THE PROSPECTS FOR OFFSHORE FINANCIAL CENTRES IN EUROPE

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EXECUTIVE SUMMARY

Since 1998, a considerable amount of attention has been devoted to offshore financial centres (OFCs). Little is known, however, about OFCs and the business environment in which they operate. The aim of this paper is therefore to increase the awareness of OFCs. It provides a critical assessment of the various initiatives targeting OFCs and a first in-depth overview and comparison of European OFCs.

The international actions targeting OFCs are partly motivated out of genuine concerns. Onshore countries fear that OFCs may erode their tax bases. They also claim that OFCs may offer a safe harbour for money launderers. Finally, it is claimed that OFCs endanger international financial stability. As a result, OFCs have faced "attacks" from the OECD on tax matters, from the Financial Action Task Force (FATF) on money laundering and the Financial Stability Forum (FSF). In addition, European OFCs are being pressured by the European Union (EU) to engage in automatic exchange of information in the context of current negotiations on the directive concerning the taxation of savings income.

At the same time, however, international actions aimed at curbing OFCs also have to be read through the prism of the cut-throat competition between financial centres for the location of lucrative financial services. Over the last 20 years, OFCs have managed to carve out a sizeable market share in private wealth management. While the world's roughly 70 OFCs only make up 1.2% of the world's population and 3.1% of the world's GDP, they are managing one-quarter of the world's assets. At the end of 1997, OFCs' share of cross-border assets stood at 54.2%, growing at an annual rate of over 6%.[1] The sum of bank deposits and funds under management in the European OFCs surveyed in this paper alone exceeds €800 billion. In that context, the main beneficiaries of curbing them will be the leading onshore financial centres, primarily the City of London and New York. It is therefore not surprising that the UK and the US have championed these policy actions and one can reasonably question the sincerity of their support.

The strength of the international action varies from issue to issue and depends on the validity of the underlying argument. On money laundering and financial stability, the recommendations have been more or less swiftly implemented by the OFCs, as the norms and principles underpinning these areas were relatively widely shared. On tax matters, things have progressed much more slowly. One of the reasons is that the underlying economic case is weaker. There is no empirical evidence supporting the claim that OFCs contribute to a "race to the bottom" in tax revenues, as these remain stable. There is also little conclusive evidence regarding a shift in the burden of taxation from mobile tax bases (capital) to immobile ones (labour). The OECD's and the EU's attempts to curb OFCs therefore rely on relatively unstable foundations. Moreover, the process has been marred by disagreements among OECD members and changes in the assessment criteria.

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[1] Walter (1998) and IMF (1999).

The events of 11 September have provided a new momentum to the international actions targeting OFCs. Any remaining doubts about the merits of the FATF's recommendations quickly evaporated, as OFCs and onshore jurisdictions raced against one another to avoid having their reputations tarnished from any association with the act of harbouring money connected with terrorist activities. This same concern over their reputation has convinced a majority of the blacklisted OFCs to start cooperating with the OECD.

The outlook for OFCs therefore looks rather bleak, as the FATF has decreased OFCs' regulatory advantage, and the OECD has taken one step further towards curbing OFCs' tax advantages. This is particularly true for European OFCs, which in addition to global demands, are faced with requests from the EU for action in two areas:

1. *Taxation.* The EU agreement on the taxation of savings income is dependent upon European OFCs imposing equivalent or similar measures to the ones envisaged by EU members. While little is known about the current status of negotiations between the EU and the OFCs, the advance of the OECD process will not harm the EU's position.
2. *Financial regulation.* The constitutional links between the EU and European OFCs vary widely. All of them are, however, not entirely free to develop their own regulatory framework as they see fit. In some cases, the impact is direct. Madeira, for example, is an integral part of Portugal and thus operates under EU single market rules. Similarly, the UK's dependent territories, the Channel Islands and the Isle of Man, often have to maintain financial regulations that match the standards in the UK, and the UK has to follow EU laws. Liechtenstein, being a member of the European Economic Area (EEA), is also obliged to enact a vast array of Single Market legislation without having a say on its content. In short, the EU's Single Market programme in one way or another affects the margin of freedom enjoyed by European OFCs.

Therefore, OFCs in general and EU OFCs in particular will find it increasingly difficult to defend their regulatory and tax advantages. In particular:

1. *FATF and the FSF.* OFCs should increase the amount of resources devoted to financial supervision and enforcement; know-your-customer rules should be strictly enforced, money laundering legislation should be kept up-to-date with FATF standards; and OFCs should rapidly implement the FATF's recent measures on terrorism financing.
2. *OECD.* OFCs should cooperate with the OECD, provided that a true level playing field is established. That would require OECD members (e.g. Switzerland and Luxembourg) to accelerate the dismantling of their harmful tax measures.
3. *EU savings tax.* The EU is already finding it difficult to convince European OFCs to implement similar measures to those adopted by member states. Advances in the OECD process is likely to be of limited importance to the EU process, as the EU demands automatic information exchange, and not just the supply of information in response to a specific request from a foreign tax administration. The reaction of European OFCs is entirely comprehensible. The only reason why the EU is engaged in negotiations is that it was the only way to persuade Luxembourg (and to some extent Austria) to agree on information exchange. A sensible compromise solution

would be that OFCs permanently introduce the same system that Luxembourg and Austria will have on an interim basis, i.e. withholding taxes of 15-20% coupled with transferring 75% of the revenue to the member state of residence of the investor. That is an offer that the EU would find hard to refuse.

In the medium to long term, OFCs should try to expand into other fields of business that depend less on low taxes and lenient regulation, but it should be recognised that this is a process that takes time and requires assistance. By virtue of their small size and flexibility, OFCs are nevertheless well placed to reap the opportunities that such a changeover implies.

INTRODUCTION

Offshore financial centres (OFCs) have received much attention over the last few years. The reasons are manifold. Not only are OFCs regarded as eroding the tax base of onshore countries and providing a convenient means to clean proceeds from crime, they are also thought to pose a threat to the world financial system due to their alleged unregulated and unsupervised financial activities and services.

Prior to the events of September 11, the international initiatives that tried to curb the actions of OFCs seemed to have lost much of their momentum. The attacks, however, have re-ignited international action on tax havens and offshore financial centres launched by various different international organisations including the EU, the OECD, the Financial Action Task Force (FATF) and the Financial Stability Forum (FSF). Nevertheless, the problems encountered in the course of these efforts to curb offshore activities illustrate the underlying difficulty of creating and sustaining international coordination in the sphere of international finance and tax.

The reasons why offshore centres are the focus of policy attention are manifold. OFCs have expanded rapidly during the last decades, both in number and in volume of business. OFCs have managed to attract a large share of the world's financial activity. While the worlds roughly 70 OFCs only make up 1.2% of the world's population and 3.1% of the world's GDP, OFCs are managing one-quarter of the world's assets. At the end of 1997, their share of cross-border assets stood at 54.2%, growing at an annual rate of over 6%.[2] Low taxes, light regulation, flexible company rules and high levels of secrecy are part of the explanation behind their success. Another explanation lies in the new opportunities offered by information technology. Thanks to information technology, OFCs may capture far vaster chunks of lucrative financial services.

As OFCs have expanded, onshore countries have started to cooperate in order to curb them. The first purpose of this paper is to explain how this cooperation has come about and to assess whether it will endure. A second purpose is to raise the awareness and understanding of offshore centres. No comparative outlook on European OFCs exists to date. The paper will concentrate on a number of questions: what are the characteristics of an OFC; why are they successful; why and how are they criticised; do the states that are criticising offshore centres have a legitimate case; what should OFCs do?

The paper starts by tracing the evolution of OFCs and depicting their main characteristics and current size. Chapter 2 presents the foundations of international policy cooperation and the major concerns raised by the activity of OFCs, namely the threat to financial stability, money laundering and harmful tax competition. Chapter 3 surveys a cross-section of European OFCs. And finally, Chapter 4 offers a tentative policy outlook, attempting to judge the prospects for OFCs in this increasingly hostile international environment.

[2] Walter (1998) and IMF (1999).

CHAPTER 1
THE RISE OF OFFSHORE FINANCIAL CENTRES

Offshore financial centres are not homogeneous entities. While attracting the same kind of business, i.e. wealth management or other tailor-made services for the rich but not so famous, they nevertheless differ according to their regulation, taxation and use of secrecy. This section presents the main characteristics of the offshore business: definition, size, specialisation and the various benefits they offer to investors, as well as the overall trends affecting the offshore segment of financial markets.

1.1 OFCs defined

Financial centres differ widely one from another and there are many ways of distinguishing between them. One can distinguish, for example, between *functional* centres, where the financial sector is serving a dynamic real economy, and *booking* centres, which mainly serve as intermediaries for transactions where the underlying value is created elsewhere.[3] Another way could be to define what counts as offshore business in any OFC and then to calculate the share of GDP accounted for by these services. Yet another way of distinguishing among OFCs has been developed by the IMF[4] in which financial centres are divided into three categories:

- *International financial centres (IFCs)* are characterised by deep and liquid markets with diverse sources and uses of funds, with advanced payments and settlements systems, which provide a full range of financial services to large domestic economies and beyond (e.g. London, New York and Tokyo).
- *Regional financial centres (RFCs)* feature developed financial markets and infrastructure, channel funds in and out of their regions, but are associated with relatively small domestic economies (e.g. Hong Kong, Singapore and Luxembourg).
- *Offshore financial centres (OFCs)* are much smaller and provide more limited specialist services.

This division may not be as clear-cut as it first seems. Some of the larger OFCs resemble the RFCs in certain respects, implying that it is difficult to define OFCs with a great degree of precision. However, OFCs normally combine some of the following characteristics: a high number of financial institutions that mainly serve non-residents, financial systems out of proportion with the domestic economy's needs, low or no taxes, light financial supervision and regulation, flexible use of different company structures, and high levels of bank secrecy and anonymity.

In short, when speaking about OFCs, this paper refers to countries or territories where the financial sector is large as compared to the domestic economy, moderately regulated, taxed at a low level and providing services mainly to non-residents.

[3] Walter (1998).

[4] IMF (2000b).

1.2 From humble beginnings to a flourishing industry

The offshore industry started to grow in the 1960s. The introduction of burdensome regulation and distortionary economic policies in industrialised countries in the 1960s – such as capital controls, interest-rate ceilings, reserve requirements, restrictions on the kind of activities that supervised institutions were allowed to undertake and high levels of taxation – led to a boost in offshore business. The most prominent early starters in Europe were Luxembourg and the Channel Islands. Today, the IMF estimates the number of OFCs at around 70.[5]

As can be seen from Table 1, the offshore finance industry is large. As a simple indication of its relative importance, the value of assets managed by OFCs was more than ten times the value of global foreign direct investment in 1998; nearly two times the value of world trade and roughly one-third the turnover value on the world's leading stock exchanges.

Nevertheless, measuring the size of OFCs is difficult, as they do not disclose much data. Only the largest OFCs (e.g. Hong Kong and Singapore) report bank data to the Bank for International Settlements (BIS). None of the European OFCs does, even though Liechtenstein by virtue of its currency union is included in Switzerland's filings with the BIS. In addition, the data do not cover over-the-counter (OTC) activity, or other financial institutions than banks. Therefore, OFC data should be regarded with a healthy dose of scepticism.

Table 1. Offshore financial centres in perspective

Activity	Size ($ bn)
Global assets under management in OFCs, 1998	7,500
World trade 1998 (exports)	4,200
FDI 1998 (inflows)	644

Source: Eurostat trade database, UNCTAD (1999) and Walter (1998).

1.3 Benefits to users and hosts

On the *demand* side, the main users of OFCs can be found among wealthy, high net-worth individuals, international companies, international investors and criminals. Their aim is generally to maximise the return on their assets by minimising the costs emanating from taxes, control and regulation. Table 2 provides a general overview of the main users and the benefits they derive from investing in an OFC.

Turning to *supply*, countries might choose to establish an OFC for a number of reasons. The primary reason is *income*. Even though fees and taxes are by definition low, they represent the major source of government revenue in the most OFCs. In addition, a country might want to *gain access to international capital markets*. For developing countries an OFC may be a convenient way to tap world markets. Second, they may want to *attract foreign technical expertise*. The benefits from an OFC are analogous to those deriving from foreign direct investment; the arrival of large multinational banks

[5] IMF (2000a).

also means the arrival of know-how. Moreover, they may want to *harness competition*. An OFC may provide a convenient way to increase competition in the financial sector while at the same time providing shelter to domestic financial institutions. Finally, a country may want to *reap indirect gains*: apart from know-how, other positive effects may be an increase in the level of employment and an increase in wages.

Table 2. The benefits from using OFCs

Actor	Benefits
International companies	• Maximise profits • Issue securitised products through special purpose vehicles • Protect assets from claimants
Investors (individuals, funds, trusts …)	• Minimise taxes • Protect assets from claimants • Avoid disclosing investment positions
Financial institutions with affiliates in OFCs	• Minimise taxes • Avoid regulatory requirements in onshore jurisdictions
Insurance companies	• Accumulate reserves in low-tax jurisdictions • Conduct business in benign regulatory environment
Criminals	• Launder proceeds from crime • Use local secrecy as protection against inquiries • Commit financial fraud

Source: Adapted from Financial Stability Forum (2000a).

As a consequence, the establishment of an OFC has sometimes been regarded as a proper *development strategy* for small states. The establishment of an OFC may indeed lead to a rapid sophistication of the financial industry and increased growth. Supported and protected by the legal framework of the state system, countries have been able to design regimes targeted at attracting wealth generated elsewhere. The effects may be direct, in terms of the tax or fee revenues from the institutions that locate in the OFC or the employment opportunities and income taxes paid by their employees. They may also be indirect in terms of the supporting sectors that are built up to serve the OFCs (associated professions, catering, hotels, etc.). This does not happen by itself however. The OFC business, by targeting non-residents only, may if not properly organised develop into a cocoon within the economy, crowding out alternative economic activity.[6] This might make a country too dependent upon one particular activity. Therefore, reaping the gains from an OFC requires active government intervention.

In addition, it would be naïve to think that the establishment of an OFC is always driven by such altruistic developmental considerations. For many cash-strapped governments, an OFC offers quick access to money (the fewer questions the government is willing to ask, the more lucrative the OFC promises to be). It is therefore more appropriate to say

[6] Hampton and Abbott (1999).

that there is a development dimension to OFCs. A financial centre can offer significant benefits to poor countries (or their governments) and *may under certain conditions* offer a short cut to a more rapid economic development.

1.4 A deteriorating business climate

At first glance, the outlook for OFCs from a purely business point of view looks bright. The assets of wealthy investors in the world are estimated to be worth more than $30 trillion by 2004. The growth in investable assets is particularly fast for people under 35 and for particular countries, such as the United States, Britain and France.

While offshore growth has long outpaced onshore growth in terms of assets, recent trends portray a shift in fortunes. According to a recent survey by PricewaterhouseCoopers, one can start to see a *move back onshore*, as offshore markets have started to fall behind onshore markets both in terms of asset and revenue growth.[7] This is a reflection of the fact that it is becoming increasingly difficult to hide wealth offshore. It is also caused by a more hands-on investment approach by investors. Information technology in general and the Internet in particular have increased the amount of financial information available to individual investors. This development, in turn, has encouraged investors to become more active in their portfolio management and less reliant on their private bankers. For example, it is estimated that among wealthy Europeans, more than 50% are using online brokers and 20% use Internet banking. This is expected to increase as information technology develops further (e.g. UMTS).[8] As a result, customers are becoming more demanding. They require higher returns that are typically only associated with equity. And because investments in equity tend to earn higher returns if the analysts are closer to major financial centres, it is more difficult for OFCs to compete in this area. The traditional comparative advantage of OFCs – discretion, no taxes – is of lesser importance in this domain.

A further contributing factor is that onshore regulation has become more market-driven and less burdensome. The tax pressure has decreased in many countries and markets have become deeper and more liquid. This is especially the case in the EU, following the introduction of the euro. As a consequence, investors have less reason to seek refuge in OFCs.

Furthermore, brand value is among the attributes highlighted as one of the most important determinants in the competition for customers. Offshore centres, characterised by anonymity, small size, small markets and limited services, and in light of ongoing international initiatives that threaten to tarnish their reputations, are finding it more difficult to grow in this environment.

So far, OFCs have responded by broadening the services they offer. The Channel Islands, for example, have created a stock exchange in order to provide deeper and more liquid securities markets. Many OFCs are currently investing heavily in telecommunications and are developing laws that will attract e-commerce providers.

[7] PricewaterhouseCoopers (2001).

[8] Booz Allen (2001).

