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Offshore Strategies in Global Political Economy: Small Islands and the Case of the EU and OECD Harmful Tax Competition Initiatives

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Offshore strategies in the global political economy: Small islands and the case of the EU and OECD Harmful Tax Competition Initiatives.

The exact relationship between the state and globalisation remains one of the most vexed questions in International Political Economy (IPE). In recent years the perception of a 'borderless world' (Ohmae 1990) in which states have been emptied of their capacity to govern economic affairs has been dismissed as empirically and epistemologically suspect (see Held *et al* 1999). Though globalisation is generally accepted to have diminished their autonomy states have proved remarkably resilient evolving a 'spectrum of adjustment strategies' (Held *et al* 1999, 9; Palan and Abbott 1996) to underpin their economic competitiveness. Nowhere were the new pressures associated with globalisation felt more keenly than in small island jurisdictions whose economic viability was already threatened by diseconomies of scale, far flung overseas markets, scarce natural and human resources, vulnerability to natural catastrophes and drastic changes in global economic conditions.

Since the late 1960s many small island jurisdictions have seized upon the provision of offshore financial services to develop and diversify their fragile economies (Dommen 1980; Srinivasan 1986; Kakazu 1994; Briguglio 1995; Commonwealth Secretariat/World Bank Joint Task Force 2000). The buoyancy and dynamism of the financial services sector led one study to conclude that offshore finance had been instrumental in lifting many of the 36 island economies that currently host offshore financial centres (OFCs) 'from the poverty of the developing world to levels of affluence few would have believed within their grasp' (Hampton and Abbott 1999, 1; see also Hampton 1994, 1996a; Possekel 1996; Hampton and Christensen 2002). Others were less sanguine about this 'parasitical' (Palan and Abbott 1996, Chapter 8) strategy observing that in addition to the practical such as susceptibility to financial crime, strains on human and natural resources, and the 'capture' of the

political apparatus by vested interests (Maingot 1994, Chapter 7) its survival depended on the continued acquiescence of principal players in the global political system. By the late 1990s this support seemed to be evaporating. OFCs stood accused by leading states of a variety of misdemeanours which were undermining the stability and sanctity of the global financial system including sponsoring financial crises, allowing money laundering, undermining development by permitting the embezzlement of aid budgets, taxes and export earnings, and eroding tax bases by enabling individuals and corporations to circumvent tax laws in their home countries. The response was a phalanx of initiatives by the International Monetary Fund (IMF), the Financial Stability Forum (FSF), the Financial Action Task Force (FATF), the European Union (EU) and the Organisation for Economic Co-operation and Development (OECD), to raise supervisory and regulatory arrangements in OFCs to internationally recognised standards. Many commentators saw this as the international community foreclosing on one of the few feasible strategies open to small island jurisdictions imperilling their competitive position in the global economy (Hampton and Levi 1999; Christensen and Hampton 1999; Sanders 2002a).

Using the example of the EU and OECD's harmful tax competition initiatives this article argues that these fears about the consequences of these international initiatives are, for the most part, overstated and OFCs remain a workable option for small island jurisdictions. The reasons for this lie in the existing literature on small states. First, offshore finance is intrinsic to the economic strategies pursued by leading states, not least the United States of America, bestowing upon small island jurisdictions with OFCs a reservoir of 'attractive power' (Singer 1972) to exploit in their dealings with their more prominent brethren. The attractive power of small island OFCs is further bolstered by appealing to many non-state structures of power particularly

multinational business enterprises and the transnational tax planning industry. Proposals to clampdown on OFCs are likely to be squashed or significantly diluted by resistance from these powerful interest groups. Second, as Katzenstein (1985) has argued the performance of small states can be aided by the creativity and flexibility of their governing institutions. The governments of some small island jurisdictions have proved extraordinarily adroit at spotting and creating niches in global financial markets and supplying an atmosphere in which financial entrepreneurs are free to engineer products tailored to the requirements of transnational capital.

