THE ROLE OF OFFSHORE
IN THE INTERNATIONAL ECONOMY

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ABSTRACT

Offshore jurisdictions attempt to attract foreign capital to themselves by having lower financial regulatory requirements than other jurisdictions. By examining the literature and the latest data on financial flows, the thesis attempts to identify the sources of the powerful systematic causes and effects of Offshore. It does this by disaggregating elements of Offshore that are normally conflated. An eclectic theory based on elements of liberal international theory and world-system structuralism is constructed in order to clarify the role of Offshore in the international economy.

The conclusions are that Offshore is an integral part of the current global economic system; that further research may reveal that Offshore serves hegemonic interests; that regulatory competition is likely to remain a part of the international economy for the foreseeable future; and that, by finding common interests among hegemons and others, the invidious Offshore element of secrecy has a serious chance of being curtailed so that systematic stability can be increased.
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'I guess I'll have to get one of those Swedish bank accounts.'

A rather simple 30-year-old relief pitcher upon signing a four-year, $4.8 million contract with the Boston Red Sox baseball team in 1985.¹

Introduction

Like transnational corporations, Offshore is an important phenomenon that must be clearly understood in order to grasp the extent of the difficulties of regulating the globalizing international economy. Offshore jurisdictions attempt to attract foreign capital by having lower financial regulatory requirements than other jurisdictions. Institutional capital is attracted due to legal provisions that include lower deposit reserve requirements; lower withholding tax requirements; fewer exchange rate restrictions; allowing the use of unhedged derivatives and unsecured loans; allowing less diversification of asset portfolios; permitting unlisted companies to be held in asset portfolios; and fewer interest restrictions and lower capital adequacy (liquidity) requirements for banks. In addition to these bank rules, Offshore jurisdictions offer lower income, withholding, capital gains and dividend taxes; less reporting rules; and more lax accounting and fiscal rules for individual and corporate "residents" of their jurisdictions.

The role of Offshore in the international political economy has been seriously misunderstood. First, Offshore is usually seen to be peripheral to the main mechanisms of the international economy, providing enclaves that are external to

the "normal" activities of the international economy. This is a serious error since
Offshore is an integral part of the international economy. A surprisingly large
portion of global assets flows through Offshore jurisdictions from both corporate and
individual clients.

The second misconception is that Offshore is conceived primarily as an
obstacle to the enforcement of laws in the developed countries. This view sees
Offshore being predominantly in the service of money launderers and facilitators of
other types of illegal activities. While this view is partially accurate, it is quite narrow
and obscures the larger systemic forces that cause and result from Offshore.

There are two serious challenges that Offshore poses to the organization of
the international economic system. First, it represents the most extreme use of the
commodification of the concept of sovereignty as countries sell their sovereignty in
an international regulatory marketplace. The result is a "race to the bottom", or,
more accurately, the eradication of the bottom of regulatory standards.

Second, Offshore allows international financial rules to be circumvented. As
a result, it allows certain actors to benefit from the ability to hide assets and from
easier access to credit. Simultaneously, Offshore prevents effective risk
management and causes serious systematic instability. International regulatory
agencies like the Bank for International Settlements and powerful private sector
actors have difficulty in making accurate risk allocation decisions.

Seen from this larger perspective there are more powerful forces, and more
serious systematic threats, than drug dealers, arms dealers and tax evaders with
a stake in Offshore. This wider view shows that any attempt to tackle the problems
of tax havens as a criminal enforcement problem are doomed unless the private, state and systemic forces that encourage tax havens are also incorporated within the analysis.

In order to get a clear picture of Offshore, answers will be attempted for the following questions. How did Offshore develop? What is the current nature of Offshore? Whom does it benefit and whom does it harm? What concepts can be used to best understand Offshore? And what can be done to curtail its harmful effects?

The paper is divided into three sections. In the first section, the development of Offshore will be sketched. The second section will provide a detailed description of the current state of Offshore. The third section provides a theoretical understanding of Offshore and proposes practical solutions to minimize its harmful effects.

**Part 1: The Development of Offshore**

In the beginning there was Switzerland. Switzerland has a long history of attracting flight capital through privacy rules dating back to feudal times. Since the Edict of Nantes in 1598, the Swiss have aggressively sought out a niche as a secure place for flight capital within a turbulent European political environment. This tradition of privacy has carried into the banking realm through the Swiss constitution, its civil law, and its criminal code.

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2 The Swiss history is from Walter (1985) p.95.
The tradition of attracting flight capital was made manifest in the Banking Law of 1934. This provided for criminal penalties for bankers who violated the zealously guarded banker-client confidentiality. The Banker-client relationship included banker-government and bank-bank relationships. A violation of the private nature of banking relationships did not have to be intentional. The law caught negligent acts of bankers who allowed the release of banking information. Moreover, the rules of confidentiality were not restricted to the period of the banker’s employment but extended for the life of the banker.

Switzerland historically enforced these rules very strictly and refused to allow exceptions for cooperation with foreign law enforcement agencies. This, of course, caused diplomatic differences between Switzerland and the countries from which taxable or illegally obtained capital was being diverted. However, Switzerland steadfastly and successfully resisted the pressure and became a progenitor of Offshore as it served as an example to other countries as to the methods of maintaining financial secrecy.

Another forerunner of secrecy was Liechtenstein. Through its Company Law of 1926, Liechtenstein was a forerunner in allowing the creation of anonymous companies and trusts aimed directly at tax evasion. Whereas Switzerland’s privacy laws were focused on individuals, Liechtenstein was the forerunner in allowing corporate assets to be hidden from authorities. To this day there is a very strong

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4 Section 2 of Article 47 of the Swiss Banking Law.
5 Section 3 of Article 47 of the Swiss Banking Law.
link between the bankers of Switzerland and the lawyers of Liechtenstein as they collectively try to serve these diversified clientele.\textsuperscript{7}

In the 1930s and 1940s rich American and Canadian individuals started using trusts and holding companies in the Bahamas as Europeans had used Switzerland previously.\textsuperscript{8} Up until the end of the 1950s Offshore jurisdictions were generally places with small amounts of money which catered to tax evaders, mafia, drug dealers and arms dealers looking to launder their money.

In 1963, domestic inflation was a serious concern for U.S. monetary authorities. As a result, the U.S. imposed taxes on foreign-owned dollars in the U.S through the Interest Equalization Act. In 1966, the U.S. capped domestic interest rates on deposits through Regulation Q. These regulations created a higher demand and supply respectively for U.S. dollars outside of the U.S. than inside.

The story now moves to Britain. Ever since the end of the 1920's, the British yearned for their previous stature in the financial world. London had been the centre of the financial world for many decades during the pax Britannica. Accordingly, the British knew like no other the power, money and other intangible benefits that came from being the primary location of the world's capital markets.

In the 1960s, the British financial establishment seized on the opportunity created by the U.S. and decided to offer a release for the pent up demand for American capital. The British government and the financial sector gave tacit assurances that they would not regulate the financial activities of foreigners or

\textsuperscript{7} Walter (1985) p.99.
foreign currencies. The result was the birth of the Euromarkets in the first major offshore centre of London. American banks opened branches in London which took deposits and loans in non-Sterling currencies and made loans outside of the constraints of any domestic regulatory system. These “offshore” banks, which were almost always subsidiaries or branches of regulated banks, were much more profitable since they had no capital reserve requirements, no deposit insurance fees, no exchange controls or other such costs of banking.

However, the London Offshore was only halfway towards an unregulated financial market. There are several reasons why London represented only a partial step towards an unregulated financial system. First, Britain was financially stable and shared many key values with the United States on the relationship between the market and the state. If the nascent Euromarket were to prove to be a net detriment to the U.S., the British government could be relied upon to cooperate with the U.S. to make adjustments to the arrangement or even to close it down.

Second, the banks' large and regulated parents were effectively the lenders of last resort for the offshore players, as well as the internal regulators of risk management and proper banking procedures. The first players in the Euromarkets were predominantly U.S. banks with a smattering of European banks. This allowed for indirect regulation through the parent banks if the market got out of control.

Third, since London was previously the world's primary financial centre, it had a tradition of sophisticated human networks which are the cornerstone of the
The informal regulatory environment of London gave confidence that the personnel involved in the Euromarkets were relatively conservative bankers who operated within a social milieu of stability-inducing constraints.

As the Euromarket grew with the growing international economy, companies and banks saw some disadvantages in dealing exclusively with London to avoid regulations. First, political restraints of the U.K. still applied to the Offshore banks. Britain was a developed country fully integrated into the international community. It had moral and legal commitments to other countries and a developed tax collection system. Therefore, there was always a suspicion that London would seize assets on behalf of its allies or that it could reimpose regulations. Second, London's business day was closing when New York's began. This made quick transactions difficult between the two major Financial Centres. Third, the advantage that it was relatively conservative placed an informal constraint on taking more aggressive risks.

So it is clear that while the Euromarkets did not have explicit rules limiting banks' activities, there were other constraints on banks' activities. For these reasons, while the Euromarket was developing in the 1960s, many U.S. TNCs started using Caribbean countries to "book" transactions and offshore mutual funds started being established in the Caribbean countries.