1.5 Unilateral attempts to handle low-tax jurisdictions[9]

As OFCs have increased in importance, countries have tried to limits their companies' and individuals' ability to use OFCs and thus escape domestic taxation. These unilateral attempts to limit the use of OFCs have taken many forms:

- *General anti-avoidance measures*. Most countries have either explicit rules or unwritten principles that allow authorities to question operations that at the outset appear legal but whose purpose are to avoid taxes. The efficacy of these rules are often called into question, especially in light of the fact that it is often difficult for tax administrators to prove fraud or the fictitious nature of a particular international operation.
- *Measures against "thin capitalisation"*. Companies can normally deduct interest expenses from their taxable income, thus diminishing the taxable base. It is therefore interesting for companies to maximise their holdings of debt instruments as opposed to equity capital. In order to stem abuses of the deductibility of interest, most countries have rules on thin capitalisation, stating that the ratio of debt to equity should not exceed a certain percentage. Most countries have such provisions for subsidiaries located in OFCs as well.
- *Audit transfer prices*. According to OECD principles, transfer prices between associated companies are supposed to take place at "arm's length", i.e. as if the transaction took place between two independent companies at market prices. This leaves plenty of scope for transfer-pricing manipulation by companies, which have an interest in placing as much value as possible in an OFC where no corporate taxes are levied. Some countries have particular rules preventing such abuse.
- *CFC rules*. Since most countries tax residents on their world-wide income but treat non-resident companies separately for tax purposes, residents can avoid or defer taxation if they place income in a foreign corporation. Such behaviour is particularly lucrative if the foreign corporation is placed in an OFC. Rules on Controlled Foreign Corporations (CFCs) serve the purpose of limiting such avoidance or deferral. As a result, countries applying CFC legislation tend to regard deferral as unacceptable if a) residents control or have a substantial interest in a foreign corporation, b) the income placed in the foreign corporation is primarily "passive" – e.g. income from royalties, dividends, rents and interest – and not genuine business income, and c) the income is taxed at a zero or low foreign rate. First imposed by the US in 1962, CFC rules are imposed today by nearly all OECD members.
- *Taxation conventions.* Tax conventions serve the laudable purpose of eliminating double taxation. They can be abused, however, by residents incorporating in OFCs and then claiming exemption from high onshore taxation by virtue of a double tax convention. In order to limit such opportunities, most onshore companies have not concluded conventions with OFCs (see Table 8b in Chapter 3). Exceptions are countries with historical ties (e.g. the Netherlands and the United Kingdom) or geographical proximity (e.g. Liechtenstein's links with Austria and Switzerland or Monaco's links with France). As elaborated below, those countries have

[9] This section builds heavily on IFA (2001).

nevertheless tried to limit the application of these conventions (e.g. excluding its application to tax exempt companies).

Apart from these measures that are generally are followed by most countries, some countries have been particularly active in dealing with OFCs.

United Kingdom

During the 1990s, the UK reviewed financial regulation in its Crown dependencies (Channel Islands and Isle of Man) and Overseas Territories (13 jurisdictions, formerly known as dependent territories mainly located in the Caribbean, but also including Gibraltar). Following increasing awareness that the UK was losing a sizeable chunk of tax revenue, over £1 billion a year according to estimations by the Inland Revenue, the UK began to exert pressure on these jurisdictions to change their tax regimes.

In the wake of criticism from international investors following a 1993 bank failure in Jersey and allegations of secrecy, poor supervision and poor cooperation, the UK decided in 1997 to launch an investigation of financial regulation in the Crown Dependencies, known as the Edwards Review after the chairman, Andrew Edwards. Its results were released in November 1998.[10]

Chairman Edwards did not see any reason for a major overhaul of the UK's financial regulation. He concluded that the dependencies are in the top division of OFCs, finding that they have a reputation for "stability, integrity, professionalism, competence and good regulation".[11] Nevertheless, the report delivers a vast array of recommendations, ranging from the creation of a financial ombudsman to strengthening the regulation of companies and disclosing more information.

The UK Inland Revenue has targeted so-called "designer regimes" in OFCs. These regimes are specifically designed to enable companies to fit into tax-exempt categories onshore by establishing a corporate shell offshore. Therefore, so-called controlled foreign companies will no longer be able to avoid taxes at home. While the effectiveness of these measures has been called into doubt, it is another signal that the UK government is less tolerant of certain forms of OFC activity.

In 1997, the National Audit Office argued that the UK might be exposed to certain risks emanating from among other things poor financial regulation and supervision in certain Overseas Territories.[12] As a response, the then Foreign Secretary Robin Cook undertook a far-reaching review of the relationship between the UK and its Overseas Territories.[13] The aim was to insure that these OFCs continue to flourish "on the basis of compliance with standards and practices consistent with international norms". The report strongly urged the territories to ensure that their financial regulation meets international standards. More specifically, Overseas Territories should implement measures to combat money laundering, provide regulators and law enforcers with adequate powers so that they can fully cooperate with their overseas counterparts on issues of

[10] UK Home Office (1998).

[11] Ibid.

[12] UK National Audit Office (1997).

[13] UK Foreign and Commonwealth Office (1999).

investigation and enforcement, implement licensing and reporting requirements that ensure fair competition and establish independent regulatory authorities. The government commissioned KPMG, the audit and consultancy company, to carry out a survey of the state of financial regulation in these territories. Since its publication in October 2000:

- all territories have adopted comprehensive anti-money laundering legislation;
- independent regulatory authorities have been established e.g. in Bermuda and the British Virgin Islands and one is being launched in the Cayman Islands; and
- all Overseas Territories are able to share information with foreign regulators (the exception being Anguilla).[14]

The government's efforts to bring its OFCs into line was somewhat undermined when an investigation by the Swiss Federal Banking Commission (SFBC) into the role of Swiss banks in the laundering of proceeds from the late Nigerian dictator Sani Abacha revealed that banks located in London had played a key role.[15] Three specific facts made the story embarrassing in particular for the British government: 1) the story was revealed by the SFBC and not the FSA; 2) the British authorities were very slow off the mark in assisting Nigerian supervisors and 3) the OFCs targeted by the British government and the international community, e.g. Liechtenstein and Jersey, by contrast, quickly assisted the Nigerian supervisors and froze a number of accounts.

The Netherlands

The Netherlands has restructured its fiscal relations with the Netherlands Antilles and Aruba. In the course of work on the Code of Conduct, the Netherlands reported its dependencies' intention to "free themselves of the tax haven image". In this respect, the parliament of the Netherlands Antilles enacted the New Fiscal Framework (NFF)., which abolished the distinction between offshore and onshore companies and introduced a flat 34.5% corporate income tax and a 10% withholding tax, among other measures. The new regime aims at achieving transparency, no ring fencing and clearly defined information exchange.[16]

The law entered into force in January 2001. Although the offshore regime was abolished, a grandfather clause ensures that companies set up before 2001 will continue to benefit from tax benefits at least until 2019, and exempted companies will continue to exist.

The United States

Long before the events of 11 September, the US was a driving force behind the increasing focus of attention on offshore financial centres. It was the US that initiated closer scrutiny of the Caribbean OFCs and lobbied hard in the various international organisations active in this field. The reasons for the US interest are related to drug trafficking and terrorism. In its efforts to stem drug abuse and root out terrorism, the US

[14] UK Treasury Assessment, May 2002.

[15] Swiss Federal Banking Commission (2000).

[16] Council of the European Union (1999).

found it effective to make it more difficult for terrorists or drug cartels to raise revenues or to process their revenues by inserting them into the financial system.

Under the Clinton administration, the US concentrated its attention on two issues: tax evasion and money laundering. On *tax evasion*, it acted externally and internally. And externally, it has acted both unilaterally and multilaterally. Early on, the US made known its irritation over the presence of tax havens, or OFCs, in the Caribbean. The US Internal Revenue Service (IRS) successfully convinced foreign banks to become "qualified intermediaries", i.e. to act on behalf of the IRS in collecting taxes from US clients. The US has concluded over 60 bilateral tax treaties that provide for information exchange[17], and has combined these measures with multilateral cooperation in the context of the OECD. Internally, they have tried to modify the "deferral" behaviour of US firms, i.e. not sending home profits from foreign affiliates in order to avoid taxation. The US has also introduced legislation on controlled foreign companies. Under this legislation, the tax authorities may force a foreign subsidiary to repatriate its profits if it believes that the subsidiary is only used for tax purposes.

Box 1. The collapse of Enron – Hiding profits and losses offshore

In the wake of the collapse of Enron, it was discovered that the energy trader had pursued an aggressive tax-planning strategy. This strategy had a common thread with Enron's creative accounting, which consisted of hiding a substantial part of the company's assets off the balance sheet in various controlled corporations. In the field of taxation, this meant an extensive use of subsidiaries and branches incorporated offshore.

According to research done by Citizens for Tax Justice, a well respected if partisan (labour movement) association, Enron paid no income tax in four of the last five years. Instead, it placed its supposedly taxable profits in 881 subsidiaries in tax havens (692 in the Cayman Islands, 119 in the Turks and Caicos, 43 in Mauritius and 8 in Bermuda).

Enron used a common technique among onshore companies; i.e. directing profits to an offshore partner which, after levying a fee, returns the profit onshore in a format that is not taxable according to onshore tax laws. An additional reason for Enron's extensive use of tax havens was that it allowed the company to make deductions for share options. By placing the cost of these options offshore, Enron's onshore balance sheet was not affected.

Enron is not the only big American company not paying corporate taxes. In 1996, 16 out of half of the Fortune 500 companies paid no taxes, according to research by Citizens for Tax Justice. In 1998 that number had risen to 24. Nor is it uncommon to use tax havens for tax planning purposes, as indeed this paper shows. However, the extent to which Enron planted subsidiaries in tax havens is uncommon. Eager to distance itself from Enron, energy rival Dynergy (which had been poised to take over Enron just weeks before Enron's implosion) stated on 16 January that it has no subsidiaries in tax havens. Another rival, ChevronTexaco, has three subsidiaries in tax havens while Exxon Mobil has six.

Source: Johnston (2002).

US support for curbing tax competition on a multilateral level fell significantly following the arrival of the Bush administration, at least on a rhetorical level. The US focus became more targeted on extracting agreement for information exchange with

[17] O'Neill (2001).

obstinate OFCs, which directly resulted in the summer of 2001, in the OECD dropping its requirement that companies enjoying special tax privileges exercise substantial, i.e. real, economic activity. That the OECD managed to convince 20 out of 35 jurisdictions to start a process of cooperation is probably a sign that the US administration was eventually persuaded to let concern over lost tax revenues take precedent over ideological difficulties with the OECD's attempts to impinge on jurisdictional competition.

The same difference between administrations has not been observed in the matter of *money laundering.* Even before the terrorist attacks, preventing the laundering of illicitly obtained money ranked high on the US political agenda. In 2000, US law enforcers pledged to prosecute any bank involved in money laundering no matter what its nationality or where the crime has been committed. A US bank doing business in OFCs that are suspected of money laundering has to abide by harsh regulations regarding customer checks. The US has also exerted significant pressure on Caribbean OFCs to improve their regulation and supervision concerning money laundering.

Box 2. The use of tax havens: The Foreign Sales Corporations (FSC) regime in the US

The inconsistent stance of the major nations on offshore centres is clearly illustrated by the fact that all try to attract as much wealth as possible, in some cases even with the deliberate use of OFCs. One form of this neo-mercantilist competition is exports, where states try to find legitimate ways of stimulating the sale of goods abroad. The US Foreign Sales Corporations (FSC) scheme is a good example.

The US, unlike most other states, applies the principle of extraterritorial taxation by which all income earned by US companies around the world should be taxed. The EU, on the other hand, applies the territorial principle, which only taxes income earned within the EU. The US has tried to alleviate the competitive disadvantage by making exemptions to the general rule.

One of these exemptions is the FSC. The FSC exempts a portion of the income of offshore subsidiaries (FSCs) of US companies from US income tax. If these subsidiaries base themselves in a tax haven, the US parent company reduces its tax bill. The gains are substantial. The reduction of the tax burden is estimated at between 15 to 30%. The European Commission claims that it gives an annual advantage of $4 billion to US companies that primarily are in industries in fierce competition with EU firms (e.g. chemicals, pharmaceuticals and mechanical machinery).

The World Trade Organisation's (WTO) dispute settlement body ruled in February 2000, that the FSC is illegal under WTO rules because the US Treasury foregoes government revenue "otherwise due". This amounts to an export subsidy, as its benefits are contingent upon export activity, which is illegal under WTO rules. The initial changes undertaken by the US were not regarded as sufficient by the EU, which took the issue back to the original panel. In January 2002, the appellate body finally found that the law remained inconsistent with US obligations under the WTO.

The FSC regime not only highlights how onshore countries find it convenient to use OFCs from time to time. The US is not the only culprit. European states also allow their companies to channel exports via tax havens, saving them over $10 billion a year (Hufbauer, 2000). It is also interesting to contrast the ease with which the OECD, the FSF and the FATF has clamped down on OFCs with the intricate and slow-moving legal wrangle between the US and the EU (the dispute of export subsidies started in 1971). Indeed, power makes all the difference.

Following the events of September 11th, the Bush administration froze the financial assets of individuals or organisations with alleged links to the perpetrators of the terrorist attacks. The administration further forbid US banks to engage in any financial transactions with these organisations. The administration also stated that foreign banks that did not observe the same rules would have their US assets frozen. This response clearly signals a significant shift in the level of punishment that the US is ready to inflict on those found guilty of money laundering.

France

France has traditionally been a vocal proponent of tax harmonisation and the fight against money laundering. This was reflected in the priorities of the French Presidency of the EU in 2000: tax harmonisation, the regulation of the international financial scene and the fight against money laundering in Europe. Moreover, France was a driving force in obtaining final approval of the EU savings tax directive.

In addition, two Socialist MPs, Vincent Peillon and Arnaud Montebourg, heading a parliamentary committee, have presented studies on the City of London, Liechtenstein, Luxembourg, Monaco and, most recently, the City of London.[18] These reports combine a high tone with in-depth analysis, but they have not yet had any practical effect outside the borders of France.[19]

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The picture that emerges from the above discussion is a sector that has increased rapidly since its origins in the 1960s but that is currently going through a challenging phase of adapting to evolving client needs and increasing competition from onshore financial centres. Countries have tried to handle the increasing use of OFCs unilaterally, but these unilateral attempts should be added the increasing number of multilateral attempts to rein in OFCs. The latter is the focus of the next chapter.

[18] Assemblée nationale (2002).

[19] Ibid. Two subheads quoted from the reports will suffice: “Switzerland: A predator of global finance” and “The Abacha affair: An example of British lethargy”.

CHAPTER 2
OFCS UNDER SIEGE

2.1 Economic integration and collective action

> The international financial system is increasingly interdependent. Deliberately ... lax supervisory practices in one part of the system are a potential source of weakness to the entire system (Financial Stability Forum, 2000a).

The general context of this paper is collective action in an economically integrated world. The world economy is becoming more integrated, thanks to the ever-closer ties in the spheres of production, trade and finance. The fact that the political sphere's basic unit remains the nation-state, however, creates problems, as individual states are increasingly unable to handle economic and political problems on their own.

This paper focuses is on international policy action directed at offshore financial centres. This action has been taken in response to certain problems that have been exacerbated by globalisation, including 1) the difficulties of raising taxes in a global environment with jurisdictional tax competition, 2) the sensitive task of blocking the proceeds from criminal activity from entering the global financial system and 3) the challenge of ensuring systemic financial stability in a world of free-moving capital. In all three areas, the ability of nation-states to tackle these problems individually has significantly decreased, as capital has been liberalised, finance has been deregulated and production has become global.

International policy cooperation and its problems

Countries chose to cooperate because they realise that they cannot achieve certain goals by themselves. If unilateral action is effective, policy cooperation does not occur. The EU's subsidiarity principle, in which Community action is only justified if regional or member state action is not efficient, is in line with this thinking.

International policy cooperation can be defined as "actors adjust[ing] their behaviour to the actual or anticipated preferences of others, through a process of policy coordination."[20] Concerted action between states can take many forms. Several authors have stressed an escalating process, starting with consultation (keeping other states informed about one's actions) and ending with coordination, which entails a "significant modification of national policies".[21]

There are several schools of thought on the likelihood of international collective action. Their respective views often depend on a broader assessment of international relations, as indicated in the following characterisations.

- *Realists.* Several observers think that the state is the key actor in world politics. States act rationally in order to maximise their self-interest. The defining feature of international relations is anarchy as there is no authority above the nation-state.

[20] Keohane (1984).

[21] Dobson (1991).

Accordingly, realists accord little hope or importance to policy coordination. In the context of OFCs, advocates of this school of thought are likely to argue that onshore states should act unilaterally with some level of force, as voluntary policy change on the part of OFCs is unlikely as long as it is against the OFCs' national interests.

