Eden Island, Mahe, Seychelles

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# Islands as offshore financial centres

## The free(r) flow of capital


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**ABSTRACT**

*A number of islands have served as the host location for financial services over the past few decades, and these offshore financial centres (OFCs) have been the object of research and analysis since the 1970s. This contribution begins by establishing the historical context experienced by the OFC in order to explore the present situation for the island economy hosting one. The specific*

*point of distinction determining that a financial centre is 'offshore', actually, is not its location on an island, but rather the operation of a legal regime to provide financial services to non-resident individuals and companies. The politico-economic rationale behind the decision to host an OFC involves several factors, including the rents collected from the services provided to foreign capital and its owners, the employment opportunities available to island residents, and the low environmental impact of an OFC as compared to alternative economic development proposals. Thus, there is a distinct difference between the island OFC when compared to a large state financial centre (e.g., Luxembourg, Netherlands, UK, or US) where these financial centres operate primarily as a complementary feature within a larger, diversified economy. At the same time, the island OFC is subjected to challenges that arise from its size and relative location within global finance which are not necessarily experienced by other financial centre jurisdictions. Several of these challenges are highlighted in this chapter, followed by some concluding thoughts on what the immediate future may hold for the island OFC.*

## INTRODUCTION

This contribution results from more than fifteen years of research investigating questions over the role, function, and consequences of offshore finance as a development path for island economies. Central to these various publications, whether on illicit capital, money laundering and terrorist finance, or on the offshore financial centre (OFC) as but one space in global flows of investment capital, has been the structural features of global finance and global financial governance (see, for example, Vlcek, 2017). To help understand the evolution of this research topic, permit me a short anecdote. My first conference presentation of a paper involving the topic of offshore finance was challenged by audience members over the 'moral wrongness' of island economies facilitating and encouraging what they viewed as illegal conduct. From their viewpoint, being a so-called 'tax haven' was wrong, whether or not it provided revenue for the local government and employment for citizens. This was in 2004, when few academics studied offshore finance and before the more widespread moral outrage that emerged after the 2008 financial crisis and the subsequent revelations of corporate and personal tax avoidance/evasion presented by 'Offshore Leaks' and the 'Panama Papers'.[1] The audience recommendation was that tropical islands should focus on tourism for purposes of economic development, rather than engaging with banking and finance in an increasingly interconnected world. Contemporary analysis of the developmental potential from tourism in the Caribbean at the beginning of the century highlighted the challenges and costs for local society and culture as a result of proposed expansion/enhancement (Karagiannis, 2002, pp. 152-164). Disregarding the impact of tourism's carbon footprint (which is a more recent criticism of global mass tourism), the circumstances affecting the global tourism industry, and thus island tourism destinations, have changed over the past two decades just as the context and circumstances for offshore finance within the global finance domain have changed.

The establishment of an island OFC represents one strategy for economic development (Baldacchino, 1993, 1998).[2] In opposition to the employment opportunities available in a tourism industry, offshore finance requires staff with higher skill levels and education (e.g., lawyers, accountants, IT specialists) and offers commensurable levels of remuneration. The OFC has a limited impact on the local economy because it is not in direct competition with local businesses. And, importantly, the OFC generates revenue for the government in the form of banking license fees, company registration fees, and other fees depending on the specific services provided. The next section of the paper addresses this finance aspect in an OFC, starting with the origins of 'offshore' as a feature of the modern system of states, and then as a development strategy for a small island economy. It then introduces other possible features of an OFC, including economic citizenship, shipping registries, and online or Internet gambling. The second section offers a short case study of one island OFC, Mauritius, which established its OFC as a diversification move in its economic development strategy. Building on this background the third section explains two contemporary challenges confronting the OFC. First is the continuing international campaign to hinder the use of foreign accounts for domestic tax avoidance/evasion, and the second reflects some of the negative consequences created by the international campaign against money laundering and terrorist finance.

## OFFSHORE AND THE ISLAND ECONOMY

Offshore finance is the term applied to a very specific legal regime designed to attract foreign capital by providing a variety of services to non-resident persons and corporations. By specifying the nature of offshore finance in this fashion the origins of it may be recognized as a distinct feature of modern finance in a largely interdependent internationalized economy. This specification also distinguishes offshore finance from the concept of the tax haven and the efforts of the wealthy to preserve their wealth from rapacious rulers. The latter practices are reflected in the story of the origins for Switzerland as a safe domicile of foreign wealth, going back at least as far as the mid-18th century when French aristocrats sought protection for their portable wealth from the King's tax farmers (Faith, 1982).

