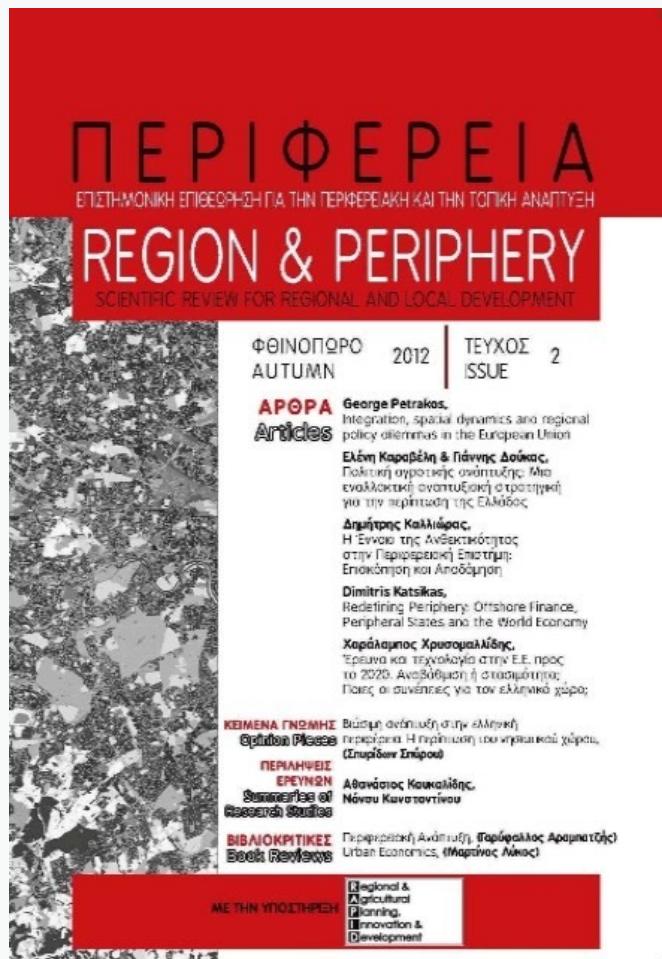


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## Επαναπροσδιορίζοντας την Περιφέρεια: Εξωχώριες Χρηματοπιστωτικές Συναλλαγές και Κράτη της Περιφέρειας στην Παγκόσμια Οικογονία

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# Redefining Periphery: Offshore Finance, Peripheral States and the World Economy

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## Abstract

This article seeks to examine the changing dynamics between the periphery and the core of the world economy. Small, peripheral states have assumed an increasingly important role in recent decades by offering financial services to an increasing and geographically expanding range of corporate entities and wealthy individuals. These Offshore Financial Centres (OFCs) or tax havens, offer a service, which often has negative consequences for non-OFC countries at the core of the global economy. Despite pressure from the latter, these small states at the periphery of the global state system are able to continue their operation unabated. This is possible because in a world of growing technological interconnectedness and capital mobility these states are able to employ the one resource they possess that has no limits: their legal sovereignty, that is, their right to write and enact law. By effectively commercializing their sovereignty small states are able to offer "juridical relocation", a valuable service to wealthy individuals and companies around the world, which in turn employ them as a core piece in their intricate global wealth managing networks.

**KEYWORDS:** Offshore Financial Centres, Tax Havens, Periphery, Legal Sovereignty, Capital Mobility, Shadow Banking

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## Επαναπροσδιορίζοντας την Περιφέρεια: Εξωχώριες Χρηματοπιστωτικές Συναλλαγές και Κράτη της Περιφέρειας στην Παγκόσμια Οικονομία

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## Περίληψη

Το άρθρο αυτό επιχειρεί να εξετάσει την μεταβαλλόμενη δυναμική της σχέσης μεταξύ της περιφέρειας και του κέντρου της παγκόσμιας οικονομίας. Τις τελευταίες δεκαετίες, μικρά κράτη της περιφέρειας έχουν αναλάβει έναν ολοένα και πιο σημαίνοντα ρόλο στην παγκόσμια οικονομία, προσφέροντας μια σειρά χρηματοπιστωτικών υπηρεσιών σε μια πληθώρα επιχειρήσεων και ευκατάστατων ιδιωτών ο αριθμός και η γεωγραφική ταυτότητα των οποίων συνεχώς επεκτείνονται. Αυτά τα Εξωχώρια Χρηματοπιστωτικά Κέντρα ή φορολογικοί παράδεισοι, προσφέρουν υπηρεσίες οι οποίες συχνά έχουν αρνητικές επιπτώσεις στις οικονομίες των χωρών του κέντρου. Ωστόσο, παρά την πίεση των τελευταίων, τα κράτη αυτά της περιφέρει-