- *Neo-realists*. According to this line of thinking, the anarchic nature of international relations and the behaviour of states can be mitigated under certain conditions so that policy coordination can occur. The reason is that states focus on relative gains rather than absolute gains. That is, the importance is not so much if one wins or loses, but how much one wins or loses compared to other states. Coordination is hard to achieve and even harder to maintain. Even though states have multiple goals, the primary goal is power, not wealth. Therefore, coordination will not mitigate the anarchic nature of international relations.
- *Neoliberal institutionalists*. According to these theorists, coordination is not easy but possible, despite the anarchic nature of international relations. States focus on absolute goals and pursue objectives other than power, e.g. wealth maximisation. As indicated by their label, these theorists attach much importance to institutions and regimes. They provide information, monitor compliance, increase contacts, facilitate issue linkages, define cheating and offer salient solutions. In short institutions and regimes facilitate the emergence and maintenance of coordination.[22]

The political economy of collective action is entirely different at the international level compared to the national scene. The extent of action therefore depends on several factors. *Necessity* is one; action is more likely if it is necessary. *Possibility* is another, as the extent and level of action depends on how politically feasible it is. It is also dependent on the *willingness* of major actors to engage in it.

Mancur Olsen's seminal study on the problems of collective action found that the success of collective action depends on the number of actors involved, the range of possible solutions, the complexity of the issue and the distribution of costs and benefits.[23] Accordingly, coordination is more difficult if there are many actors, the issue is complex, there are many solutions to the problem involved and the distribution of costs and benefits is skewed. Conversely, research has shown that coordination is more likely to occur and be sustained if some of the following conditions are fulfilled:

- Actors are few, the problem straightforward and easy to solve and if everyone is benefiting or paying roughly the same (collective action theory, e.g. original GATT);
- Actors know that they will meet again (game theory, e.g. Council meetings in the EU);[24]
- A framework of supporting principles, rules and decision-making procedures is in place (international regime theory, e.g. discussions on the new international financial architecture in the context of existing IMF structures);[25]

[22] Keohane and Nye (1977).

[23] Olsen (1965).

[24] Axelrod (1984).

- A cadre of supporting technocrats carry out the coordination (epistemic community theory, e.g. the role of central bankers in European monetary integration);[26]
- Domestic preferences favour coordination (thus the domestic political game matters), the distribution and balance of legislative powers is stable, and information about the policy coordination is widely dispersed;[27] and
- Power is distributed in an asymmetric way (hegemonic stability theory).[28] This may be counter-intuitive, but the logic is that once a major actor sets the rules of the game, cooperation is more likely to occur and be sustained.

The last point is of particular importance in the field of tax and finance.

Policy coordination in the sphere of international finance

Cooperation in the sphere of international finance is heavily influenced by two factors: *complexity* and *power*. Externalities in the field of finance often require specific and detailed policy coordination responses. For example, the risk posed to the world financial system from the failure of international banks led to the establishment of the Basel Capital Adequacy Accord, which sets detailed rules for the capital that every bank must have in place. A second characteristic is that the location of financial services providers is unequally spread in the world. There are two major financial centres in the world: the City of London and New York. In addition, Frankfurt, Paris, Tokyo, Zurich and a number of other cities provide significant financial services.

Table 3. Policy coordination in the field of tax and finance

	High incentives to emulate	**Low incentives to emulate**
Significant negative externalities	Dominant centre promotes harmonisation Followers adjust	Dominant centre promotes harmonisation Followers resist
Insignificant negative externalities	Dominant centre promotes unilateralism Followers adjust.	Dominant centre promotes unilateralism Followers resist

Source: Simmons (2001).

The effect of complexity and unequal power distribution is that policy coordination in the field of finance is not cooperative but rather the indirect result of states emulating the changes imposed by the major financial centres.[29] Even if other states do not immediately emulate the changes imposed by the dominating centres, the dominant centres have the ability to exert pressure and thus force change. The use of pressure becomes increasingly likely if the change is potentially costly for the dominant centres (e.g. the result of an increase in taxes or more burdensome regulation which may lead to

25 Krasner (1983).

26 Haas (1992).

27 Milner (1997).

28 Lake (1993) and Keohane (1984).

29 Simmons (2001).

capital flight and de-location of financial institutions), i.e. it is associated with a negative externality. Similarly, other countries will be less inclined to change their policies if they stand to gain from the change in the dominant centres (e.g. inflow of funds or institutions), i.e. they have low incentives to emulate. According to this view, coordination in the sphere of finance can be summarised as indicated in the table above.

The outcome in this table that is of interest in the context of this paper is the square in the top left-hand corner. The EU and the United States have higher taxes and regulatory standards than OFCs. As a result, they face a negative externality: outflow of capital, money laundering and financial stability risks. They therefore push for international policy coordination.

Policy coordination in the field of offshore finance

International policy action on OFCs provides a good case study of how globalisation changes the conditions of policy-making and the difficulty of achieving old policy goals with old instruments. The problems associated with offshore centres are such that unilateral or bilateral actions by individual countries are close to meaningless. One single country cannot control its tax base in an economically integrated world. One single country cannot solve the problem of money laundering if other countries continue to engage in it. One single country cannot increase the stability of the financial system if other countries continue to endanger it.

Therefore, there is a rationale for coordination. In light of the prospects for successful policy coordination outlined above, however, coordination in the OFC area is difficult, as it involves many actors, a complex of issues and a skewed distribution of benefits and costs. Nevertheless, this has not decreased the enthusiasm with which the international community has tackled OFCs. Table 4 provides a summary of the recent and in some cases ongoing policy initiatives with an offshore connection.

Of these, three areas of general concern stand out: circumstances where OFCs may endanger financial stability and offer opportunities for tax evasion or money laundering. The remainder of this chapter will assess how these concerns have been handled by the Financial Stability Forum (FSF), the Financial Action Task Force (FATF), the European Union (EU) and by key countries.

Table 4. Summary of policy initiatives

	Topic	Result
Multilateral		
Basel Committee	Supervision of cross-border banking	Survey on implementation of 1996 report
FATF	Identifying detrimental practices and non-cooperative jurisdictions	List of non-cooperative jurisdictions established and reviewed; sanctions imposed on Nauru
FSF	Potential effects of OFCs on global financial stability	Categorisation of countries according to risks they pose to the financial system; certain offshore centres singled out
G7	Cross-border cooperation between law enforcement and regulators	Ten key principles
OECD	Tax competition	List of 35 tax havens published; some jurisdictions have agreed to reform tax system
Offshore Group of Banking Supervisors (OGBS)	Evaluate OFCs compliance with Basel's Core Principles	Survey on implementation of 1996 report
United Nations	Develop minimum performance standards for OFCs	Standards to be finalised
Regional		
European Union	Code of conduct on harmful tax practices	66 measures identified as harmful and due to be eliminated before January 2003
	Taxation of savings income	Agreement to exchange information so that EU citizens' savings deposited in another member state can be taxed; agreement dependent upon cooperation from European OFCs.
	Money laundering	Update of EU legislation in order to widen what constitutes an offence and extending reporting requirements to non-financial professions
	State aid rules	Developing doctrine on state aid rules; aid to set up OFCs questioned by European Commission

Unilateral		
United States	Efforts to curb money laundering, terrorist financing and tax evasion	National action plans on money laundering, establishment of list of terrorist organisations, freezing of accounts and information exchange agreements
United Kingdom	Efforts to ensure proper regulation and supervision of associated territories and dependencies	Edwards report, White papers, "KPMG report"
Netherlands	Revision of tax links with associated territories	Change in tax regime
France	High political priority given to denouncing money laundering and tax evasion	High-level support for FATF; hearings and reports on European financial centres in National Assembly

2.2 The FSF – Threat to financial stability

In March 2000, the Financial Stability Forum (FSF) presented a report on OFCs which contained a key concern: while attracting large volumes of financial activity, OFCs often do not live up to international standards of supervision and information disclosure. In addition, OFCs make corporate structures and financial transactions complex and opaque.[30] In times of ever-increasing financial interdependence, this has the potential of endangering global financial stability.

Lack of resources devoted to supervision

The weakness in supervision and the failure to cooperate with other states lead to two sets of problems: prudential concerns and market integrity. *Prudential concerns* arise when internationally active financial intermediaries are not sufficiently supervised, thereby indirectly endangering international financial stability. The lack of supervision and international cooperation makes it more difficult to combat illegal activities and abusive market behaviour. This endangers *market integrity.*

More specifically, by not exchanging information, OFCs block adequate access to information and the ability to verify information. This makes it more difficult to foster international cooperation so that financial stability can be harnessed. In addition, the lack of detailed data on OFCs' financial activities makes it more difficult to monitor capital movements. Moreover, weak supervision undermines the consolidated supervision by the home supervisor of institutions active in OFCs, and the lack of due diligence and inadequate disclosure may facilitate inappropriate business structures. This makes supervision even more difficult. As many OFCs devote little resources to financial supervision, effective control is very hard to achieve.

[30] Ibid.

The Financial Stability Forum's plan

The aim of the FSF report is to bring all OFCs in line with international standards of regulation, supervision, disclosure and information-sharing. While recognising that some OFCs are subject to prudential regulation and do disclose and share information, the FSF nevertheless states that certain OFCs "hinder efforts" to improve global financial supervision, "frustrate collective efforts" to improve financial stability and are "creating a potential systemic threat to the financial system".[31]

The FSF wants OFCs to raise standards in three areas: cross-border cooperation, information sharing and confidentiality; supervisory powers and practices; and customer identification and record-keeping.[32]

In order to scrutinise the adherence to international standards the FSF carried out an initial assessment. The FSF asked both onshore and offshore supervisors for their judgement on various OFCs adherence to international standards. Based on these observations, the FSF released a report in spring 2000 dividing OFCs into three groups.[33] *Group I* are those jurisdictions that cooperate, maintain high quality supervision and adhere to international standards. *Group II* are those jurisdictions that have institutions and procedures in place but that fail to implement them. *Group III* are those that have poor quality of supervision and that do not cooperate well with onshore supervisors and that do not try to adhere to international standards.[34]

Two European OFCs, Cyprus and Liechtenstein, were regarded as devoting so little resources to supervision and cooperation relative to their size that they were placed in group III. Andorra, Gibraltar and Monaco were placed in group II, while Guernsey, Jersey and the Isle of Man came out with honours.

The FSF designed an assessment process divided into several stages, where the international community should help OFCs to undertake a self-assessment that would eventually lead to increasing adherence to standards. The FSF recommended that the IMF should be responsible for monitoring this process. Following this recommendation and after further endorsement by the G-7 meeting in Okinawa in July 2000, the IMF has agreed to assume this task.[35] This falls into line with the work on a new international financial architecture that the Fund has undertaken since the Asian crisis.[36] In March 2002, a first progress review was undertaken. Progress was deemed generally satisfactory, with only a handful of OFCs not yet scheduled for an IMF assessment..

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[31] Ibid.

[32] Financial Stability Forum (2000a).

[33] Financial Stability Forum (2000b).

[34] Financial Stability Forum (2000a).

[35] G-7 (2000) and IMF (2000b).

[36] Since the Asian crisis, the IMF has tried to build a stronger international financial system. It has concentrated on five major areas: transparency, international standards, financial sector strengthening, involving the private sector and systemic improvements (IMF intervention funds). For further work on these matters, consult the IMF web page (www.imf.org).

2.3 The OECD – Harmful tax competition

The second area of concern is taxation. One of OFCs' main attractions is their low level of taxation. For onshore countries, this poses the risk of an exodus of their mobile activities (such as financial capital).

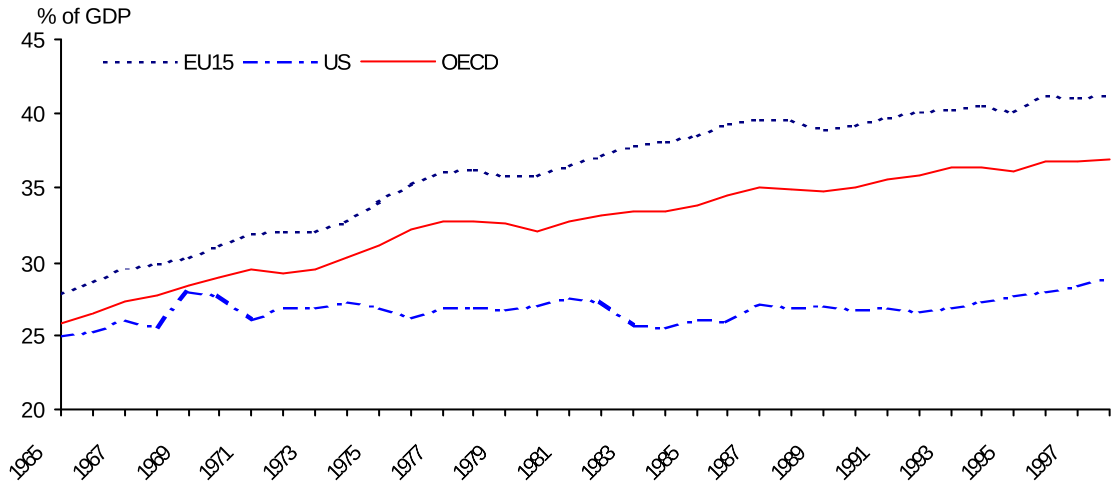
Poaching the tax base of other countries?

According to the OECD, tax havens are defined as:

- Jurisdictions that have no or only nominal taxes;
- Jurisdictions that do not engage effectively in exchanging information with foreign supervisors;
- Jurisdictions whose regimes lack transparency, or have inadequate regulatory supervision or financial disclosure; and
- Jurisdictions that facilitate establishment of foreign-owned entities without the need for a local substantive presence, or prohibit these entities from having any commercial impact on the local economy (ring fencing).[37]

While there is no clear economic case for tax harmonisation, as preferences about the appropriate tax level legitimately differ between countries, a majority of OECD states argue that tax competition can be harmful. Harmful tax practices are said to erode the tax base of other countries.[38] The harmful feature is not necessarily a race to the bottom, which is not proved empirically, but rather an increasingly skewed distribution of the tax burden. As certain mobile components of the tax base escape taxation, other less mobile components have to compensate by paying more tax. In other words, the deterioration of the tax system is not illustrated so much by a generalised reduction of revenues, but rather by an increasing imbalance in the tax system.[39]

Figure 1. Total tax revenues as a percentage of GDP



Source: OECD (2000).

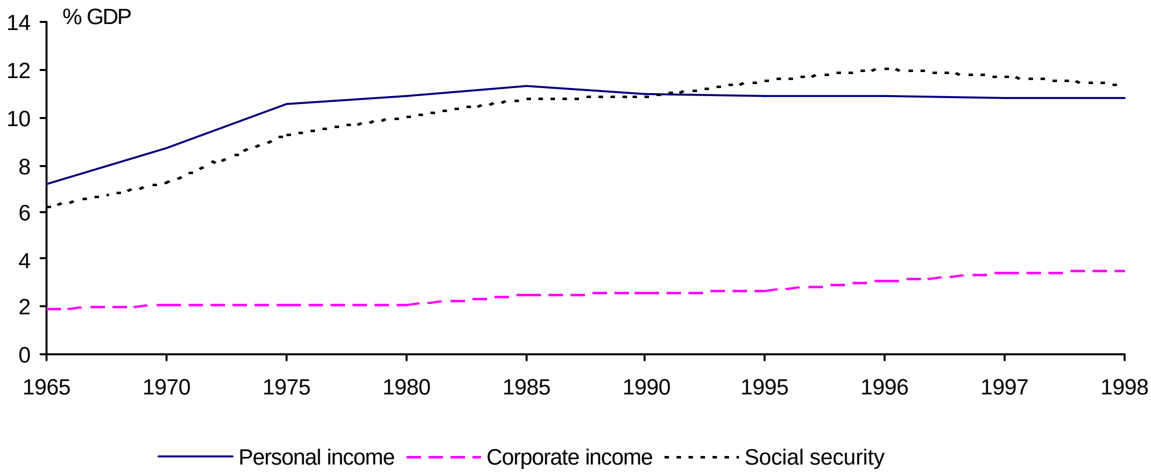
[37] OECD (2000d).

[38] OECD (2000a).

[39] Radaelli (2000).

