressure. This gives the context for both offshore in general, and for specific OFCs such as the British Channel Island of Jersey.[3]

The sequence of international initiatives from around 1998 is unprecedented in the history of offshore finance, and overall, it appears that many OFC host governments were caught somewhat off-balance by this rapid sequence of external initiatives. This may be due to two aspects: first, the impact of RC^3 itself has been significant with associated resource issues and costs to the host governments. Second, it appears that many OFC host governments may have succumbed to believing their own 'spin', that is, their official line over how much they control their part of this vast global industry. For example, in the official narrative of the Jersey OFC, the story goes that the island's government - the States of Jersey -showed great foresight and leadership and actively created the OFC from the early 1960s.[4] In fact, Hampton (1996a) demonstrates a rather different story where the emerging offshore centre was driven by international financial capital, merchant banks, who set up in the island to service certain wealthy customers. In fact, it appears that the States of Jersey belatedly woke up to the existence and scope of the tax haven 15 years later in the

mid 1970s. This may be associated with the 'capture of the state' argument developed by Christensen and Hampton (1999) that contend that the island's largest industry not only dominates the island's economy but also has effectively 'captured' the local state so that the interests of financial sector tend to dominate the local political economy.

Further, this all takes place within the specific historical context of the late 1990s and early twenty-first century of increasing liberalisation and the globalisation of financial services and markets. Palan (2003) and Sikka (2003b) go further, arguing that offshore finance is in fact a crucial part of the globalisation process as capital restructures itself. It can be argued, following Lenin (1965); Hilferding (1981); and Fine (1984) that financial capital is now the most advanced form of modern capitalism in the early twenty-first century being highly liquid (compared to manufacturing capital); fast moving; highly mobile and having extensive political influence (Coakley and Harris, 1983; Harvey, 1989; Roberts, 1999; Sikka, 2003b).

Yet increasing cracks in the monolith have appeared recently with huge corporate scandals such as Enron, Global Crossing, Parmalat, issues of corporate governance and questions about the power of transnational, service-based firms particularly the 'Big Four' firms of international accountants: PWC, Deloites, KPMG and Ernst & Young (Sikka and Hampton, 2005).

In addition, the global economy has experienced periodic instability in financial markets with the most recent being the Asian currency problems in 1997-8, but also is seeing smaller, more localised regional crises which, given the level of integration of financial markets, have the potential to cause large-scale instability.

In the wider geo-political context, the present period appears to be a time of increased instability in the post 9/11 world of increased international terrorism and heightened political instability. Given the collapse of the former USSR, the remaining superpower, the US, seems to be

entering a new phase with new imperial designs and increased direct intervention in the Middle East. Further, this is associated with struggling (failing?) supra-national bodies (exemplified by the UN over Iraq in 2003, or the collapse of WTO Cancun round) and some elements in the present US government having an interest in a politically weakened, and thus less competitive, EU. Thus, it can be argued that this 'new world disorder' all forms the backdrop to understanding the impact of RC^3 on the tax havens.

THE FOUR SPACES AND OFFSHORE FINANCE.

The composition of the waves of rapid complex constant changes (RC^3) affecting OFCs can be examined more closely by using the notion of the 'four spaces' first developed by Hampton (1996b). It can be argued that the emergence of offshore finance can be modelled in terms of international financial capital (the banks and other financial institutions) having the 'space' to operate. This can be conceptualised as four spaces: regulatory space; fiscal space; secrecy space and political space. Although conceptually separated, these overlap and have complementary attractions.[5]

The first space, regulatory space, is seen where financial institutions moving offshore were able to use the regulatory space that had opened up between bank regulation in the small jurisdiction and that in the large 'onshore' economies. This was a function of the political space enjoyed by most OFCs which are effectively independent political jurisdictions in all but name, but loosely connected to the British Crown through historical ties whether as Crown Dependencies or Overseas Territories. Overall, OFCs' regulatory space was clearly attractive to financial capital. Most OFCs do not impose reserve requirements, there are relaxed capital adequacy demands, an ease of entry for newcomers, and in general, minimal banking legislation until the 1990s.[6] However, as offshore finance grew, major financial institutions sought to reduce the exposure of their OFC activities to

international scrutiny especially by the EU, the OECD and the Bank for International Settlements by encouraging the local host governments to adopt regulation encompassing all sectors of the OFC, following international best practice. Since the early 1990s a fundamental tension for OFC hosts has existed over regulation: too little and the OFC may suffer financial failure and scandal and thus reputational damage, whereas too much regulation - as perceived - and asking too many questions of potential customers might drive away the very business that OFCs seek to attract.

The second space, fiscal space, is built around the tax haven activities in OFCs. In addition to the generally low or no tax environment, the key development was that of allowing offshore companies to be created that were exempt from normal corporate profit tax, that is, generally ring-fenced from the rest of the host's domestic economy and only liable for a nominal annual fee (offshore exempt company) or minimal rate of under two per cent profit tax rate (International Business Company).[7] Thus international financial capital could take advantage of the fiscal space created by these jurisdictions' low tax regimes. In a similar way, wealthy individuals were also drawn by this to either move physically to such places, or at least place their funds there.