Offshore finance and harmful tax competition

An OFC 'hosts financial activities that are separated from major regulating units (states) by geography and/or legislation' (Hampton 1996a, 4). Typically OFCs offer an combination of low tax rates and light touch regulatory regimes wedded to stringent secrecy laws which preclude the beneficiaries of assets being identified. The last 30 years have witnessed a rapid expansion in offshore financial activity. Over 100 jurisdictions (Palan and Abbott 1996; Organisation for Economic Cooperation and Development 1998; Errico and Musalem 1999; Financial Stability Forum 2000; US State Department 2000) tender offshore financial services controlling combined assets worth $11.5 trillion (Tax Justice Network 2005b). Hampton (1996b) contends this blossoming offshore sector is consequent upon the existence of four 'spaces': political, regulatory, fiscal and secrecy spaces. Political space refers to the extent to which the domestic polity and the international community support the development of OFCs. Domestically the peculiarities of some small islands in having weak political institutions and lacking sources of critical comment such as a free press and academic institutions supplied a tranquil environment in which OFCs could be forged. Internationally, leading

states and international institutions adopted a largely benign attitude towards OFCs with some actively promoting them as avenues for development. The manoeuvrability conferred by political space permits small island jurisdictions to enact the inducements emblematic of OFCs. Fiscal space refers to a predilection for no or low rates of taxation and permissive tax arrangements for non-residents. Regulatory space consists of lighter and more flexible regulatory rules and less onerous supervisory arrangements that reduce the costs of transacting business. Lastly, secrecy space is bestowed by uncompromising confidentiality laws prohibiting the exchange of information with other jurisdictions and complex investment vehicles making it impossible to identify the beneficiaries of assets and thwarting attempts by foreign authorities to audit and apply their tax and regulatory rules to their citizens' extraterritorial activities.

That heightened mobility has debilitated the capacity of states to levy taxes on capital has become one of the most commonly asserted nostrums in the globalisation debate (see Organisation for Economic Cooperation and Development 1991; Owens 1993; Tanzi 2001. For a more sceptical account see Swank 1998; Hobson 2003; Steinmo 2003). Proponents of this thesis posit that financial liberalisation and technological advances have erased the barriers previously inhibiting transfers of capital across national boundaries unleashing a competitive dynamic whereby states bid to attract and retain mobile capital by cutting the regulatory and fiscal burden. Liberal economists have welcomed tax competition as a means of facilitating a more favourable investment climate and restraining expenditure by otherwise profligate governments. However, the active solicitation of mobile capital by preferential tax regimes in developed countries and a proliferation of offshore jurisdictions sensitised leading states to the downsides of tax competition. National treasuries are thought to haemorrhage $255bn in tax revenue each year as High Net Worth Individuals (HNWIs) (Tax Justice Network 2005a, 1) take

advantage of the secrecy afforded by OFCs to place their assets beyond the state's prying tentacles. This figure does not include revenue sacrificed through avoidance by corporate actors or that forfeited by states so fixated by capital mobility that they refuse to increase taxes on mobile capital in fear of the outflows that would ensue. Unbridled tax competition and widespread tax avoidance by corporations and HNWIs abrogates the social contract upon which most advanced industrialised societies are based threatening to 'undermine the broad social acceptance of tax systems' (Organisation for Economic Cooperation and Development 1998, 8). Corporations are voracious consumers of public goods paid for out of general taxation. Yet, while they and HNWIs enjoy the fruits of the public purse, judicious use of offshore financial instruments means they are able to partially or totally escape their tax obligations. Dwindling tax yields from mobile capital compels states to retrench public service provision or to look elsewhere to raise revenue to cover its spending pledges. Many states have instigated taxes on consumption and less mobile factors of production to make good this shortfall resulting in a more regressive tax system impeding the pursuit of redistribution and broader social goals.

Apprehension about a ruinous race to the fiscal bottom prompted the beginnings of closure in the political space that had previously allowed OFCs to flourish. This was reflected by moves towards international action to restrict tax competition. These efforts, spearheaded by the EU and the OECD, proceed from the premise that 'harmful' tax competition exists when a jurisdiction 'combines low or no rates of taxation on foreign owned assets with legal or administrative restrictions that prevent overseas tax authorities from identifying the owners of those assets and hence levying tax upon them' (Woodward 2004a, 618). They also broadly agree that tackling harmful tax competition requires jurisdictions to improve the transparency of their

financial systems and assenting to exchange information about income earned from assets owned by non-residents with their counterparts abroad.