There are many reasons why the unregulated jurisdictions expanded to the Caribbean and not some other place. First, the new Offshore jurisdictions were

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mostly English-speaking jurisdictions with common law legal systems. Second, they were in the same time zone as New York. Third, they were physically close to New York so that transportation was relatively easy. Fourth, their physical beauty and climate made them very desirable places to visit. As a result, their tourist trade could provide supplemental demand for communication and transportation infrastructure which was necessary for their establishment as a Financial centre.

In the 60s and 70s bank branches sprouted throughout the Caribbean archipelago. Table 1 shows that, in ten years, the Caribbean became as desirable a place to locate for U.S. banks as Europe, Asia or Latin America. This is especially remarkable if the relative sizes of the GDPs of the regions are considered.

Table 1 – Number of Overseas Branches of U.S. Banks Located in Different Regions in Different Years

<table>
<thead>
<tr>
<th>Region</th>
<th>1965</th>
<th>1970</th>
<th>1975</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>32</td>
<td>103</td>
<td>167</td>
</tr>
<tr>
<td>Asia</td>
<td>45</td>
<td>83</td>
<td>143</td>
</tr>
<tr>
<td>Latin America</td>
<td>72</td>
<td>182</td>
<td>198</td>
</tr>
<tr>
<td>Caribbean</td>
<td>5</td>
<td>53</td>
<td>164</td>
</tr>
</tbody>
</table>

The Offshore became qualitatively different when it moved to the Caribbean. There are three reasons for this. The first reason was that tax levels in the Caribbean ranged from extremely low to non-existent. This element was not present

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in London previously. Thus, capital was transferred to the Caribbean offshore for tax optimization purposes.

Second, these countries did not have the human or financial resources to be aware of what was happening financially within their jurisdictions. The Caribbean countries did not have a history of dealing with enormous financial institutions. They were poor jurisdictions that found themselves in a position to gain whatever benefits they could from the large pipeline of capital flowing past their doors. As underdeveloped colonies and ex-colonies, they were not able to regulate international capital movements even if they wanted to.

Thus, in contrast to London, which did not exercise regulatory supervision because it didn't want to, Caribbean countries were not capable of supervising these massive flows. Thus institutions could operate in the Caribbean without even any potential supervision. The Caribbean Offshore represented a return to the pre-1930s era of completely unregulated financial institutions.

However, the regulatory laxity offered by the Caribbean jurisdictions was not the key qualitative difference between London and the Caribbean. By far the most important qualitative difference between London and the Caribbean Offshore was the fact that the Caribbean Offshore had also adopted the element of secrecy that was not present in London. Banks, companies and trusts could be created without any public registry of their owners.

The Caribbean Offshore represented the development of the modern Offshore because there was the mixing of three elements that had not been previously combined. The first element was secrecy which moved to the Caribbean
from Switzerland and Liechtenstein. The second element was the Euromarkets which caused large amounts of capital to flow where banking operations were more profitable. Finally, there were low taxes and other regulations. These elements came together to create the Offshore phenomenon.

As a result of the new character of Offshore, the clientele in the Caribbean were much more diversified than they were in London. Not only would clients be major banks doing interbank transactions, but they could also be individuals taking advantage of bank secrecy or shell corporations or TNCs moving Offshore into low tax environments.¹¹

Of course, there was a major obstacle to doing big business in tiny, relatively underdeveloped countries. The political stability of these jurisdictions was always uncertain. Most were fighting for independence from Britain. Their legal systems were also unpredictable. Nevertheless, the uncertainty regarding the stability of these Caribbean jurisdictions was outweighed by the profits that could be generated by "booking" transactions through them. Since almost all of the people who had the experience and clout to agree to the transactions were in New York and London, the agreements were actually made there and they were merely recorded or "booked" as if they occurred in the low-regulation jurisdiction in order to obtain the benefits of those jurisdictions.

Quickly seeing the benefits of booking, financial institutions set up skeleton offices in the Caribbean with only a few low level personnel to ensure that the

¹¹ The relationship between Offshore and TNCs is the subject of future research that I am currently working on.
administration of the transactions were properly carried out. The capital was still controlled by the same institution, only in another jurisdiction. For non-institutional clients, they could use these branch banks or set up a shell company, a trust, or an anonymous account to transfer the legal residence of the assets to the tax haven, while keeping the assets themselves located in a much safer institution in a developed country. In this way, the major obstacle of the political and economic instability of the tax haven could be overcome.

Other countries quickly realized their best commodity was their sovereign ability to attract capital to their jurisdictions by lowering regulatory standards. The result was a regulatory marketplace in which financial actors were able to construct legal entities through which they would operate. The legal residence of these entities could be distributed across jurisdictions so as to maximize their benefits and reduce their risks. Assets could be transferred across this legal network quickly as conditions changed.

Multilateral containment of this regulatory arbitrage seemed unforeseeable and so the race to the bottom was on. In 1968 Singapore started the first offshore market in Asia while in the early 70s, Luxembourg and Bahrain actively started attracting capital. In the 80s and 90s, small states throughout the world adopted Offshore strategies to the point where they were present in every time zone and around every financial centre in the world.

The final stage of Offshore development occurred in the 1980s when the two largest economies created Offshore jurisdictions within them. In 1981, the U.S. created International Banking Facilities (IBFs), which were Offshore jurisdictions
located in major financial centres in the U.S. In 1986, Japan created an Offshore jurisdiction in Tokyo called the Japanese Offshore Market (JOM) with legislation based on the American IBF. In 1988, within two years of its establishment, the JOM had assets of $400 billion located within it representing 7.8% of the world total of international bank assets while $290 billion was resident in the New York IBF.\textsuperscript{12} With the development of the IBFs and the JOM, Offshore had become fully integrated within the state system.

\textbf{Part 2: Conceiving and Describing Offshore}

I define Offshore as the set of practices by which a state uses its power to make and enforce laws for the purpose of obtaining jurisdiction over assets and economic transactions that would not otherwise locate within that jurisdiction.

Offshore is almost universally conceived as a "space" or a juridical realm within which economic activity is "located" or resides. As such, it is generally conceived as an abstract geographic concept. It is then contrasted with the "onshore", which are jurisdictions in which economic activity occurs for reasons other than regulatory arbitrage. To be sure, there are benefits of perceiving Offshore in this way if one is trying to decide to understand where to locate one's assets or what policies states should adopt in order to successfully attract economic activity to its shores. However, the focus of this paper is understanding the systematic implications of Offshore.

\textsuperscript{12} Hampton (1996) p.63.
At this macro level of analysis Offshore is best conceived as a structural force, much like gravity and magnetism are physical forces within fields. Offshore is like these physical forces in that when they gain sufficient strength, they have such an influence that the normal conception of space becomes useless. Moreover, even those who are the most able to influence it are still affected by its field of influence. Its influence pervades the entire environment.

Offshore can only operate under certain conditions that globalization brings since it requires the international mobility of capital and people and an international communications network. The greater the extent of these globalizing influences, the greater the influence of Offshore. Offshore operates like magnets in an electrical field. It is a force which exerts varying degrees of influence “pulling” assets and people within the overall globalized “field” of international economic activity. Similarly “onshore” can be conceived as the opposite force of “pushing” assets and people within the field.

It is useful to disaggregate Offshore into four components: stability, secrecy, low residence costs and financial regulation laxity. These elements are often conflated when discussing the offshore. This conflation prevents clarity of understanding since each component has unique characteristics and the interrelation of the components can significantly change the character of Offshore.

**Stability**

The stability of Offshore is the expectation that it will persist into the future. This expectation is formed by examining the degree to which there is a consensus
among the powerful towards the future of the jurisdiction. Many Offshore jurisdictions are dependencies of other states. Many Offshore jurisdictions in the Caribbean have internal debates regarding the degree to which they should be independent of their former colonizers like Britain or the Netherlands. On the other hand, the United Kingdom, for reasons to be discussed later, is reviewing the degree of independence that it will allow for its dependencies to set their own financial rules. These are all sources of instability.

However, by far the greatest source of instability is the fact that there are also many countries that do not have sufficiently entrenched political and legal institutions to make the Offshore force sufficiently strong to attract capital or people. In the globalized world, capital abhors instability. The greater the stability of the Offshore jurisdiction, the stronger the Offshore force.

**Secrecy**

Secrecy is the ability to obscure the connection between assets and the beneficiary of those assets. There are many different legal entities that can own and/or control assets. Trusts, corporations, partnerships, banks, pension funds, brokerage firms and mutual funds are some examples. All of these entities are ultimately created to manage assets for the benefit of individuals we will call “beneficiaries”.

The nature of modern asset management creates a further separation between beneficiaries and assets. All financial assets have a legal owner. Often the

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legal owner entrusts the management of assets to a professional manager/trustee. Thus one asset often involves four different legal entities that can each be located in a separate jurisdiction. This allows for assets to be located in one jurisdiction, the legal ownership to be located in another jurisdiction, the manager/trustee of the assets to be in a third jurisdiction and the beneficiary of those assets to be in a fourth jurisdiction.