The third space, secrecy for offshore business, has two aspects: the traditional Anglo-Saxon banking practise of customer confidentiality; and the legal separation of most OFCs from the large, onshore economies. Even where OFCs do not have literal bank secrecy backed by criminal law, bank confidentiality results in effective secrecy. This can be tightened further by the setting up of offshore companies often in conjunction with an offshore trust. The use of nominees and complex layers of offshore companies (sometimes in different OFCs) can mask the real owners of assets.

The separate legal jurisdiction from the large, onshore economies also augments the effective secrecy of OFCs. Foreign judicial or revenue authorities' attempts to obtain information about bank details undergo prolonged, complex and often very slow processes that often result in the

investigation of an emptied account as the money has flown elsewhere. The only exceptions are changes since the mid 1980s that allow international cooperation over suspected money laundering, drug trafficking and international terrorism. However, since the large-scale terrorist attacks on the US in September 2001, significant changes have been made to international anti- money laundering efforts and cooperation which the paper will examine later.

The fourth space, political space, is based upon the relative political autonomy of the offshore jurisdictions. For some OFCs such as The Bahamas or Mauritius, their political freedom stems from a position of being independent nation states under international law. However, most of the largest functional OFCs are not independent but are in some form of relationship with a larger country being dependencies (the British Channel Islands) or overseas territories (Cayman Islands, Netherlands Antilles). This relationship is key to the concept of political space. Regarding the UK, its dependencies and territories are responsible for their own domestic legislation, and the UK is responsible for their international affairs and defence.[8] Thus the small jurisdictions have sufficient local political autonomy to enact their own fiscal and regulatory legislation and many have set up as tax havens. Therefore, this notion of the four spaces gives an organising framework within to view the sequence of RC^3 presently facing offshore centres.

Regulatory Space.

Following the dramatic events of the East Asian financial crisis of 1997 the G7 Financial Stability Forum (FSF) formed a Working Group to examine the role of OFCs within the global financial system. The Working Group's report (FSF, 2000a) noted the role of some OFCs in financial crises. The second report (FSF 2000b) published a ranking of world OFCs by their regulation into Groups I to III (best to least well-regulated). This was the first time that any international body had attempted

such a public exercise. Previously, although there were unofficial rankings within the offshore industry of the 'better' and 'less savoury' centres, this was unattributable and informal. Further, although some OFCs were seen as being top rank by consensus, in the lower reaches, the choice of 'dodgy' OFCs became highly subjective amongst professionals perhaps reflecting their investment choices, recommendations to their customers, and their own geographical origins.

The results of the 2000 FSF listings were fascinating and caused a furore amongst many OFCs (Williams, Suss and Mendis, 2005). The UK Crown Dependencies (Guernsey, Jersey, Isle of Man) were in Group I. The rest of this group comprised Regional/Global Financial Centres such as Singapore; Barbados was placed in Group II, but most OFCs were categorised as being in Group III to their fury.

Significantly, the FSF also recommended that the IMF play a central role in collating data on OFCs and should begin a systematic program of inspections of their regulatory regimes. The IMF once charged with this responsibility has played an increasing role since 2000 and inspections have taken place in most OFCs. The IMF now collates and publishes some baseline statistics (IMF, 2003) is beginning to make international comparisons easier, as previously the secrecy and lack of usable data on OFCs limited analysis by researchers.[9]

The IMF inspections, (Financial Services Assessment Program) made good progress so that over 40 OFCs had been assessed by end 2005 (IMF, 2006). Further, in contrast to many OFCs' previous cultures of secrecy, some results have been published.[10] IMF inspections so far have included all the major OFCs across the world, with 'new' centres also being assessed. Interestingly, although two Pacific OFCs, Nauru and Niue, initially refused to co-operate with the IMF, later they accepted 'technical assistance' (IMF, 2005).

Nevertheless, despite the better information collected and some increased transparency

resulting from the IMF inspections, two questions remain. First, will the IMF eventually become the global regulator for offshore finance, or will it continue to be just an information clearing-house that is somewhat subject to limitations imposed by the OFCs themselves? Second, if it does become the global regulator, will it have sufficient teeth, that is, will it have the influence and power to enforce regulation if necessary on OFCs? This remains unclear at present.

At the national level, the UK government commissioned reports on OFC regulation in the Crown Dependencies (The Edwards Report, 1998); and in its Caribbean Overseas Territories (KPMG Report, 2000). Despite the OFCs' initial reactions, the effect was to close some of the gaps in OFC regulation such as concerning trust companies. It appears that beyond the minor changes, the main impact was the political message that the UK government was now actively aware of OFCs compared with its former stance which might be styled 'affable neglect'.

Fiscal Space.

Until the late 1990s, government interest in offshore could mainly be observed from the revenue departments of large onshore countries. In the US the Internal Revenue Service (IRS) had periodic bursts of activity against certain Caribbean tax havens in the 1970s (*Los Angeles Times*, 1977; The Gordon Report, 1981), and in the UK the Inland Revenue pursued large artificial tax evasion schemes such as the Rossminster case in the late 1970s (Clarke, 1986) and attempted to close tax loopholes using annual budget announcements. This could be seen as a 'cat and mouse' game played between the onshore revenue departments and the increasing numbers of international tax planning advisers. Occasional media coverage of tax havens focused on blatant or dramatic tax evasion, money laundering or bank failures such as BCCI, and seldom shifted focus from the particular scandal to the broader political economic picture.