Initial efforts to stifle tax competition were spurred by the European single market project. From the outset, European officials harboured latent concerns about market distortions arising from capital fleeing to countries which did not exchange information or levy taxes upon income deriving from the assets of non-resident investors. This problem became manifest in 1988 following the approval of a European Directive to eliminate capital controls between member states. The European Commission's proposed solution that all member states should levy a common withholding tax on interest income earned by non-residents on savings and bonds foundered upon ideological clashes, the unwillingness of member states to surrender sovereignty, and competing national interests. Undeterred the Commission continued to examine this issue and in 1997 disclosed a new package of measures to tackle tax competition (European Commission 1997). The first element was a Code of Conduct for Business Taxation, a non-binding accord whereby member states agreed to refrain from harmful tax practices in the corporate sphere. The second aspect pertained to taxation of income on individual savings. With several countries still opposed to a withholding tax the Commission unveiled a 'co-existence model' allowing states to choose between levying a minimum withholding tax or exchanging information with other member states about savings income accruing to non-residents. After interminable horse trading a deal on the Savings Tax Directive was struck at the EU Summit in Feira in June 2000. Eleven member states agreed to exchange information whilst three others (Belgium, Luxembourg and Austria) would levy a withholding tax for seven years from the date of Directive coming into force. At the conclusion of this period these countries would join the information exchange regime. Importantly the EU announced its intention to widen the scope of the initiative by making key third countries (Switzerland, Liechtenstein, Monaco, Andorra,

San Marino and the United States) and the dependent territories of EU members (incorporating numerous small island jurisdictions) party to the Savings Tax Directive requiring them to apply 'equivalent measures' to prevent the displacement of tax avoidance to non-EU countries.

Dialogue at the OECD was borne of frustration at ponderous progress in the EU. The 1996 OECD Ministerial Meeting demanded 'measures to counter the distorting effects of harmful tax competition' (quoted in Organisation for Economic Cooperation and Development 1998, 7). Two years later the OECD Committee on Fiscal Affairs' Report, *Harmful Tax Competition: An Emerging Global Issue* (hereafter the 1998 Report), was endorsed by the OECD Council (Organisation for Economic Cooperation and Development 1998). The report distinguished two categories of tax competition: tax havens and preferential tax regimes. Tax havens and preferential tax regimes were both characterised by low or no rates of taxation, a disinclination to exchange information, a lack of transparency and the absence of substantial economic activities linked to the assets located there. The difference centred upon the fact that in tax havens low or no tax rates apply jurisdiction wide whereas preferential tax regimes exist in industrialised countries that generate sizeable revenues from taxing domestic assets but grant partial or total exemptions to non-resident investors. Signatories to the 1998 Report agreed to abolish harmful tax practices within five years. Participants were obliged to interrogate their own tax regimes and to highlight any aspects which could be construed harmful. These regimes were then subject to a peer assessment process under the auspices of the OECD's newly created Global Forum on Harmful Tax Practices which identified 47 harmful preferential tax regimes in 21 OECD countries. More controversially the 1998 Report also required the Global Forum to produce a list of non member tax havens. In contrast to the procedures followed for preferential tax regimes non-member tax havens were subjected to external scrutiny by representatives of the OECD Global

Forum. Between July 1999 and April 2000 representatives from 41 jurisdictions, including 33 small island jurisdictions, were arraigned before the Global Forum for perpetuating harmful fiscal regimes. Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino provided commitments to eliminate harmful tax practices. The remaining 35 jurisdictions were listed in the OECD's 2000 Report *Towards Global Tax Cooperation* and informed that they had until July 2001 to make a commitment to eradicate harmful tax practices by 2005. Any jurisdiction which failed to comply with this demand would appear on a list of non-cooperative tax havens and be liable to 'countermeasures' from OECD countries including the annulment of double tax treaties, the introduction of withholding taxes and compulsory information reporting for dealings taking place in these jurisdictions (Organisation for Economic Cooperation and Development 2000, 24-5).