No firm evidence can be found that there is a race to the bottom, as overall tax revenues have not decreased. There nevertheless appears to be an increasing imbalance in onshore tax systems. Some evidence suggest that mobile tax sources pay less tax, while the tax burden appears to be shifted onto immobile tax sources (e.g. income tax) and levied in more indirect ways (e.g. VAT).[40] As can be seen from the graphs, labour yields substantially more tax revenues than companies.[41] However, since 1975 the difference has remained stable, or even decreased. This would seem to suggest that the argument of a wide shift of the tax burden towards labour is refuted. However, if one looks at another measure of taxation, some support emerges. The effective tax burden on capital has decreased from 45% to 35% between 1981 and 1996. During the same time, the effective tax burden on labour has increased from 35 to 42%.[42] The most pronounced change has, however, been in social security contributions. Revenues from social security contributions have increased from 6.3% of GDP in 1965 to 11.4% in 1998 (from 22.8% to 27.8% as share of total taxation).[43]

Figure 2. Different taxes as share of GDP in the EU



Source: OECD (2000e).

[40] Ibid.

[41] There are several problems with the statistics, however. For example, the measure for labour taxation – personal income – includes taxation of personal capital income.

[42] Lautenberg (1999). Capital taxes are, however, borne both by individuals and companies. It is therefore not a conclusive evidence of a shift in burden.

[43] The rise in social security contributions is probably explained by the increase in aggregate welfare spending, related to the increase in unemployment, an older population and more generous healthcare programmes. There are, however, wide differences in the relative importance of contributions. In some countries, welfare is financed nearly entirely by general government tax revenues and as a result contributions account for a very low share in the tax mix (e.g. Denmark 3%). In a large part of continental Europe social security systems are based on the so-called "Bismarck model", where social security is seen as an insurance and contributions and benefits depend on the wage of the worker. In these countries, contributions account for a much larger share of the tax mix (e.g. Germany 40%). In times of fiscal crises, reliance on contribution funded welfare schemes have increased (e.g. Denmark from 1980-85, and Sweden from 1990-95).

The OECD initiative

The OECD has since the mid-1990s developed measures to counter the "distorting effects of harmful tax competition". A report on harmful tax competition released in 1998 led to the creation of the OECD *Forum on Tax Harmonisation*. The Forum's remit is to identify harmful tax practices within member states and remove them by the end of the year 2005. The forum, additionally, encourages non-member countries to associate themselves with the OECD guidelines. The objective is to enable states to tax their subjects as they may wish, to promote a fair distribution of the tax burden and ensure that taxes are not the main reason for deciding where to allocate capital.

In April 2000, the OECD Committee on Fiscal Affairs released a report on *bank secrecy*.[44] The unique characteristic is that the report was adopted unanimously; all 29 members approved (including Switzerland and Luxembourg). The report proposes certain measures in order to limit bank secrecy, as follows: First, eliminate anonymous accounts and require identification of bank customers and beneficial owners. Second, re-examine "domestic tax interest requirement", i.e. countries should not require a national interest in order to disclose information. Third, re-examine policies and practices that prevent information exchange for criminal tax cases. Fourth, take more initiatives to achieve access to bank information for civil tax cases. The goal, according to the OECD, is not to end bank secrecy, but to deal with dishonest taxpayers in order to maintain confidence in the fairness of the tax system.

In June 2000, the Forum named 35 jurisdictions (most of them OFCs) that met the *tax haven* criteria.[45] These jurisdictions were encouraged to start a process of cooperation with the OECD before the end of February 2002, in order to eliminate their harmful tax practices before the end of 2005. Despite a protracted battle between OFCs and the OECD, more than 20 jurisdictions, among them Cyprus, the Channel Islands, Isle of Man, Malta and San Marino, had decided to cooperate when the deadline expired in February 2002.[46] Those jurisdictions that have not initiated a process of change will face counter-measures by OECD members. These will range from the termination of existing tax conventions with the jurisdictions concerned to the imposition of additional burdens on financial institutions dealing with these OFCs.

Box 3. Possible counter-measures by the OECD

- Disallow deductions, exemptions or credits related to transactions
- Compulsory transaction reporting rules
- Comprehensive penalty scheme
- Withholding taxes on certain payments to residents in tax havens
- Deny availability of foreign tax credit
- Transactional charges ("levies") on certain transactions

Source: OECD (2000d).

[44] OECD (2000b).
[45] OECD (2000d).
[46] OECD (2002).

A complicating factor is that the OECD has no power to enforce implementation of its recommendations, but is dependent upon its members to implement agreed sanctions. Although it is therefore not yet clear whether the counter-measures will be carried out and in what form, the OECD process has gone further than many observers expected two years ago. That nearly 60% of the designated tax havens have signed up is a clear sign of success. The OECD has therefore managed to overcome the lack of a clear economic case, the complex issues and the complexity of dealing with many actors.

It is difficult to say to what extent the events of September 11 contributed to the jurisdictions' decisions to make commitments before the OECD deadline. Modifications to the OECD project were decided before the events, notably dropping the substantial activity criteria, but it is probable that the terrorist attacks tipped the balance towards a cooperative stance. Although a majority of targeted OFCs has decided to cooperate, a substantial minority (15 OFCs) has nevertheless not committed themselves so far to cooperate.

2.4 The FATF – Money laundering

Money laundering is the "process of introducing the proceeds of crime into the legitimate stream of financial commerce by masking their origin".[47] It has been estimated that money laundering amounts to $600 billion a year, or between 2 to 5% of the world's GDP. Money laundering fuels criminal activity and erodes the integrity of financial institutions. In small and vulnerable economies it may go as far as to undermine the official economy and to significantly hamper the power of the state. Due to the interconnectedness of the international financial system, the efforts to combat money laundering are not stronger than its weakest part. OFCs have proven to be a weak spot in this respect.

Bank secrecy as a veil

The Financial Action Task Force on Money Laundering (FATF) has identified a number of rules and procedures in OFCs that prevent the effective combating of the laundering of proceeds emanating from criminal activities. These include:

- No or inadequate regulation and supervision of financial institutions,
- Inadequate rules for the licensing and creation of financial institutions,
- Inadequate customer identification requirements for financial institutions,
- Lack of identification of beneficial owners of legal and business entities,
- Laws or regulations prohibiting international exchange of information, and
- In some cases, obvious unwillingness to respond constructively to pledges of assistance.[48]

Most OFCs have bank secrecy. In the "respectable" ones (e.g. Switzerland), it can be lifted by order of a judge if there is proof or suspicion of criminal activity. Nevertheless, bank secrecy makes the task of collecting evidence more difficult, as the police cannot

[47] US Department of Treasury (2000).

[48] FATF (2000).

go on "fishing expeditions", i.e. to screen a bank's entire set of accounts in search of any suspicious transaction.

OFCs may not only attract questionable activities. They may also undermine international efforts to combat these very activities. It is important to reiterate what was stated above, i.e. the OFC community is not homogeneous. Some OFCs do cooperate and provide information and exercise scrupulous supervision and regulation. In addition, the relatively small size of their financial systems should make it easier to screen.[49] Nevertheless, all OFCs are characterised by a mix of low taxation, low regulation and secrecy, which make OFCs a thriving ground for individuals and business trying to avoid attention.

The FATF programme

Attempts to curb money laundering at the multilateral level are embodied in the Financial Action Task Force (FATF) on Money Laundering. It was set up by the G7 at its meeting in Paris 1989 and presented 40 recommendations in 1990, which have since become the benchmark for money laundering legislation world-wide.[50] In order to ensure that these recommendations gain world-wide effect, the FATF has developed 25 criteria for defining countries that do not implement these recommendations ("non-cooperative"). The criteria focus on:

- Loopholes in financial regulations that allow no or inadequate supervision of the financial sector, weak licensing or customer identification requirements, excessive financial secrecy provisions, or lack of suspicious transaction reporting systems.
- Weaknesses in commercial requirements including the identification of beneficial ownership and the registration procedures of business entities.
- Obstacles to international cooperation, regarding both administrative and judicial levels.
- Inadequate resources for preventing, detecting and repressing money laundering activities.[51]

The FATF charged four regional groups with the task of reviewing jurisdictions within their region against these criteria. In Europe, the responsible body is a select committee of the Council of Europe (PC-R-EV).[52]

In June 2000, the FATF presented an initial shortlist of non-cooperative jurisdictions.[53] At that time, Liechtenstein was the only European OFC to be judged to have "serious systemic problems". However, since then Liechtenstein and some of the other blacklisted jurisdictions have taken measures that have allowed them to be taken off the

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[49] Compare with the City of London, whose sheer size makes it more difficult to protect fully against money laundering.

[50] FATF (1998).

[51] FATF (2000a).

[52] The so-called "Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures" (see web page http://www.legal.coe.int).

[53] FATF (2000b).

list.[54] Several offshore and onshore centres nevertheless remain on the list. So far, the FATF has imposed sanctions on Nauru (5 December 2001) and is closely observing the Philippines where pending legislation is judged to be deficient.[55]

Table 5. FATF's blacklist (as of February 2002)

Cook Islands	Hungary	Myanmar	Russia
Dominica	Indonesia	Nauru	St Kitts and Nevis
Egypt	Israel	Nigeria	St. Vincent and the Grenadines
Grenada	Lebanon	Niue	Ukraine
Guatemala	Marshall Islands	Philippines	

Source: FATF (2002).

Box 4. FATF counter-measures against non-cooperative jurisdictions and territories

Generally, FATF sanctions against states that do not implement the principles are governed by Recommendation 21, according to which financial institutions should give "special attention" to businesses and transactions from countries that do not apply the recommendations. The institutions should also examine suspicious transactions from such countries and make the findings available to supervisors. Following the publication of the 2000 report, the FATF has developed an additional set of sanctions that should be taken in concert by all member states and be "gradual, proportionate and flexible" in their means:

- "Stringent requirements for identifying clients and enhancement of advisories, including jurisdiction-specific financial advisories, to financial institutions for identification of the beneficial owners before business relationships are established with individuals or companies from these countries;
- Enhanced relevant reporting mechanisms or systematic reporting of financial transactions on the basis that financial transactions with such countries are more likely to be suspicious;
- In considering requests for approving the establishment in FATF member countries of subsidiaries or branches or representative offices of banks, taking into account the fact that the relevant bank is from an NCCT;
- Warning non-financial sector businesses that transactions with entities within the NCCTs might run the risk of money laundering."

Source: FATF (2001a).

Following the events of 11 September, the FATF in October 2001 broadened its area of competence to cover terrorism financing as well. FATF members agreed upon eight special recommendations to be implemented by all members before June 2002. These are summarised in the table below. Non-members are "invited" to undertake a similar assessment before May 2002. Countries unwilling to implement the recommendations will face sanctions.

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[54] FATF (2001a).

[55] FATF (2001c and 2001d). The EU decided to impose counter-measures against Nauru and the Philippines with immediate effect if necessary at the joint Ecofin/JHA Council on 16 October 2001.

Table 6. The FATF's special recommendations on terrorist financing

1.	Ratify and implement the 1999 UN Convention for the Suppression of the Financing of Terrorism
2.	Include terrorism in predicate offences under money laundering rules
3.	Freeze and confiscate terrorist assets
4.	Impose reporting requirements on suspicious transactions related to terrorism
5.	Formalise greatest possible measure of mutual legal assistance and information exchange in connection with terrorism
6.	Set up licensing and registering system for money/value transmission services
7.	Force financial institutions to include originator information on funds transfers and related messages that are sent through the payment chain
8	Review laws relating to entities that can be abused for the financing of terrorism (e.g. NGOs)

Source: FATF (2001b).

Apart from this immediate response, it may well be that the terrorist attacks are altering what has been politically achievable so far. For example, the FATF does not want to abolish bank secrecy, but requires it to be lifted in cases of proof of criminal activity. This is supposed to be effective with active supervision and strong enforcement. It is clear, however, that banking secrecy makes the task of collecting proof of financial crime harder. Will this be acceptable to US authorities responsible for investigating the financial trail of the terrorists? Will they be able to convince OFCs to lift bank secrecy even if firm proof does not exist, or does it have to be abolished altogether? Although there was no support for scrapping bank secrecy before the attacks on the US, the conditions may have changed.

2.5 The EU – Obstacles to the integrity of the single market

With the launch of the euro, a further qualitative step has been taken on the road towards achieving a truly single market. The immediate effect of the launch has been to expose any remaining obstacles, including taxation, state aid and money laundering. Offshore centres are as such not the main motivation of these policy developments. The proposed policies, however, significantly affect them.

The Code of Conduct on harmful tax practices

On 1 December 1997, the European Council agreed on a package of measures to combat harmful tax competition in the EU. The Monti Group (so-called after its chairman, the then Internal Market Commissioner Mario Monti) outlined three areas where further action was needed to combat harmful tax competition and create a truly single market. These were business taxation, taxation on interest income from savings investment, and withholding taxes on cross-border interest and royalty payments between companies.

The initiative stemmed from the overall assessment that taxation on income from labour was becoming too heavy as a result of a downward spiral of unfair tax competition between the member states to attract investment. This was considered harmful since it led to a loss of tax revenue, distorted the single market and undermined employment.

Two of the areas have links with OFCs: the code of conduct on corporate taxation and the new proposal for a directive on the taxation of income from savings.

For a long time, the EU's approach differed from the OECD's attempts to curb harmful tax practices. Unlike the OECD, the EU did not focus on mobile financial activities, but instead took a broader approach bringing in the whole of business taxation. In addition, while the OECD clearly favoured an information exchange system, the EU pushed for a withholding tax. Moreover, the OECD political agenda is – essentially – to put administrations in a position where they can tax their residents. The idea is one of 'looking through' the dark glass of tax havens and tax residents. There is no attempt to defend the social market economy or comparatively high levels of taxation – a goal that is instead shared by some, although certainly not by all – EU policy-makers.

On *business taxation,* initial results were obtained with the publication of the Primarolo report (Council of the EU, 1999) in November 1999, which identified 66 measures in the member states that were considered harmful, i.e. "tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question". Among the categories covered were measures relating to offshore companies and harmful measures applied in associated and dependent territories. On 27 November 2000, the Ecofin Council decided that these measures should be dismantled before 1 January 2003.

On *taxation of savings income,* a substantial breakthrough was achieved at the Feira European Council. After successful lobbying by the UK, the EU fell into line with international trends and decided, although hesitantly and with certain key preconditions, to eventually adopt information exchange as the basis of taxation of savings income. The details of the agreement are presented in Table 7.

Table 7. The Feira European Council agreement on the taxation of savings

Basis	Exchange of information as the basis for taxation of savings income of non-residents.
Timetable	Agreement on the substantial content of the Directive before *31 December 2000.* Adopt the Directive, by unanimity, no later than *31 December 2002.* Implement exchange of information as soon as conditions permit, and *no later than seven years* after the entry into force of the directive.
Contents	• In years 1 through 7, Austria, Belgium and Luxembourg apply a withholding tax of 20%, the other member states apply information exchange. • From year 7 onwards, all member states apply information exchange. • 25% of the revenues from the withholding tax will be sent to the home country of the non-resident saver. • The directive will cover bank deposits and investment funds with less than 40% in interest-generating bonds.
Preconditions	The directive will only be adopted if there are sufficient assurances that: • the same measures are applied in *dependent or associated territories* (the Channel Islands, Isle of Man, dependent or associated territories in the Caribbean) and • equivalent measures are applied in the *US and key third countries* (Switzerland, Liechtenstein, Monaco, Andorra and San Marino).

Source: Council of the European Union (2000a).

The concern of Luxembourg (the main proponent of a withholding tax) was that the adoption of information exchange, thereby scrapping the cherished practice of bank secrecy, would lead to an exodus of financial capital to third countries. Therefore, the Feira agreement was made dependent on similar measures being adopted by the US and key third countries. The European Council accordingly charged the European Commission to enter into discussions with these countries immediately.

State aid and taxation

State aid in any form, including taxation, is normally prohibited in the EU. There are, however, certain exceptions (see box below). These exceptions have theoretically created the possibility for the so-called outermost regions to set up an OFC for development purposes.[56] The only region to have done so is Madeira (see section 3.7).

Box 5. State aid rules in the EU

What tax measures constitute state aid?

1. The measure must relieve a company from a charge that it would normally have borne in the budget. This reduction in the tax burden may come from a reduction in the tax base, a total or partial reduction in the amount of tax or the deferment, cancellation or special rescheduling of tax debt.
2. The advantage must be granted by the state or through state resources (regional or local bodies included).
3. The measure must affect competition and trade between member states.
4. The measure must be specific/selective in the sense that it favours "certain undertakings or the production of certain goods".

What derogations may be granted?

1. Specific measures may be permitted if they are shown to derive directly from the "guiding principles of the tax system".
2. More importantly, state aid may be allowed to the so-called *outermost regions* (Madeira, Azores, etc.) provided that they are justified and that the level is proportional to the handicaps the aid is supposed to alleviate. Normally, such aid has to be degressive and limited in time. However, state aid that is not degressive and time limited may be granted to outermost regions in order to offset additional costs resulting from factors mentioned in Article 299(2) of the Treaty. However, the region must prove that such handicaps exist.
3. Aid to promote *economic development* may also be permitted, provided that it is supplied roughly under the same conditions as outlined above (proportional, targeted). In addition, the aid must contribute to activities with a local impact and relate to local handicaps.