In the UK successive governments encouraged its overseas territories and dependencies[11] to establish themselves as tax havens to reduce their dependence upon UK grant in aid. This was exemplified by the planned development of the New Hebrides (now Vanuatu) as a tax haven in the 1970s (Rawlings, 2004) and as seen in the Foreign Office's Gallagher Report (1990) on OFCs in the UK Caribbean territories. The wider issue of the role played by tax havens and OFCs in re-configuring the global political economy was not, until recently, on the mainstream political agenda.[12] However, by the late 1990s the scope and magnitude of the flow offshore and the increasing use of 'profit laundering' (Sikka, 2003a) through tax havens was attracting the attention of the OECD and the EU as both appeared to share concerns about the negative impact of harmful tax competition on the nation state and its business environment. These concerns led to the 1998 OECD report on harmful tax competition and its 2000 update that identified 35 'tax havens' as being involved in harmful tax practices (OECD, 1998; 2000).

The OECD list included a number of high profile OFCs such as the Isle of Man and Jersey and Guernsey. Despite extensive lobbying, only six offshore jurisdictions (Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, San Marino) persuaded the OECD to remove their names from the list immediately prior to its publication and gave high-level political undertakings to follow OECD guidelines and make significant improvements. The 35 OFCs identified by the OECD were then given one year to commit themselves to fundamental reform of their fiscal policies and to agree to broaden the exchange of information with national tax authorities. Non compliance was threatened with economic sanctions (OECD, 1998, 2000). The OECD initiative caused consternation in many OFCs, particularly the threat to publicly list non co-operative 'tax havens' and name and shame jurisdictions that would not begin to reform the most anti-competitive and artificial aspects of their tax haven activity. Eventually, most OFCs raced to send letters of intent to co-operate to the OECD.

During this period three main types of reactions by OFCs to the OECD could be observed: co-operation; denunciation; and ignoring it. The co-operative group became first-movers and cleverly avoided the label 'tax haven' and were dubbed 'Advanced Commitment Jurisdictions' by the OECD (for example the Cayman Islands). The second form of reaction was observed in most OFCs, that of denunciation and bluster but interestingly, most OFCs then signed up anyhow just days before the deadline (for example Jersey). The third type of reaction, that of ignoring the OECD initiative was taken by a few centres but risked being blacklisted by the OECD (for example Nauru).

However, despite all of the international publicity generated by this OECD initiative, particularly the issue of co-operating and non-co-operating tax havens, it appears that in reality, all the tax havens did was write to the OECD stating that they were prepared to co-operate. This appears to be paying lip-service to the notion of co-operation and it remains unclear what, if anything, has actually changed. Significant concerns remain about the capability of most OFCs to effectively regulate the sizeable offshore services that they host. Further, despite the majority of centres agreeing (32 OFCs co-operating with OECD over Information Exchange and ending 'ring fencing' of offshore entities) and the small number of only six 'uncooperative tax havens' (Andorra, Liechtenstein, Liberia, Monaco, Marshall Islands, Nauru) it appears that the OECD initiative became too watered down and thus ineffective, and that the OFCs' paper promises mean little in practice.

However, a longer-term impact, and one harder to quantify, is the expression of the unprecedented idea from such a body as OECD that the very existence of tax havens hurts international business and creates fundamentally unfair, harmful competition. Until 1998 this fundamental issue had never been expressed, and until then it appeared that the apologist argument used by the OFCs themselves that they somehow 'oil the wheels' of international commerce had been accepted as a given. Recently, some nation states have become more pro-active against tax

havens. For example, Ireland - despite a recent history of even the most senior government ministers using offshore structures (Roberts, 1999) - has seen the Revenue Commissioners pursue Irish residents' offshore accounts and has recovered millions of Euros in unpaid taxes (Quinn, 2004).

The EU also had a significant and growing role over fiscal matters focusing on information exchange, and tax harmonisation. First, proposals made in the late 1990s for a EU-wide level of withholding tax charged on dividends were strenuously resisted by the UK government on the grounds that it would seriously damage the lucrative London-based Eurobond market. After a prolonged series of proposals and counter-proposals - and, we can assume, intense lobbying of the government by the largest financial institutions - it was eventually agreed in 2000 that withholding tax would not be applied to the UK Eurobond market. In early 2003 this was finally accepted by the European Council of Finance Ministers (Ecofin). Withholding taxes will be gradually phased out in the EU and direct information exchange will be facilitated between national tax authorities.[13] Not surprisingly, reactions to this significant policy change varied between member states. For some EU members with significant 'offshore' financial activities such as Austria and Luxembourg, these moves provoked heated reactions.

These EU moves towards increased information exchange are highly significant as banking secrecy (the secrecy space) is a fundamental pillar of offshore finance (Hampton, 1996b).[14] Despite protestations to the contrary, banking secrecy remains in great demand by offshore customers wishing to hide transactions from their governments, tax authorities, family members or law courts. The reactions from the tax havens themselves were fascinating. The Swiss resisted information exchange, whilst Guernsey and Jersey decided to opt for withholding tax. The EU Savings Directive finally came into force in July 2005 (Hill, 2005) setting an initial 15 per cent rate of withholding tax.

In addition, in 2003 the EU's Ecofin finally reached agreement over the "tax package" and

decided that offshore 'exempt' companies and International Business Companies were to be phased out by 2008 and 2011 respectively in Jersey, Guernsey and the Isle of Man.

Secrecy Space (Money laundering).