Though some attempts were made through the Commonwealth and the Pacific Islands Forum small island jurisdictions did not articulate a collective position in regard to harmful tax competition. Nevertheless, the representatives from the many affected jurisdictions which did speak out against the proposals exhibited similar anxieties. They were particularly unhappy at being forced to conform to rules imposed by bodies in which they had no direct representation or voice and with the iniquitous prosecution of these projects prompting one Caribbean diplomat to denounce them as acts of 'fiscal colonialism' (Sanders 2002). Moreover, these initiatives seemed set to have a detrimental impact upon these territories regardless of whether they decided to conform. Capitulating to the EU and OECD's demands would necessitate signing agreements with other jurisdictions to exchange information, the systematic dismantling of privacy laws, and an embargo on investment vehicles designed to obscure the identity of beneficiaries, jeopardising the secrecy space that is the lifeblood of offshore finance. Defying the EU and OECD was an equally hazardous strategy. Failure to

commit to the OECD initiative carried with it the threat of inclusion on a list of uncooperative tax havens and countermeasures from OECD members. These impositions would curtail fiscal, regulatory and secrecy spaces, and substantially raise the cost of undertaking business in non-compliant territories. The EU did not elucidate any specific punitive measures flowing from a failure to commit to the Savings Tax Directive but rebellious dependent territories came under unbearable pressure as their former colonial masters sought to coax agreement from them. In short, as the Pacific Islands Forum (quoted in Woodward 2004b, 118) counselled, small jurisdictions confronted an unappetising choice between 'committing to the initiative (so suffering possible and immediate to long term loss of economic activity through the loss of offshore sector clients) or not providing a commitment (and suffering loss of economic activity through the imposition of defensive measures by OECD members). In either case the elements which make offshore financial tools attractive will be removed and so cause the shrinkage or closure of this sector in listed nations'.

These dilemmas were aggravated by the absence of a level field that would drastically reduce or close fiscal, regulatory and secrecy spaces in small island jurisdictions but would leave them unfettered elsewhere. Switzerland steadfastly resisted pressure to subscribe to the Savings Tax Directive and, along with Luxembourg, abstained from the OECD's 1998 Report meaning they were neither bound by its contents nor had made commitments on information exchange and transparency equivalent to those required of tax havens. Small island jurisdictions were also uneasy about the omission of other countries from the EU and OECD offensive. Hong Kong, Singapore and Dubai each maintained a noteworthy offshore presence yet were not being hounded to join the EU's Savings Tax Directive or censured in the OECD's 1998 and 2000 Reports. Small island jurisdictions believed revoking financial privacy and confidentiality laws would prompt an exodus of financial capital

towards countries that refused or were not required to tolerate such action and where it could still benefit from the shield of financial secrecy. Moreover, the iniquities existent in the initial trawl of tax havens and preferential tax regimes were carried forward into the implementation phase. Before tax havens jurisdictions could participate in the deliberations of the OECD's Global Forum on Harmful Tax Practices they had to make a commitment. This requirement fatally undermined the bargaining position of tax havens from the outset because a commitment would connote a tacit acceptance that their regime was harmful and legitimised the OECD as a suitable organ to deal with this issue (Sanders 2002b, 50-1). In contrast, OECD member states were automatically granted membership of the Forum irrespective of whether they had committed to eliminate their harmful preferential tax regimes. Unequal treatment also extended to the system of punishments and listings. It was unclear whether the OECD had the stomach to recommend sanctions against its own members should they fail to comply. Interestingly although Switzerland and Luxembourg declined to sign the 1998 and 2000 Reports they have never appeared on any of the OECD's lists of uncooperative jurisdictions. Furthermore while the 2000 Report envisages 'possible countermeasures…..*with regard to Uncooperative tax havens*' it contains no pledge to invoke similar measures against member states with uncooperative *preferential tax regimes* (Woodward 2004a, 623-5).