Source: Commission's clarifying note on tax and state aid (98/C 384/03), Amendments to guidelines on national regional aid (00/C 258/06).

So far, the European Commission has approved those attempts. In the current review of the Madeira regime, however, the Commission has expressed increasing concerns and reservations over allowing state aid to attract offshore *financial* activities. The Commission considers that such financial activities do not contribute sufficiently to the

[56] Canary Islands, Guadeloupe, Martinique, French Guyana, Réunion, Azores and Madeira.

local economy in order to be eligible under state aid rules and that the development benefits are not proportional to the aid granted.[57] The Commission has not yet taken a decision, however.

The EU programme on money laundering

Following September 11, the EU's institutions managed to reach an agreement on the update of the money laundering directive. Before the September events, the directive had been stuck in co-decision due to disagreement between the Commission, the European Parliament and the Council. The disagreement related to two issues:

i) the widening of what constitutes money laundering offence to include all organised crime and not only drug trafficking, and

ii) the extension of the obligations of the directive (e.g. reporting requirement) to cover certain non-financial activities and professions (lawyers and accountants).

The agreement reached by the Conciliation Committee in mid-October and voted through in the European Parliament's third reading on 13 November 2001, is a compromise whereby which the directive was indeed extended to cover all crimes. Reporting requirements were also extended under *certain conditions* to *some* non-financial professions that are vulnerable to money laundering attempts, as follows:

- *Notaries and independent legal professionals* will be covered by the obligations of the directive when participating in "financial or corporate transactions, including providing tax advice".
- *Lawyers and other legal advisers* are exempt from the reporting requirement on information "obtained either before, during or after judicial proceedings, or in the course of ascertaining the legal position for a client." Therefore, legal advice will continue to be subject to professional secrecy "unless the legal counsellor is taking part in money laundering activities, the legal advice is provided for money laundering purposes, or the lawyer know that the client is seeking legal advice for money laundering purposes."[58]

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Well before the terrorist attacks on the US, there was significant attention on OFCs from major states and international organisations. The result of this attention was not conclusive however. The effects of the terrorist attack seem to have mustered sufficient political will to draw these processes to their end: progress in the OECD and FATF initiatives seems to suggest an increasing likelihood that sanctions may be imposed on those OFCs that shelter money launderers, pose a threat to financial stability and do not exchange information for tax purposes. How a number of European OFCs score in this respect is the focus of the following chapter.

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[57] European Commission (2000).

[58] European Union (2001).

CHAPTER 3
A SURVEY OF EUROPEAN OFCS

The ambition of this survey is to assess how some of the European OFCs compare with respect to the concerns raised above. While the large number of OFCs and their heterogeneity make comparisons difficult, the OFCs included in this survey (Andorra, Gibraltar, Guernsey, Isle of Man, Jersey, Liechtenstein, Madeira and Monaco) are all either located in Europe, under the jurisdiction dependent of a European country or, as in one case, are an integral part of an EU member state. The survey does not include all European OFCs and there are certain countries that perhaps could or should have been included (e.g. Cyprus, Malta, San Marino). Moreover, the *City of London*, *Ireland*, *Luxembourg* and *Switzerland* are providing significant services for non-residents, but because they serve such large domestic economies and provide such a full range of services that they were deemed to be RFCs (see above).

It should be remembered that there are other regions with OFCs that are much larger. The *Caribbean* is home to some of the most famous and notorious of these (e.g. Antigua, Bermuda and Cayman Islands). Some of these have constitutional ties with an EU member state (e.g. the Bahamas, Bermuda and the British Virgin Islands are territories of the UK and the Netherlands Antilles and Aruba are connected to the Netherlands). There are some very prominent OFCs in *Asia and the Pacific* (Hong Kong, Singapore). Some countries in the *Middle East* (Israel, Lebanon) and *Africa* (Tangier, Liberia) also offer offshore services. Therefore, OFCs are a global phenomenon and compete in a global context. This is important to keep in mind for those who would require the European OFCs to mend their ways. The offshore business is extremely footloose: there are little physical installations that deter offshore institutions from moving if the margin of tax and regulatory benefits change to a particular jurisdiction's disadvantage.

A fundamental difficulty when analysing OFCs is the lack of data. As mentioned above, most OFCs do not disclose data to the Bank for International Settlements (BIS) and very few, if any, surveys exist. In addition, most OFCs are very small states, with limited national accounts and small civil services. Moreover, data are sometimes not comparable. Funds under management are sometimes included in bank deposits; what falls under the label "company" sometimes includes foundations and trusts, and sometimes not.

Consequently, any comparison should be taken with a dose of scepticism. The following comparison is based on BIS and IMF estimates, surveys in journals and periodicals, and to a large extent, public information disclosed by the OFCs themselves. Table 8 provides a summary of the findings concerning these OFCs in terms of financial size and tax regimes.

Table 8. A survey of selected OFCs

a) Financial size (2001, or the most recent year available)

	Andorra	Gibraltar	Guernsey	Isle of Man	Jersey	Liechten-stein	Madeira	Monaco
Population	65,939	27,649	58,681	71,714	85,200	32,491	261,800	29,972
GDP per capita, €	21,645	18,940	32,054	21,383	26,000	53,570	9,145	27,000
Bank deposits, €bn	8.1	9.1[a]	132.0	43.6	211.9	19.3	2.9[b]	43.3
Funds under management, €bn	n.a.	n.a.	48.5	7.9	155.7	80.9	n.a.	39.6
Insurance assets, €bn	n.a.	0.4	14.4	29.6	0.9	0.2	n.a.	n.a.
Offshore companies	n.a.	8,800[c]	15,453	41,747	35,000	80,000	5,931	n.a.
Number of banks	6	18	76	60	70	16	41	40
Employees in finance sector	1,328	2,200	6,500	5,400	7,600	1,400	590	1,700
Share of total employment, %	19	n.a.	21	26	n.a.	n.a.	3	6
Contribution of offshore sector to economy, %	5	25[d]	46	41	55	23	13[e]	50

[a] Offshore business only: €3.2bn (IMF, 2001).

[b] Deposits by emigrants held offshore in the MIBC 1997. This excludes deposits held by other non-residents, e.g. from the EU. Therefore, the real number is larger. Most of the banking entities in the MIBC are external branches, and therefore they consolidate deposits at Head Office level.

[c] Total number of registered companies is 28,500, of which 8,800 are exempt and another 146 qualifying companies with substantially reduced tax rates (IMF, 2001).

[d] Estimated contribution of financial sector (both on- and offshore) to the economy (IMF, 2001).

[e] Based on a study carried out by the regional government in 1997. The figure is based on value-added.

Sources: Jurisdictions, IMF, Standard & Poor's, CIA and http://www.lowtax.net.

b) Tax measures

	Andorra	Gibraltar	Guernsey	Isle of Man[a]	Jersey	Liechten-stein	Madeira	Monaco
Direct taxes								
Corporate tax	0%	£225 <	0-30%	0-15%	0-30%	2‰-20%	0-12.5%[a]	0-33%
Personal income tax	0%	< £10,000	20%	10-15%	20%	3.6-18.6%	14-40%	0%[c]
Indirect taxes								
VAT	1-12%	0%	0%	17.5%[b]	0%	7.5%	17%	5.5-17.5%
Withholding tax	0	1%	0%	0%	0%	0%	0%	0%
Stamp duty	0	0	0%	0%	0%	2%	0%	0%
Excise taxes	Y	0	0%	0%	0%	Y	0%	0%
Cooperation								
Double taxation treaties	0	0	1	1	2	2	32	1

[a] Not yet effective.

[b] Offset by generous allowances.

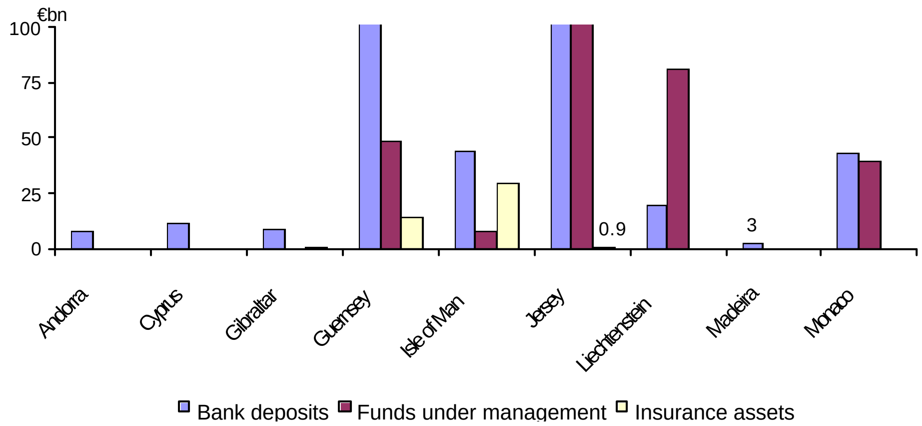
[c] Not applicable to French citizens.

Sources: Jurisdictions, IMF and http://www.lowtax.net.

The OFCs also have different attitudes towards disclosing data. Certain OFCs (e.g. the Channel Islands and the Isle of Man) have excellent web resources and disclose financial data, but they remain the exception rather than the norm. Overall, it is clear that some European OFCs correspond more clearly to the traditional image of OFCs as opaque and secretive.

As can be seen from the table, these OFCs have different specialisations. As illustrated by the graph below, Jersey has the largest bank sector followed by Guernsey and the Isle of Man. This is still very little compared to the Cayman Islands, where banks have assets estimated at €740 billion. Regarding asset management, Jersey manages funds worth €156 billion. Liechtenstein also hosts a significant asset management industry, worth €81billion. The insurance industry is generally less developed, with the Isle of Man and Guernsey as the only (confirmed) European players.

Figure 3. The different specialisations of OFCs (2001, or the most recent available)



Sources: Jurisdictions, Standard & Pool's, CIA and http://www.lowtax.net.

Liechtenstein is the most popular destination for offshore companies in Europe followed by the Isle of Man and Cyprus. However, the Liechtenstein definition of what constitutes a company is more inclusive than many other OFCs (e.g. Liechtenstein includes foundations). Moreover, by international standards, this number of offshore companies is not that much. Hong Kong has close to 500,000 companies and the British Virgin Islands over 300,000.[59]

3.1 Andorra

Andorra is a co-principality. The co-princes are the French President and the Bishop of Urgell. Andorra gained divided sovereignty in 1278 but it was not until 1993 that it became fully sovereign. The General Council, elected by the people every four years, governs the principality.

[59] UK Home Office (1998).

Andorra is not a member of the EU, but is part of the customs union. It is therefore treated as an EU member in issues related to trade in manufacturing products, where it enjoys zero tariffs. While tourism is the main source of income (80% of GDP), the banking sector also makes a substantial contribution to the economy (13% of GDP).

Table 9. Andorra's financial centre

Population	65,939
GDP per capita, €	21,645
Bank deposits, €bn	8.1
Number of banks	6
Employees in financial sector	1,328
Share of total employment, %	19
Contribution of offshore sector to the local economy, %	5

Source: Chamber of Commerce of Andorra.

A substantial amount, €8.1 billion, is deposited in Andorra's banks. According to official figures, the financial sector employs nearly one-fifth (19%) of Andorra's workforce. In all, the financial sector consists of six banks, nine financial institutions other than banks and around 40 insurance companies.

It is difficult for foreigners to establish a commercial presence in Andorra. Foreign ownership is limited to 33%, except in banking where foreigners are allowed to have a majority stake (51%). In addition, law prohibits fiduciary contracts or using an Andorran individual as a nominee. Moreover, Andorran law does not recognise trusts. Accordingly, it is fair to say that Andorra is not a centre for offshore companies.

Financial supervision

Until 1993, the banks regulated Andorra's financial system. The enactment of the Law Governing the Financial System (LOSF) introduced a complementary regulatory layer of "technical bodies" set up by the government. The National Andorran Institute of Finance (INAF) has since then been responsible for supervising all financial institutions. It also advises the government on financial regulation, maintains relations with foreign supervisors and enforces rules.

Money laundering

Since 1990, Andorran banks have operated under a due diligence code. The same year money laundering became an offence under the Criminal Code. In 1995, Andorra enacted the Law on the Protection of Bank Secrecy and the Prevention of Money Laundering. Violating bank secrecy is a criminal offence, which may lead to prison. It is only possible to violate secrecy on the command of a judge. Nevertheless, the law also imposes requirements regarding reporting, supervision and cooperation that banks are "expected to comply with" when money laundering is suspected. In 1998, the Government set up a special commission with the task of reviewing and strengthening anti-money laundering regulation. The Commission may propose the creation of a

Financial Information Unit. Moreover, in April 1999, the Andorran parliament ratified the proposal to sign the Vienna and Strasbourg Conventions on money laundering.

While having gained a "very positive overall impression concerning Andorra's anti-money laundering regime", the Council of Europe, which is responsible for the FATF's assessments in the wider Europe, raised some important concerns:

- The exception to bank secrecy (request by a judge) is contested in civil proceedings. Bank secrecy continues to be rigorously defended, notably by violations falling under the criminal code. Moreover, it is difficult for foreign authorities to gain access to information protected by secrecy.
- A very limited number of offences are listed as predicate in the Criminal Code (drug trafficking, sequestration, illegal arms sales, prostitution and terrorism). This makes it difficult to fight money laundering and to cooperate internationally.
- International cooperation is made even more difficult since Andorra has no multilateral treaties or legislation on international cooperation.
- Due diligence obligations applies only to banks.
- Andorra has numbered accounts.
- While banks have an obligation to report suspicious transactions, there is no sanction if they choose not to.[60]

Tax regime

Andorra levies no taxes on personal or corporate income. The only taxes it levies are an indirect goods tax (IMI) ranging between 1 to 12%, customs duties, social security charges and taxes on for example motor vehicles and gambling. Accordingly, the OECD classified Andorra as a tax haven. In addition, Andorra has no double taxation treaties. It exchanges no information for tax purposes with other countries. Although information exchange is facilitated in the case of serious crimes, this does not include tax evasion.

3.2 Gibraltar

Gibraltar has been "part of her Majesty's dominions" since 1704 and is currently a UK overseas territory. It was ceded to the UK by Spain in 1713 under the Treaty of Utrecht and became a crown colony in 1830. The 1969 Constitution defines the powers of the local government (e.g. fiscal affairs), leaving all remaining areas to the Crown's representative, the Governor (notably all areas that might have a "conceivable impact on the security of the fortress"). Gibraltar implements all EU legislation apart from matters relating to the Common Agricultural Policy, the common customs tariff and the harmonisation of turnover taxes (i.e. VAT). It is therefore part of the internal market.

Gibraltar's financial centre dates back from 1967 when a special tax regime for international business (tax exempt companies) was created.[61] This was further developed in the early 1980s with the "Income Tax Ordinance". Banks and investment

[60] Council of Europe (2000).

[61] Companies (Taxation and Concessions) Ordinance (1967).

management dominate the financial sector. The institutions mainly, but not only, serve the wealthy expatriates living in southern Spain. A crucial element in Gibraltar's commercial prospects is its ability to "passport" financial services to the EU/EEA, i.e. enabling institutions approved in Gibraltar to provide their services across the EU/EEA. In principle, this should only depend on whether the UK judges that Gibraltar's financial regulation is stringent enough ("match UK standards"). However, the ability to passport has also become linked to overall relations with Spain. An agreement in April 2000 extended passporting to cover insurance and banking.

There are many threats to the future of Gibraltar: being part of the EU puts an effective lid on its ability to design policies entirely on its own, and relations with Spain, notably the forthcoming reunification, may in the long run prevent the solidification of Gibraltar as an offshore centre.

Table 10. Gibraltar's financial centre

Population	27,649
GDP per capita, €	18,940
Bank deposits, €bn	9.1[a]
Insurance assets, €bn	0.4
Number of registered offshore companies	8,800[b]
Number of banks	18
Employees in offshore sector	2,200
Contribution of offshore sector to economy, %	25[c]

[a] Offshore business only: €3.2 billion.

[b] Total number of registered companies is 28,500, of which 8,800 are exempt and another 146 qualifying companies with substantially reduced tax rates.

[c] Estimated contribution of financial sector (both on- and offshore) to the economy.

Source: Gibraltar Financial Services Commission (2001) and IMF (2001).

Tax regime

Gibraltar has no capital gains tax, wealth tax, estate duty, inheritance tax or VAT. The normal corporate and personal income tax rate is 35%, the withholding tax is 1%.