The link from asset to beneficiary can be even further complicated since there are often multiple owners, managers and beneficiaries for each asset and they can each be located in separate jurisdictions. Moreover, there is often cross-ownership. For example, the manager itself could be an asset that is partially owned by the legal owner or the beneficiary could be owned by another corporate party.

In onshore jurisdictions there are mechanisms to allow for a public link of the assets to their beneficiaries through the maze of all of these financial intermediaries. There are public registries for trust deeds; estate probate records; property registries; corporate registries including public records of corporate officers and shareholders; and banks, public companies and mutual funds are required to have audits and to disclose their audited financial statements.

Offshore jurisdictions intentionally avoid such public records and actively prohibit people like bankers and trustees from disclosing the identities of the beneficiaries of the assets under their control. With the intermediation of other legal entities, the linking of the assets to the beneficiaries can be obscured. The implications of this de-linkage are enormous and will be discussed in more detail
below. However, my point at this stage is to show that by separating the legal ownership from the beneficiaries of those assets there is a huge "pull" force created since the beneficiaries can hide their assets from authorities or private parties who make claims upon those assets. The effect is the creation of a huge pool of anonymous assets. It is the anonymity of these assets that makes the force of this aspect of Offshore so powerful.

**Financial Regulation Laxity**

In most sectors of the economy, the interaction of non-oligopolistic private self-interest tends to allocate resources efficiently over the long-term. The financial services industry is an exception to this rule because the underlying commodity being exchanged is risk. Financial institutions operate by pooling and spreading the risks of their customers so that a failure by any one customer can be offset by the success of the other customers. In order to manage the risks that they assume, they "insure" themselves by spreading their risks among their clients and other financial institutions. The result is that the financial sector is inextricably intertwined, with institutions holding credit obligations of their clients and even many of their competitors.

Because the financial sector focuses on trading risk, financial institutions have an alternative that is not available to other sectors of the economy. Financial institutions need not compete by offering better services to their customers. Banks need not lower interest rates or offer better terms for loans to increase their profits.

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Insurance companies need not lower their premiums or offer better terms of insurance to increase their profits. The unique alternative that these institutions have is the ability to unilaterally increase the risk that they assume. Increasing risk makes financial institutions more profitable as long as they maintain solvency. The evidence supports this as it is clear that offshore banks are more profitable than domestic banks and that they are more leveraged.\footnote{Dale, Richard. 1984. The Regulation of International Banking (Cambridge, U.K.: Woodhead-Faulkner) p.13. See also clear evidence provided in (IMF) Errico, Luca and Alberto Musalem Offshore Banking: An Analysis of Micro- and Macro-Prudential Issues. 1999 A Working Paper of the International Monetary Fund (1999) p.27. This Working Paper was put together through the combined efforts of the staff at the IMF and the BIS. As will become apparent, the quantitative analysis in my paper owes a great deal of debt to the consolidation of the raw BIS data into a more meaningful format by these researchers. The working paper can be found at http://www.imf.org/external/pubs/ft/wp/1999/wp9905.pdf}

Offshore operates by allowing banks to avoid operating requirements that exist onshore. In doing so, they assume more risk than they would be allowed to assume onshore. Low capital adequacy (liquidity) and low capital reserve requirements allow banks to be highly leveraged. Pooled management funds and brokerage firms are allowed to use derivatives such that they are highly leveraged. Insurance companies are permitted to operate without as much reinsurance as their competitors. The result is that the Offshore force in the financial sector takes on the form of a “pull” towards higher risk operation of financial institutions.

**Low Residence Costs**

There are costs of either people or legal entities residing in jurisdictions. The main cost of residency is taxation. This is why many Offshore jurisdictions are referred
to as "tax havens". However, this name is misleading since it is very incomplete. To be sure, low taxes are a huge part of the power of Offshore.

There are many different types of taxes that Offshore jurisdictions eliminate or minimize:

1. Income
2. Asset (e.g. assets are taxed in Germany and Sweden in addition to income)
3. Capital gains/transfer/gift
4. Death and/or estate
5. Withholding
6. Sales

However, there are many reasons other than low taxes that there is a "pull" towards Offshore jurisdictions. This is why the term "tax haven" is misleading. By having low administrative requirements, costs can be substantially reduced. For example, accounting and legal costs are minimized due to the minimal filing requirements for companies and trusts. Another example is that insurance cost on business assets are minimized because the assets are difficult to seize due to them being legally hidden from creditors.

A further consequence of Offshore is the practice of transfer pricing. Transfer pricing is the activity of a TNC using a third country as a means of avoiding taxes. A and C are high tax jurisdictions. B is an Offshore jurisdiction. The MNC 'transfers' an item by selling from A to a subsidiary in B at below market price thereby creating lower than normal revenues in the high tax jurisdiction of A. Then the subsidiary sells the same item from B to another subsidiary in C at above market price. In this way, the cost base in the high tax jurisdiction of C is higher than normal and its
profit is therefore lower than normal. The higher than normal profit is created in the low tax jurisdiction of B. In this way, the MNC transfers the profits from A and C to B, the Offshore jurisdiction.

A further aspect of low residency costs is the practice of selling citizenship. For example, in Canada there is the investor immigration program in which CAD$400,000 is invested in return for Canadian permanent residence. The small Caribbean island of Dominica is much less subtle about selling citizenship as it simply charges people US$50,000 for citizenship. By changing their legal jurisdiction of residence, individuals can also avoid non-financial obligations, such as serving in the military or doing community service in their original country. The larger the disparity between the costs of residence of the onshore and Offshore jurisdictions, the stronger is the force of the Offshore.

How the Components of Offshore Interact

I have offered a conception of Offshore as a force in the web of international activity. The components of Offshore have been analyzed with a view to understanding what the source of the force is and how it generates its strength. The specific combination of elements in each Offshore jurisdiction significantly changes the character of the force.

The component of stability is different from the others in that it is a necessary requirement. Without political stability, the other components will not have any force in attracting people or capital. This element of Offshore ties the Offshore to being
a part of the international political community since its purpose is to allow the Offshore jurisdiction to have a long-term expectation of interaction with the onshore.

While secrecy is not a necessary element of Offshore, it is different from the latter two in that it operates by undermining rather than competing with an important element of the onshore. The identity of the beneficial owner of an asset is an important requirement in regulating the international economy. I will later argue that it is this component which is truly invidious to the international economy.

The components of financial regulatory laxity and low residence costs are not unique to Offshore. Jurisdictions are constantly competing with others by using their power to create rules that attract capital and desired individuals to them while, at the same time, they are trying to cooperate to create ground rules for their competition. What sets these components of Offshore jurisdictions apart from the onshore is the fact that the states regulatory power is being used in the competition in a specific way which is particularly challenging to the state system. This will be discussed in more detail further in the paper.

Offshore jurisdictions require political stability and at least one of the other components. For example, Switzerland has political stability and secrecy but it does not have low residency costs nor financial regulatory laxity as its tax rates are around the median European rate and its financial institutions are highly regulated. Most Offshore jurisdictions have varying degrees of political stability and all of the other components but it is not necessary for all of the other three components to be present.
Where are the Offshore Jurisdictions

It is difficult to identify Offshore jurisdictions because they change their nature rather quickly. Small island dependencies can become politically unstable rather quickly and regulatory provisions can change even more quickly. Identifying Offshore jurisdictions is even more difficult because every paper, including this one, uses its own definition of Offshore. My purpose here is not to be exact and exhaustive. It is to give a basic idea of the enormity of the phenomenon.

The most extensive study of jurisdictions with financial regulatory laxity has been done by the IMF. It identifies the following jurisdictions as “Offshore Financial Centres”:\(^{16}\)

Africa: Djibouti, Liberia, Mauritius, Seychelles, Tangier

Asia and Pacific: Australia, Cook Islands, Guam, Hong Kong, Japan (Japanese Offshore Market), Macau, Malaysia (Labuan), Marianas, Marshall Islands, Micronesia, Nauru, Niue, Philippines, Singapore (Asian Currency Units), Thailand (Bangkok International Banking Facilities), Vanuatu, Western Samoa

Europe: Austria, Andorra, Campione, Cyprus, Gibraltar, Guernsey, Hungary, Ireland (Dublin), Sark & Isle of Man, Jersey, Liechtenstein, Luxembourg, Malta, Madeira, Monaco, Netherlands, Russia, Switzerland, U.K. (London)

Middle East: Bahrain, Dubai, Israel, Kuwait, Lebanon, Oman

Western Hemisphere: Antigua, Anguilla, Aruba, Bahamas, Barbados, Belize, Bermuda, BVI, Cayman Islands, Costa Rica, Dominica, Grenada, Montserrat, Netherlands Antilles, St. Kitts and Nevis, St. Lucia, Panama, Puerto Rico, St. Vincent & the Grenadines, Turks & Caicos Islands, United States (IBFs in New York, Miami, Houston, Chicago, Los Angeles-San Francisco), Uruguay.