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### *Offshore finance, its origins and specialization in the late 20th century*

As a modern financial phenomenon, offshore finance emerged as a specific, identifiable aspect of global finance in the 1950s. In this period of the Cold War, European reconstruction was a large part of the world economy and global finance was managed under the Bretton Woods fixed exchange rate regime of the IMF. Central to this exchange rate system was the US dollar, leading to increasing quantities of US dollars in circulation outside of US territory (Cohen, 1977, pp. 95-102). National regulatory environments constrained cross-border financial activity and other bank strategies for increasing business and profits. One bank regulation that is believed to have encouraged the creation of offshore finance was Regulation Q in the US. It limited the rate of interest paid on short-term deposits in the US until it was withdrawn in 1963 (Schenk, 1998, p. 222). This situation suggests that the dollars in circulation outside the US were deposited in foreign banks offering a higher rate of interest in pursuit of profits. In this situation banks could use the dollar deposits to further arbitrage the interest rate differential between the US and Europe and thereby increase their interest income. Catherine Schenk located this financial innovation and the creation of the 'Eurodollar' market at the UK's Midland Bank in 1955 (Schenk, 1998, pp. 224-227). In the analysis of Gary Burn, this innovation created a supportive environment, but for these 'Eurodollars' to become 'offshore' dollars a further move was required. This second move he located in 1957 when banks in London used the dollar deposits to make loans denominated in US dollars (Burn, 1999, p. 230). The growing success of British banks with the profitable recirculation of US dollars outside of the US attracted the attention of American banks, and they in turn opened branches in London to profit from not only the Eurodollar markets, but also for the ability to operate beyond the constraint of Regulation Q (Burn, 2006, pp. 28-29).

The success of US banks in London encouraged bankers to look at opening branches in the UK territories of the Caribbean, operating in the same time zone as New York City but under British regulatory guidance and still beyond the jurisdiction of Regulation Q. By the time that regulation was withdrawn, the profitable foundation of offshore banking and related financial services was clearly recognized. As Schenk observed, "The regulatory framework in which banks operated encouraged innovation as a means of evading controls" during this period of widespread capital controls and related regulations (Schenk, 1998, p. 233). Continued financial innovation marks the evolution of global finance since the emergence of the Eurodollar and with it the growth of offshore finance. Innovation is also responsible for some financial crises, as demonstrated with the 2007-2008 financial crisis, which also was initially and incorrectly blamed by some observers on OFCs (see, for example, Blundell-Wignall & Atkinson, 2009). The end of the Bretton Woods system for managing international monetary relations coincided with significant growth in the Eurodollar markets, accelerated by the introduction of 'petro-dollar' recycling. On this aspect, Cohen writes that "after 1973, oil producers poured literally tens of billions of dollars in the market" (Cohen, 1977, p. 140).

In an effort to understand the impact of the Eurodollar markets in global capital flows, the Bank for International Settlements (BIS) began collecting and reporting locational banking statistics in the early 1970s. This data collection was extended to include the locations involved in petro-dollar recycling and has grown further in response to subsequent events, leading to the inclusion of many OFCs (Monetary and Economic Department, 2006, p. 2). As part of this data collection exercise, the BIS created an operational definition for an offshore financial centre as the "expression used to describe countries with banking sectors dealing primarily with non-residents and/or foreign currency on a scale out of proportion to the size of the host economy" (Monetary and Economic Department, 2006, p. 60). This operationalization of the concept is suitable for the purposes of the BIS, to specify and identify the location of pools of mobile capital to be subject to the oversight of global financial management. Yet, this definition also serves to obscure the operation of other financial centres in large states (e.g., Netherlands, United States) where the financial centre with its non-resident capital is primarily a complementary feature of a larger diversified economy. Thus, studies specifying the OFC as determined by the size of the financial centre vis à vis the host economy generally do not identify these large states as an OFC because the financial services sector is subsumed within the broader economy (Zoromé, 2007). The essential point for the present discussion is that the practices of offshore finance are not limited to small island economies. At the same time, the structural features of the island that make it conducive to offshore finance are similarly conducive to a number of other economic development strategies (Baldacchino & Mellor, 2015).