Attractive power and the retrenchment of harmful tax competition projects

The EU's agreement at Feira and the publication of the OECD's 2000 Report were the high watermark of the campaign to extinguish harmful tax competition. Had these positions been sustained the outlook for OFCs in small islands would have been bleak. Fortunately from the perspective of small

islands implementation of these measures was to be frustrated by a constellation of powerful interests. Confronted by opposition from within their own ranks and a looming impasse on harmful tax competition, the EU and the OECD were forced to retreat to salvage the whole operation.

Asphyxiating offshore finance requires 'an unprecedented degree of cooperation by states and international organisations' (Hampton and Abbott 1999, 16). The EU and the OECD expect such cooperation to be forthcoming because they deem tax competition as a straightforward collective action problem. All advanced industrialised countries are perceived to confront an identical dilemma, namely the erosion of tax bases resulting from tax competition, and therefore have a common interest in stymieing this phenomenon. In reality, the predilections of states regarding levels and composition of taxation, the extent to which tax planning is viewed as legitimate exercise, and hence their attitude towards OFCs and tax competition vary enormously (Sharman 2004; Webb 2004). For states which rely on offshore flows to fund trade and government deficits, whose societies are predisposed towards financial privacy, and for whom multinational corporations are highly significant for their economic wellbeing small islands with OFCs are indispensable conferring upon them considerable attractive power. Fortunately for small island OFCs the economic strategies pursued by core economies, not least the United States in recent decades, would be unsustainable without a steady flow of offshore money. Offshore finance has provided a relatively inexpensive means of financing chronic trade and budget deficits. The policies followed by United States' administrations in the 1980s and 1990s including abolishing withholding taxes, allowing states including Colorado, Delaware, Nevada and Montana to persist in offering 'Swiss style' secrecy provisions for foreign business incorporation and foreign capital depositories, and pressure from Washington to get states to relinquish capital controls made the country a magnet for foreign investors (Hutton 2002).

These tactics alongside the USA's low rates of taxation and strict privacy laws have lured over $9trillion of overseas investment making it the world's largest tax haven (Mitchell 2001). Given the present administrations' seemingly insatiable craving for military adventure, inveterate tax cutting instincts, and growing social security commitments some observers forecast the federal budget deficit to rise to $2.4trillion in the next decade. To finance a debt of this magnitude the USA must convince the world's investors, mainly from overseas, to lend it $4bn net every day (Bush 2004). In short, the United States and many other deficit countries in the OECD such as the UK and Australia 'would not be able to afford the cost of lost investment that would inevitably follow any international crackdown (on OFCs)' (Palan and Abbott 1996, 174). The attractiveness of small island OFCs would begin to create fissures amongst the alliance of states which had triumphed in the initial battles on tax competition.

A second source of attractive power stems from non-state actors which, for a variety of reasons, wished to see the perpetuity of OFCs in small islands. First, transnational corporations, reminiscent of the states from which they hail, make extensive use of the instruments offered by OFCs. According to one survey nearly a quarter of Fortune 500 companies paid no net tax in the United States in 1998 (Mitchell et.al. 2002, 6) whilst another reported that tax havens account for 26% of the assets and 31% of the profits of United States' multinationals (Hines and Rice 1994). In many advanced industrialised states these enterprises, abetted by the transnational tax planning industry that has evolved to service their requirements, have lobbied frenetically and made generous contributions to political parties in the hope of preserving the status quo (Mitchell 2002, 18). The second set of opponents were civil society groups afraid that the derogation of financial privacy would result in the unwarranted interference of the state into the private affairs of citizens removing an indispensable bulwark of individual freedom. These groups were not