The G7's Financial Action Task Force (FATF) was set up in 1989 as a result of concerns over money-laundering especially the proceeds of the illegal drugs trade and fiscal crime. In April 2000 the FATF published a Report on Non Co-operative Countries and Territories (FATF, 2000a) which identified detrimental practices restricting anti money-laundering measures and stated that counter-measures would be developed against non co-operating jurisdictions. A second report published in June 2000 listed 15 'non co-operative' jurisdictions (FATF, 2000b).[15] Interestingly, by October 2000, only four months after the second FATF report, seven of the 'named and shamed' jurisdictions had rushed legislation through in an attempt to be removed from the list (FATF, 2000c).

Since then many jurisdictions including St Kitts and Nevis enacted anti-money laundering legislation. It remains unclear, however, whether the new legislation will be effective in removing obstacles to international co-operation against money laundering. By mid 2005, of the non co-operative jurisdictions originally identified by the FATF in 2000, only three remained. One was a tax haven, Nauru, which finally abolished its 400 shell banks later that year and was 'de-listed' by the FATF (FATF, 2006)).[16] In addition, in the aftermath of the 9/11 terrorist attacks, the FATF was given a new remit to counter money laundering of terrorist funds placing further pressure on OFCs (*The Economist*, 2001).

The rush to legislation could be seen as a window dressing exercise, rather than a genuine attempt to co-operate with the international community, particularly concerning fiscal crime. Switzerland, for example, still does not recognise tax evasion as a crime and refuses to remove

statutory obstacles posed by banking secrecy provisions in cases of tax authorities' legitimate inquiries. Despite claiming to have state-of-the-art anti-money laundering legislation (Fleck, 2000: 2) Swiss money laundering investigations remain concentrated at cantonal level, and lacks co-operation between the cantons. Successful prosecutions are rare, and Geneva prosecutors have yet to achieve a successful prosecution in several cases involving Russian money laundering.

In June 2003 the FATF issued the revised *Forty Recommendations* (FATF, 2003). The main changes being that definitions of money laundering were widened to include terrorist financing and recommended increased due diligence and international co-operation especially between Financial Intelligence Units. Further, the money laundering remit now includes non-financial institutions and firms such as real estate, precious metals/stones, casinos, accountants and lawyers. Last, there was a move to 'see through' corporate structures to reveal beneficial owners of companies and trusts, and the revised Forty Recommendations also banned shell banks.

In addition to the FATF, a multitude of other international organisations also have an anti money-laundering remit ranging from the regional FATFs,[17] plus the Egmont Group (of Financial Intelligence Units) to the UN's Office for Drug Control and Crime Prevention.

Another initiative concerning money laundering originates from the United Nations Global Program against Money Laundering. A major report was issued in 1998 (Blum et al, 1998) and since then the UN Office for Drug Control and Crime Prevention launched an 'Offshore Initiative'. A plenary meeting was held in the Cayman Islands in 2000 which resulted in a communiqué signed by 31 OFCs agreeing to a high level political commitment to support the UN programme against money laundering (UN Information Service, 2000). However, as with other grand-sounding declarations, it remains to be seen whether this is anything more than the offshore jurisdictions paying lip service to the international pressures to reform their OFCs and set up effective, well-resourced, independent,

and adequately-staffed Financial Intelligence Units.

Three main recent changes can be identified, first the increasing role (and teeth) of the FATF; second, since the 9/11 event increasing international co-operation especially over anti-terrorist money laundering; and third, far tighter rules with wider coverage and less loopholes with more international coverage as seen by the multitude of international organisations noted earlier. It seems that - especially since 9/11 – allowing international money laundering is now indefensible in OFCs, leaving the OFCs as being morally obliged to co-operate in applying anti money-laundering counter-measures.

Political Space.

The UK is highly influential in the offshore world with a web of both direct and indirect links to most OFCs. As noted earlier, the UK has direct political links to the largest OFCs, many of whom are UK Crown Dependencies (Channel Islands, the Isle of Man) or UK Overseas Territories (British Virgin Islands, Cayman, Bermuda, Gibraltar, Turks and Caicos Islands). In addition, due to its imperial history, the UK also has indirect links to most of the other significant OFCs through the Commonwealth (Barbados, Cyprus, The Bahamas, Malta, Mauritius, Seychelles, St Lucia and Vanuatu).

However, within the UK government large contradictions can be observed. For example, Gordon Brown in public has appeared to be anti tax havens, however, this may have created some inconsistency and tension given the use of OFCs by some of the Labour Party's largest donors (Mitchell et al., 2002). Also, any British Chancellor has another tension to consider between the key economic role of the City of London in the UK economy – itself arguably the world's largest offshore centre - versus the continuing existence of Britain's offshore tax haven islands and small

territories. As noted earlier, the issue of EU withholding tax illustrates this, forcing perhaps a political calculation in government concerning the relative importance of the lucrative Eurobond market in London balanced against the continued existence of, say the Channel Island OFCs. One indication of the relative positions could be observed when the UK threatened 'big stick' sanctions against the Channel Islands if they did not co-operate with the OECD over harmful tax competition in spring 2002 (Bennett and Peel, 2002).