ας συνεχίζουν να λειτουργούν χωρίς σοβαρά προβλήματα. Αυτό καθίσταται εφικτό γιατί σε ένα κόρμο υψηλής τεχνολογικής διασύνδεσης και ελευθερίας κινήσεων των κεφαλαίων αυτά τα κράτη μπορούν να χρησιμοποιήσουν αποτελεσματικά έναν πόρο που ξεπερνάει τους περιορισμούς του μεγέθους τους: την νομική εθνική κυριαρχία τους, δηλαδή το δικαίωμα τους να δημιουργούν και να εφαρμόζουν τους δικούς τους νόμους. Χρησιμοποιώντας ουσιαστικά την εθνική κυριαρχία τους σας εμπορικό ανταγωνιστικό πλεονέκτημα, τα κράτη αυτά προοφέρουν την δυνατότητα μιας νομικής μετακίνησης της έδρας των επιχειρήσεων και των ιδιωτών, οι οποίοι εκμεταλλεύονται την δυνατότητα αυτή τοποθετώντας τα κράτη αυτά στο κέντρο των παγκόσμιων δικτύων που χρησιμοποιούν για την διαχείριση του πλούτου τους.

**ΛΕΞΕΙΣ-ΚΛΕΙΔΙΑ:** Εξωχώρια Χρηματοπιστωτικά Κέντρα, Φορολογικοί Παράδεισοι, Περιφέρεια, Νομική Εθνική Κυριαρχία, Ελευθερία Κινήσεως Κεφαλαίων, Σκιώδες Τραπεζικό Σύστημα

## 1. Introduction

The financial crisis wreaked havoc to the global financial system and led to the most severe economic crisis since the interwar years. The prompt intervention of governments and central banks averted the collapse of the global financial system. However, the enormous cost of these interventions derailed fiscal policy and prepared the ground for the current debt crisis. The policy response, particularly in Europe, was the endorsement of an austerity policy programme, which however, has plunged Europe into recession for the second time in a period of three years, making the task of raising public (tax) revenues all the more difficult. In these circumstances, the search for alternative sources of public revenues in order to facilitate fiscal adjustment and avoid burdening further the large mass of middle-to-low income tax-payers, have catapulted the issues of tax evasion and tax avoidance to the forefront of public policy debate, particularly in countries that undergo strict fiscal consolidation programmes.<sup>1</sup> The so-called “Lagarde list” affair, which gripped public opinion in Greece during the autumn of 2012, is a case in point. The list contains the names of Greek taxpayers with deposit accounts at HSBC’s branch in Switzerland; its mishandling by the Ministry of Finance, which failed to make any meaningful use of the list, even for informal investigation purposes, led to accusations of a political cover-up, which provoked an intense political clash and has consequently led to parliamentary and judicial inquiries.<sup>2</sup> At the same time, the efforts in recent weeks by the British and French governments to reveal tax avoidance practices by major multinational companies (MNCs) such as Amazon, Google and Starbucks and oblige them to pay a corporate tax bill commensurate with the scope of economic activities these companies undertake in their jurisdictions, has been making headlines in international media.<sup>3</sup>

These incidents while demonstrating the heightened interest of national authorities in the issues of tax evasion and avoidance, they also testify to their difficulties in tackling these problems. In a sense, this is truly astonishing given that the bulk of activities related to tax evasion and tax avoidance, take place through small states, usually situated in distant, isolated locations or in the far reaches of

the periphery of big individual countries or continents. Given the substantial fiscal consequences for large developed, but also developing countries, it is truly puzzling how these financial centres continue to operate unabated. The puzzle becomes even more intriguing when one takes into account the substantial campaign against tax havens that major international organizations such as the Organization for Economic Cooperation and Development (OECD) or the Financial Stability Forum (FSF) and its successor the Financial Stability Board (FSB) have embarked on in recent years. What is more, the international pressure on tax havens increased further in the aftermath of the global financial crisis, with the G20 identifying the issue as a top priority for restoring transparency and stability in the global financial system.<sup>4</sup>

Although significant progress has been made, given the terms of the mandate and the policy options and tools employed by the international community and endorsed by the G20, many analysts adopt a pessimistic view when it comes to the outcomes of these multilateral initiatives (Palan et al., 2010; Rixen, 2012). This pessimism is corroborated by recent research, which shows that despite the onslaught of multilateral initiatives in recent years tax havens have been able to continue their operations and in some case expand both their activities and their client base (Sharman, 2012).

The answer to this empirical puzzle is that contrary to images of tax havens as small peripheral entities that operate outside the global economy, they are in fact a central part of the global financial system. The growing integration of world markets through technological innovation and crucially, capital mobility, have altered the ability of remote, small jurisdictions to participate in the world economy and most importantly in the global financial system. In this sense, traditional measures of the concept of peripheral states such as size, domestic material resources and geographical position are misleading. In a world of growing technological interconnectedness and capital mobility, small, peripheral states are able to employ the one resource they possess that has no limits: their sovereignty. By effectively commercializing their sovereignty small states are able to offer “juridical relocation”, a valuable service to wealthy individuals and companies around the world, which in turn employ them as a core piece in their intricate global wealth managing networks.

The article is organized as follows. In the first section, the concept of tax havens will be introduced and their increasing significance for the global financial system will be demonstrated. Next, a theoretical discussion will develop the argument about the changed conceptualization of periphery in a world of technological interconnectedness and capital mobility. Another section will provide some empirical evidence about the central position of offshore finance in the global financial system, through a brief examination of the role of offshore financial centers in the recent global financial crisis. A final section will summarize and conclude the article.