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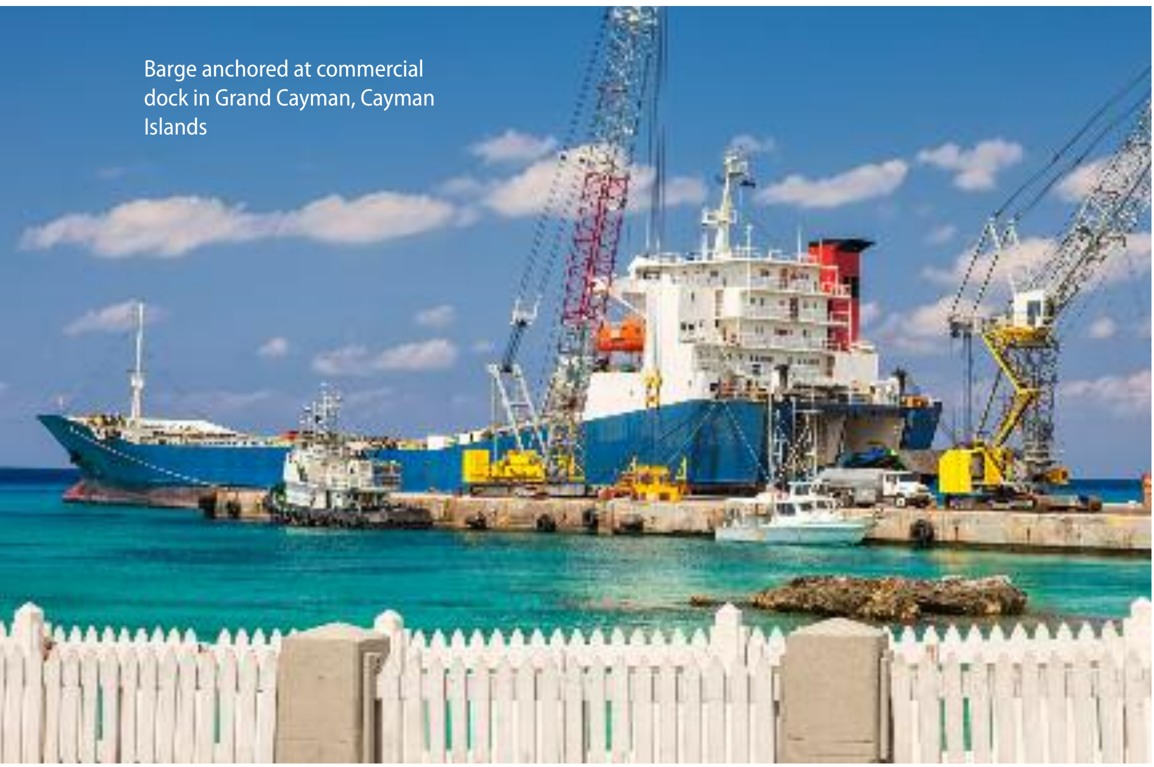
### *Offshore finance as an island development strategy*

As a development strategy, the explicit establishment of an OFC is entangled with the notion of the tax haven. Beyond the historical record of Switzerland as a financial safe haven since aristocratic times, Switzerland and other European territories began serving as a haven from taxation in the early 20th century (Ogle, 2017, p. 1437). The intersection of the tax haven jurisdiction with the phenomenon of offshore finance in the 1950s created the concept for the OFC as a strategy for economic development (Vlcek, 2008, pp. 24-25). For the United Kingdom and its territories, the concept was debated across government departments with contrasting visions depending on scope of responsibility. The Foreign and Commonwealth Office, with its interest in promoting independence, felt the OFC offered the small island territory in the Caribbean or Pacific with a revenue source in the absence of other options (e.g., valuable natural resources), whereas the Treasury and Inland Revenue recognized the potential loss of tax revenue for the UK and other states (United Kingdom. Public Record Office, 1967-1969, 1970). The various perspectives were gathered in a Working Group Report on Tax Havens in 1970, which also listed the "Established" tax havens of the time: the Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Gibraltar, Hong Kong, and Montserrat; along with the "Potential" tax havens of the British Solomon Islands, Gilbert and Ellice Islands, St. Helena and Turks and Caicos Islands (United Kingdom. Public Record Office, 1973). But not all banks chose to establish their offshore subsidiaries in the Caribbean, instead choosing the Channel Islands as a more convenient location for an OFC. In the case of Jersey the offshore sector would eventually supplant the long-standing agriculture and tourism industries, providing nearly half of the island's GDP in 1990 (Hampton, 1994).


Barge anchored at commercial dock in Grand Cayman, Cayman Islands

Which is not to say that British government encouragement to use offshore finance as economic development among its small territories was not challenged by other governments. In the case of New Hebrides (Vanuatu), the Australian government was quite concerned by the establishment of an OFC in 1971 because it became a 'tax haven' for Australians. The Australian Prime Minister sent a letter to the British Prime Minister in July 1974 raising the issue, and received his reply a month later. The background material for the reply letter contained in the archives echoed the tension between those worried about the potential for tax evasion (with the British Embassy in Canberra supporting the Australian position) and those promoting economic development in the territory, most especially the British officials in New Hebrides (United Kingdom. Public Record Office, 1973-1974). The latter position succeeded in privileging economic development over potential revenue losses in the reply letter, in which the British Prime Minister commiserated with the Australian Prime Minister about the problem highlighted by their respective tax administrations. Nonetheless, the 'problem' for the British government regarding "New Hebrides must also be viewed in the context of the need to promote the territory's economic development" (United Kingdom. Public Record Office, 1974, Folio 68). The independent island state of Vanuatu has declined in significance for British foreign and development policy while proximity to Australia means that Vanuatu remains a concern for tax evasion (Rawlings, 2011).