In addition, sometimes contradictory policies may also be due to the lack of so-called 'joined up' government given the continuing lack of coordination between the Treasury, the Inland Revenue and Customs, the Foreign Office and Home Office over tax haven issues. Finally, another aspect affecting OFCs in the policy environment is the continuing close relationship between UK government and the 'Big Four' accountants who have a huge presence in all major OFCs themselves and have even drafted OFC legislation in some cases (Sikka, 1996; Hampton and Christensen, 1999). Yet, the UK government continues to commission reports by the Big Four accountants on OFCs, for example the KPMG 2000 report on the UK's Caribbean OFCs, and secondments of these firms' staff are common to government departments such the Treasury.

Concerning the US and the political space for offshore, before 2001 the George W Bush administration and his (then) Treasury Secretary O'Neil downplayed the OECD harmful tax initiatives. However, the terrorist attacks of September 2001 (9/11) led to a rapid and fundamental reversal of this policy. Given the possible use of offshore as routes for terrorist money laundering, anti money laundering policies were given significant new funding and high political priority to combat the perceived financing of terrorism. Internationally, the US led a revamp of the FATF. However, the 'with us/against us' dichotomy in the Bush administration's so-called 'war on terror' put severe pressure on the OFCs especially in the Caribbean region (Walsh, 2002). Nevertheless, there are

also contradictions and opposing tensions within the US administration itself, for example over the issue of corporate headquarters being moved to Bermuda with incorporation there and the effects of the US Patriot Act.

Within the EU the continuing issue of tax harmonisation across Europe is clearly complex, and given different national interests, agreement is unlikely to be reached in the short to medium term. However, there appears to be a growing awareness of tax havens as a live issue for the EU and as noted earlier, Ecofin reached agreement over the 'tax package' in mid 2003 to effectively close down most forms of offshore 'exempt' companies and International Business Companies to end by 2011 in Jersey, Guernsey and the Isle of Man. This in combination with the Savings Directive implemented in mid 2005 is likely to have significant impacts on both EU residents wishing to place assets offshore and on the tax havens themselves.

Therefore, given this unprecedented sequence of international initiatives affecting OFCs since the late 1990s, it seems that there has been and continues to be rapid, complex and constant change (RC^3) facing the OFCs' host governments. Next the paper examines the effects of RC^3 upon the small host economies.

RAPID COMPLEX CONSTANT CHANGE (RC^3) AND THE OFC HOSTS.

Many tax havens and OFCs are hosted in islands or small states in the Caribbean, around the European periphery and in the Indian and Pacific Oceans. For some island economies, offshore finance has become the main economic activity making a significant contribution to GDP, government revenue, and direct employment. In extreme cases such as Jersey, the OFC contributes over 80 per cent of GDP, over 90 per cent of government revenue and over 23 per cent of direct employment (source: 2001 Census, States of Jersey).

In the small but growing literature concerning small economies, a subset examines small island economies (SIEs). It has been found that particular characteristics can be observed that arguably distinguish them from larger economies and societies (Dommen, 1980; Royle, 2001; Bertram, 2004). SIEs are here defined as being those with a total population of under 1.5 million (Commonwealth Secretariat, 1997; Srebrnik, 2004). The literature suggests that SIEs, like the majority of remote and peripheral areas, are characterised by profound economic disadvantages, including restricted comparative advantages; diseconomies of scale; dysfunctional market structures; high transport costs; high level of openness to international trade; tendencies to be price-takers not price-makers; limited natural resources; and small labour markets with deficiencies in professional and institutional knowledge and experience (Briguglio, 1995; Armstrong et al, 1998; Armstrong and Read, 2000; Royle, 2001). That said, conversely, it has also been suggested that small islands have certain advantages such as social capital, and as small polities, may be faster-moving and more flexible in policy terms than some larger jurisdictions with larger government structures (Baldacchino, 1993). Nevertheless, in light of these economic characteristics, offshore finance, and external events that affect this industry have become increasingly important to many SIEs' governments.

The impact of RC^3.

The litany of initiatives and other external events that comprises RC^3 continues to have significant resource issues and costs for OFC host governments. First, there is the cost of new financial regulation for the sector and its enforcement. The raft of new initiatives such as tighter anti money laundering procedures, documenting the changes, preparing new legislation, setting up a Financial Intelligence Unit and extending the capacity of the existing OFC regulatory body all requires internationally competent and experienced (and therefore expensive) regulators for host OFCs.

Sharman (2005) suggests that for some of the smallest OFCs in the Caribbean, cost benefit analysis shows that the local cost of compliance with latest international best practice regulation outweighs the actual income stream from offshore fees and other government receipts. Williams, Suss and Mendis (2005) concur, noting high regulatory costs for the smaller OFCs based upon their own IMF experiences in the Caribbean. This then, may lead to some of the smallest OFCs leaving the offshore business. Some OFC industry sources in fact suggest that the main impact of what this paper calls RC^3 will be the eventual shrinkage in the short-to medium term of the present 70 or so centres down to around twelve globally.[18]

Second, within the host government itself, many lack the skilled personnel or even the structures to deal with RC^3. This is mainly due to the small size of most host government establishments. Given the limited numbers of staff, serious questions remain about how islands and small states handle a single crisis in terms of capacity, but this paper argues that the phenomenon of RC^3 results in the 'overload' of local systems' abilities to cope. Further, this overload may be compounded by the private sector OFC firms poaching talented individuals away from government given the higher salaries and perks offered. In Jersey, for example, it is common for government departments to struggle to fill vacancies and lose staff to OFC firms once trained at public cost. This links to the 'vulnerability' verses 'resilience' debate in the island economies literature (Briguglio, 1995; Pelling and Uitto, 2001). There is a question whether the ability to handle crises or not (or $RC^{3)}$ is simply a function of the small size of the host. Alternatively, the question arises is it associated with the political power that the OFC sector enjoys in many host economies and may be connected to dominant industry type arguments such as the 'capture of the state' thesis suggested by Hampton and Christensen (1999) which is a form of political 'Dutch disease'. Finally, it is possible that this is exacerbated by the tendency of some host government to believe their own public relations

departments or consultants.