particularly concerned with the economic fate of small islands except to the extent that the imminent denouement for OFCs would force the repatriation of funds onshore where they would be under the state's watchful gaze. They were more anxious that if small states and small islands could be browbeaten into accepting financial transparency it would trigger a domino effect whereby all governments would seek to apply these principles in their own regimes. Stultifying initiatives in small states and small islands was seen as a prerequisite for forestalling future developments in advanced industrialised states. Financial communities in countries such as Switzerland, Luxembourg, Liechtenstein and Austria that had pioneered financial confidentiality articulated their opposition through their entrenched positions in the governing structures of those nations. Opposition to the plans in the United States was more overt with a regiment of 40 free market think tanks marching under the masthead of the Coalition for Tax Competition finding a sympathetic audience in the newly elected Republican administration. This pattern of civil society groupings is mirrored in the international domain. For example, the OECD has long standing and formally institutionalised arrangements for ensuring that commercial viewpoints are satisfactorily incorporated into OECD decisions and discussions through the Business and Industry Advisory Committee (BIAC). Despite attempts to forge links with a greater diversity of civil society groupings the OECD remains beholden to a narrow range of pro-market interests originating from the developed world (Woodward 2004b, 119-21). Nowhere is this better illustrated than in the field of tax competition where dissenting groups have been excluded from OECD discussions (Webb 2004, 811-2).

These debates would have severe repercussions for the harmful tax competition initiatives. The OECD initiative was especially vulnerable because its authority is operationalised primarily through non-binding 'soft law' instruments. The success of these instruments depends critically upon

appeasing dissenting factions. Displeasure voiced by BIAC weakened OECD resolve and began to move it away from its original objectives (Webb 2004). The first outward signs of difficulties for the OECD came in May 2001 when United States' Treasury Secretary, Paul O'Neill, though underscoring their commitment to the principles of transparency and information exchange, condemned the iniquities of the initiative and the notion that the absence of substantial business activities were prima facie evidence for the existence of harmful tax practices (US Treasury Department 2001). The outrage of Switzerland, Luxembourg and small non-member states were embarrassments for the OECD but opposition from the United States imperilled the entire project. Without the participation of the world's largest tax haven an agreement on tax competition would be worthless. Following intense discussions at the OECD two significant dispensations were made. First, the presence of investment unrelated to real economic activity would be retained as a criterion for identifying harmful tax practices however, it would no longer be used to determine whether a jurisdiction was *uncooperative*. This meant the OECD had ditched its insistence that countries commit to abolishing tax practices that solicited this type of investment effectively legitimising the kinds of tax planning based on fictional residence that the original proposals were intended to subvert. Second, countermeasures against non-member tax havens would not commence prior to action against OECD member states with preferential tax regimes. This concession brought the harmful tax competition project to a stalemate. Today, all small island jurisdictions bar the Marshall Islands have committed to exchange information and improve the transparency of their tax regimes but the implacable opposition all OECD countries to do the same means these undertakings are 'virtually meaningless' (Centre for Freedom and Prosperity 2002). Moves against tax haven jurisdictions by OECD countries are precluded unless they all abandon harmful tax practices or show a proclivity to commence countermeasures

against fellow members. Such a scenario appears unlikely. Prosaic statements from the OECD referring to 'cooperation' and 'progress' cannot disguise the fact that at the beginning of 2006 the project is little further advanced than in 2002. There has been a perceptible softening in the OECD's rhetoric with 'tax havens' becoming 'participating partners' and the pursuit of 'harmful tax competition' being progressively displaced by demands for 'fiscal transparency'. Of the 47 preferential tax regimes identified in OECD countries 44 have been abolished, amended or found not to be harmful (Organisation for Economic Cooperation and Development 2004, 5-9). Finally, 'virtually all the participants reaffirmed their commitments to the principles underlying the exchange of information standard' at a meeting of the OECD Global Forum on Taxation held in Ottawa in October 2003 (Organisation for Economic Cooperation and Development 2004, 12). Nevertheless, the assent of '*virtually* all' participants is insufficient for further progress. Further Global Forum meetings dedicated to the level playing field issue were held in Berlin (June 2004) and Melbourne (November 2005) but failed to reach a resolution. Indeed the dissenters have grown in number with Austria, Portugal, Belgium and the US joining the perennial malcontents Switzerland and Luxembourg in impeding the initiative (Centre for Freedom and Prosperity 2005). Until this deadlock is resolved tax havens are free to prop open their secrecy spaces for the benefit of international capital.

