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Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance

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Summary. — The stock of wealth held offshore is estimated at US$6 trillion. Many small island economies (SIEs) host offshore finance centers, and some SIEs are highly dependent upon offshore finance. Extreme examples have over 90% of government revenues derived from finance sector activities. Since 1998 a series of international initiatives have been launched to combat harmful tax practices, money laundering, and inadequate financial regulation. These initiatives will transform the economies of many SIEs. This paper explores the dependence of many SIEs upon offshore finance and the barriers to diversification arising from their smallness and unique political economies.

Key words — offshore finance centers, economic development, small states, island economies

1. INTRODUCTION

Over the last 40 years many small island economies (SIEs)—here defined as places having under 1.5 million populations (Commonwealth Secretariat, 1997)—have become hosts of offshore finance centers (OFCs). Clusters of well-known OFCs are located around the European periphery (for example, the Channel Islands, Isle of Man, Malta, Cyprus); in and around the Caribbean (Cayman Islands, British Virgin Islands (BVI), The Bahamas, Bermuda); the Pacific (Vanuatu, Cook Islands) and Indian Oceans (Mauritius, Seychelles). Many SIEs have become highly dependent upon hosting OFC and tax haven activities with extreme examples such as the British Channel Island of Jersey having over 90% of its government revenues originating from such activities, and the OFC directly employs up to 20% of the local labor force. [1]

The value of the stock of wealth held offshore has been estimated at over US$6 trillion (The Edwards Report, 1998), and is apparently still growing. The development of the present integrated global financial system was facilitated by advances in telecommunications and information technology that allow the rapid transfers of funds around the globe, and by the liberalization and deregulation of international finance since the 1980s.

The two main user categories of offshore are trans-national corporations (TNCs) and the world's wealthiest individuals. Since the 1960s a range of services have been created including "one-stop" global asset management for wealthy individuals using a variety of asset-holding trusts and offshore companies; specialist offshore corporate vehicles such as International Business Corporations (IBCs); captive insurance and offshore funds. Some OFCs have

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developed specializations in areas such as captive insurance (Bermuda), protected cell companies (Guernsey), offshore company registration (the BVI) and trust management and securitization (Jersey).

Since the late 1990s, however, an unprecedented sequence of international initiatives have been taken which individually and collectively have the potential to significantly reconfigure the global finance industry and offshore finance in particular. This process may have been further accelerated by the terrorist attacks on the United States on September 11 2001.

We begin this paper by examining the key initiatives concerning harmful tax competition and tax harmonization; money laundering; and offshore financial regulation. In view of the political power of the onshore interests ranged against offshore finance we argue that island hosts of OFCs face a volatile and increasingly unpredictable international context over which they have neither influence nor control. Their destinies therefore depend to a considerable extent upon decisions that will be taken by international fora at which they are not directly represented. The welfare of SIEs dependent upon their tax havens and OFC activities will only be one among a number of arguably more important strategic concerns about global financial stability, money laundering, fiscal degradation, and moves to define an international tax policy in the context of the globalization process.

In the light of rising uncertainty about the structure (maybe the future) of offshore finance, we examine the economic dependence of many SIEs upon offshore finance and tax haven activities, and we argue that this dependence upon OFC activities has been exacerbated by the structural problems of smallness and the unique political economies of small islands. We also consider how offshore finance crowds-out SIEs by acting as a "cuckoo in the nest," and identify the barriers that restrict the scope for diversification in the post-OFC period.

2. KEY INITIATIVES AGAINST OFFSHORE FINANCE

Until very recently the activities of tax havens have attracted only intermittent attention from academics and from governments. This is surprising in view of the rapid growth of the volume of transactions routed through the offshore circuits, the stock of wealth held offshore, and the rising number of jurisdictions that engage in tax haven and offshore finance activities.

Data on offshore finance are sparse and collating statistics on offshore financial flows presents methodological problems arising from the secrecy that surrounds the offshore finance world and the potential for double-counting (even when jurisdictions publish total offshore bank deposits). Nonetheless some of the available data illustrate the rapid growth of offshore finance. In 1968 an estimated US$11 billion was held in OFC bank deposits. By 1978 this had increased to US$385 billion (OECD, 1987). At the end of the 1980s deposits held in the Caribbean region alone amounted to over US$400 billion (Peagam, 1989), and in the early 1990s Kochen (1991) put the total value of offshore deposits at approximately US$1 trillion. This figure rose sharply during the 1990s. The most recent estimate values the stock of wealth held offshore at around US$6 trillion (The Edwards Report, 1998). The scale of the flow of funds offshore is large and significant, and appears to be increasing. Table 1 illustrates key data for selected island OFCs.

In the academic sphere the subject of offshore finance was relatively unexplored until Johns (1983) applied a neoclassical analysis to the economics of offshore finance, and Gorostiaga (1984) examined the economics of finance centers located in less-developed countries (LDCs). [2]

During the 1990s the subject attracted further studies, including further neoclassical analyses of the role of offshore finance in the global economy (Johns & Le Marchant, 1993; Hines & Rice, 1994); analyses of how offshore finance functions (Roberts, 1994; Hampton, 1994, 1996b); analyses of the regulation of OFC activity (Sikka, 1996; Le Marchant, 1999); the political and economic geography of "offshore" (Cobb, 1998; Hudson, 1998); the role of OFCs within the discourse of the state, sovereignty and jurisdiction (Roberts, 1995; Palan, 1999; Picciotto, 1999); the interconnection between OFCs and onshore economies as mediated through political elites (Roberts, 1999); the role of OFCs in developing countries (Possekel, 1996; Marshall, 1996) and the social anthropology of host OFCs (Maurer, 1995).

Recently the discussion in the growing offshore literature has considered the regulation of OFCs and the current reconfiguration of the "regulatory landscape" (Picciotto & Haines,