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\(^{16}\) IMF (1999) p.11. The sources the IMF uses in amassing this list are: BIS, IMF staff, Ghosh and Ortiz (1994) [no citation given], Cassard (1994) [no citation given], Far Eastern Economic Review (March 1992), Doggart (1993) [no citation given] and Blum et. Al. (1998). The jurisdictions listed in brackets are the Offshore jurisdictions contained within the onshore jurisdictions.
A United Nations study has identified the following jurisdictions that have a high degree of secrecy.\textsuperscript{17}

Caribbean: Anguilla, Antigua, Aruba, Bahamas, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Costa Rica, Netherlands Antilles, Panama, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Turks and Caicos Islands

Europe: Andorra, Campione, Cyprus, Gibraltar, Guernsey, Ireland (Dublin), Isle of Man, Jersey, Liechtenstein, Luxembourg, Madeira, Malta, Monaco, Sark, Switzerland

Asia and the Pacific: Cook Islands, Hong Kong, Labuan, Macao, Marianas, Marshall Islands, Nauru, Niue, Samoa, Singapore, Vanuatu.

Middle East: Bahrain, Dubai, Lebanon

Africa: Liberia, Mauritius, Seychelles

As can be seen, the number of Offshore jurisdictions rivals onshore jurisdictions and they are spread throughout the world.

\textit{The Strength of Offshore}

Measuring the strength of Offshore is a dubious business. This is primarily due to the element of secrecy which impedes obtaining information about the amount of assets that are located in Offshore jurisdictions, the amount of assets that flow through Offshore jurisdictions, the amount of assets that are under the

\textsuperscript{17} Jack A. Blum, Michael Levi, R. Thomas Naylor and Phil Williams. 1998. \textit{Financial havens, banking secrecy and money laundering} (Vienna, Austria: A study prepared on behalf of the United Nations under the auspices of the Global Programme against Money Laundering, Office for Drug Control and Crime Prevention) (Page numbers not available since using internet version.)
control of owners or financial managers in Offshore jurisdictions, or the number and size of beneficiaries in Offshore jurisdictions.

Nevertheless, there are data that allow us to get a glimpse of the strength of Offshore. Since Offshore jurisdictions are primarily involved in the business of attracting foreign capital, we can assume that almost all of their assets are cross-border assets. During the period from 1992-1997 bank assets in Offshore jurisdictions grew at an annual rate of 6.4% to the point where they totaled US$4.8 trillion by the end of 1997.\textsuperscript{18} 85% of assets in the reporting Offshore jurisdictions are bank assets.\textsuperscript{19} Therefore, total assets in the reporting Offshore jurisdictions were US$5.7 trillion in 1997. This represented 54.2% of global cross-border bank assets.

The majority of Offshore transactions are interbank and almost all are eurocurrency.\textsuperscript{20} In December 1997, 72% of Offshore bank cross-border assets and 58% of bank cross-border liabilities were interbank. The discrepancy between assets and liabilities can be accounted for by the large amounts of deposits that are taken from non-bank institutions like TNCs, insurance firms and investment funds. These figures remained relatively constant over the period 1992-1997.\textsuperscript{21}

Aside from the usual banking activities of taking deposits and issuing loans, Offshore jurisdictions account for large and expanding amount of the eurobond markets. From 1992-1997 eurobond underwriting increased annually on average

\textsuperscript{18} IMF (1999) p.4. Again one is left to only speculate what the proportion of bank to total assets is in non-reporting countries.
\textsuperscript{19} IMF (1999) p.5.
by 20% to the point where at the end of 1997, US$746 billion, or over 21% of the world eurobond market, was located in Offshore jurisdictions.\textsuperscript{22}

It is more significant than just a footnote to note that these statistics only represent those jurisdictions that report to the BIS. Therefore there is a natural bias within these statistics to underestimate the size of Offshore jurisdictions in the world economy. Since many Offshore jurisdictions do not report to the BIS, the actual size of the assets located in these jurisdictions is a matter of speculation.\textsuperscript{23}

Offshore transactions are, to a great extent, wholesale banking transactions. Often they occur intra-bank among subsidiaries, branches and parent banks.\textsuperscript{24} Many transactions are negotiated and physically completed in one jurisdiction and merely recorded, or “booked”, as if they occurred in another jurisdiction.\textsuperscript{25}

A significant feature of cross-border assets is their incredibly high mobility. Approximately 80% of all foreign exchange transactions are invested for less than seven days and 40% for less than two days.\textsuperscript{26}

Overall the big picture is one of assets flowing at high speeds around the world with a great proportion of these assets flowing through Offshore jurisdictions. This shows that Offshore is by no means peripheral to the international economy. It is an integral force in the flow of assets around the world.

\textsuperscript{23} The Offshore jurisdictions that report to the BIS are Bahamas, Bahrain, Cayman Islands, Hong Kong, the U.S. International Banking Facilities located in New York, Miami, Houston, Chicago, Los Angeles and San Francisco, the Japanese Offshore Market, Luxembourg, Singapore and the UK (London). All other Offshore jurisdictions are excluded from these figures.
\textsuperscript{25} The main Offshore booking jurisdictions are Aruba, Bahamas, Barbados, BVI, Cayman Islands, Channel Islands, Seychelles, Turks and Caicos, Marshall Islands, Netherlands Antilles and Vanuatu. IMF (1999) p.13.
Part 3: Understanding Offshore

In this section of the paper I will assemble a variety of ideas from different authors in order to provide a new explanation of Offshore.

Theories of international political economy (IPE) are generally presented as offering three general alternative perspectives. The various perspectives differ in both their descriptive characterizations of how the international economy operates and their normative prescriptions on how to solve the key problems that the modern global economy poses. With the rise and persistence of neo-liberalism beginning in the 1970s, a new broad perspective has developed that rivals the three traditional views. As a result there are now four main broad perspectives.

In the chart below, the four main perspectives are presented according to their position with respect to three issues. The horizontal axis describes an author’s view on the issue of whether states or markets are more influential in setting the parameters of international economic activity. In the vertical axis describes an author’s view on the issue of whether a majority or a minority of the population benefits from the perceived relationship between states and the market. These two axes contain descriptive positions. Within the matrix of the grid are the labels commonly given to the cross-section of these descriptive beliefs along with the prescriptive remedy for the most important challenge perceived by the position’s adherents. Finally, a typical advocate of each perspective is presented.
Table 2: Overview of Theories of International Political Economy

<table>
<thead>
<tr>
<th>State/Market Balance Benefits the Majority of People in the World</th>
<th>State More Influential than Market in Affecting Parameters of Action</th>
<th>Market More Influential than State in Affecting Parameters of Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liberal – More intra-state and inter-state cooperation to create legitimate authority and to create incentives to prevent market deficiencies. E.g. Hirst and Thompson(^\text{27})</td>
<td>Neo-liberal – State should withdraw from the management of the economy both domestically and internationally to allow the benefits of the market to spread more widely. E.g. Kenichi Ohmae.</td>
<td></td>
</tr>
<tr>
<td>Realist – Intra-state and inter-state checks and balances/balance of power so no individual or group gets too powerful both within and between states. E.g. Robert Gilpin(^\text{28})</td>
<td>Marxist – Change economic system for the benefit of the majority and/or disengage from the system. E.g. Robert Cox.</td>
<td></td>
</tr>
</tbody>
</table>

My position is that to some extent and in certain conditions each perspective is accurate and that often the differences are only a matter of degree rather than outright opposition. My goal is to extract from each of these general perspectives concepts that help understand Offshore and to combine them in such a way that they provide a coherent point of view.


The Neo-Liberal View of Tax Havens

For neo-liberals, like Kenichi Ohmae\textsuperscript{29} and Robert Reich\textsuperscript{30}, the market is much better than the state at achieving social welfare. For them, states impede transnational flows of goods, services and capital causing widespread inefficiencies. For neo-liberals, the increased prosperity that comes from the development of a transnational economic system outweighs any loss of influence of states.

Remarkably, neo-liberals see few benefits in having international market forces subject to constraints. Market deficiencies such as monopolies, dumping, environmental degradation or massive employment dislocations bring forth little concern presumably because they believe that such deficiencies are short-lived and that the market will eventually self-correct.

Tony Johns and Chris Le Marchant approach Offshore from this perspective.\textsuperscript{31} They see interjurisdictional disparities causing market "friction". Offshore is a natural market consequence of this friction. As such, it represents the beachhead of the neo-liberal assault on the state system. For neo-liberals, competition places states within a competition that none can ultimately win and all will eventually lose. The result of the competition is to withdraw the power of the state from the regulation of the market. As such, Offshore represents the neo-liberal apotheosis of the state in which it uses its powers to undermine both itself and the

\textsuperscript{31} Johns and Le Marchant (1993).
system that supports it. The neo-liberal approach to the state is the equivalent of
the divide and conquer approach to domination. They cunningly set their opponents
(states) against each other so that in the end they are all defeated by market forces.