Differing narratives.

Many OFC hosts appear to have succumbed to believing their own 'spin', that is, their official narrative concerning how much actual control they have over their part of this highly mobile, advanced global financial services industry. The case of Jersey illustrates some of these ideas. There now appears to be a growing contrast between the official narrative of the Jersey OFC that portrays a wise and proactive role of the island's government and another narrative, that of the emerging OFC being driven by the arriving and entrepreneurial merchant banks from the 1960s, with the States of Jersey, only beginning to draft policy concerning the OFC over 15 years after it had started (Hampton, 1996a). Interestingly, the official line in the States of Jersey publicity material and from politicians and government officials is that Jersey is not a tax haven, not even an offshore finance centre, rather, is a self-styled 'international finance centre' (Powell, 2002). This angle has also been taken by the island's only newspaper, the *Jersey Evening Post* which is owned by a retired very senior politician and former 'chancellor' in the island's government. Newspaper articles and editorials in the *Jersey Evening Post* commonly complain that the island is unfairly portrayed by external media, governments and certain academics as a 'tax haven'. The government of Jersey is not alone in doing this, as many other jurisdictions regularly issue denials of being tax havens (*The Guardian*, 2004a, b, c). No official history exists of the emergence of the Jersey OFC[19] but in various publications the clear theme from the Jersey government is that they have guided the OFC, rather than being driven by its (global) needs (Powell 2002).

In the late 1990s, around the time of the beginning of the UK's Edwards Report, the official line was that Jersey was so well-regulated that other OFCs should learn from them. After the 1998

OECD report, various island politicians made bellicose public comments about who did the OECD think they were telling Jersey how to runs its affairs. However, some Jersey politicians in private told the author that this had echoes of a 'mouse telling the cat to mind its own business'. Overall, it seems there is some evidence of the political elites believing the public relations firms rather than considering the facts of the relative political power and size of the island of Jersey relative to the UK and its OECD partners.[20]

At another level, following Baldacchino's idea (1993), it appears that the States of Jersey still have to actively 'manage' their dependency on the UK. Anti-compliance, or anti-OECD rhetoric for local island consumption is one matter, but States of Jersey policy that aggravates the nearby large power, the UK government, is problematic. This is complicated by the demands of the dominant industry, the OFC, which may working to their own global agenda rather than fully considering the interests of the host island (Hampton and Christensen, 1999).

The Reactions of the Tax Havens.

It is interesting to analyse how the tax havens reacted to RC^3, to what some have dubbed 'initiative overload'. A sequence can be mapped of the tax havens' rhetoric as it changed tone and content in response to other events. A common first reaction around 1999-2000 tended to be the hosts commenting on the unfairness of being singled out for attention by international bodies such as OECD, often alongside claims that OFCs were actually better regulated than the City of London or New York. This argument parallels the stance taken by Le Marchant (1999) – a Guernsey OFC regulator - that OFCs are in effect, regulatory 'laboratories' that test more effective or innovative regulation and so deserve praise and emulation not criticism. OECD member countries were also criticised for their 'high' tax rates that drove business offshore in the first place which is an argument

used by apologists such as Johns (1983), *The Economist* Intelligence Unit (Doggart, 1991), Johns and Le Marchant (1993) and Teather (2002):

> Offshore exists but they see it as a bad thing. If the OECD stopped imposing penal taxes on their own citizens, we wouldn't exist. That's all they need to do. They'd solve the problem. They're so-called capitalist countries imposing socialist rates of tax on their own citizens. It's more or less a human rights issue really. (Isaac Legair, Director, Financial Supervision Unit, St Lucia[21])

This first common reaction was then superseded around 2000-1 by the second noticeable response which was an angry rhetoric that accused the large countries and the OECD of a form of 'new imperialism'. This theme could be seen in government speeches particularly from several Caribbean OFCs. Other offshore centres emphasised the economic importance of their OFCs asking :

> What would we do instead? If the OECD closed us down, we would become depopulated and derelict. (John Cashen, Chief Finance Officer of the Isle of Man, quoted in *The Financial Times*, 2000).

Other OFCs set out stark warnings that if their main industry was affected the consequences would be difficult for most:

> Destruction of our international financial services sector would have not only dire direct income and employment effects but also severe social consequences. In addition, we are

forced to ask the question: *what would the developed countries have us do for a living?* (Ralph Fonseca from Belize, representing the Joint Caribbean Group, 1999, emphasis added[22])

This type of reaction was common until the time of the extreme events of the 9/11 attack on the US in 2001 when the global political economy changed rapidly. International, and also regional politics, especially in the Caribbean, became affected by that highly charged atmosphere and the Bush administration's response. Given the renewed energy of anti terrorist money laundering moves, OFCs swiftly fell into line declaring themselves part of the 'war on terror' in a third reaction. Tax haven government pronouncements assured the US and international community that they were racing to 'comply with international best practice'. Since then no clear response can be observed, rather, individual OFCs appear to be negotiating their own ways forward with the various international bodies. Unfortunately for the tax havens, in the chronology of events, the exceptional situation of the 9/11 attacks on the US in 2001 came at the time when OFC response to the main components of RC^3, especially the OECD tax competition moves, was beginning to coalesce into what could have been an effective group opposition to its main thrust. Once the political world had changed in the post 9/11 context, it became extremely difficult for the tax havens to oppose certain parts of RC^3.