The EU meanwhile had coaxed, cajoled or bludgeoned several non-member states into committing to the Savings Tax Directive. Nevertheless it continued to encounter trenchant opposition from the Cayman Islands, the US, and Switzerland without whose participation the deal would crumble. The Cayman Islands resistance was ultimately futile because the UK government could legislate to force them to comply if they would not do so voluntarily. The standoff with the US ended with the EU's announcement in December 2002 that the requirement that third countries apply 'equivalent measures' to

those agreed by EU member states was 'effectively satisfied in the case of the United States of America' (European Commission 2003) despite the fact that there had been no relevant substantive changes in United States-EU tax arrangements since the Feira agreement. However, to cement Swiss approval the EU was forced, though it was careful to avoid the terminology, to regress to the co-existence model. In June 2003 the European Council adopted a Directive to come into force from 1 July 2005 offering countries a choice between exchanging information and applying a withholding tax for a transitional period. The transitional period will end when all countries accede to the information exchange protocols. Twelve EU countries plus Anguilla, Aruba, the Cayman Islands and Montserrat opted to exchange information while Luxembourg, Austria, Belgium, Switzerland and six dependent territories would levy a withholding tax of 15% until June 2008, 20% from June 2008 to June 2011, and 35% thereafter. From the perspective of small islands these were significant concessions. This 'coexistence' model is weaker than its predecessor because although information exchange remains the Directive's ultimate objective this facet of the deal only becomes active when the EU has secured a deal to exchange information under the rubric of the OECD Model Tax Agreement with Switzerland, Monaco, San Marino, Andorra and the United States. The intransigence of these jurisdictions suggests such agreements are unlikely to be forthcoming allowing the 'transitory period' to endure indefinitely leaving secrecy space unchecked. Moreover, the EU's decision to allow states to impose a withholding tax undermines the OECD's crusade for compulsory information exchange because it recognises the rights of states to uphold arrangements financial privacy. The Directive's other significant escape clause is that it applies to investments held by individuals but not to corporate investment vehicles such as trusts, limited partnerships, foundations and companies. Individual investors can elude the Directive by the simple expedient of registering as a company and taking advantage of the

special purpose vehicles on offer to corporate customers. For those that have selected to exchange information the EU Savings Tax Directive does impair secrecy space at the margins by revealing the identities of individual savers but corporate investment vehicles remain unscathed.

A bright future for small island OFCs?

The retrenchment of the EU Savings Tax Directive and the impasse vexing the OECD has not fully assuaged reservations of small islands about the effects of a crackdown on harmful tax competition. Nevertheless, there are reasons for optimism. If the attractive power of OFCs was important in halting the OECD juggernaut then a second feature of small states and small islands may help them to take advantage of harmful tax rules that are riddled with loopholes and inconsistencies. Katzenstein's (1985) study of small European states demonstrated that what they lacked in coercive military power they compensated for by 'nimble' governing institutions capable of innovative and flexible policy making. The economic openness that is a consequence of their size means that small islands are already well versed in coping with the exigencies of the globalised environment and might be said to be at something of an advantage over larger states. Equally however, because of their vulnerability the quality of their institutions becomes paramount (Brautigam and Woolcock 2001). Here it is important to draw a distinction between 'notional' and 'functional' OFCs (Hampton 1996a, 4-8). Notional OFCs are largely booking centres for financial transactions and tend to be found in jurisdictions with weaker or unrefined government machinery. These types of OFCs are easier to establish requiring only minimal legislation and regulation and little infrastructural support. Nonetheless, because they can only offer a limited range of low margin products the economic rewards are negligible. Moreover, fulfilling the information exchange requirements of the

EU and OECD would obligate the creation of elaborate regulatory machinery. Erecting a regulatory edifice capable of satiating their demands would be precluded by a chronic shortage of supervisory expertise (Briguglio *et al* 2005). Even if the requisite staff were available the extra costs of compliance with international standards may exceed the benefits accruing to the government and the island inhabitants. For these reasons a number of notional OFCs have already conceded defeat. For example, the tiny Pacific Islands of Tonga, Niue and Nauru have all repealed or drastically shorn their legislation pertaining to offshore financial services whilst the IMF (2003, 13) reports that in Vanuatu 'the offshore industry appears, at best, to have stagnated in recent years and has shown a marked decline in some sectors'.