In light of globalization in the 1990s, Philip Cerny made a case for the emergence of the competition state, which is characterized by its desire to establish domestic economic activities that are internationally competitive (Cerny, 2000). The competitive national economic sector would then draw business away from other similar but less competitive national economic sectors. This situation is recognizable in the transnational tournament among OFCS, with specific OFCs recognized as the leader for a particular market segment; examples include Bermuda with regards to insurance/re-insurance companies and the Cayman Islands for investment/hedge funds. As an example of the extreme measures that a small island economy might take in order to be competitive, the government of the Seychelles in 1995 approved the 'Economic Development Act, 1995' with incentives for attracting investors to the Seychelles. For a \$10 million investment, the incentives included immunity from prosecution, unless the crime involved violence or illegal drugs trafficking in the Seychelles. This approach to development attracted international outrage and condemnation, leading the government to have it declared unconstitutional without ever implementing it (Sharman, 2011, p. 126). Elsewhere, Sharman has noted the fact that this piece of legislation was "written by outside lawyers, often those working for offshore firms" which is not unique to the experience of the Seychelles (Sharman, 2017, p. 39). Van Fossen provides rich details on the conduct of

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offshore promoters (lawyers, accountants, and others) encouraging the creation of an OFC among the Pacific Island territories (van Fossen, 2012), while Ogle suggests that these private actors are frequently absent from historical accounts of development among the former colonial territories (Ogle, 2017, p. 1439).


### *The offshore industry beyond finance*

The construction of a legal regime for financial services specifically intended to attract the foreign client has encouraged the construction of similar legal regimes to attract clients for non-financial services. Similar to offshore finance these legal regimes are not limited to island economies, yet it is often the island that attracts the greatest amount of media interest. The attraction may be due to allegations of criminality and illicit conduct, or because these activities attract sufficient revenue that it becomes a significant percentage of total government revenue. Any number of activities could be governed by an offshore regime, as long as the activity requires a discrimination based on nationality or governing legal jurisdiction. Three specific activities are discussed below, but in addition to economic citizenship, shipping registries, and online gambling, other activities operating 'offshore' include aircraft leasing, investment vehicles supporting securitization, and export processing zones (EPZs).

#### *Economic citizenship (second passports)*

The 'sale' of economic citizenship, or at a minimum residency visas, has gained media attention in the UK at the time of writing. In part this interest was generated by a report from Transparency International with Global Witness on so-called 'golden visas', whereby this economic development tactic is transformed into a source of risk for the European Union from corrupt foreigners with their illegal assets (Transparency International & Global Witness, 2018). Beyond the headlines, this tactic represents a commercial transaction and one that is employed by states large and small in which they are essentially 'selling sovereignty', or at least some of the trappings of sovereignty (Surak, 2016). The passport or visa, however, is not so much 'sold' as it is exchanged for a direct investment in the local economy. In the case of a large state, such as the UK, an investment of £2 million in the UK secures a Tier 1 (investor) visa with the option to apply for residency status after three years with a total investment of £5 million or after two years with a £10 million investment.[3] Small island economies by contrast have a more limited scope for direct investment, leading to programs such as implemented in St. Kitts. In this instance, the investment leading to a passport and economic citizenship is made in the island's Sugar Industry Diversification Fund, while other islands (including Dominica, Grenada, and St. Lucia) encourage investment in luxury condominium development projects (Surak, 2016, pp. 17-18, 24).

### *Shipping registries*

Traditionally a ship was registered in the jurisdiction of its owners; however, the use of a flag from a different jurisdiction may be used to avoid government regulations. The origins for the offshore shipping registry, or 'flag of convenience', is believed to be associated with foreign ships registered in Liberia and Panama after the First World War (Osieke, 1979). The idea, however, for operating under a flag different from that of the ship's origin or crew's citizenship is arguably much older. John M. Hobson notes, for example, in his book *The Eastern Origins of Western Civilisation* that following the Chinese 'imperial ban' of 1434 against foreign trade by private Chinese merchant ships, they began operating under a Portuguese flag. This action served effectively to 'reflag' a Chinese ship as a Portuguese ship and provides an early example for regulatory arbitrage in the shipping industry because the Chinese ship owner could continue to trade, but as a 'Portuguese' merchant (Hobson, 2004, pp. 151-152). In the 20th century the practice re-emerged when, for example, US ship owners chose, in the 1920s, to flag their ships in Panama in order to avoid new US shipping regulations which they did not like.