## 2. Offshore Financial Centres and the Global Financial System

Providing a definition for offshore finance is not easy. Preferential Tax Regimes (PTRs), tax havens and offshore financial centres are all labels that have been in use for many years and their differences are not always easy

to identify. Thus, for example, PTRs are found in many developed and large developing countries, their pronounced objective being to offer preferential tax and regulatory treatment in order to attract foreign business. In this sense, PTRs could be thought of as an instrument of industrial policy, which primarily aims to attract Foreign Direct Investment (FDI) in manufacturing and other “real economy” activities in order to raise national income and employment. However, often PTRs are used not to attract real business activities but rather to help non-resident companies and individuals lower their tax burden. As a result, it is often very difficult to distinguish in practice a PTR from a tax haven, the latter generally thought to be intentionally enacting legislation that aims to offer tax advantages and protection to non-resident corporate entities and individuals. Such a definition of tax havens however, makes it equally difficult to distinguish them from Offshore Financial Centres (OFCs). According to the International Monetary Fund (IMF), offshore finance is “the provision of financial services by banks and other agents to non-residents” (IMF 2000). Accordingly, an OFC could be thought of as “any financial centre where offshore activity takes place” (IMF, 2000). However, it is obvious that it is very difficult to distinguish between offshore financial centres, which use financial activities as an instrument to facilitate tax evasion and/or tax avoidance and those that offer a wide range of “legitimate” financial services, which may or may not offer tax and other regulatory advantages. What is more, financial services to non-residents are offered in many financial centres that would otherwise be considered “onshore”. Thus, for example, London and New York are considered major OFCs, since they offer a wide range of financial services to non-residents. More generally, in recent years the liberalization of capital mobility and the gradual abolition of regulatory obstacles in financial services have made the provision of financial services to non-residents possible in literally all financial jurisdictions.

Therefore, and in order to avoid the conceptual difficulties of distinguishing between OFCs and tax havens, this article will use the terms interchangeably as long as jurisdictions fulfil the following criteria (IMF, 2000):

- (a) Jurisdictions that have relatively large numbers of financial institutions engaged primarily in business with non-residents;
- (a) Financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and
- (a) More popularly, centres which provide some or all of the following services: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity.

These criteria are designed to single out jurisdictions, which specialize in providing services to non-residents; that is the bulk of their activity is geared towards non-residents. This is a tell-tell sign of a tax haven since major international financial centres such as London, New York or Tokyo, are not solely or primarily geared towards servicing non-residents.<sup>5</sup> A tax haven or OFC specialize exclusively in providing services to non-residents, this why the size of their financial system is generally substantially out of proportion with what the needs of the domestic economy would call for. This in turn means that a

large part of the financial transactions taking place through OFCs are virtual, in the sense that they do represent actual, physical transactions taking place in these jurisdictions; these transactions are made elsewhere and they are only “booked” in OFCs, so that they can benefit from the tax and other regulatory advantages these jurisdictions offer. This brings us to the last and arguably, most important point, which is related to the kind of services these jurisdictions offer, which usually is very low or zero taxation and regulation, combined with very strong legal provisions for the protection of the identity of their clients.<sup>6</sup> This combination is of course what enrages other countries and makes OFCs a target of multilateral initiatives for their regulation. Through OFCs and tax havens wealthy individuals from other countries, as well as corporate entities including MNCs, have the ability to reroute their transactions, hiding thus taxable income from their national taxation authorities and/or eschewing regulatory requirements requested by their domestic regulatory authorities.

Table 1 presents two lists that were compiled by the OECD and the FSF, listing jurisdictions characterized as tax havens and offshore financial centres respectively. Although the language regarding the characterization and cooperation with international authorities of some of these jurisdictions has changed over time, these lists are indicative of the type of jurisdictions that specialize in offshore financial activities.

**Table 1. List of Tax Havens/ Offshore Financial Centres**

	<b>Jurisdiction</b>	<b>OECD*</b>	<b>FSF**</b>
<b>1</b>	Andorra	•	•
<b>2</b>	Anguilla	•	•
<b>3</b>	Antigua & Barbuda	•	•
<b>4</b>	Aruba	•	•
<b>5</b>	Bahamas	•	•
<b>6</b>	Bahrain	•	•
<b>7</b>	Barbados	•	•
<b>8</b>	Belize	•	•
<b>9</b>	Bermuda	•	•
<b>10</b>	British Virgin Islands	•	•
<b>11</b>	Cayman Islands	•	•
<b>12</b>	Cook Islands	•	•
<b>13</b>	Costa Rica		•
<b>14</b>	Cyprus	•	•
<b>15</b>	Dominica	•	
<b>16</b>	Gibraltar	•	•
<b>17</b>	Grenada	•	
<b>18</b>	Guernsey, Sark & Alderney	•	•
<b>19</b>	Hong Kong		•
<b>20</b>	Ireland		•