Table 11. Gibraltar's tax regime

Personal income tax	50%[a]
Qualifying individuals	£10,000-20,000
Corporate tax	35%
Exempt companies	£225
Qualified companies	0-35%
Capital gains tax	0
Inheritance tax	0
VAT	0
Withholding tax	1%

[a] At income exceeding £19,500.

However, as a non-resident individual or as a company dealing only with non-residents, much lower rates apply, as can be seen from the table. Wealthy investors will pay a maximum tax of £10,000. Certain companies are eligible for tax exemption and as such pay an annual tax of £225. Other companies may apply to fit in under the "qualified company" status, which enables them to negotiate a tax rate well below the normal rate, normally around 5-10%.

Financial supervision

The FSF placed Gibraltar in its second group, meaning those OFCs that have legislation and supervisory structures in place, but that fail to implement them. Gibraltar has contested this judgement. A closer scrutiny renders some support to its argument.

The Financial Services Commission (FSC) carries out financial supervision. Since its inception in 1989, it has managed to clean up Gibraltar's financial sector, which was tarnished after scandals in the 1980s (e.g. the Barlow Clowes affair). Two facts ensure a close link with UK supervision: a) the Governor appoints the Commissioner with approval from the Foreign and Commonwealth Office (FCO), and b) the Commission has a statutory obligation to establish supervisory practices that match those in the UK. The above-mentioned Edwards Review also rendered support to Gibraltar's level of supervision. It highlighted the independent nature of the FSC, its abstinence from any marketing role and the absence of governors with a political link. In addition, being part of the EU, Gibraltar is obliged to implement all the relevant directives. Gibraltar has a deposit and investor protection scheme.

Money laundering

Gibraltar has had a stringent money laundering regime in place since the EU money laundering directive was transposed in 1995. It has signed up to the FATF and is participating in the mutual evaluation process within the structures of the Offshore Group of Banking Supervisors (OGBS). As a consequence, the FATF did not mention Gibraltar in its report on non-cooperative jurisdictions. A 2001 IMF assessments concluded that a comprehensive regime was in place, but that "as in other jurisdictions, there always scope for improving know your customer requirements".[62]

3.3 Guernsey

Guernsey is one of the five main islands comprising the Channel Islands, the other four being Jersey, Alderney, Sark and Herm. Their existence dates back to 1204, when the islands won the right of self-government in return for loyalty to the English Crown. The UK is responsible for defence and international relations and ultimately also for the good governance of these islands, but it cannot legislate for these islands on tax matters. Domestic affairs are handled by the legislatures of the islands. The relations between the Channel Islands and Isle of Man are dealt with in Protocol 3 of the UK's accession treaty with the EU. According to this, the Channel Islands are part of the customs territory.[63] In other words, they apply the CCT and CAP, but have no free movement of

[62] IMF (2001).

[63] European Communities (1973).

capital, services and persons. As a result, in contrast with Gibraltar, the Channel Islands and the Isle of Man are not part of the internal market.

Following high-profile bank scandals in the early 1990s, the UK launched a review of their crown dependencies' financial regulation (the above-mentioned Edwards Review). While concluding that these OFCs were in the first division of OFCs, the report nevertheless found that financial regulation had to be deepened and that company regulation had to be strengthened. As a consequence, the islands have since been engaged in regulatory reform and dialogue with the OECD and the FSF.

The financial sector accounts for 46% of Guernsey's economy. The main sectors are banking, investment management and insurance. There are 76 banks located in Guernsey, possessing deposits worth €132 billion. They are mostly subsidiaries or branches of large parent banks in the UK, the EU, North America, Australia and Asia.[64] The banks employ 2,700 staff members, which accounts for nearly one-quarter of the total workforce.

Table 12. Guernsey's financial centre

Population	58,681
GDP per capita, €	32,054
Bank deposits, € billion	132.0
Funds under management, € billion	48.5
Insurance assets, € billion	14.4
Offshore companies	15,453
Number of banks	76
Employees in financial sector	6,500
Share of total employment, %	21
Contribution of financial sector to the economy, %	46

The investment business consists of the management, administration and custody of collective investment schemes.[65] There are more than 80 groups from nearly 40 countries that are managing funds. In 2001, Guernsey funds managed assets worth €48.5 billion. Guernsey is also a centre for captive insurance. Since its origins in the 1920s, the number of companies underwriting the insurance risks of other companies has grown to over 340. Guernsey has been named as Europe's biggest domicile for offshore insurance. It accounts for €14.4 billion. Guernsey is also an important company centre. There are over 130 companies specialised in company and trust administration. Consequently, Guernsey is the home of over 15,000 offshore companies.

[64] UK Home Office (1998).

[65] Ibid.

Tax regime

Guernsey only levies two taxes: income and corporate, both at 20%. There are exemptions, however. Exempt companies (i.e. where the beneficial ownership is in the hands on non-residents who do not carry out any substantial activity) pay an annual flat fee of £600. International companies (i.e. owned by non-residents and generating income exclusively for non-residents) negotiate their tax fee with the authorities. Typically the tax is in the range of 0 to 2%.[66] Guernsey has only one double-taxation treaty and that is with the UK.

Table 13. Guernsey's tax regime

Income tax	20%
Corporate taxes	20%
Exempt companies	£600
International company	0-30%
Capital gains tax	0
Inheritance tax	0
VAT	0
Withholding tax	0

On 21 February 2002, Guernsey signed up to the OECD project. While stressing that it already does exchange information for tax purposes, Guernsey undertook to negotiate reciprocal information exchange agreements, to ensure that Guernsey authorities have access to bank information that is "relevant to tax matters" and force companies to keep audited accounts, all this before the end of 2005.[67] Whether to his will affect tax rates remains to be seen.

Financial regulation and supervision

The Financial Services Commission (FSC) carries out financial supervision. The Edwards Review concluded that financial regulation was adequate but that consumer protection schemes should be developed. Guernsey is therefore in the process of creating a depositor protection scheme, while adapting such a scheme to the island's wealthy and sophisticated investors.[68] The FSF also judged financial regulation, supervision and cooperation to be satisfactory and consequently placed the islands in its first group.

Money laundering

Guernsey has a comprehensive anti-money laundering system. Banks apply a "know-your-customer" policy. Anonymous bank accounts are not permitted and even though there is a significant amount of confidentiality in bank relations, there are legal

[66] UK Home Office (1998).

[67] Guernsey Financial services Commission (2002).

[68] The FSC proposes to limit it to £35,000, at par with the UK and Jersey levels (Guernsey FSC, 2002).

windows enabling it to be circumscribed in certain situations. In addition, both the Edwards Review and the FSF report judged that Guernsey cooperates well with foreign authorities.

3.4 Isle of Man

The Isle of Man (IoM) is significantly larger than the Channel Islands, thereby easing the pressure on property prices. As a consequence, the island has a competitive edge over the other dependencies in certain financial services. IoM has the world's oldest parliament, the Tynwald, dating back to the Viking age. It has the same relations with the EU as the Channel Islands, but has a customs union with the UK. As a consequence, the IoM has the same VAT as the UK, 17.5%.

The main activities of the financial sector in the Isle of Man are deposit-taking, asset protection and management, packaged investments such as unit trusts, life assurance and also fiduciary services such as company and trust management. The financial sector employs nearly 5,400 people. Another 1,500 are employed in related "professional services" (accountants, lawyers, etc.). The financial sector contributed 41% to national income in 2001.

Table 14. Isle of Man's financial centre

Population	71,714
GDP per capita, €	21,383
Bank deposits, € billion	43.6
Funds under management, € billion	7.9
Insurance assets, € billion	29.6
Offshore companies	41,747
Number of banks	60
Employees in financial sector	5,400
Share of total employment, %	26
Contribution of offshore sector to the economy, %	41

Source: Webpages of the Isle of Man Treasury.

Bank deposits in the Isle of Man amount to €43.6 billion. This is less than both Guernsey and Jersey. The Isle of Man is also smaller in managing assets than the two Channel Islands. The island is one of the largest offshore centres for insurance. This is partly due to specific factors such as space and educated workforce, which well suits the relatively more labour-intensive insurance business. The island is also very competitive in company administration. Over 40,000 companies are officially registered in the IoM, of which around half are exempt or non-resident.

Tax regime

Individuals and corporations are subject to income tax. The levels depend on the size of the revenue, as can be seen from the table below. As mentioned above, IoM levies

VAT. To curb its unequal effect (poor people pay a higher share of their income in VAT), IoM also has a system of allowances that are quite generous (e.g. married couples receive an annual allowance of nearly £15,000). IoM has no estate, capital gains, capital transfers or wealth taxes. IoM has a double-taxation agreement with the UK.

To meet the concerns of the OECD, the Isle of Man has announced a radical overhaul of its tax regime, which would go some way to curb the harmful features identified by the OECD. Under the proposals presented by the Minister of the Treasury, approved by the Council of Ministers and to be presented to the parliament in October, Isle of Man will over the next five years reduce its corporate and income taxes (see table). At the same time, it will bring in those exempt companies that have a significant local presence under the normal tax regime, albeit at a zero rate. This means that all shipping, insurance and fund management business will pay zero tax, no matter whether they are residents or not.[69] These changes will be phased in over two years. This meets OECD's concern on ring fencing. The IoM has also announced that they are ready to renegotiate their tax agreement with the UK so that information exchange can be ensured. At the same time, the IoM has declared that they are open to discuss the continued existence of the IBC and exempt categories.

The Isle of Man decided to cooperate much earlier with the OECD than the Channel Islands. Whether this set an example or whether it will work to the Isle of Man's disadvantage (it promised to scrap ring-fencing, which no longer forms part of the OECD's requirements) remains to be seen.

Table 15. Isle of Man's tax regime

Old regime		**New regime**	
Income tax		**Income tax**	
Standard rate	14%	Standard rate	10%
Higher rate	20%	Higher rate	15%
Non-resident	20%	Non-resident	10%
Corporate tax		**Corporate tax**	
Domestic	14-20%	Trading companies	10%
Exempt	£400	Others	15%
IBC	0.5-35% (min. £1,200)	Ship, insurance, fund management	0%
Other		**Other**	
VAT	17.5%	VAT	17.5%

Source: Webpages of Isle of Man Treasury.

[69] Isle of Man, Department of the Treasury (2000).

Financial regulation and supervision

The Financial Services Commission was established in 1983. Since its inception it has corrected the initial flaws of unsupervised deregulation that characterised the early 1980s. Today, the Isle of Man's financial regulation is regarded as transparent and efficient. Strong licensing tests, a separate enforcement division and depositor and investor protection provide stability to its financial centre. In addition, its financial authorities work closely and share information with regulators from other countries.[70] The FSF accordingly placed IoM in its first group.

Money laundering

IoM financial institutions apply "know-your-customer" principles. The FATF has judged that IoM has all the relevant regulations in place.

3.5 Jersey

Jersey is the largest of the Channel Islands. It has the same relations with the UK and the EU as Guernsey. Jersey is first and foremost an international banking centre, with nearly 80 banks, from 17 countries accounting for total deposits of nearly €212 billion. There are nearly 90 fund management houses handling assets worth €156 billion. Moreover, Jersey is the home to over 35,000 offshore companies. On the other hand, Jersey has a relatively small insurance industry (€9 million). However, the island is working hard to acquire a larger share of the insurance industry, as is witnessed by the 1996 Insurance Law. Overall, the financial sector employs 7,600 people.

Table 16. Jersey's financial centre

Population	85,200
GDP per capita, €	26,000
Bank deposits, € billion	211.9
Funds under management, € billion	155.7
Insurance assets, € billion	0.9
Offshore companies	35,000
Number of banks	70
Employees in financial sector	7,600
Share of total employment, %	n.a.
Contribution of offshore sector to the economy, %	55

Source: Webpages of Financial Services Commission (2001).

Since the 1980s, Jersey has been the prime location for special purpose vehicles in asset-backed securitisation transactions.[71] The reasons for this success are not only

[70] Standard & Poor's (2000).

[71] International Financial Law Review (1999).

beneficial tax levels, but also the presence of major accountancy firms, international banks and large commercial law firms.

Tax regime

Jersey has no capital or wealth taxes. Personal income is taxed at 20%. Exempt companies (see Guernsey for definition) pay an annual fee of £600. International business companies (IBCs) (insurance companies allowed) pay taxes on their profits (maximum 2%) and 30% on their "other income". The exact distribution between profits and other income is determined in discussions with the Comptroller of Income Tax.

Table 17. Jersey's tax regime

Personal income tax	20%
Exempt company	£600
IBCs	
Profits	< 2%
Other income	30%

Financial regulation and supervision

The Financial Stability Forum placed Jersey in its first group, i.e. countries that cooperate, have high quality supervision and that adhere to international standards. This endorses the efforts that Jersey has taken to implement the remarks in the Edward Review, e.g. the enactment of a new regulatory regime for trusts and companies and the creation of a more independent Financial Services Commission.

In addition, Jersey is in the process of enacting new powers to improve its international cooperation and to impose a new depositor protection scheme. Jersey was well regulated even before the Edwards Review. BCCI, the bank that spectacularly went bust in the early 1990s and that triggered a debate on supervisory cross-border cooperation, twice applied for establishment in Jersey. It was turned down both times.

Money laundering

Jersey has a comprehensive "all crimes" anti-money laundering legislation in place since 1999. The FATF judged Jersey to be cooperative, but expressed the same concerns as for Guernsey. The US Department of State has classified Jersey as of "primary concern", but this is only because of the size of its financial sector and its proximity to major business centres. The same report stated that Jersey has "clearly demonstrated the political will to ensure that its financial institutions and services industry is not used to launder money."[72]

[72] US Department of State (2000).

3.6 Liechtenstein

Liechtenstein is famous for its strict banking secrecy and the wide range of offshore vehicles an investor can choose from. In 2000, the Principality achieved the not-so-envious feat of figuring on all three blacklists (FATF, FSF and OECD).

Liechtenstein is a constitutional hereditary monarchy. The Prince represents the Principality abroad, signs all laws, appoints the government and passes judgement on proposals from the parliament. A 25-seat parliament is responsible for legislation. It has a long-standing customs union with Switzerland. Since the beginning of 1990s, the Prince has anchored the Principality more firmly into the international community: Liechtenstein joined the United Nations in 1990 and the European Economic Area (EEA) and the World Trade Organisation (WTO) in 1995. Liechtenstein has a diversified economy, which is performing well. Its economic success rewards Liechtenstein with one of the highest GDPs per capita in the world, €54,000.[73]

Table 18. Liechtenstein's financial centre

Population	32,491
GDP per capita, €	53,570
Bank deposits, € billion	19.3
Funds under management, € billion	80.9
Insurance assets, € billion	0.2
Offshore companies	80,000
Number of banks	17
Employees in financial sector	1,400
Share of total employment, %	n.a.
Contribution of offshore sector to the economy, %	23

Sources: Standard & Poor's (2001) and Liechtenstein government.

Liechtenstein is the home to a large financial sector. The financial sector employs over 1,400 persons. The main services relate to private banking, fund management and company and trust management.

The banking sector is dominated by private banking directed to wealthy investors. It was opened up to foreign competition in 1992. Today, there are 17 banks with deposits worth €19.3 billion. Funds under management amount to €80.9 billion. The insurance sector is quite limited, estimated at €200 million.

Offshore vehicles

There are five different types of companies:

- *Foundation.* Assets set aside and dedicated to a specific purpose. Beneficial ownership is strictly confidential. Ideal for inheritance planning.

[73] Standard & Poor's (1999).

- *Establishment.* Unique to Liechtenstein. Special purpose company with the right to carry out commercial activity. Independent legal personality. Capital need not be divided into shares. More flexible than Plc.
- *Trust***.** Unique in continental Europe. More flexible than its common law equivalent.
- *Trust enterprise***.** Typically a legal entity with own assets. Trustor transfers assets to the company and specifies the purpose.
- *Public limited company***.** Resembles the Plc in most European countries.

In total, Liechtenstein is the home to 80,000 companies.[74]

Tax regime

An outline of Liechtenstein's tax regime can be found below. Liechtenstein has a tax system that resembles many OECD countries in the sense that it taxes many bases (private income, corporate income, capital etc.). This is a reflection that Liechtenstein, compared to many other OFCs, has a solid "state" foundation. The difference is that the rates are lower, especially for offshore businesses.

Tax evasion normally falls under administrative law, i.e. it is not judicially punishable. In certain cases (so-called "qualified tax evasion"), tax evasion becomes a criminal offence (e.g. if documents are falsified). Supervisors do not disclose information for tax reasons to other countries. Liechtenstein is currently negotiating with the OECD.