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The leading shipping registries today are Panama, the Marshall Islands, Liberia, Hong Kong, Singapore, and Malta.[4] It is not a coincidence that four of these six jurisdictions are small islands. The impact has been that ships must follow the shipping regulations of the state of registry, regarding labour practices, ship maintenance, environmental practices, etc. This in turn has led some ports to impose requirements on ships docking at the port to meet local standards for environmental practices and ship construction. A leading criticism of these shipping registry jurisdictions has been their low labour standards as compared to other jurisdictions with strong labour unions regarding work practices and wages for crews. Another concern with ships operating under a flag of convenience has been the illegitimate use of a foreign registry, chiefly to conceal true ownership. But this practice may be used for more than simple tax


Stern of a ship under the Panamanian flag

evasion by wealthy yacht owners. Another illegitimate use with wider international political consequences is changing ship names, recorded ownership, and flags in order to evade economic sanctions. This technique was found with Iranian-owned (originally) ships evading sanctions in 2010 by transferring ownership of the vessel to an offshore company and flag registration to an offshore registry (Becker, 2010).[5]

### *Online gambling*

From one perspective, online gambling is a very recent phenomenon utilizing the worldwide access potential of the Internet by a person sitting at a computer in a jurisdiction where gambling is illegal to connect to an online casino or poker game operated from a server located in a jurisdiction where this activity is not illegal. Again, the underlying practice of manipulating jurisdictional boundaries is older than this attribution for online gambling. Ships have practiced this approach for years, taking on passengers in a jurisdiction where gambling is illegal and transporting them to a location offshore beyond the legal jurisdiction of such laws in order to gamble legally, offshore. Yet, for a period of time in the early 2000s, everywhere one looked in London there was an advertisement for online poker: on bus shelters, in Underground stations and trains, and in the daily newspapers. The phenomenon of online poker led to a companion industry of instruction books and how-to columns in newspapers. The industry attracted a lot of investment, and the websites supporting the online poker craze for the most part were located offshore, frequently in an island OFC and in some cases with the infrastructure and staff also located on the island (Berzon, 2012; Goodman, 2011; Reilly, 2005).

One example is the case of Antigua-Barbuda, which began developing an online gambling sector in the late 1990s which employed 3,000 people in 1999—significant when the population was only 67,000 (Cooper, 2009, p. 213). Online gambling was framed by the US government, however, as a threat to society because it would encourage underage gambling, facilitate money laundering and organized crime, and promote gambling addiction (Cooper, 2011, pp. 43-47). The US response to the activity was a series of aggressive measures to suppress it, blocking payment processing to the firms, and applying anti-money-laundering laws against the banks, credit card companies, and money transfer companies (Cooper, 2011, p. 128). Direct action was also taken against the owners of these firms, arresting and charging them with illegal gambling if they entered US territory (Cooper, 2011, pp. 14-17). Antigua-Barbuda initiated a WTO Dispute Panel action against the US, accusing it of violating the General Agreement on Trade in Services (GATS) treaty. It won the case, and then won again when the US appealed the first decision. In the long term, however, the island state lost as the US government refused to change its laws against online gambling, or to pay the compensation determined by the Dispute Panel. The online gambling industry in Antigua-Barbuda withered and similar firms operating in other, offshore territories continue to avoid US-based customers.

## MAURITIUS: THE OFC AS ECONOMIC DIVERSIFICATION

To illustrate the foregoing narrative, consider the case of Mauritius as one island operating an OFC, while also undertaking other initiatives for economic development.[6] At the beginning of the 21st century Mauritius represented the only offshore financial centre marketed as such in any African state, as was documented by an International Monetary Fund working paper and the BIS in its compilation of international banking statistics (Monetary and Economic Department, 2006, p. 68; Zoromé, 2007).[7] As the only fully operational OFC in Africa, in conjunction with its location in the Indian Ocean, Mauritius serves as an intermediate location for the movement of capital between Europe and Africa, Europe and India, India and Asia, and Asia and Africa. In turn, its diasporic communities also mean that it is well situated culturally to benefit from its geographic location in these global flows of investments and profits to India, China, Hong Kong SAR, and Sub-Saharan Africa. Beyond the simple fact that Mauritius had been home to the now extinct dodo bird, the islands of Mauritius were empty of human habitation at the time European colonialists arrived. After a failed attempt by the Dutch to establish a colony, France would succeed and controlled the territory from 1715 to 1810. The French brought in African slaves to work the sugar plantations they established, while, after 1810, when it was a British colony, the British ended the practice of slavery but brought indentured workers from India and China to Mauritius. In 1968, when Mauritius gained independence from Britain, it had a population of "700,000 people who originated from three continents, spoke a variety of languages, and practiced four of the world's major religions" (Lange, 2003, p. 402). At independence the national economy was a monoculture dominated by sugar, which was mostly exported to France. Mauritian sugar continued to receive preferential access to the European Union until 2017 (Cotterill, 2017).