21	Isle of Man	•	•
22	Jersey	•	•
23	Lebanon		•
24	Liberia	•	
25	Lichtenstein	•	•
26	Luxembourg		•
27	Macao		•
28	Malaysia		•
29	Maldives	•	
30	Malta	•	•
31	Marshall Islands	•	•
32	Mauritius	•	•
33	Monaco	•	•
34	Montserrat	•	
35	Nauru	•	•
36	Netherlands Antilles	•	•
37	Niue	•	•
38	Palau		
39	Panama	•	•
40	Saint Kitts & Nevis	•	•
41	Saint Lucia	•	•
42	Saint Vincent & the Grenadines	•	•
43	Samoa	•	•
44	San Marino	•	
45	Seychelles	•	•
46	Singapore		•
47	Switzerland		•
48	Tonga	•	
49	Turks & Caicos Islands	•	•
50	US Virgin Islands	•	
51	Vanuatu	•	•

Source: OECD 1998, 2000; FSF 2000.

\* This original OECD list in 1998 identified 47 possible tax havens. OECD's 2000 report listed 35 tax havens; six were still acknowledged as tax havens (and are included here) but they were kept off the list because they had committed to cooperate with the OECD. Another six were excluded from the list because of a change in the definition of what constitutes a tax haven. The OECD has in the meantime decided that three jurisdictions (Barbados, Maldives and Tonga) should not be included anymore in the list. In its latest report (May 2012), the OECD reports that all jurisdictions have committed to implementing its tax standard, which effectively is a standard about transparency and information exchange.

\*\*The FSF list contains 42 jurisdictions characterized as offshore financial centres. The jurisdictions were grouped into three categories reflecting their perceived quality of supervision and perceived degree of co-operation with other national and international authorities.

It probably comes as no surprise that most of the jurisdictions that satisfy these criteria are to be found in small, remote countries, which typically exist at the periphery of developed countries such as the United Kingdom (Jersey, Isle of Man, Guernsey) or the United States (Cayman Islands, Barbados, Bahamas, Dominica, Turks and Caicos Islands, Belize, etc.) and at the outer fringes of continents like Europe (Malta, Cyprus, Gibraltar), Asia (Hong Kong, Singapore, Macao), and Oceania (Vanuatu, Tonga, Nauru, Marshall Islands, Samoa). Even when these jurisdictions are centrally located (as is the case in Europe with Monaco, Luxembourg, Liechtenstein, Switzerland and San Marino), these are small countries and/or administrative regions which have traditionally existed at the periphery of the mainstream political developments and economic activity of their country and/or continent. These are typically very small states with very low population, extremely limited domestic economic and natural resources and virtually no geopolitical significance. For example, it is characteristic that of the forty-two jurisdictions identified by the FSF as OFCs, thirty-three have a population of less than a million. As it will be shown in the next section, in view of their handicap in the global economic competition game, these states have opted to use their one valuable asset, their ability to write law, as a tool to attract financial business.

Despite their limited size, population and natural resources, these states have been able to play an increasingly important role in the global economy, by becoming an integral part of the global financial system. Tables 2 and 3 display the total banking assets and liabilities of the top thirty reporting jurisdictions (by volume of assets and liabilities) respectively.

**Table 2. External Positions of Banks in all Currencies vis-à-vis all Sectors in Individual Reporting Countries Assets (\$ billions, June 2012)**

<b>Country*</b>	<b>Assets</b>
United Kingdom	5,640
Japan	3,165
United States	3,139
Germany	2,414
France	2,278
<b>Cayman Islands</b>	1,429
Netherlands	1,122
<b>Hong Kong</b>	953
<b>Singapore</b>	889
<b>Luxembourg</b>	732
<b>Switzerland</b>	718
Belgium	682
<i>Japanese Offshore Market (JOM)</i>	677
Italy	652
Spain	530

<b>Ireland</b>	501
Canada	458
Sweden	446
<i>United States International Banking Facilities (IBFs)</i>	433
Finland	430
Australia	378
Austria	377
<b>Bahamas</b>	336
<b>Jersey</b>	270
Chinese Taipei	225
<b>Guernsey</b>	190
Norway	175
Denmark	165
<b>Bahrain</b>	145
Greece	142

Source: Bank of International Settlements

\* *With bold are designated countries that are included in at least in one of the OECD/ FSF lists. With italics are offshore regimes explicitly designed as such within the jurisdictions of the United States and Japan.*

**Table 3. External Positions of Banks in all Currencies vis-à-vis all Sectors in Individual Reporting Countries Liabilities (\$ billions, June 2012)**

<b>Country*</b>	<b>Liabilities</b>
United Kingdom	5814
United States	3576
France	2041
Germany	1866
<b>Cayman Islands</b>	1473
Netherlands	1387
Japan	1300
<b>Singapore</b>	949
<b>Switzerland</b>	815
Italy	796
<b>Hong Kong</b>	715
Australia	708
Sweden	634
Belgium	630
Spain	599
Finland	583