The unrestrained enthusiastic belief in the idea that markets self-regulate is
an obvious flaw in the neo-liberal perspective. There are numerous examples of the
social devastation that follows from market collapses including the great depression
and the 1997 collapse of the east-Asian economies. The very existence of market
collapses, let alone the prevalence of market failures, should make one very wary
of accepting "self-correcting" market forces as the structural parameters of social
organization.

Another extremely problematic aspect of the unfettered market is the
tendency of capital to concentrate into the hands of fewer and fewer people until
there is a de facto oligarchy. Without constraints, Offshore can become a weapon
of the wealthy and powerful to avoid democratic forces. Neo-liberals do not take this
care concern seriously.

Ultimately, neo-liberalism is simplistic and unbalanced. The market is seen
as the unmitigated saviour of humanity. Neo-liberalism is more of an ideology than
a theory because its premises are more like blind convictions than the result of any
verification with reality. Now that we have examined the role of Offshore from its
most enthusiastic supporters, we turn to the liberal perspective for a more balanced
and sophisticated approach.


Liberal Conceptual Contributions

The most prevalent view of the global economy is the liberal view. The main starting point for liberals is the distinction between states and markets. Liberals propose that states should control international economic forces in order to ensure that market forces result in social benefits. The liberal view sees the private sector as the realm within which private competition should occur. Self-interest interacts in the market to produce public goods such as efficient resource development, efficient resource distribution and the creation of incentives that encourage innovation.

However, unlike neo-liberals, liberals believe that the market is an extremely beneficial tool for social welfare but it is also frequently fallible. For liberals, markets are like waterfalls with their own internal set of forces such that capital cascades, disperses and collects wherever its own forces take it and not necessarily where the capital is most beneficial. Unconstrained markets can lead to market collapses, monopolies, an excessive concentration of wealth, environmental damage and a disregard for employee dislocation and other serious problems.

The public realm is where self-interest, while prevalent, is subordinate to the cooperative compromises that are necessary to ensure that desired outcomes are achieved. Therefore, the role of states is to correct the faults of the international market either through international cooperation or through beneficent hegemonic leadership. Serious problems occur in the public realm when competitive self-interest is not subordinated to cooperation. Not only will resources not be allocated
efficiently, but private international economic actors will also not be accountable to any authority for their actions.

For liberals, the main inherent tension is the private-public distinction. The private sector can accumulate great wealth. However, the accumulation of wealth is only one goal among others. Great value is placed in the state since it is through the state that goals such as equality, freedom, physical security and well-being and knowledge among others can be achieved. The best way to achieve these varied goals is through the state representing the public interest.

The international economy challenges the liberal framework because public authority is based on territorially constrained states while the globalizing economy can transcend these territorially based units of authority. Stanley Hoffman captures the essence of the problem in these terms,

"We are now moving toward an integrated world market of trade, production and distribution. The new world economy is made of national and multinational corporations operating across borders... The global economy is literally out of control, not subject to the rules of accountability and principles of legitimacy that apply to relations between individuals and states.... What is desperately needed is a theory that acknowledges the public aspects and effects of such private activities across borders and establishes a kind of common government for those activities..."^{32}

The "common government" Hoffman calls for has two general possible forms. The first form is exemplified by the World Trade Organization and the G-7. These are organizations that require the executive of the state to willingly comply with

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decisions taken in international forums on a case-by-case basis. The executive enforces decisions which are against the short term interests of a sector of its own economy with the belief that the longer term and wider interests of the domestic economy are better served through the international coordination of trade, currency and monetary rules. Thus, under this form of common government enforcement is self-imposed on a case-by-case basis.

The other form of common government is exemplified by the European Union. The EU enforces undesirable decisions upon member states through judicial or quasi-judicial rulings that are enforceable through the judicial branch of the state. The executive branch is much more constrained under this form of government. Accordingly, enforcement is much less subject to political pressures and the enforcement of the rules are much more certain since the most powerful states, like Germany, France and the U.K., have previously agreed to transfer their enforcement power from the political arena into the judicial arena.

No matter which form of common government is taken, the goal for liberals is the same: to ensure that the market is subject to supervision so that it produces desirable outcomes and is accountable to democratic forces.

**Michael Moran’s International Liberalism**

Michael Moran argues innovatively from a liberal perspective that there are significant benefits to the globalization of finance. While his views are restricted to the financial sector, they probably have great applicability in other sectors of the economy as well.
Moran starts from the proposition that there is a diversity of interests within and between corporations, industrial sectors and state actors. States, classes and markets are not sufficiently homogeneous to be useful concepts for description or prescription. However, this fragmentation is overcome through alliances between actors in various public and private roles who share common perspectives, values and interests.

Before globalization, financial players were so powerful that they were effectively unaccountable in any meaningful way. Through informal personal relationships wealthy individuals, corporate executives, bankers, insurance executives and investment managers were without de facto public accountability. This was because they had the money, connections, knowledge and organizational resources to convince public authorities that they need not have serious public oversight as they could do it better themselves. As a result, they arranged their affairs to minimize competition for their own self-interest. Moran terms this state of affairs "meso-corporatism". 33

Meso-corporatism is the key "bargain" made to accommodate opposing public and private interests. 34 Moran believes that there is some degree of separation that regulatory agencies can attain from private interests. However, the state is in a perpetual battle with key private sector actors to maintain its independence. Ultimately, some sort of reconciliation must be made. Meso-

34 I am here taking the approach advocated by Susan Strange in States and Markets to identify the crucial bargains that are made to accommodate the most powerful opposing interests in a system.
corporatism represents the capture of the state but in the most publicly beneficial way possible. This is the bargain that must be made in order to accommodate public and private forces.

Meso-corporatism is a serious conceptual rival to the commonly accepted notion of liberal public authority. Those that are wealthiest, most knowledgeable and most technically skilled tend to be in the private sector. This makes fully independent regulation impossible. However, in order to obtain the legitimacy of the public sector meso-corporatism must rely on a fundamental myth that Moran calls "the ideology of business". The ideology of business is the belief that self-regulation is truly in the public interest and that accountability is best assured through the practical material benefits that follow as a consequence of self-regulation. This consequentialist basis for legitimacy of meso-corporatism is in stark contrast to the democratic legitimacy that ultimately derives from a procedural electoral base.

Moran's use of Concepts Developed by Cox and Strange

Moran relies on seminal concepts developed by Robert Cox and Susan Strange. He borrows from Cox the concept of a "transnational managerial class" which is "not limited to persons actually employed among the managerial cadres of multinational corporations and their families. It encompasses public officials in the national and international agencies involved with economic management and a

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whole range of experts and specialists who in some way are connected with the maintenance of the world economy."36

For Moran, the transnational managerial class is the mechanism by which American structural power is propagated. Structural power is the concept developed by Strange which represents the ability of an actor to influence the parameters in which other actors operate. Hegemons have structural power because they have the greatest influence on establishing the incentives and disincentives of the other actors.

In contrast to the prevalent view that sees American hegemony decreasing as the latter half of the twentieth century progresses, Strange convincingly argues that American hegemony has actually increased during this period through the more subtle mechanism of structural power. By spreading its influence through the security, knowledge, finance and production structures, the United States frames the issues and options facing other actors in the world.37

Moran adopts Strange's concept of structural power and locates the most distinct elements of American structural power in the extraordinary degree with which open, democratic, pluralist competition is practiced. The American political psyche is ultimately based on a preoccupation with conspiracies and secrecy. In Moran's words, "There exists a passion for openness and a hunger to expose and to root out conspiracies."38 In response to this primary concern, Americans use

checks and balances complemented by written rules enforced by independent prosecutors and independent courts.

Moran combines these structuralist concepts of Cox and Strange to argue that the United States maintains power over the finance structure through the influence of the transnational managerial class.39 U.S. values are instilled in the transnational managerial class through the enormous structural power of the U.S. in the knowledge structure. Moran concludes, "Through this knowledge structure American regulatory ideologies are being exported. Since those ideologies are in important ways damaging to business power, the world financial services revolution is, to put it mildly, a mixed blessing for the giant firms in the financial services sector." 40

According to Moran, globalization breaks down the cozy situation for domestic elites by making international finance much less responsive to informal personal relationships and much more responsive to competitive pressures that are enforced through formal rules and independent courts. The globalization of the economic system results in a global economic system that is forcing vested interests within states to become "increasingly codified, institutionalized and juridified".41 This severely hampers the traditional power brokers' ability to control their regulatory environment.

Moran's overall assessment of globalization is that while it threatens to escape the restraints of democratic government, it also has significant positive

effects because it simultaneously causes the structural benefit of transnationally spreading the rule of law such that the vested interests of powerful private sector actors are subjected to the universalizing aspects of democracy. Globalization combats the tendency of the market to concentrate power by promoting a transnational organization of power in which equality under the law—a fundamental democratic precept—ultimately reigns supreme.

We can see Moran's use of the transnational managerial class as the response to Hoffman's call for a beneficent "common government". Moran's argument focuses on containing the tendency towards meso-corporatism via the transnational spread of liberal-democratic forces. By meshing the crucial concepts of meso-corporatism, the transnational managerial class and structural power, we can start to develop a sophisticated liberal theory.