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As indicated in the previous section, an EPZ is one form of 'offshore' practice beyond finance, representing a territory in which a special economic and tax regime operates for resident businesses which is different from businesses in the rest of the domestic economy. In 1972 Mauritius established an EPZ for export-oriented textile production, which permitted the manufacturers to benefit from a 'Made in Mauritius' label and work around the national export limits imposed by the Multi-Fibre Arrangement. The EPZ became a significant source of

Sugar cane harvesting in Mauritius

employment as an alternative to the sugar plantations (Lincoln, 2006). Simultaneously, the Mauritian government increased its efforts to promote tourism as an additional way to diversify the economy, and in 1990 further diversified its economy by establishing an offshore financial centre. The latter diversification move benefited from a Double Taxation Avoidance (DTA) Treaty in place between Mauritius and India since 1983, which did not attract significant use until after the establishment of the OFC. The availability of the Mauritian OFC intersected with a changing political economic environment in India which made it more receptive towards foreign investment. Subsequently, Mauritius grew to become a significant source of FDI to India, with the Reserve Bank of India reporting that for the 2008-2009 fiscal year "Mauritius remained the largest [source of FDI], with a share of 44.8%, followed by Singapore with a share of 14.8%" (Reserve Bank of India, 2009, p. 177). The next three major sources of FDI to India for that period, in order, were the United States, Cyprus, and the United Kingdom; and, as with Mauritius, Cyprus is an OFC serving as a waypoint in the flow of foreign investment capital to India from some unidentified point of departure (Reserve Bank of India, 2009, p. 180).

This combination of treaty and financial centre turned Mauritius into the preferred tax haven for many firms and wealthy citizens from India while it also served as the legal residence for much of the foreign direct investment into India from elsewhere. Nonetheless, the relationship between India and Mauritius over the operation of the DTA Treaty was conflictual. On the one hand, the treaty, in conjunction with the Mauritian OFC, facilitated substantial foreign investment flows into India; while, on the other, India could not tax the profits of this investment capital under the terms of the DTA Treaty. The lost potential tax revenue attributed to the use of Mauritius as the point of entry to India was the motivation behind domestic criticism of the treaty, including a number of court cases, and it was eventually revised in 2016, with effect from April 2017 (Kotha, 2017). For the 2008-2009 fiscal year, Mauritius with Singapore represented 59.6% of FDI flows into India, while in the 2017-2018 fiscal year, following the implementation of the treaty revision, Mauritius and Singapore together continued to be the point of departure for "about 61% of total equity investments" into India (Reserve Bank of India, 2018, p. 81). And while in the latter annual report of the Reserve Bank of India the position of Cyprus on the list of inbound FDI was well down, the Cayman Islands had risen to sixth position, behind the Netherlands, US, and Japan (Reserve Bank of India, 2018, p. 245).

Beyond avoiding the collection of income and capital gains taxes on investments within India, the use of a Mauritian-registered corporate subsidiary has been part of a long-running court battle involving the multinational corporation (MNC) Vodafone and India's tax administration. Vodafone purchased the Indian mobile phone subsidiary of Hutchison Whampoa in 2007 in a transaction which took place 'offshore'. The Hutchison Whampoa subsidiary was owned by a Cayman Islands–registered subsidiary, and the Vodafone subsidiary making the purchase was registered in the Netherlands. As the transaction involved foreign-registered corporate entities (including in Mauritius), neither party considered the need to withhold capital gains tax on it, nor to remit any form of tax payment to the Indian government. This situation was the specific argument made in documents submitted to a court in India, that the Indian tax authorities did not have jurisdiction to claim that it was a taxable transaction in India when it involved foreign entities outside of India (Whalley & Curwen, 2014, p. 372). When the Indian Supreme Court upheld this argument on appeal in 2012, the government chose to change the law and explicitly include foreign merger and acquisition transactions that involved Indian assets, and then to apply the law retroactively to Vodafone's acquisition. As a result of further legislative activity and a change of government in India, the tax claim on Vodafone remains unresolved. This case highlights an intersection between a large developing economy, one of the Brazil, Russia, India, China (BRIC) states and an OFC within the context of a global financial regulatory architecture substantially created by other, developed, states to serve their economic and financial objectives with little regard for either BRIC (developing) states or the OFCs. The complexities of this particular tax dispute between India and a large foreign MNC working through an offshore subsidiary deserves further detailed research.

## 21ST-CENTURY CHALLENGES

Going forward from the present moment, the challenge for the island OFC involves the risk perception held by the governments and regulatory agencies of non-OFC territories. As discussed further below, this risk may involve the use of the OFC in possible tax evasion or money-laundering transactions. But more traditional banking risks remain for the OFC, such as a liquidity crisis and a 'run on the bank', if the banks serving the offshore sector are not separate and distinct entities ring-fenced away from domestic retail banking. It was this set of circumstances which struck the banking sector of Cyprus in 2012, because local Cypriot banks were serving both the retail sector and the offshore sector on the island. Moreover, they possessed large quantities of Greek sovereign debt that were subjected to a reduction in value as part of the efforts made to resolve the Greek financial crisis while Cypriot banks also maintained branches in Greece. As a result, these factors combined to transmit the financial crisis in Greece through to the banks on Cyprus, leading to the Cypriot financial crisis (Demetriades, 2017b; for more detailed information, see Demetriades, 2017a). The important point here is that just because an OFC is involved, that does not also mean that any problem may be limited to those offshore banks.