Table 19. Liechtenstein's tax regime

Personal taxes		**Coupon Tax**	
Wealth tax	1.8‰ - 8.91‰%	Legal entities, bonds, investment funds units etc.	4%
Income tax	3.6% - 18.6%	**Foreign insurance companies**	
Corporate Taxes		Premium income (life, annuities)	1%
Organisation tax	3‰ / 2‰	Other types premium income	2%
Capital tax	2‰	**Investment funds**	
Earnings tax	7.5% - 20%	Stamp duty	2%
Special Corporate Taxes		Transfer stamp tax	0.15% - 0.3%
Tax on capital and reserves of domiciliary and holding companies	1‰	Capital and income tax	4‰ - 15‰

Source: Presse und Informationsamt, 2002.

Financial regulation and supervision

The FSF placed Liechtenstein in its third group, i.e. countries not cooperating, not devoting sufficient resources to supervision and not adhering to international standards.

[74] Ibid.

As a result, Liechtenstein has since increased the resources of the Financial Services Authority (AFD), which is responsible for carrying out supervision, notably in numbers of staff.

Money laundering

In 1998, the German Secret Service (BND) accused the Principality of being a major centre for international money laundering. A French parliamentary report in 2000 launched similar accusations.[75] In June 2000, the FATF placed Liechtenstein on its blacklist, the only European OFC to suffer this reproach.

The problem with Liechtenstein according to these reports was not that the Principality did not have laws in place. On the contrary, since the mid-1990s, Liechtenstein had adopted a Due Diligence Act and a law on International Mutual Assistance in Criminal Matters. Moreover, money laundering had been made a criminal offence in the Criminal Code. The problem rather was a *lack of enforcement* of these laws. For example, the Council of Europe's select committee judged that the system needed to be improved both on the "preventive and repressive side".[76]

Following Liechtenstein's *annus horribilis*, the Principality has acted resolutely to address the problems while not touching its cherished bank secrecy[77]:

- In July 2000, Liechtenstein's Banking Association strengthened *know-your-customer (KYC) rules*. As a result, the practice whereby banks in some cases only knew the identity of a beneficial owner via an intermediary (e.g. lawyer) was abolished. In November 2001, Liechtenstein's government decided to freeze the accounts where banks had not been able to identify the beneficial owner.
- The law on *mutual assistance* was changed in November 2000, in order to make the procedure faster and more efficient.
- On *money laundering*, an updated Criminal Code entered into force in December 2000. There, the predicate offences have been extended to cover "misdemeanours in relation to corruption offences" and own-funds laundering. The knowledge requirement has been replaced with "intent", which makes it much easier for prosecutors to prove that laundering has taken place.
- An amended *Due Diligence* Act came into force in January 2001. Its applicability has been extended to money exchange bureaus and to persons engaged in "trust-like operations". This ensures that all persons who accept or keep in custody other persons' assets, or help to invest or to transfer them, will be subject to the act. Provisions regarding origins of funds have been extended, requiring the establishment of the origin and economic background of funds as well as the purpose of the transaction. If there is suspicion of money laundering, institutions have an obligation to clarify the situation. If suspicions remain, institutions have an obligation to report their findings. Institutions will also have to prove that they have lived up to their due diligence obligations, not only to show that they have proper

[75] Assemblée nationale (2000).

[76] Council of Europe (2000).

[77] Fürstentum Liechtenstein (2001).

procedures in place. The new act also imposes an internal and external cooperation regulation. Internally, all authorities are obliged to cooperate. Externally, the regulation makes cooperation with foreign Financial Intelligence Units (FIUs) easier.

- The government established a separate *Financial Intelligence Unit* (FIU) in February 2001. The main task of the FIU is to receive, evaluate and analyse the suspicious activity reports received from financial intermediaries. If money laundering is detected, the case is forwarded to the public prosecutor's office. The FIU is allowed to cooperate with foreign FIUs.
- Generally, the *regulatory and supervisory resources have been expanded*. More judges have been employed, the number of staff in the Prosecutor's office dealing with financial crime has doubled. The AFD created a new division on "Duties of due diligence/compliance" and a new economic crime unit under the police has been set up (EWOK).

One sign that the new system appears effective is the number of suspicious transactions reported to the FIU. In 2001, the FIU received 158 reports, mostly related to suspicion of fraud (38%) or money laundering (31%). Of these, financial intermediaries themselves (banks, fiduciaries, lawyers, etc.) reported 64 cases reflecting suspicions arising during their due diligence process. An equal number came from law authorities, which took action in response to requests for mutual assistance. Finally, 30 reports were filed in conjunction with a domestic court action. There was a clear trend over the year of an increased incidence of reporting by financial intermediaries to the FIU, reflecting an increase in awareness of the problem. Of the 158 reported suspicions, 121 were forwarded to the Prosecutor's office.[78]

As a result of all these changes, the FATF removed Liechtenstein from its blacklist in June 2001.

3.7 Madeira

Madeira's international business centre (MIBC) dates back to the mid-1980s. The MIBC is a particular case, as the Madeiran islands are integral parts of Portugal and thus the EU. As a consequence, Madeira does not have full liberty in setting its tax rates, supervisory arrangements and regulation. The European Commission's explicit, albeit conditional, approval explains nevertheless that Madeira has been able to create an offshore centre.

Portugal and Madeira were motivated to set up an offshore centre by a desire to stimulate economic development. Madeira is one of the poorest parts of Portugal, with a local GDP per capita amounting to only 46% of the EU's average.

The MIBC consists of four sectors: the industrial free trade zone, the financial sector, the "international services" sector (consultancy, legal advice, management…) and a shipping register. As can be seen from the table, the financial part of the MIBC appears to be small compared to the major European OFCs. As only limited data are available, however, there is still a considerable margin of uncertainty.

[78] Data drawn from Financial Intelligence Unit of Liechtenstein (2002).

Box 6. Fiscal incentives in the Canary Islands

Another example of OFC activities taking place within the EU is the advantageous economic regimes being accorded to the Canary Islands. Although these incentives are in accordance with EU law, notably due to being limited in time and proportional to the tax loss incurred, they fundamentally apply the same instruments of competition as offshore centres in order to attract economic activity: low taxes. The main difference is that mobile financial services are excluded from these activities. Nevertheless, other lucrative services (e.g. tax consultancy) remains eligible.

The general Canary Islands Economic and Fiscal Regime *(REF*) was set up in 1972.[a] A general strand is that the REF employs a number of instruments, involving both direct and indirect taxes and modifying both the tax rate and the tax base.

Apart from the general regime, after approval of the European Commission in January 2000 the Canary Islands benefit from the Canary Islands Special Zone (*ZEC)* regime. The ZEC will initially apply until 31 December 2008, with company registrations ending in December 2006. However, the Commission may extend these limits. The ZEC covers both service activities, which may locate freely in the Canary Islands, as well as industrial activities, which may locate in designated areas close to ports and airports on the various islands.

The ZEC imposes *requirements* that a company must fulfil in order to qualify for its tax benefits: one of the managers must be a resident of the Canary Islands, the company must make an investment of at least €100.000 in fixed assets within the first two years, it must create at least five jobs within six months and maintain these five jobs during its time as a ZEC entity. Finally, it is only allowed to engage in certain activities. Notably, financial services, intragroup services and coordination centres are excluded. However, the scope of activities is wide, covering everything from manufacturing (e.g. food, machinery and chemicals) to services (e.g. telecommunications, tax consultancy, auditing, consultancy and holding).

ZEC companies enjoy substantial additional *tax benefits*. First, on part of their corporate income tax base they pay a tax of between 1-5%. The extent of this tax base exemption and the rate depends on number of jobs created, type of economic activity and timing of establishment. Second, as the Canary Islands are an integral part of the EU, ZEC companies benefit from Spain's double taxation agreements and the EU parent-subsidiary directive. No withholding taxes are thus levied on profits repatriated from a ZEC subsidiary to its parent company. Many of these benefits apply to non-EU residents as well. Finally, ZEC companies are exempt from stamp duty in many cases. These tax benefits apply differentially depending on economic activity. Activities that are likely to contribute more to the local economy (e.g. in terms of employment and investments) receive larger tax benefits. Activities with low local contribution receive lower tax benefits.

Overall, Spanish authorities have estimated that the ZEC will cover 563 firms, employing roughly 2.800 persons. This would lead to a net tax loss of €102 million (lost tax receipts – fees). The factors listed above (handicap, proportionality, degressiveness, time limit) led the European Commission to endorse the scheme.

Sources: Canary Islands Economic and Fiscal Regime Act; Law 30/1972, Royal Decree Law 13/1996; Royal Decree Law 7/1998; COM (2000) 891; COM (2001) 732; European Commission, Aide d'état no. 708/98; Hager and Levin, 2002.

Table 20. Madeira's financial centre

Population	261,800
GDP per capita, €	9,145
Bank deposits, € billion[a]	2.9
Funds under management, € billion	n.a.
Insurance assets, € billion	n.a.
Offshore companies	5,931
Number of banks (incl. branches)	41
Employees in offshore sector	3,729
Share of total employment	3

[a] Deposits held offshore by emigrants in the MIBC in 1997. This excludes deposits held by other non-residents, e.g. from the EU. Therefore, the real number is larger. Most of the banking entities in the MIBC are external branches, and therefore they consolidate deposits at Head Office level.

Source: SDM; Madeira regional government and Portuguese government.

Tax regime

Companies in the MIBC currently pay no corporate taxes. As can be seen from the table below, employees pay normal personal income taxes and VAT is at 17.5%, which is high by offshore standards.

Table 21. Madeira's tax regime

Direct taxes	
Corporate tax	0% - 12.5%
Personal income tax	14% - 40%
Indirect taxes	
VAT	17%
Withholding tax	0%
Stamp duty	0%
Excise taxes	0% (industry zone)

Madeira is an interesting OFC in the sense that its tax incentives have to be approved by the European Commission under state aid rules. The EC Treaty prohibits state aid in any form under normal circumstances (see Box 5). Under certain circumstances, however, certain state aid measures are allowed including state aid to the so-called outermost regions of the EU, of which Madeira forms part.

Nevertheless, even though outermost regions may receive state aid, such aid is subject to regular evaluation. The MIBC tax measures are currently scrutinised by the European Commission as part of a regular revaluation of the MIBC scheme. Madeira's ability to authorise new institutions to register under the MIBC has not been renewed yet by the

Commission. Therefore, Madeira is currently unable to accept new entrants to its MIBC. The MIBC has also been scrutinised under the EU's Code of Conduct. Despite reservations from the Portuguese delegation, the Code of Conduct group included the tax measures applying to the financial sector in its list of 66 harmful measures (B006).[79]

Financial regulation and supervision

Madeira is unusual in another sense as well. Being an integral part of Portugal, supervision is carried out by the Bank of Portugal, the country's central bank. EU financial legislation applies to Madeira as well. Therefore, the EU's recently updated money laundering directive will also apply in Madeira. Furthermore, being part of Portugal also means benefiting from Portugal's vast array of double tax treaties (currently 20). Since 2001, Portugal, and thus Madeira, has abolished bank secrecy. Portugal has also signed up for the draft directive on savings taxation, which envisages automatic information exchange for tax purposes.

To sum up, Madeira is not a typical OFC. While having a comparative tax advantage, these taxes are limited in time (2011) and subject to revaluation by the EU and are therefore not a permanent arrangement. Moreover, regulation and supervision match onshore standards. It is therefore likely that Madeira, being part of the EU, will find it difficult to sustain its offshore business centre by means that are inconsistent with EU norms.

3.8 Monaco

The Principality of Monaco, a constitutional monarchy, is primarily a locus for private banking. Monaco offers offshore financial services to individuals and firms of all nationalities except French. Monaco has a customs and monetary union with France. It is not part of the EU, except for VAT purposes. While private banking was the driving force behind Monaco's establishment as an OFC, the Principality has recently developed other activities, e.g. real estate banking, corporate lending, interbank and shipping-operations.

Table 22. Monaco's financial centre

Population	29,972
GDP per capita, €	27,000
Bank deposits, € billion	43.3
Funds under management, € billion	39.6
Insurance assets, € billion	n.a.
Offshore companies	n.a.
Number of banks	40
Employees in financial sector	1,700
Share of total employment, %	5.6
Contribution of offshore sector to the economy, %	50

Source: Monaco sur le web (http://www.monte-carlo.mc/invest/index.html#fiscal).

[79] Council of the European Union (1999).

Offshore companies

There are five different forms of companies: individual enterprises, partnerships, companies, other collective commercial bodies, *bureaux administratif* and agencies. The law prohibits pure holding companies. Only residents can form trusts, but it is easy to transfer trusts formed elsewhere. No official number exists, but it has been estimated that there are roughly as many offshore companies as there are inhabitants.

Tax regime

As can be seen from the table, Monaco levies no income tax on individuals and very few other taxes. Tax evasion is not a crime. Due to a tax agreement with France, French citizens are not eligible for these advantageous rates, but instead pay French taxes. The rates for corporations are interesting as well. The same tax rate applies to all kinds of offshore companies. Monaco has not reacted to its inclusion on the OECD list.

Table 23. Monaco's tax regime

Corporate taxation	
Business income tax (locals)	0%
Business income tax (if more than 25% of sales are generated outside Monaco)	33.33%
Natural persons (except French nationals)	
Income tax	0
Inheritance tax	0
VAT	5.5% - 17.5%

Financial regulation and supervision

The FSF placed Monaco in its second group. Therefore, the IMF will soon contact it, as the FSF recommended the Fund to concentrate on group II jurisdictions. French banking law applies in Monaco. The French Banking Commission supervises the banking sector. Monaco has not adhered to the European Convention on Judicial Cooperation in Penal Matters. The country currently has 12 bilateral cooperation treaties. Historically it has been difficult to obtain cooperation with Monegasque authorities.

Money laundering

Money laundering is a criminal offence in Monaco. The main problems relate to the presence of many casinos. The FATF judged that the Principality has comprehensive legislation in place, but that the Financial Intelligence Unit (FIU) lacks resources to properly combat financial crime. This contrasts with a French parliamentary report last year that came to a different conclusion, claiming that Monaco's banking secrecy, lax supervision and insufficient international cooperation made the country vulnerable to money laundering.[80]

[80] Assemblée nationale (2000).

3.9 "Legitimate" OFCs

The term offshore centre, which historically has had an image of exoticism and adventure, has increasingly become laden with a negative connotation. The processes outlined above can partly be seen as a rational response aimed at eliminating money laundering and reducing harmful tax competition. It is not surprising, however, that these processes are primarily pushed by onshore countries whose commercial centre actors have a self-interest in reducing the competition they face. Therefore, the power to designate what constitutes an on- and offshore centre is vital. In that respect, it should be remembered that several, if not most onshore financial centres share some of the characteristics of an OFC. Some of these are outlined below.

Dublin

Sometimes, the establishment of an offshore centre is regarded as a development strategy. By creating a zone where taxes are lower and regulation less burdensome, a jurisdiction is able to attract business that it would otherwise forego, whose benefits may spread to the onshore economy.

This was the reasoning behind the Irish government's decision in 1987 to set up the International Financial Services Centre (IFSC) in Dublin. Financial services were growing fast around the world and the government thought that Ireland, with its abundant supply of well educated but cheap labour, would be able to gain a share of the location of these services.

The centre has proven to be a success. It today employs nearly 4,000 people and over 400 financial institutions are operating directly from Dublin. It has gained a particular foothold in fund management as well as a substantial share in international banking, corporate treasury and some insurance activities. The main explanation for the success is low taxes. Corporation tax for firms located in the IFSC is 10%, far below the EU average of 37%. Dublin therefore is just as much a tax haven as, say, the Channel Islands.

The difference is that the Irish government sought, and got, permission from the other members of the EU before embarking on the road of tax competition. The European Commission regarded it as a development strategy and also saw the instrument, low taxes, as proportionate to the harm done. However, one requirement was that the IFSC had to be dismantled once its aims were achieved. That is exactly what has happened. In December 1999, a replacement scheme was developed, in which a new corporate income tax rate of 12.5% will apply from 1 January 2003. For firms already registered in the IFSC, the new tax rate will be phased in between 2005 (IFSC, Shannon) and 2010 (manufacturing, certain internationally traded services) (see www.ifsc.ie).

The new rate is still far below the EU average and brings some understandable resentment among OFCs. Why should they comply with the OECD's and the EU's claims if the EU lets one of its own members maintain harmful tax measures?

The City of London[81]

One of the first offshore markets was the eurodollar market. The eurodollar market was the first step towards the demise of the Bretton Woods system (operational from 1958 to 1971), where international capital flows were tightly regulated, and a return to a system of liberalised capital flows which was the rule under the gold standard.

The eurodollar market originated in the 1940s and 1950s when the Soviet Union and China decided to deposit their dollar holdings in Paris and London, as they feared that these revenues might otherwise be frozen (as the US had done with Yugoslavia's gold held in New York). One of the banks chosen for this purpose, Banque Commerciale pour l'Europe du Nord, had the telex address EURBANK; thus the term eurodollars.