<i>United States International Banking Facilities (IBFs)</i>	556
<b>Luxembourg</b>	539
<b>Ireland</b>	422
Canada	360
<b>Bahamas</b>	331
<i>Japanese Offshore Market (JOM)</i>	288
Denmark	288
Austria	243
Norway	242
<b>Jersey</b>	232
South Korea	229
<b>Bahrain</b>	143
Brazil	142
<b>Guernsey</b>	136
Chinese Taipei	130

Source: Bank of International Settlements

\* *With bold are designated countries that are included in at least in one of the OECD/ FSF lists. With italics are offshore regimes explicitly designed as such within the jurisdictions of the United States and Japan.*

According to the data presented above, ten of these small states are among the thirty largest financial centres in the world. Indeed, in terms of assets, the Cayman Islands seem to be the sixth largest financial centre globally. Of course, some of the OFCs in tables 2 and 3, are countries such as Switzerland, Hong Kong, Singapore and Ireland, which have a substantial domestic economy, they offer a wider array of financial services, with real value-added and should perhaps not be considered in the same category as other OFCs.<sup>7</sup> Even if one excludes such states however, the results are still astonishing, as tiny islands like Jersey and Guernsey, with less than 100,000 inhabitants seem to be more important financial centres than economic powers such as Brazil, India, Mexico, South Africa, Norway, Denmark and South Korea.<sup>8</sup> To take a different measure, according to BIS figures, bank deposits in offshore centres in June 2012 totalled \$3.9 trillion; by comparison the respective amount for the United States, Japan, Australia, Canada and New Zealand collectively was \$4.7 trillion and for the Euro-area \$5.8 trillion.<sup>9</sup> In total, according to BIS data, offshore financial centres hold approximately 18% of global bank deposits. These astonishing figures notwithstanding, what is even more astonishing is the fact that these numbers underestimate the true significance of OFCs in today's global financial system. This is because not all OFCs report information on banking activities, and more importantly, an increasing number of financial transactions take place outside the traditional banking system, through private trusts, hedge funds and a host of other entities of the so-called shadow banking system. Thus, while the figures concerning the deposits mentioned above are impressive, they only refer to cash deposits and do not take into account other forms of wealth such as shares,

bonds, real estate, gold, etc. In their effort to estimate the total wealth that may be located or channelled through OFCs, Palan et al. (2010), review a number of studies and report figures that range from \$8 - \$12 trillion.

Even these figures however, do not provide the whole picture, as OFCs play also a central role in corporate tax strategies, particularly those of MNCs. It seems that approximately 30% of all FDI is invested or passes through OFCs (Palan et al. 2010), while OFCs also play an integral part in MNCs' transfer pricing strategies. While accurate global estimates are not available, data from individual countries show that intra-firm trade makes up an increasing share of global trade (Dunning and Lundan, 2008). Based on such evidence a recent OECD report estimates intra-firm trade at approximately 30% of global trade (OECD 2010). In this context, transfer pricing, that is, the manipulation of the trading prices between different affiliates of the same MNC in order to exploit differences in tax regimes across countries, has become an increasingly important phenomenon. According to a 2010 survey of Ernst & Young covering twenty-five markets and 643 MNCs, 30% of parent companies tax directors consider transfer pricing as the most important tax issue, while 74% considered it a crucial or very important consideration for the next two years (Ernst & Young 2010). Finally, it is also worth mentioning that the discussion above has focused on the manipulation of wealth and income transactions produced by legal economic activities. However, this is again only part of the picture, as these figures do not include illicit money transactions. According to a recent report by the United Nations Office on Drugs and Crime, the proceeds from crime are estimated in 2009 at 3.6% of global GDP or \$2.1 trillion, while amounts laundered are estimated at 2.7% of global GDP or \$1.6 trillion (UNODC, 2011). OFCs are a key component in the global money laundering mechanism of proceeds from criminal activities. Therefore, it is not surprising that in the International Narcotics Control Strategy Report (INCSR) of the United States Department of State for 2012, no less than eighteen OFCs are reported as major money laundering centres.

### 3. Redefining Periphery in the Global Financial System

From the previous section, it is clear that OFCs and/or tax havens are playing a significant part in the operation of the global economy. This development has significant negative repercussions for other countries; the operation of OFCs leads to the loss of considerable amounts of tax revenue for non-OFC jurisdictions,<sup>10</sup> it facilitates the laundering of illicit money from criminal activities and very importantly (and not realized until the recent financial crisis) threatens the stability of the global financial system. The obvious empirical puzzle then, is how these small, peripheral states are able to continue these operations seemingly unabated.