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### *Cross-border tax collection*

The preceding section provided the case of Vodafone as one example for some of the problems present within efforts at cross-border tax collection involving an MNC. Central to these problems are the competing interests of the MNC, its home jurisdiction, and all of the other jurisdictions hosting a subsidiary or affiliate of the MNC, or even the customers of the MNC where it provides goods and services across the border to a jurisdiction where it does not have a local affiliate. Which tax is appropriate to the transaction and which party is responsible for paying that tax are subject to interpretation of local legislation, existing bilateral tax agreements, and potentially an accountant's determination of whether there was any taxable income or capital gain as part of the transaction. A further example involving Mauritius was documented in a report produced for the NGO ActionAid (Hearson & Brooks, 2010). It outlined the impact on local tax revenue collection from SABMiller's corporate structure, which at the time comprised subsidiaries performing specialized tasks in locations independent of the location of brewery operations. Specifically looking at the relationship of the Accra (Ghana) Brewery with several SABMiller subsidiaries, the report highlighted the fees paid to a subsidiary in the Netherlands retaining licensed trademark ownership, management fees paid to a Swiss-based subsidiary, and the purchase of centrally sourced raw materials and other supplies from a SABMiller subsidiary based in Mauritius. The ActionAid report concluded that collectively these payments served to transfer potential taxable profits out of Ghana to locations with no or low corporate income tax rates.

While not a new problem, these concerns with addressing potential lost income tax revenue intersected with the 2008 financial crisis and served to motivate renewed activity in international organizations to create international regulatory guidance and pursue multilateral cooperation. The location of OFCs within corporate structures to minimize tax obligations has been a central concern at the OECD since at least the late 1990s (see, for example, Organisation for Economic Co-operation and Development, 1998, 2000). Current endeavours by the OECD represent a progression over the past twenty years to reshape the international financial regulatory environment in a way that removes the privacy/ secrecy aspects facilitated by the interaction between the multiple legal regimes involved in these structures, particularly when an OFC is present. For businesses, as seen in the SABMiller example, the OECD has established a programme to address "base erosion and profit shifting" (Vlcek, 2017, pp. 141-150). The efforts of the Indian government to change its tax legislation in order to capture tax on foreign transactions involving Indian assets could be seen as falling under the broad scope of the OECD programme. For wealthy individuals pursuing tax avoidance, the OECD is promoting a common reporting standard (CRS) to support the automatic exchange of account holder information (Vlcek, 2017, pp. 138-140). Progress by the OECD to gain increasing compliance with CRS and the exchange of bank account information has led to an additional tax avoidance structure. The OECD has observed the growth of economic citizenship as described above, and identified the way in which this form of secondary citizenship may be used to circumvent the intentions of the CRS.[8] The technique involves acquiring tax residency in an OFC, and reporting that territory as one's registered tax authority for a bank account in a state which is CRS-compliant (Garside, 2018; 'Sweet deserts', 2018).

### *Compliance costs, derisking and financial isolation*

Embedded within the concern over the use of an offshore account or company to facilitate cross-border tax evasion is the fear that it is being used to conceal money laundering or terrorist finance. The earliest international campaign against OFCs focused far more on the laundering of illegal drugs trafficking money than it did on potential tax evasion. The US put money laundering on the international financial governance agenda in the late 1980s when it encouraged the G7 to establish the Financial Action Task Force (FATF). The first purpose for the FATF was to establish the procedures and processes used to launder money, which it then followed with the production of a set of Recommendations guiding the creation of national legislation against money laun-

St. Kitts in the Caribbean

dering (Financial Action Task Force, 1990). These Recommendations for dealing with money laundering have evolved over the decades since their initial publication in 1990, with the first significant change made in 2001 to incorporate processes to combat terrorist finance and subsequently to counter the financing of weapons of mass destruction (Financial Action Task Force, 2012). For much of its initial decade the FATF's attention was placed on the conduct and operation of the banking sector of its member states. The outflow of capital from Russia in the 1990s revealed that the focus on a single segment of the global financial system encouraged those engaged in cross-border money laundering to seek other locations for their business.

The revelations in 1999 that Russian capital flight passed through banks in New York City on its way to offshore banks in the Pacific (in Nauru, Niue, Palau, and Tuvalu), before disappearing from view (and regulatory oversight), demonstrated the need for collective, global enforcement of the FATF's anti-money laundering (AML) campaign. The response of the FATF was to conduct an evaluation of non-member states and territories for their compliance with its AML guidance, and then to publish a list of non-cooperative countries and territories (NCCT). The initial NCCT list in 2000 contained a number of island OFCs, and the named territories were effectively 'blacklisted' and all financial transactions with them were to be treated by FATF members as potential money-laundering transactions (Vlcek, 2010). The remedy for this situation among the listed territories was to introduce legislation implementing the AML Recommendations and to establish the agencies needed to enforce the new AML laws. But for the island OFC it is a remedy that could cost the government more than any revenue generated by the operation of the OFC. A study of three OFCs in 2008 reported that the compliance costs for their governments had exceeded the measurable benefits provided by the OFC to the territory (Sharman & Mistry, 2008). The cost of AML compliance is not just a problem for the OFC regulators, however: it is also an issue for the financial institutions. For large multinational banks, the cost of compliance may involve up to 10% of all employees simply to monitor and enforce AML procedures, plus the cost of any fines imposed by regulators for failing to adequately address money laundering activity among its customers (Ensign & Colchester, 2015).