By contrast functional OFCs offer a diverse range of financial services tailored to a sophisticated clientele underpinned by a high quality regulatory environment. These centres emerge over much longer periods of time, usually evolving from the basic notional centres, but can only exist in islands with intricate and elaborate government machinery able not only to elucidate a basic framework for the development of offshore financial services but also to respond to the changing demands of international business and the best practice requirements laid down by the likes of the EU and OECD. Such elasticity leaves functional OFCs well placed to prosper in the face of this supposed regulatory onslaught. First, paradoxically the ability and willingness of functional OFCs to accede to demands for fiscal transparency and better regulatory standards may have bolstered their competitive position. Even vociferous critics of the clampdown on tax havens concede that improving transparency has made these centres more reputable and therefore more attractive to legitimate business which does not wish to be tarnished by association with jurisdictions branded as 'unco-operative' or that appear on international blacklists (Sanders 2002a). International action to cleanse the murkier aspects of the offshore world may improve the quality of the financial

services industry making it a firmer basis for ongoing development. Despite the changes introduced as a result of the raft of international initiatives functional OFCs such as Jersey, Guernsey and the Cayman Islands have experienced robust growth across a wide variety of sectors and, although it is too early to make a concrete assessment, the banking sector in the Channel Islands appear unaffected by the implementation of the Savings Tax Directive (Cayman Islands Financial Services Association 2004; Law and Tax News.com 2005; Tax-News.com 2005; Datamonitor 2005; International Monetary Fund 2006). Rising business levels have offset expenses incurred as a result of compliance with the Savings Tax Directive which it is estimated will cost financial services providers $30m a year in the Cayman Islands alone (Cayman Islands' Financial Services Association 2004). There is some anecdotal evidence that jurisdictions lying outside the remit of the EU and OECD such as Singapore and Hong Kong have gained some funds at the expense of small island OFCs and that the overall numbers of financial institutions, especially in Caribbean centres, is falling. However, these many analysts believe these declines should be attributed to the inherent dynamism of, and ongoing consolidation in, the financial services industry, rather than the impact of international initiatives (Rawlings 2004). Second, the messy compromises brokered by the EU and OECD have resulted in a piecemeal regime for governing tax competition. This is an ideal environment for cultivating offshore finance engendering endless opportunities for functional OFCs to manipulate their tax, regulatory and secrecy provisions to differentiate them from the onshore world and their offshore rivals.

Conclusion

Initially the case of harmful tax competition appears to vindicate the conventional wisdom that small island jurisdictions are powerless actors

perhaps not even worthy of serious consideration by scholars of International Relations and International Political Economy. Their economic openness exposes them to the vicissitude of global competitive forces but their lack of power precludes them from setting the agenda or actively shaping the rules which govern the rules of global commerce. Clearly their exclusion from the process of developing the rules to govern tax competition demonstrates that the offshore strategy deployed by some small island jurisdictions is precarious and continues to rely on the goodwill of leading states. As Susan Strange (1998, 132) comments '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'. However, this article has argued that such a scenario is unlikely in the foreseeable future. Just as small islands have made the supply of offshore finance a core strategy to fortify their competitive position so many powerful actors including large states and multinational enterprises have done the same but as consumers of offshore services. Without the continuous supply of cheap offshore funds and the provision of offshore investment vehicles their economic strategies would be unsustainable. Though small islands are unable to drive the agenda the attractive power yielded as a consequence of their usefulness to more powerful actors ought to shield them future harm and ensure the survival of the offshore strategy. This will be particularly the case in those small islands with efficient and effective government machinery accomplished in evolving to the needs of their clientele, enacting changes required to meet international standards of best practice, and manufacturing niches out of the untidy compromises that are emblematic of global financial governance. This ceaseless capacity for innovation, their new found reputation as diligent citizens of the global

financial community, and the sanctuary afforded by the dependence of powerful actors on offshore finance seems set to ensure their survival in the years ahead.

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