Traditionally, the core-periphery dichotomy in the study of international relations has been characterized by an implicit categorization of states, where the core comprises powerful states, which dominate international affairs and impose their will on weak peripheral states. In this sense, the conceptualization of periphery has been tied up with the concept of state power in international

relations. State power in turn has been largely dominated by realism's conceptualization of power "as the ability of one state to use material resources to get another state to do what it otherwise would not do" (Barnett and Duvall, 2005:2). According to traditional realist approaches, these material resources typically comprise the size of its territory and population, its natural resources, its level of economic and technological development and most importantly, its military capabilities. The sum of such material resources determines state power, which in turn determines the position of the state in the hierarchy of the world state system (Waltz, 1979). It is worth noting, that this understanding of state power and the consequent segregation of states into a classification of power, has also played a key role in the analysis of the international political economy. Thus, for example, it was a key component in many of the different strands of dependency and neo-Marxist theories, which emerged in the aftermath of the dissolution of the great empires in the post-war period and which explicitly sought to analyse global political and economic affairs under the prism of a core-periphery dichotomy (Baran, 1957; Franck, 1967; Wallerstein, 1974). While developments in recent decades have undermined both the credence of dependency theories and the dominance of realism, the idea that material resources such as the size and sophistication of the domestic market provide a power advantage in the global economy is still a dominant one in current debates on global economic governance. Sophisticated realist-inspired approaches argue that such material resources offers substantial bargaining advantages in global economic governance negotiations (Gruber, 2000; Simmons, 2001; Drezner, 2007).

The validity of such arguments notwithstanding, the rise of OFCs has demonstrated that the constraints imposed on states by the scarcity of material resources can, to some degree, be overcome in an environment of technological interconnectedness and capital mobility. The ability to communicate and transact across borders instantly and at very low cost, combined with the increasing liberalization of capital movements in recent decades have transformed the global economy. The multinational company has risen to the position of the dominant economic entity, a development, which as we saw above has changed dramatically the nature of global trade. Global production and trade patterns create a complex web of economic transactions, in the midst of which lies an equally complex financial system. This flurry of transnational activity has meant that increasingly, several aspects of everyday life, particularly in the economic realm, are operating in the context of a functional geography, which often is at odds with the territorial geography of political authority (O'Brien 1991; Neuer 1998; Kobrin 2002). It is the exigencies of this functional geography, which give rise to a new power resource that is equally abundant and available in every nation-state, however small or peripheral: legal sovereignty, or the sovereign right to write and enact law. As companies and individuals transact increasingly across borders, they seek out jurisdictions that offer them advantages both in carrying out these transactions and in safeguarding the income they earn on them. In this context there is a risk that states will engage in competitive deregulation in order to attract foreign investment.

While there is still disagreement over the degree to which a “race to the bottom” is taking place in terms of regulatory standards in different economic sectors (Abbott and Snidal, 2009), there is no doubt that international tax competition is an increasingly significant phenomenon (OCED 1998). The proliferation and growth of tax havens and OFCs in recent decades provides the most definitive evidence of this development. Tax havens and OFCs differ from other types of competitive deregulation, in that their objective is not to attract business away from other jurisdictions; not real business anyway. The extremely small size, the dearth of natural, human and other economic resources and the geographical remoteness of many of these peripheral states means that in many cases it is not possible to attract typical FDI flows. In the case of small, peripheral tax havens real economic activity is not relocated; rather the *“principal attraction of tax havens”* and the main cause for their spectacular success lie in their ability to provide protection from national regulation and taxation *without* the need to physically relocate to the host country” (Palan, 2000: 163).<sup>11</sup> What is relocated is the juridical residence of the transacting parties: companies and individuals relocate their legally acknowledged place of residence for some purposes in jurisdictions, which offer low or nil taxation, secrecy and light regulatory requirements, without however having to relocate physically their activities or business to these jurisdictions. This in turn is possible because of the denial of the legal unity of the subject (Palan, 2002). According to Palan, states have been able to manage the tension between the insulation of the state in law and the internationalization of capital, already evident since the 19th century, by allowing the (fictional) separation of the legal subject (Palan, 2002). This allows individuals and companies to be at the same time in different (legal) places, a peculiar situation which however offers them the great advantages of calculated ambiguity, such as enjoying “the advantages of ownership while divesting themselves of the liabilities, borrowing without taking on debt, simultaneously reporting high profits and none at all, and ‘round-tripping’ domestic capital as foreign investment (Sharman, 2010: 2). In this context, it is not surprising to discover that the majority of companies that reside in OFCs and tax havens are really “shell” companies, that is, companies with no real substance, economic activity or even employees; they exist only in name in a juridical plane in order to confer to their owners the advantages on offer by the OFCs.

This complex web of legal and economic interlinkages between the offshore world and onshore entities and individuals goes a long way towards explaining why small peripheral states such as Cayman Islands, Mauritius and Turks and Caicos islands can go on playing such a significant role in the global financial system, despite the negative consequences that this can have for their much larger and powerful neighbours. In the first instance, this transnational web has created powerful interest constituencies that strive for its survival. These constituencies comprise the corporate entities and wealthy individuals that reside physically on the shore, but which gain tremendously by the existence of the offshore. In a sense, the conflict between tax havens and other countries is really a domestic conflict between interest constituencies in the onshore countries

(Rixen, 2012). This is why as is obvious from tables 2 and 3, even major onshore financial centres such as New York and Tokyo have sought to capitalize on the demand for offshore services by instituting distinct offshore markets within their own jurisdictions. What is more, the situation is now further complicated by the rise of new emerging economic powers in the world scene. According to Sharman (2012), most tax havens have continued to thrive or at the very least have been able to resist the recent campaigns against them, by effectively capitalizing on a new great source of demand for their services, which is none other than the corporate entities and the “new rich” of emerging markets such as China, Brazil and India. In these circumstances, it should come as no surprise that recent multilateral initiatives against tax havens have not really led to any fundamental changes and that despite the increasing politicization of the issue by civil society movements, an abolition of tax havens in the foreseeable future is not forthcoming (Rixen, 2008).