CONCLUSIONS AND LESSONS FOR OFC HOSTS.

This paper has argued that the waves of international initiatives that appeared in the late 1990s and early twenty-first century have not struck OFC hosts completely 'out of the blue'. Tax havens clearly do not operate in a vacuum; clearly they are affected by the wider political economy and changing

international context, what Mowforth and Munt (2002) call 'political globalisation'. As with all the other tax haven governments, the States of Jersey are experiencing what is called here RC^3 (Rapid Complex Constant Change). The paper used the concept of the 'four spaces'(Hampton, 1996b) - regulatory space; fiscal space; secrecy space and political space - to analyse the main components that comprise the RC^3 affecting OFCs.

One initial, and perhaps obvious, observation is that the present situation is significantly different to the early years of offshore finance of the 1960s or the mature period of the late 1970s and 1980s when the so-called 'regulatory burden' (Biswas, 2002) was lighter and OFCs could compete in regulatory laxity to attract international business. However, it seems that belatedly, onshore governments and international bodies such as the OECD and EU have finally woken up to tax havens and to the vast scale and scope of the largest transnational corporations and wealthiest individuals routinely transferring wealth or profit laundering through the offshore system. This paper has argued that the context, the scale and the scope of offshore finance has fundamentally changed since its emergence in the 1960s with possibly a quarter of the world's money supply now held offshore. Paradoxically for such small places OFCs are not merely at the periphery of global capitalism, they lie at its very centre (Roberts, 1995; Sikka 2003b). Further, what this paper has called RC^3 could be framed in terms of other theory so that following the ideas of Pelling and Uitto (2001) it could be argued that this acceleration of external initiatives and events that affect offshore centres (RC^3) is in fact a manifestation of Harvey's notion of 'time-space compression' (1990). In other words, the dynamics involved in RC^3 and its impact on tax haven host economies begins to illustrate a wider process of change under the globalisation of advanced capitalism that also affects larger economies than just islands or small states.

There seems to be a clear pattern emerging of RC^3 so that for local policy-makers the big

question remains of how to cope with (or even manage) such major changes? This paper has argued that the process of RC^3 has been exacerbated by the structural characteristics of the small host economies. Unlike the optimism seen in Srebrnik's paper (2004) on democratic values in islands and how small islands are exemplars of good governance and functioning democracies, this paper argues that the small size of most hosts' government apparatus, the constraints of smallness and over-dependence on one major industry, has all resulted in problems in dealing with external shocks such as RC^3.

Finally, what are the trends for the short- to medium-term outlook for offshore finance? It could be argued that the response of OFCs themselves to external shock such as RC^3 will have ultimately help decide their future. If OFCs are broadly divided into a simple binary of Functional OFCs versus Notional OFCs (paper or 'brass plate' centres[23]) then it can be observed that the Functional OFCs have generally complied with many initiatives (albeit after complaining) whereas some notional OFCs have tended to ignore such initiatives and have risked black-listing. To use an analogy from sport, there appears to be a trend developing into a two part split between OFCs who are like the largest professional league clubs, and those more like clubs seen in week-end amateur leagues. It is reasonable to argue that further external shock or RC^3 will exacerbate this trend. What is unclear, however, given the growing civil society response to tax havens (exemplified by the international campaigns of the Tax Justice Network[24], AABA and Attac NGOs), and in light of UN comment in 2004, is how this might affect the future of offshore finance. It is conceivable that a sea change away from civil society's broad acceptance of tax havens could drastically change the overall picture with a significant reduction in the number of tax havens and the scale and scope of their activities. A recent example from Ireland is illuminating. As noted earlier, a successful anti-tax evasion initiative by the Irish Revenue since 2002 has seen over 200 million Euros belonging to Irish

residents withdrawn from bank accounts in Jersey, Guernsey and the Isle of Man. The latter tax haven island saw Irish deposits fall by £20 million in the financial quarter ending June 2004 (Quinn, 2004). The impact of effective and timely revenue authorities' actions on offshore havens is very clear. Thus, it is not impossible to consider that the golden years of offshore finance may be already past, and that the speed of change like an incoming tide will continue to surprise many observers both in tax havens and in the air-conditioned offices of international firms of accountants, lawyers, bankers and tax planners.

NOTES.

[1] There is some discussion in the literature over the historical origins of offshore finance. Palan (2003) argues that offshore has its origins in the 1950s, whereas Hampton (1996a) notes the use of tax havens by wealthy individuals and the early transnational corporations (TNCs) from the 1920s.

[2] The distinction is that while a tax haven is based upon a jurisdiction having no or low effective taxation, an offshore finance centre can be defined as being "a centre that hosts financial activities that are separated from major regulating units (states) by geography/and or legislation" (Hampton, 1996a, p.4). Most OFCs are usually tax havens but not all tax havens are also OFCs. This distinction is highly contested as most tax havens will not admit to being so, and call themselves OFCs.