**Injecting the State into Moran's Framework**

For Moran the state is too fragmented a concept to have much descriptive or prescriptive value in determining important forces in the international economy. With the exception of American hegemonic forces, states per se (as opposed to selected fragments of states) are relatively insignificant concepts in his conclusions. It is safe to say that Moran's analysis underestimates the role of the state. This is probably as a result of a bias in the selection of his sample. Moran's book is based on a comparison of the insider trading rules in Britain, the U.S. and Japan. These three countries are very similar in that they are among the most developed, most powerful and largest economies in the world. A wider selection sample of countries
with more varied situations would almost certainly reveal a significant role for states in insider trading and financial regulation in general.

States are fundamental actors in the world. They derive their power from legitimacy conferred on them through democratic or traditional forms of authority. Louis Pauly forcefully argues that banks, while being transnational to varying degrees, always maintain strong allegiance to their home countries. Furthermore, non-financial TNCs spend most of their research and development dollars in their home country and transfer their key technologies outside of their home countries very reluctantly. Ethan Kapstein echoes this position when he states, “banks are not extranational actors, but highly regulated firms which must identify the piece of territory they call home. In short, states provide financial actors with a framework in which they operate. Even transnational actors “identify” and act according to their “allegiance” to a territorially based political unit.

If we place more importance on the role of states, Moran’s foundational concepts can be applied to a more accurate picture of the world. Let us start this process by acknowledging that there is a world order that is dominated by the U.S. at least to some degree. Let us then take the liberal perspective and focus on the central tension between the non-territorial based international economy operating alongside the territorial based state-system of authority. The state based authorities

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manage the tension through a transnational managerial class. This transnational managerial class represents the exercise of public authority through a network of people in both the public and private sectors who share similar views on how the world operates and should progress. That is not to say that there are no disagreements among the transnational managerial class. Rather, the claim is that they share a core set of beliefs and the problems are framed within this core set of beliefs. This core set of beliefs includes the descriptive and normative belief that authority originates and is delegated through states. The core also includes the descriptive and normative belief that a regulated transnational economy is a net benefit to the majority of people in the world.

In this sophisticated liberal worldview, what is the primary challenge to states as they try to cooperate to regulate the market? The answer is minimizing the competition between states. The challenge of liberal "governance" is to manage entities that are fiercely competing while they are trying to cooperate. In the domestic setting, private competition is overseen by the public sector. However, in the international realm competition is occurring between different public sectors represented by different states. International cooperation is so complex because it involves mediating among competing domestic and international interests at the same time.

Offshore represents a particularly perverse form of state competition that is particularly invidious to international cooperation. Ironically, it is Moran himself who captures this phenomenon particularly well,

"In the struggle for comparative advantage states dispose of one critical resource – the system of regulation itself...... competitive
conditions in financial services are uniquely sensitive to the regulatory arrangements because the "goods" traded are themselves mostly regulatory creations – contracts, legally binding or otherwise, embodying a structure of financial claims and obligations... The struggle for comparative advantage is the dominant fact of life in financial markets; systems of regulation are themselves powerful sources of comparative advantage; the single most important feature of a system of regulation is the form and extent of state power in that system.46

Ronen Palan points out that the use of state powers to favour its own industries and attract foreign investment is an inherent part of the economic system.47 Offshore's primary difference is that it deals with the financial sector. Due to the especially abstract nature of the products and services involved, subsidies in the financial sector usually take the form of regulatory laxity. In order to compete, the more regulated states are creating legal realms within themselves in order to get in on the competitive game.

The unique element of Offshore is not the competition between states but the fact that the competition takes the form of the withdrawal of the state. This shows the paradox that in the financial service field, if the state is to be competitive it must undermine itself and the state system by inducing competitive forces that impede regulation both within itself and among itself and other states. Let us take a more detailed look at how this state competition plays out.

47 Palan, Ronen. 1998. "Trying to have Your Cake and Eating It: How and Why the State System Has Created Offshore" International Studies Quarterly 42 p.641. I am also indebted to Prof. Palan for providing me with a draft of an unpublished manuscript entitled "Tax Havens and the Commercialization of State Sovereignty".
The Role of Secrecy

Secrecy is an especially invidious element of Offshore. Secrecy permits and encourages ingenious legal structures in order to separate the legal residence from the beneficiaries of assets. The residence of the legal owner of the assets is distributed among an international web in order to avoid the state-based rules of the global economy. By so doing, international and domestic criminal enforcement agencies are severely hindered in their attempts to connect people with their assets.\textsuperscript{48}

Financial institutions and regulatory agencies are also harmed by secrecy. Recall that modern Offshore jurisdictions are a combination of the elements of secrecy, the Euromarket and low tax areas. Also recall that the Euromarkets are extremely interdependent as they are predominantly inter-bank markets that deal in Eurocurrencies. As long as the Euromarkets were free of secrecy, the lack of external regulation may have been sustainable. However, the combination of large sums of institutional funds flowing around the world through jurisdictions that allow for secrecy is extremely dangerous for the viability of the global economic system.

As the most recent UN report on this issue puts it,

What started as a business to service the needs of a privileged few has become an enormous hole in the international legal and fiscal system. It is estimated that there are now more than a million anonymous corporations. Consultants for the offshore banking centres say that the centres are home to more than $5,000 billion in assets—$1,000 billion in bank deposits and $4,000 billion held in the form of stock, bonds, real estate and commodities.\textsuperscript{49}

\textsuperscript{48} The literature on this aspect of Offshore is extensive. See Walter (1985), Naylor (1987) and Blum (1988).
\textsuperscript{49} Blum (1988). Page number not available since using internet version.
This “hole in the international legal and fiscal system” is primarily a result of the secrecy that is promoted through Offshore jurisdictions. The lynchpins of contemporary regulation of the financial sector are internal risk management and external consolidated supervision. Both of these management techniques are severely hindered by secrecy. Any risk management technique requires accurate data about the assets and liabilities of potential debtors. Internal risk management is impeded to the extent that individuals, corporations and institutions can hide their assets and liabilities. This is also especially important for the credit rating agencies and their role in the global economy. If credit rating agencies cannot accurately assess credit risk, institutional players are left in the dark when trying to assess the solvency of institutions or corporations.

Moreover, consolidated supervision becomes extremely difficult, if not impossible, when financial institutions’ ownership structures are not transparent. Much of the history of recent global banking supervision, from the original Basle Concordat to the present regulatory arrangement under the BIS and the G-7, can be seen as an attempt to deal with cross-border ownership arrangements of banks. The use of financial holding companies, containing other financial and non-financial assets, makes consolidated supervision a serious challenge even when ownership structures are transparent.\(^{50}\) However, this challenge becomes a nightmare without transparency.

This section has been intentionally sparse. Much has already been written regarding the element of secrecy in the global economy and this paper is not

intended to add much to this discussion. These are rather trite propositions: that secrecy causes problems in the global economy; that the benefits from secrecy accrue to the undeserved, and that the potential harm to states, taxpayers, victims of crime and the economic system greatly outweighs any negligible benefit that comes from privacy. However, what is usually underestimated is the threat to international economic stability which emanates from the secrecy element of Offshore.

**The Cat and Mouse Game of State vs. Jurisdictional Arbitragers**

In addition to secrecy, Offshore jurisdictions play a more subtle game with legal concepts in order to undermine attempts at onshore regulation. In this section we will examine how this game operates.

State authorities derive their jurisdiction from their control over their territory. The concept of "residence" is used to determine whether entities fall within a state's territory. States only have legal power over economic transactions conducted (or "resident") within their jurisdiction or by actors resident in their jurisdiction. There is therefore a strong incentive for economic actors, be they individuals or corporate entities, to manage their affairs so that the residency rules are to their maximum benefit. In determining residence, authorities usually rely on the control principle which holds that the assets of a corporation or an individual are those that they control.
The concept of a trust is used to circumvent the control principle. The trust forfeits legal control of assets to a trustee according to the terms of a trust document. This results in the separation of the control of the assets from the beneficiary of those assets.

The trust is not useful to corporations since they generally need to be able to change the allocation of their resources. The terms of trust instruments are difficult to alter. However, the trust, especially the family trust, is an important instrument for individuals and families who want their assets treated more favourably than if the legal ownership were to reside in the beneficiaries. With the legal ownership of the assets residing where the trust is located, the residence of assets can be separated from the individual beneficiary. Moreover, even if the jurisdiction of the trust is the same as that of the beneficiary, the assets are still legally separated from the beneficiary. In many offshore jurisdictions there is no requirement to register or record the existence of a trust residing within them, so the income paid from the trust to the beneficiary can be easily hidden. Trusts are also effectively used for the better tax treatment of intergenerational transfers of wealth thereby minimizing the effect of estate/inheritance taxes and capital gains taxes. They are also used for the splitting of income among family members.