One unfortunate side effect of the high cost of compliance experienced by the large multinational bank is the decision made by a number of them to withdraw from business sectors or locations with a perceived higher risk of money laundering. Thus, if a particular business activity (e.g., payment transfer services for migrant remittances) appears to be susceptible for money laundering (or terrorist finance), then the bank can decide to close all accounts supporting that activity. Similarly, if a territory is perceived to be more susceptible for illegal financial activity, then the firm will close its branches or end its correspondent banking relationship with local banks in that territory. This particular business practice is known in the industry as derisking, because it represents the efforts of the financial firm to reduce its contact with potentially risky customer relationships, which in turn should reduce its exposure to regulatory punishment in the future (Vlcek, 2018). The consequence for the businesses and territories 'derisked' is to leave them isolated and outside the formal, regulated financial system. For the small island country (because it is not simply the OFC territories that have been targeted), this situation is worse than FATF blacklisting, because at that time they were still connected to the global financial system, whereas the termination of correspondent banking relationships leaves local financial firms abandoned and disconnected from financial networks (Wright, 2016).

## THE WAY FORWARD FOR ISLAND OFCS

The offshore practices considered here are not limited to island territories. But the larger, continental states engaged in offshore finance, economic citizenship schemes, or Internet gambling have these activities within a larger economy where their success or failure has less of an impact on the national economy as a whole. Similarly, the challenges confronting the offshore, and the free movement of capital in a global economy, are experienced in continental territories as well as islands. The size and scale of an island economy, however, means that these challenges may have a greater relative impact on the island. Consequently, the present moment calls for reflection on the evolution of offshore finance and the location of islands within the global financial system.

The experience of Cyprus and its banking crisis was mentioned above as a cautionary tale for the need to maintain good regulatory enforcement; and, in particular, to avoid the regulatory capture described by Demetriades which sought to maintain the island's financial business model rather than seeking to assure good banking and finance practices (Demetriades, 2017b, pp. 51-67). One could argue that the Cypriot experience is not a good representative example because this island's situation was a product of its membership in the European Union and the Euro common currency, with their regulatory framework and membership obligations. Therefore, the Cypriot OFC would not serve as a useful example or comparative case for other island OFCs, or islands considering the establishment of an OFC, because they would not be constrained by EU membership. It is a valid observation, however, the Cyprus case also demonstrates that the design of the offshore finance legal regime is important because local retail banks were allowed to serve the offshore bank business rather than keeping offshore flows segregated from the domestic economy in specialist financial firms.

To a great extent, the challenges facing an OFC today are also a reflection of regulatory enforcement of global financial governance. The OECD wants to be sure that the island OFC is implementing and rigorously enforcing the standards regarding international taxation. Similarly, large MNCs act based on perceptions of risk, perceptions that also are based on the implementation and rigorous enforcement of international standards against money laundering and terrorist finance. Notwithstanding the size of an island's bank and finance sector, it is critical that sufficient institutional capacity is committed to providing the necessary regulatory oversight.

## NOTES

1 For purposes of clarity and legal precision, tax avoidance is the legal and lawful minimization of taxes owed by adherence to the letter of the law. Tax evasion, on the other hand, involves fraudulent conduct to evade taxation by, for example, failing to report income or otherwise seeking to conceal and disguise taxable income. Corporations may also be said to pursue tax minimization by using offshore corporate entities or investing in locations where the government operates a special tax regime to encourage such investment.

2 My thanks to Wang Yong and Faye Donnelly for discussions involving this subject and their suggestions about this paper.

3 See https://www.gov.uk/tier-1-investor.

4 See https://www.gov.uk/government/statistics/shipping-fleet-statistics-2017.

5 The animated graphic accompanying the original online publication of this article remains accessible at http://archive.nytimes.com/www.nytimes.com/interactive/2010/06/08/world/middleeast/sanctions-graphic.html.

6 This section has benefited from a number of conversations in the past about Mauritius with Donne Lee and Terry Barringer.

7 One alternative list of 'tax havens and offshore financial centres' containing further African jurisdictions includes Liberia, Maldives, São Tomé e Principe, Somalia, and South Africa (Tax Justice Network, 2007). Missing from these lists are Botswana, which created an International Financial Services Centre in 2003 (https://www.gobotswana.com/sector/financial-and-business-services) and Ghana, which has created the initial structures for an OFC (Vlcek, 2011).

8 See the OECD's webpage at http://www.oecd.org/tax/automatic-exchange/crs-implementation-and-assistance/residence-citizenship-by-investment/.

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