[3] The Channel Islands are not part of the UK, rather, they are Crown Dependencies and have a high level of local autonomy in domestic matters. The UK is ultimately responsible for their good governance and for defence and international affairs. They consist of two separate baliwicks of

Jersey and Guernsey, each with their own government. The Bailiwick of Guernsey also includes the islands of Alderney, Herm and Sark.

[4] The notion of the local government having actively led the development of the OFC, rather than being the more passive partner, persists in local public discussion and is a common theme in letters to the island's only newspaper, the *Jersey Evening Post*.

[5.] 'Spaces' refers to non-physical spaces. Here the 'spaces' are read as being more than just something that exists in a passive sense, i.e. that just happens to be there and thus able to be colonised by financial capital. At the same time, financial capital can also create 'spaces' in which to operate to circumvent actions of the onshore nation state such as regulation or taxation. Thus the word 'spaces' is understood to have a wider meaning than is first apparent.

[6.] It can also be argued that most OFCs' regulatory authorities were slow to realise the scope and rapid growth of offshore activities so that financial capital exploited this lag between penetration and increasing supervision of the sector.

[7.] The fiscal space was further widened with the 1993 introduction of International Business Companies for TNC customers. These special companies offer extremely low effective tax rates and are have proved highly successful parts of offshore structures.

[8] The UK is ultimately responsible for the good governance of its dependencies and territories so it retains the right to intervene in what the islands may see as being 'their' jurisdiction. In principle, despite historical precedent of allowing local rule, it is conceivable that a UK government might act against a British OFC if the some action was seen to threaten good governance as defined by the UK.

[9] The IMF has created yet another acronym for offshore centres - SEIFiCs (Small Economies with

International Finance Centres) to add to the growing list.

[10] The FSAP process has been criticised by anti-tax havens campaign groups such as the Tax Justice Network since OFCs being assessed have to agree the IMF's findings before the report is signed off, clearly reducing the independence of the IMF assessment. Also, few FSAPs have been made public, so that this process, although an improvement on the lack of data previously, remains somewhat partial. The next rounds of consultation, workshops and information-sharing (IMF, 2006) *may* allow more transparency.

[11] The former British Dependent Territories were re-named in the 1990s as UK Overseas Territories and consist 13 tiny remnants of the British Empire including many OFCs (the Cayman Islands, the British Virgin Islands, the Turks and Caicos Islands etc). However, the three British Crown Dependencies (the Isle of Man, Guernsey and Jersey) are ancient jurisdictions subject to the Crown, have their own parliaments, and are not within the UK (Le Herissier, 1972).

[12] Elements in the US government have historically been highly active against tax havens especially in the Caribbean since the late 1960s with dramatic IRS raids in The Bahamas in the 1970s, court action against banks in the Cayman Islands in the mid 1980s, and in the 1990s being one of the driving forces against international drug money laundering by leading initiatives such as the creation of the FATF.

[13] The author heard concerns in many OFCs that the UK government might sacrifice the British OFCs to the EU to retain the London Eurobond market. They feared that the UK government would rather see its OFCs reduced rather than lose the status and market share of London's global financial centre.

[14] A distinction can be made between banking secrecy and confidentiality. The latter is the reasonable right to privacy in one's affairs, whereas the former goes far beyond this. For example, in

the case of an offshore bank account, if one has nothing to hide, then legitimate inquiry by the state does not breach the confidentiality expected in banker-client relationships. Bank secrecy in many OFCs prevents such legitimate inquiries. However, it now appears that bank secrecy is under growing threat of extinction as exemplified by Switzerland's increasing willingness to freeze assets pending court actions.

[15] Certain OFCs appeared on all three listings (the OECD list of ' tax havens'; FSF least well-regulated OFCs; and the FATF list of 'non co-operative' jurisdictions). OFCs appearing on all three lists are: The Bahamas, Cook Islands, Marshall Islands, Nauru, Niue, Panama, St Kitts and Nevis, St Vincent. The Cayman Islands would have appeared on all three lists, but just days before the OECD report was published agreed to roll back tax haven activities and were removed from the OECD list.

[16] At the time of writing (mid 2006), only one country, Myanmar (Burma), remains labelled as 'non co-operative' (FATF, 2005; 2006).

[17] The main regional FATFs are: Caribbean - CFATF; Asia-Pacific - APG; (Non FATF); Europe - MONEYVAL; Latin America - GAFISUD; Africa – ESAAMLG.

[18] Source: various anonymous senior OFC staff in informal conversations.

[19] Colin Powell, the former Chief Economic Adviser to the island, has told the author of his plans to write an official history in his retirement.

[20] In addition to the independent spirit seen in many other islands, Jersey people have mixed feelings towards the UK based upon twentieth century history and the UK's reaction to the island's occupation by German forces in the Second World War (Hampton, 1996a).

[21] Interview with Mr Legair in Castries, St Lucia on 1 June 2000.

[22] Statement by Ralph Fonseca on behalf of the Joint Caribbean Group at the Joint Annual Discussion, Boards of Governors Annual Meetings, World Bank Group/IMF, Washington DC, 28-30 September 1999. Press Release no.50.

[23] For more details on a typology of OFCs see Hampton (1996a).

[24] The Tax Justice Network began in 2002 and actively campaigns against tax havens and international tax dodging http://www.taxjustice.net

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