This process soon spread to other market operators as well, who discovered that by placing their deposits in London they could avoiding exchange control regulations and benefit from interest rate arbitrage (avoiding the US regulation Q, which set a ceiling on interest paid by banks on their deposits and avoiding minimum reserve requirements). An additional boost was that the US ran continuous balance-of-payment deficits, which increased the amount of credit flowing from the US to other countries. As more and more banks participated, this led to the creation of a liquid international money market. This market was offshore in the sense that the vehicle used was US dollars, but the marketplace was the City of London and the participants were of all nationalities.

The advent of the eurodollar market is also a tale of how the establishment of an offshore market can affect financial power and standing. The Bank of England and the City tacitly encouraged the eurodollar market. The City's fortunes had until World War II been tightly connected to sterling. Sterling's role as an international reserve and trading currency gave a dominant role to the City. With the weakness of sterling after the war, the City was prevented from resuming its previous role as the world's major financial centre. By nurturing the creation of a eurodollar market in the City, the Bank of England created a new lucrative business line. Although this weakened the position of sterling to the benefit of the dollar, it strengthened the position of the City compared to New York.

At the end of the 1950s, demand for US products started to decline. The short-term eurodollar market then expanded into longer-term instruments with the advent of certificates of deposits and eurobonds. Eurobonds are international bonds issued by a syndicate of securities houses in any international currency and placed in more than one country.

An important characteristic of the eurobond market is the non-application of withholding taxes. Under the EU's draft savings taxation directive, the eurobonds already in circulation before 1 March 2001, will continue to benefit from this provision under a grandfather clause until 2009 (see Ecofin Council Conclusions, 27 November 2000, and Draft Council Directive, COM(2001)400 of 18 July 2001). Most trading in eurobonds is currently taking place in London – and to a large extent, over-the-counter (OTC). Euroclear and Clearstream (formerly Cedel) have been the main clearing and settlement houses for eurobonds ever since their inception.

[81] Drawn from Burn (1999).

Luxembourg

Luxembourg has been at the centre of attention since the attacks on OFCs started in the spring of 2000. A member of the EU and the OECD, the country carries out those same practices with the same methods that are being singled out by these two organisations as unacceptable. For many OFCs, this highlights the hypocritical nature of the attacks.

Luxembourg's financial sector dates back to the 1960s. It initially focused on the euro credit market, but when this crashed in the 1980s, the financial sector turned towards offshore private banking. In the late 1980s, the government introduced tax breaks and favourable legislation in order to stimulate the development of investment management. Luxembourg today is therefore the home of a disproportionately large financial sector, especially concentrated on fund management where it ranks third in the world, only by the US and France, and private banking. Net assets amounted to €780 billion in March 2000. The banking sector is more limited (€208 billion) and the insurance industry remains small compared to other centres (see Financial Times, 2000 and CEPROS, 1999).

While nominal corporation tax in Luxembourg is high (37.45%), effective rates are often lower due to favourable reductions and exemptions. More importantly, Luxembourg applies no withholding tax and applies a policy of strict banking secrecy. Consequently, Luxembourg is opposed to the OECD initiative on harmful tax competition. When the OECD started its process in 1998, Luxembourg did not sign the report and did not consider itself bound by the OECD's recommendations. Luxembourg has also resisted efforts by the EU's Code of Conduct Group on business taxation to phase out measures that affect, or may affect, in a significant way the location of business activity in the Community.

Things are about to change however. In December 1999, the Code of Conduct Group released a report on harmful tax measures in the EU. It singled out a number of preferential regimes in Luxembourg that have to be dismantled, among them preferential tax benefits accorded to collective investment undertakings, venture capital funds and holding companies. Moreover, at the Feira European Council in March 2000, Luxembourg finally caved in on establishing information exchange as the basis for taxation on savings. It did so provided that Europe's offshore centres and key third countries abide to the provisions as well. Although this is highly questionable at this stage (March 2002), the formal agreement to apply information exchange at some future stage marks a turning point in Luxembourg's position.

This is further reflected by Luxembourg's decision to abide by a request by the United States to act on behalf of the US Internal Revenue Service (IRS) to collect taxes from clients who are American citizens. The IRS has pressured foreign banks to perform these tasks and to become "qualified intermediaries" or face the threat of being excluded from the US market. Since 1 January 2001, therefore, Luxembourg has withheld taxes on investment income earned by US citizens and transferred these funds to the IRS.

It is uncertain how far-reaching the effects will be on bank secrecy. Under the agreement with the US, Luxembourg authorities will not disclose the identity of account holders to the IRS, thus maintaining secrecy. However, US citizens will not be allowed to hold US bonds or equities in Luxembourg unless they are ready to have their identity revealed to the IRS. In any case, it is likely that the EU will exploit Luxembourg's decision to exchange information with the US in order to push the Grand Duchy into implementing the Feira agreement.

So is Luxembourg an OFC? Despite its size and increasing diversification, Luxembourg is still to a large extent an offshore centre. Once again, however, the discussion of whether Luxembourg is or is not an OFC reflects the muddled definition of offshore centres.

Switzerland

Is Switzerland an offshore centre? Some would answer yes. Swiss banks undoubtedly provide services mainly to non-residents. Moreover, the FSF included Switzerland in its list of OFCs posing a potential risk to the world's financial system, albeit in the least dangerous group.

Others would answer no. Switzerland is well supervised, well regulated and cooperates fully with other jurisdictions. For example, Switzerland has established a strong track record of exposing its own banks if they behave badly, as illustrated by the Swiss Federal Banking Commission's (CFB) investigation into dirty money related to the late Nigerian dictator Abacha, and of imposing sanctions on foreign banks with branches or subsidiaries if they do not follow the rules, as illustrated by investigations into the holdings of Vladimiro Montesinos where the General Manager of Bank Leumi le-Israel was forced to resign.[82]*

Switzerland can also argue that it does not fit the OECD's description of a tax haven. Its taxes on business and investment income are close to the OECD average. In addition, it applies a withholding tax of 35% to all interest and dividend payments of Swiss issuers or debtors (irrespective of the domicile). Moreover, Switzerland does not apply "ring-fencing", i.e. a special advantageous regime for offshore non-resident companies.

Another reason for not including Switzerland is its size. Switzerland is more of a regional financial centre, i.e. it is a large international centre, with deep and liquid markets with diverse sources and uses of funds, with advanced payments and settlements systems, which provide a full range of financial services to its domestic economy and beyond. There are 372 banks in Switzerland employing nearly 120,000 people. Funds under management in Switzerland amounts to €1,300 billion. (see the Financial Times Survey on Switzerland, 2000 and Swiss Bankers Association, 1999). Moreover, the financial sector, despite its size, does not account for more than 9% of GDP. This is more than other large financial centres such as the UK (7%), but far less than the OFCs surveyed in this paper.

Consequently, the issues at stake for Switzerland are different from those of the OFCs in this paper. Switzerland has a functioning regulatory and supervisory machinery in place. It has a very broad anti-money laundering regime, which is strictly enforced. Despite its bank secrecy, Switzerland is increasingly cooperating with foreign authorities.

[82] The CFB listed a number of Swiss banks in this affair, notably Credit Suisse Group, Crédit Agricole Indosuez (Suisse), UBP Union Bank Privée and M.M. Warburg (Schweiz) AG (see CFB, 2000). For details on the Montesino case, see CFB (2001).

Nevertheless, despite recent regulatory improvements and broadening of financial activity, Switzerland is still to a large extent competing in the same market as other OFCs: attracting the savings of non-resident, high net-worth individuals. The big Swiss banks definitely do provide offshore services. And, despite what is mentioned above, there are ways of escaping the withholding tax (e.g. fiduciary deposits). Most importantly from a EU-perspective, Swiss authorities do not assist foreign authorities in tracking down tax evaders, as tax evasion is not an offence under Swiss law.

CHAPTER 4
THE PROSPECTS FOR OFCS

The environment for offshore centres is increasingly harsh. Over the last decade onshore governments have pursued *domestic economic reforms* that have liberalised their economies and they are thus catching up with OFCs. In addition, governments are increasingly cooperating in order to create new structures of *international governance*. Refining rules and institutions so that the international financial system remains stable, chasing down the darker side of free capital movements and putting limits on what is acceptable tax competition between sovereign states are all areas where new forms of governance are emerging.

4.1 A deteriorating outlook

The traditional comparative advantages of OFCs have been low taxes, less burdensome regulation and secrecy. All these advantages are now being undermined by international action:

- *Regulation*. Following increasing compliance with FSF and FATF demands, the general level of regulation in OFCs is increasing. OFCs therefore find it harder to compete with less burdensome regulation.
- *Taxation*. Low taxes are still OFCs' major point of attraction. The EU's and OECD's attempts to curb these tax advantages have been marred by problems. The events of 11 September, however, appear to have convinced many OFCs to cooperate with the OECD. This should provide *some* momentum to the EU's project on taxing savings income, although the EU-project is more far-reaching (as it attempts to establish automatic information exchange).
- *Bank secrecy*. The preservation of bank secrecy is a common interest between some OFCs and some onshore states. Since September 11th, however, bank secrecy has been in the spotlight as financial intelligence units all over the world have gone on "fishing expeditions", i.e. looking for suspect transactions. Bank secrecy makes this more difficult. Whether bank secrecy can be reconciled with the increased need for financial intelligence remains to be seen.

As a result, OFCs traditional comparative advantages are being eroded, although there are some forces that mitigate these trends:

- Taxation goes to the heart of sovereignty. Most states are reluctant to concede any of this sovereignty. It is therefore problematic to use power to bring OFCs within the fold. The proposition that tax sovereignty is a core part of national sovereignty resonates profoundly within most states.
- To force OFCs into the fold regarding taxes would require a firm international regime. Such a regime, albeit entirely plausible, would be difficult to set up, and to sustain over time. Difficulties increase with the number of actors and the complexity of the issue and if the costs and benefits are unevenly divided. International action on OFCs is a case in point.

- While the competition for the location of financial activity increases, the number and kind of services susceptible to be carried out in remote locations have increased. This trend is likely to continue.

4.2 Policy recommendations

OFCs have to change

The challenge for OFCs is to develop business lines that are less dependent upon secrecy and tax and regulatory advantages. OFCs ought to react pro-actively by thinking strategically about which industries and which activities they should foster and attract. OFCs should aim at increasing their reputation by bringing themselves into line with emerging international norms while keeping some of their traditional advantages.

Table 24. Strategies for adapting to a harsh environment

Time frame	Aim	Measures
Short term	Show that OFC does not harbour criminal money launderers	Comply with FATF • Strict know-your-customer rules • Stringent and comprehensive regulation • Effective implementation • Tough supervision and enforcement • Follow Swiss example of naming and shaming publicly Start process of cooperation with OECD Start self-assessment on terrorism financing
Medium term	Adjust functioning of tax system in order to comply with OECD requests before 2005	End opaque tax practices Make sure bank secrecy provisions are compatible with *specific* information exchange requirements Concentrate efforts on confidentiality standards of information exchange agreements Argue strongly for tax sovereignty in international arena
Long term	Widen business base	Widen scope of services Develop other comparative advantages: not build industry entirely on tax/regulatory advantages Attract key skills/people

In the *short term*:

- OFCs should ensure that they are not placed on the FATF's blacklist. This will mean fulfilling the FATF recommendations and in particular, blocking the accounts where beneficial owners have not been identified.

- OFCs should continue the cooperative stance in the new screening exercise of the FATF on terrorism financing that is due to start in June 2002.
- OFCs should improve the standing and status of their supervisory authorities. Increasing their regulatory powers or increasing their numbers could achieve this aim for example.
- OFCs also ought to name and shame individuals or companies that breach money laundering or other financial rules. Switzerland is a good example, where this practice has had the spin-off effect of improving the image of the Swiss financial centre.
- Bearing in mind that bank secrecy is of instrumental importance, OFCs have to show in practice that it does not make it more difficult to find financial criminals, whether they have terrorist links or not.
- OFCs should increase the resources devoted to financial supervision in order to match the significant size of their financial sectors. The argument that OFCs face insurmountable obstacles due to the limited size of their work force rings hollow. By attracting a sizeable and lucrative chunk of international capital, it is the duty of OFCs to ensure that this capital is clean and poses no risk to the international financial system.
- In addition, professional quality should be underscored by promoting self-regulation among the different professions involved in OFCs. They should set codes promoting high levels of integrity in day-to-day business. Since OFCs are generally small, these should not be too difficult to implement.
- OFCs should engage constructively with the OECD, provided that a true level playing field is established. That would require OECD members (e.g. Switzerland and Luxembourg) to accelerate the dismantling of their harmful tax measures.
- There is a widespread lack of information about offshore centres. To a large extent this is inherent in the very concept of offshore as a place where financial capital can be quietly deposited. Many OFCs have, however, much higher standards of supervision, disclosure, etc., than commonly thought. They ought to communicate that fact more effectively to the outside world. One way would be to improve their presence on the Internet, another would be to engage in more reporting to international financial institutions (e.g. BIS).

In the *medium term*, OFCs ought to improve the image and reputation of their tax systems. Although the OECD project has been marred with difficulties, it has proven itself to be resilient. Therefore, OFCs should be proactive:

- A first, and rather uncontroversial step, would be to end opaque tax practices (i.e. non-public tax measures, e.g. negotiated discretionary tax rates). This would meet some of the transparency requirements of the OECD.
- A second, and more controversial step, would be to try to find ways to reconcile the prerogatives of bank secrecy with the demands of *specific* information exchange demanded by the OECD. One avenue to explore is ways to define the confidentiality standards that such information exchange agreements are subject to (in other words, the ways that the information delivered by Liechtenstein would be used).

- OFCs ought to argue strongly for the case of tax sovereignty. It is not only low tax countries that feel uncomfortable with the emerging tax regime. High-tax countries are not interested in an international regime, which by the logic of negotiation, would tend to strike a compromise between low tax regimes and high tax regimes.
- The EU is already finding it difficult to convince European OFCs to implement similar measures to those adopted by member states. Advances in the OECD process is likely to be of limited importance to the EU process, as the EU demands *automatic* information exchange, not specific information as is called for by the OECD. The reaction of European OFCs is entirely comprehensible. The only reason why the EU is engaged in negotiations is that it was the only way to persuade Luxembourg (and to some extent Austria) to agree on information exchange. A sensible compromise solution would be that OFCs permanently introduce the same system that Luxembourg and Austria will have on an interim basis, i.e. withholding taxes of 15-20%, coupled with transferring 75% of the revenue to the member state of residence of the investor. That is an offer that the EU would find hard to refuse.

In the *long term*, OFCs ought to widen the business base:

- The services should not be based entirely on secrecy, tax and regulatory advantages.
- OFCs should compete to attract key financial skills and people.

The international community has to address the legitimacy problem

The international community is now engaged in a process whose eventual goal is to pressure sovereign states or semi-sovereign jurisdictions to make sweeping changes to their policies. This poses problems of legitimacy, especially as the international public good involved in certain cases rests on fairly uncertain theoretical ground. The international community has a responsibility to ensure that this process is as fair, transparent and reliable as possible. In this domain there is a room for improvement.

On *fairness,* the international community should ensure a level playing field. OFCs compete for capital in a global financial market. Clamping down only on some will only divert that capital elsewhere and lead to a massive exodus of financial capital out of the law-abiding OFC. Moreover, the main benefactors will be key OECD members (the UK and the US). Applying the law to only a select few does not solve the problem of harmful tax practices, financial systemic risk and money laundering. In addition, it is unfair to the concerned jurisdictions. They are highly dependent on their financial sector and cannot legitimately be asked to take unilateral steps that would eliminate it.

In order to increase their credibility and defuse accusations of hypocrisy, the EU's and the OECD's members should eliminate their own harmful tax practices before demanding anything similar from non-members. The large financial centres should ensure that they have adequately combated money laundering before bashing OFCs. So far, as OFC representatives have accurately pointed out, members have aggressively protected their national interests.

The OECD, the FATF and the FSF should be prepared to provide assistance to those OFCs that agree to cooperate.

On *transparency and reliability***,** it is important that sanctions be defined more clearly. This would raise the stakes and increase the domestic "win-set" in the jurisdictions concerned, as it would be clear what costs would be imposed in the case of non-compliance. The time for constructive ambiguity is over. Overall, the carrot side of the name-and-shame process should be more fully developed and more precisely defined as well. As it is now, OFCs face a huge risk to their reputation if they do not comply, yet conversely, there is today little reward for compliance (e.g. public praise from an international institution).

In sum, the OECD in particular, with the support of other institutions as well, should aim at developing a more systematic assessment approach with clear and well defined carrots and sticks and a systematic, fair and reliable way of testing progress.

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