The International Business Company, or “IBC”, is a similar device to a trust except that it is much more useful to corporations than are trusts. Instead of a trustee holding the assets, a corporation holds assets and shareholders control the

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51 For example, in Canada there are no estate or inheritance taxes. However, an estate is deemed by law to have disposed of all assets at market rates on the date of death of the testator. This usually triggers a substantial capital gains tax.
company. The structure of a corporation allows for much more flexibility in the management of assets than does a trust. Secrecy is also provided, since offshore rules allow IBCs to avoid registering or recording their very existence, their terms of incorporation, their directors, their managers, their management meetings and resolutions, their dividend payments, their loans, their financial statements, audits or their shareholders. Of course, the degree of secrecy varies by jurisdiction. In short, IBCs allow for the avoidance of most of the rules that exist in onshore jurisdictions so that a company's officers are accountable to third parties for their actions. These third parties include creditors, shareholders, other officers and employees.

Corporations are entities that have been encouraged by states in order to allow for the pooling of assets so that efficiencies of scale can be achieved. Corporations allow for the investment of resources while providing for the simultaneous limiting of the risks inherent in the investment. Corporations play a valuable role in the development of wealth. However, if all of the constitutive elements of a company are identical, one wonders what could possibly be the business purpose of the corporate structure? The answer is that the business purpose of a corporation diminishes to the extent that the identities of creditors, shareholders, officers and employees are the same.

In Offshore jurisdictions, the beneficial wealth-generating functions of corporations are being misused. Offshore corporations are used for ulterior motives that have much more to do with hiding assets and avoiding taxes than limiting the liabilities of investing in business operations.
As a response to this realization, onshore states “pierced the corporate veil” by distinguishing between active and passive companies. Active companies were defined to be actually carrying on business activities and they were treated as separate entities for tax purposes. Passive companies were defined as those that served no business purpose and they were consolidated with their beneficiaries for tax purposes.

In response to these rules other creative legal entities were created that allowed beneficiaries to be separated from the legal ownership of their assets. These include limited partnerships, companies limited by guarantee (with and without shares), cell companies, limited liability companies, anstalts and stiftungs. There are many more legal entities that are variants on the theme but the basic concept remains that in order to circumvent consolidation, the offshore jurisdiction creates laws allowing and promoting the creation of legal entities in order to circumvent the concept of consolidation. Once the onshore authorities catch wind of the attack on consolidation, they must push the political and administrative wheels in motion to develop rules to extend the net of consolidation over these legally innovative entities. The result is an elaborate, high-stakes game of cat and mouse.

Is Offshore a Result of Hegemonic Interests?

The challenge posed by Offshore for a liberal world order is defeating regulatory competition that provides incentives for encouraging secrecy and regulatory laxity.

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52 For a basic description of the differences and operations of these entities see Laight, Gordon. 1998. Offshore Advantage (Scarborough: Prentice-Hall).
However, it may be that this way of looking at things may be terribly myopic and
distracting from a much more serious role of Offshore. In other words, might the
entire focus of debate be misguided? Might it be irrelevant whether the cat or the
mouse wins the game? Might there be actors who benefit more than the cat or the
mouse from the game itself? It is to this alternative that we now turn.

For Palan, Offshore will not be easily removed from the system because
state competition is as much a part of the system as is cooperation and state
competition is just as much a part of the financial service industry as any other
industry. Palan views Offshore as a key reconciliation of the contradiction between
the state-system and the transnational economy. As such, it is part of the system
and in many ways is like an escape valve that allows the two major forces to coexist
by reducing the tension between them.

However, there is another possibility that has not yet been considered. What
if Offshore exists because it is in the interests of the hegemonic powers? In this
section I do not claim to provide conclusive evidence that this is the case. I merely
wish to raise this possibility to establish that future research towards this hypothesis
may prove fruitful and to examine what the policy implications would be if it were
established.

There is a strong argument to be made that the U.S., Britain and a few other
wealthy states use Offshore as an important means by which they maintain their
hegemonic status. The U.S. and Britain intentionally omitted to curtail the

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Euromarkets even though they were easily able to do so. They did this because it was in the interest of these states to allow the pent up demand for dollars to be released in a mutually beneficial place. Domestically the U.S. needed tight money to constrain inflation while its large corporations needed more credit to allow them to expand internationally. Britain was happy to benefit by supplying services to these large U.S. corporations.

Similarly, the U.S. intentionally allowed the Euromarkets to move to the Caribbean because it better suited the functioning of their banking sector. It is no coincidence that many Offshore jurisdictions in the western hemisphere were and still are British dependencies. The only Offshore jurisdictions that are not former British dependencies are Panama and Puerto Rico (both U.S. dependencies), Aruba and Netherlands Antilles (Dutch dependencies), Costa Rica and Uruguay. The Offshore jurisdictions of Anguilla, the British Virgin Islands, Montserrat, Turks and Caicos, the Cayman Islands and Bermuda are all still British dependencies.

The familiar U.S.-British axis is apparent here. Moreover, some of the more influential non-Caribbean Offshore jurisdictions are British dependencies. They are Gibraltar, the Channel Islands (Guernsey and Jersey and Sark) and the Isle of Man. There is a clear trend that Offshore extended generally to areas with significant British influence.

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55 The following Offshore jurisdictions achieved independence from Britain in the respective years: Antigua, 1981; Bahamas, 1973; Barbados, 1966; Belize, 1981; Dominica, 1978; Grenada, 1974; St. Kitts, 1983; St. Lucia 1979; St. Vincent, 1979.
Offshore jurisdictions are key nodes in the transmission of capital throughout the world. They give TNCs and institutional investors higher returns for their capital than domestic institutions. At the same time, they give TNCs and institutions cheaper and quicker access to capital than domestic institutions. This makes the offshore market very liquid and responsive to changes in the market.

Hegemonic states are key beneficiaries of prudential laxity. Through the structural control over the issuance of credit, U.S. and British based TNCs have easier access to credit. Most of the 42% of bank liabilities that are not interbank liabilities come from large depositors such as insurance companies and TNCs. They benefit enormously from both higher rates of return on money market instruments and cheaper access to credit. These actors were the main sources of the demand for dollars that originally created the Euromarkets and are key sources for the persistence of the Euromarkets today. This is an important point, not just because it explains why Offshore jurisdictions were created, but more importantly, why they persist.

There is more evidence that supports the hegemony hypothesis. In a detailed mathematical analysis, James Hines Jr. and Eric Rice establish a proposition that is counterintuitive. It is usually suggested that Offshore jurisdictions harm the tax base of onshore jurisdictions. However, Hines and Rice show that the contrary is true for the U.S. In their frequently cited article, Offshore jurisdictions are shown to increase the tax base of the U.S. because tax havens tend not to have tax treaties with the U.S. As a result, foreign tax credits do not apply to the profits of American resident corporations that conduct business in Offshore jurisdictions. The
result is counterintuitive but well documented. Since Offshore jurisdictions attract business activity to them and away from jurisdictions which result in foreign corporate tax credits, the U.S. tax base actually rises as a result of Offshore!\textsuperscript{56}

Therefore, the U.S. and Britain may have allowed, and continue to allow, a great amount of Offshore jurisdictions to exist because of the structural power that they gain from them. By having jurisdictions under their control that give huge economic advantages to their banking industries, the U.S. and Britain maintain disproportionate influence over the issuance of credit in the global economy.

There are serious implications if the hegemonic hypothesis can be better established. If established, Offshore would represent a means, not for the reconciliation of the transnational market with the state system as Palan argues, but a means by which hegemonic states can reconcile their domestic political-economic interests with the interests of their internationally privileged positions. In other words, Offshore may act as a safety valve to allow hegemonic domestic interests to be reconciled with hegemonic international interests.

If more detailed research supports the hegemonic theory of Offshore, it would suggest that the spread of American hegemonic power is not as beneficial as Moran's analysis would indicate. Recall that Moran perceived globalization in the financial services industry to have important benefits because the American penchant for openness and the rule of law was spread to countries in which vested interests had previously operated in an anti-competitive manner.

However, Moran's analysis, while extremely innovative and insightful, ultimately falters because he only perceives meso-corporatism as occurring within a domestic context. He does not allow for the possibility that the American hegemonic influence, which he saw as being so beneficial, could itself take a meso-corporate form. In other words, American openness may be very effective in breaking down barriers to competition domestically but it may in fact *impede structural competition internationally*. The root of the problem lies in the proclivity of hegemonic states to foster competition domestically but to restrict competition internationally so that they continue to benefit from their hegemonic status. This is the great reward of economic structural hegemony.

Meso-corporatism legitimates itself via myths. Recall that domestic meso-corporatism relies on the myth that business interests will regulate themselves for public benefit when in fact they are merely placating democratic forces. International meso-corporatism also relies on a myth. It is a myth of "beneficent hegemony". This is the myth that the transnational managerial class manages the economic system for the benefit of the majority of people within the majority of states when in fact they are managing the system primarily for the benefit of, at best, the developed countries and, at worst, the privileged within those countries. In both its domestic and international forms, meso-corporatism is a means by which privilege can be perpetuated by being presented as though it is in the interests of the underprivileged.