#### 4. Offshore Finance and the Global Financial System

From above, it is obvious that the offshore has become an integral part of the global economic system, altering the traditional dynamics of the core-periphery continuum. The two poles of the system are economically and legally interconnected and interpenetrated to such a degree that often this dichotomy is rendered meaningless. In finance, this is more evident than in any other area of economic activity. As we saw previously, in the aftermath of the crisis the onshore – offshore dichotomy has been raised to the forefront of policy debates. In the area of finance, the increased attention to this dichotomy is because the crisis revealed an entire section of the global financial system, which operated unregulated and unsupervised, the so-called shadow banking system. This system includes various institutions that perform the functions of traditional financial intermediaries (maturity, credit and liquidity transformation) but without being subject to the same regulatory requirements and supervision, or public protection privileges such as access to central bank liquidity or government guarantees (Pozsar et al., 2012). Moreover, while typically associated in some way with onshore financial institutions, in many cases these shadow banks operate out of offshore financial centres further eschewing regulatory control and supervision. In all cases, there are strong indications that the operation of the shadow banking system facilitates tax evasion and avoidance for individual and institutional residents of developed countries’ jurisdictions and reduces significantly the tax burden of a wide array of financial institutions at the expense of taxpayers in the onshore jurisdictions.

Although most analyses have looked at the practices of the shadow banking institutions and the financial instruments they produced and supplied to the global financial system (Acharya and Richardson, 2009; Adrian and Shin, 2009; Pozsar et al. 2012), recent work has also pointed to the crucial role played by the institutions that created the demand for the products of shadow banks (Acharya and Schnabl, 2010; Pozsar and Singh, 2011; Pozsar, 2011). For example, a major driver for the growth of the shadow banking system has been the emergence of

large institutional cash pools, that is “large, centrally managed, short-term cash balances of global non-financial corporations and institutional investors such as asset managers, securities lenders and pension funds” (Pozsar, 2011:4). These institutional cash pools display an ever increasing demand for safe, high-quality, liquid, short-term debt instruments which cannot be satisfied neither by partially insured deposits nor by government guaranteed short-term instruments. The gap has been filled by short-term debt instruments which combine liquidity, satisfactory yields and capital safety, as they are privately insured (for example repurchase agreements - repos, asset-backed commercial paper - ABCP - and money market tranches of asset-backed securities – ABS), (Pozsar, 2011). One of the most significant reasons for the creation of these large institutional cash pools is the high demand for the long-term securities in which asset managers routinely invest in. These assets are in demand as a source of collateral for broker-dealers and universal banks (security borrowers) in order to be re-used for other purposes and they are usually exchanged for cash (for example through the use of reverse repos), which then is invested in short-term debt instruments as described above (Pozsar and Singh, 2011).

In terms of the tax implications of the demand side of the shadow banking system, a major problem lies with the fact that the funds that form these institutional cash pools are often concentrated and centrally managed (by specialized asset management companies) in low-tax jurisdictions or tax havens, eschewing thus taxation in the countries where the initial funds came from (e.g. the country where the headquarters of a non-financial corporation is located, or the country of origin of a high net worth individual, whose family office is set up as an offshore legal entity). This problem is further complicated by the fact that as mentioned above, these institutional cash pools do not invest in traditional M2 measures of money such as certificates of deposit, savings and checking accounts, time deposits etc. Rather they invest their cash balances into privately secured short-term debt instruments, which are very hard to monitor accurately, as the related transactions span the global financial system, and the result is invested positions into instruments which are in effect cash-equivalent but do not appear in bank cash balances. Therefore, even in cases where international agreements could force offshore jurisdictions to report, or at least collect tax from bank balances of individuals and companies (even less likely), this type of wealth would probably neither be reported nor taxed.

On the supply side, shadow banks perform credit intermediation. However, credit intermediation in the shadow banking system is securitization-based and depends on the wholesale funding by money market funds and the institutional cash pools and asset managers referred to above. The main feature of securitized credit intermediation is that in contrast to traditional banking intermediation the process takes place in a number of steps typically performed by a number of different institutions (Pozsar et al., 2012). The result is long credit intermediation chains, which link banks, broker-dealers, insurers, limited purpose finance companies, money market funds, institutional cash pools and asset managers into a complex process of credit, liquidity, maturity and reverse maturity

transformation. It is evident that these intermediation chains straddle both the official and the shadow banking systems. A major link between the two systems is the establishment of a wide array of structured investment vehicles (SIVs), special purpose vehicles (SPVs) and funds that are typically off-balance sheet subsidiaries of universal banks and/ or major broker dealers, often incorporated in tax havens and offshore financial centres. It is obvious that this global network of off-balance sheet subsidiaries allows individuals and companies to hide earned income from their home jurisdictions, while also operating as a huge transfer pricing mechanism for the global financial system, reducing financial institutions' own tax bill. Monitoring is particularly difficult given the volume and geographical scope of these transactions, as well as the fact that a large part of the shadow banking system has been operating on an over-the-counter (OTC) basis, away from organized exchanges, with little information publicly available.

From the brief analysis of the demand and supply of the shadow banking system, it becomes obvious that it straddles both the onshore and offshore worlds by relocating funds and the institutional vehicles through which these are managed to OFCs, while the beneficiaries remain on the shore. These beneficiaries, which include some of the world's most prestigious financial institutions, non-finance corporations and businessmen, are hidden by long intermediation chains, which interconnect a wide array of diverse institutional vehicles, making it virtually impossible to trace, regulate and tax the flow of wealth through the global financial system. It is evident, that the emergence of the shadow banking system, is not only the result of the actions of some small, remote and secretive jurisdictions at the far reaches of the globe; the financial imbalances that led the global financial crisis, including the growth of a virtually unregulated parallel universe of financial activities, have been the result of regulatory forbearance, deliberate policy choices and ideological and normative rigidities in developed countries, without which the complex interpenetration between the onshore and the offshore worlds would not have been possible.

## 5. Conclusions

This article has sought to examine the changing dynamics between the periphery and the core of the world economy. Small, peripheral states have assumed an increasingly important role in recent decades by offering financial services to an increasing and geographically expanding range of corporate entities and wealthy individuals. Technological interconnectedness and capital mobility have made this possible, as these are in effect virtual financial services, between institutions related to the same beneficiaries but located in different jurisdictions. These activities have harmful consequences for non-OFC countries, which are typically much larger, wealthier and powerful than OFCs and tax havens. However, despite these consequences and the power asymmetry between OFCs in the periphery and countries at the core of the global economy, the former seem to defy the pressure of the latter. This is because, first, the OFCs take advantage of the principle of legal separation of the subject, which is deeply ingrained in the

structure of the modern state system, and whose negation could create serious practical, but also political and ethical challenges for the latter, particularly in an era of economic interdependence and interpenetration. Secondly, these economic circumstances have linked the offshore world in intricate and multi-layered ways with the onshore, making the regulation of the former impossible without a comparable regulatory reform of the latter. This is where the true difficulty in campaigns against OFCs lies; in effect, the regulation of both the onshore and the offshore are really an issue of balancing interest groups in the core countries. The distribution of resources between these groups do not leave much room for hope that OFCs' practices are coming soon to an end, despite the proclamations of statesmen in the core countries and international organizations to the contrary. Besides, the emergence of new economic powers, whose rising corporations and new rich seek to share in the benefits of offshore services, is likely to complicate things further by expanding the web of onshore-offshore interlinkages and adding another layer of clashing interests over the operation of the OFCs.

## Notes

1. Both tax evasion and avoidance aim at reducing the tax burden of an individual or a company. The difference is that evasion takes place through illegal practices such as hiding income, while avoidance employs legal instruments and loopholes to achieve the same result without violating the letter of the law.
2. The list has been named after the former French Minister of Finance Christine Lagarde (currently Director of the International Monetary Fund – IMF), who gave the list to her Greek counterpart in 2010.
3. See for example "US groups grilled over low tax payments", Financial Times, 12 November 2012 and "France considers broad tax clampdown on web companies", Reuters, 14 November 2012.
4. G20 Declaration on Strengthening the Financial System, London, 2 April 2009.
5. London may be an exception, as it is the world's largest centre for non-resident financial activity. Still, to a large degree this is the result of its deep and liquid capital markets and its sophistication in terms of legal procedures and market infrastructure and not the result of a deliberate strategy to develop an OFC; it is what Palan calls a "spontaneous" offshore cite (Palan, 1998).
6. The model here is Switzerland, which was the first to develop very strong laws for the protection of banking secrecy.
7. Although such a distinction could be valid based on the size and sophistication of the domestic economies of these jurisdictions, their categorization as OFCs or tax havens should not be in doubt, given that Hong Kong, Singapore and Switzerland have been listed as such in nine out of eleven major international studies, while Ireland has been included in eight studies. For a comprehensive overview, see Palan et al. 2010.
8. See full list for external positions of banks by nationality of reporting country available at: [http://www.bis.org/publ/qtrpdf/r\\_qa1212\\_anx2a.pdf](http://www.bis.org/publ/qtrpdf/r_qa1212_anx2a.pdf).

9. Available from the BIS website at: [http://www.bis.org/publ/qtrpdf/r\\_qa1212\\_anx7a.pdf](http://www.bis.org/publ/qtrpdf/r_qa1212_anx7a.pdf).
10. While there are no reliable figures for global tax losses, evidence from individual countries suggests that it is substantial. For example, studies have estimated the tax gap (that is, the difference between declared profits and paid taxes and actual taxes paid) at 2% of GDP for the United States and 2-2.5% for the EU (Palan et al. 2010: 66).
- 11 Emphasis in the original.

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