The original grid presented four alternative perspectives of the world facing global markets. These have now been reduced to two alternatives. The neo-liberal
perspective was shown to be too weak to be viable since the market is not sufficiently self-regulatory to achieve widely beneficial social outcomes. The realist and the Marxist perspectives have been conflated into a world-system structuralism along the lines of Robert Cox. A liberal perspective has been constructed which provides a serious rival approach. The hegemonic theory of Offshore represents an eclectic mix of elements of liberalism and world-system structuralism.

**The Development of a Consensus on the Future Direction of Offshore**

In this section, I use the hegemonic theory to try to develop constructive policies towards Offshore. The strategy is to locate interests that are shared by the hegemonic powers that are common to other states generally. In this way, a mutually beneficial basis for action can be forged.

A key finding of a recent IMF report is that Offshore jurisdictions played a catalytic role in the recent collapse of the economies in South East Asia.\(^57\) Since actors in Offshore jurisdictions did not have adequate external supervision limiting the risks that they could assume, they were key sources of overly aggressive loans to the region. This is just the most recent and obvious example of how Offshore jurisdictions contribute to systematic instability in the international economy.

Another source of instability comes from the fact that Offshore jurisdictions place a large portion of the world's capital outside of the direct influence of central banks.\(^58\) Since, monetary policy and exchange rate management are the key

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mechanisms by which states control the global economy, any device that diminishes the effectiveness of monetary policy makes it more difficult for states to control the economy.

Offshore jurisdictions clearly make monetary policy and exchange rate management more difficult. Since large amounts of capital, usually denominated in dollars, are located outside of the direct influence of the Federal Reserve, changes in interest rates are less effective at managing the money supply. Moreover, many Offshore jurisdictions are not members of the G-10 or the OECD. Therefore, international regulatory bodies have little control over the financial institutions within them. As a result, exchange rate coordination is seriously hampered by Offshore.

To summarize where we are so far, Offshore jurisdictions play a key role in maintaining the hegemony of the United States because they allow it to disproportionately control the supply of credit globally. However, offshore jurisdictions are also sources of systematic instability for the same reason that they are so valued – the fact that they are unregulated. Moreover, Offshore jurisdictions cause monetary policy to be less effective because the capital located in them is outside of the direct influence of G-7 central banks. By realizing that all states have an interest in systematic stability, we can form the basis for concrete international policies towards Offshore.

*International Efforts to Coordinate Action*

With respect to secrecy, the Financial Action Task Force on Money Laundering (FATF) was established by the G-7 in 1989 to examine measures to
combat money laundering.\(^{59}\) This group aids international law enforcement agencies to coordinate their activities to thwart criminal activities that result from secrecy. The FATF is doomed to failure because it is approaching the problem at a symptomatic level. Its semi-annual reports merely describe the regulatory problems rather than suggesting any solution is on the horizon. Statements like "pressure should be put on countries that do not cooperate" are typical.\(^{60}\) The FATF is trying to deal with the symptoms of secrecy rather than cutting it off at its source. Trying to break through ownership structures that are inherent within the system is very frustrating and ultimately unrewarding. For this reason, this approach will likely prove unfruitful.

Whereas secrecy has been high on the international agenda for over a decade, the global systematic threats from Offshore jurisdictions are just starting to be taken seriously by global authorities. The G-7 has recently created a "super-

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\(^{59}\) The member countries are Australia, Austria, Belgium, Canada, Denmark, European Community, Finland, France, Germany, Greece, Gulf Cooperation Council, Hong Kong (China), Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States.

\(^{60}\) For example, the 1998-1999 Report on Money Laundering Typologies, February 10, 1999 at p.6 states:

23. Obtaining information from some offshore jurisdictions on the true owners or beneficiaries of foreign registered business entities — shell companies, international business companies, offshore trusts, etc. — appears to be the primary obstacle in investigating transnational laundering activity.

24. A number of FATF member countries mentioned that they regularly attempt to request information on foreign legal entities using mutual legal assistance treaties or other agreements with the offshore jurisdiction. Often non-cooperative jurisdictions refuse to respond to a foreign request for investigative or judicial assistance because there is no bilateral agreement that would permit such co-operation. The jurisdictions might also refuse the foreign request because the information requested is not maintained in any official registry. In some cases, information on legal entities may be protected from disclosure to foreign investigative agencies because of strict banking secrecy (with a variation related to non-release of fiscal information, including criminal or civil liability for disclosure) that is impenetrable even to domestic judicial or regulatory authorities. Some delegations also mentioned the increasing use of the Internet for the marketing and provision of such services.
regulator" of the international financial sector in response to the threats from globalization to governance of the international financial system. The Financial Stability Forum (FSF) brings together all of the world's major financial regulators in order to coordinate financial regulation. It is chaired by the head of the Bank of International Settlements and reports to G-7 Finance Ministers and Central Bank Governors. It was created in February 1999 and meets semi-annually. It has the following members:

1. The finance ministers and the Central Bank governors of each of the G-7 countries.
2. The IMF.
4. The Bank for International Settlements
5. The OECD
6. The International Organization of Securities Commissions
7. The International Association of Insurance Supervisors
8. The Basle Committee on Banking Supervision
9. The Committee on Payment & Settlement Systems (a committee of G-7 central bank representatives)
10. The Committee on the Global Financial System (another committee of G-7 central bank representatives)

As can be seen, this is the ultimate powerhouse of international financial regulators. The FSF has a working group dedicated to the role of Offshore jurisdictions in the global economy and has made them its primary focus in its first year.

How should the FSF deal with Offshore? Most people consider the problem in dealing with Offshore jurisdictions to be the problem of getting unanimous consent
from all of the tiny jurisdictions involved.\textsuperscript{61} However, as Strange and Palan\textsuperscript{62} point out, this is not the problem at all as it ignores the systematic role of hegemons in the system.

There is a simple remedial action that could be taken against Offshore jurisdictions. In Susan Strange's recent book she describes the threats posed by financial havens and she very insightfully perceives that the problems could be solved in the following way,

"If the Group of Seven were to announce that they would be publishing a blacklist of the known tax havens and another blacklist of the firms and individuals actively making use of tax havens, and would impose fines or other sanctions on them unless the accounts were closed within a specified time, there can be little doubt that most could not survive for very long. The reasons why this does not happen are, once again, political rather than technical.\textsuperscript{63}

The political reasons that concrete action will be difficult to obtain is that the hegemonic powers, in conjunction with their private sector partners, will resist taking action against Offshore because Offshore serves the interests of the hegemonic powers more than other players. I am not suggesting that the United States and Britain will oppose reigning in Offshore under any circumstances. I am only suggesting that they have stronger vested interests in the status quo and that they will weigh the pros and cons of taking action in a much more conservative way. Therefore, the future portends that international action will focus on minimizing the

\textsuperscript{61} See, for example, the leader in the Financial Times November 30, 1999.
\textsuperscript{62} Palan (1998) "Quite simply, if the U.S. and the EU decide, either separately or together, to place an embargo on .... financial transactions taking place by companies registered in a particular tax haven, then that particular facility is doomed. It is therefore within the powers of these large regional organizations to reverse the trend toward offshore." p.641.
\textsuperscript{63} Strange (1998) p.132.
destabilizing effects of Offshore jurisdictions in the global economy, rather than
directly challenging their existence.

As for the element of secrecy, if the FSF distinguishes between the secretive
element and the element of regulatory laxity towards financial institutions, then
concrete action can be taken in the way that Strange proposes. Because of the
interrelated nature of financial markets, the secrecy element of Offshore
jurisdictions can be effectively excised from the system. The United States and
Britain can be made to see that secrecy is not in their interests, even though the
other elements of Offshore jurisdictions are in their interests.

The key is to accurately distinguish the elements of Offshore that are more
harmful to hegemonic interests from those that are less harmful. This can only be
accomplished if the elements of Offshore are disaggregated and approached
individually. Secrecy is the element of Offshore that is the most harmful to the
interests of the hegemonic states. By realizing this, the superficial regulatory game
of cat and mouse can be ended and the harmful effects of Offshore can be
constructively and pragmatically attacked.

Conclusion

International Relations theory is a complex business. There are aggregations
of interests domestically, internationally, and transnationally within and among
private and public actors. As a result, forces like Offshore have conflicting causes
and effects. Moreover, each cause and effect favours some more than others. In
order to fully understand a phenomenon, it must be analyzed from the most useful
level of detail. This paper has argued that Offshore has been analyzed from too
general of a perspective. Moreover, there has not been sufficient assessment of its
effects upon powerful actors. When the appropriate investigations are made
certain conclusions can be drawn.

First, Offshore is a potent force with significant implications for the global
order of finance. Second, there is a strong possibility that Offshore contributes
significantly towards maintaining economic hegemonic power while simultaneously
undermining the political and economic system upon which that power ultimately
resides. Finally, the harmful effects of regulatory arbitrage will be with us for the
foreseeable future. However, by finding common interests among hegemons and
others, systematic stability can be increased by diminishing the harmful role of
secrecy in the international economy.
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