

TO APPEAR AS**Van Fossen, Anthony****2008 Why Are Tax Havens in Small States? In J. R. Pillarisetti, R. Lawrey, J.T.S. Yean, S.A. Siddiqui, and A. Ahmad (eds.), *Small Economies and Global Economics*. New York: Nova Science Publishers, pp. 221-231.****WHY ARE TAX HAVENS IN SMALL STATES?¹****By****Anthony van Fossen
Griffith University****ABSTRACT**

This chapter examines why small nations are such congenial environments for offshore financial centers (OFCs). There are four structural reasons. OFCs make significant contributions in small local economies. They play an important role in small nations' domestic politics. They often turn small states into legal laboratories. Small states contain few interest groups which are inclined to oppose tax haven development.

The world's most important tax havens or offshore financial centers² (OFCs) are concentrated in relatively small states (see Appendix 1, for those which are considered in this chapter). This gives these small nations a prominence in global finance that is greatly disproportionate to their size. The principle of sovereignty (particularly the ability to pass their own tax laws) allows them to create structures which attract a wide range of wealthy and powerful clients and produce a new kind of international political economy. OFCs in small states account for about 26% (\$6.9 trillion) of all reported external currency assets of banks in the world (\$24.5 trillion)

in September 2006 (see Table 1). Significant numbers of small state OFCs (for example, those of Samoa and the Cook Islands) do not report their offshore bank deposits, so this figure is understated. To put these figures into perspective, banks in the United States (with a population of 298,444,215) had total external currency assets of \$2,184.6 billion or \$7,320 per capita.

TABLE 1: EXTERNAL CURRENCY ASSETS OF BANKS IN REPORTING OFFSHORE FINANCIAL CENTERS (September 2006)

JURISDICTION	TOTAL (\$ billions)	PER CAPITA (\$)
Cayman Islands	1,498.1	34,756,281
Switzerland	1,130.6	150,267
Luxembourg	871.6	1,937,218
Ireland	722.2	177,734
Singapore	583.1	129,804
Hong Kong SAR	581.3	83,756
Jersey	415.2	4,587,774
Bahamas	339.4	1,117,293
Guernsey	171.3	2,634,128
Bahrain	141.8	202,982
Isle of Man	66.0	884,077
Netherlands Antilles	21.5	97,746

Source: Bank for International Settlements, *Quarterly Bulletin*, March 2007, Kashner 2007

The enormous assets formally held by such diminutive states have often surprised, amused or scandalized metropolitan outsiders if they become aware of the situation. Such small nations are often criticized for encouraging rich metropolitan clients to

pretend to be something else—to assume a false character, feigning some genuine link with a tax haven in order to gain advantages bordering on fraud. These opponents go further and argue that these OFCs assist the development of a corrupt international ruling class, which takes unfair advantage of the general population, especially in the Third World (Naylor 1994).

If the issue is raised, people in large countries may feel that tax havens in mini-states are weakening their political systems or democracies (allowing the wealthiest to opt out of their responsibilities), while small nations frequently see attacks on their tax havens as a form of persecution, a denial of their sovereign equality (van Fossen 2003). Many small tax haven nations have acquired substantial sovereignty relatively recently (in the post-colonial period) and they are frequently sensitive to apparent harassment from larger, older, more established, powerful or formerly imperial states. The ability of small haven countries to trap and tangle large states (and the international organizations which they control) in double standards, self-contradictions and hypocrisy has helped small OFC states immobilize and even reverse some significant advances in the OECD anti-tax haven campaign (Sharman 2006).

The tension between large polities and small OFC nations often develops as a conflict of sovereignties—where the metropolitan state and the small haven polity form contrasting descriptions of the same situation. An example is the years of debate over whether the same large (“Magnum-style”) transactions should be governed by the

laws of the states which house the corporate parents (New Zealand, Australia, Japan, or the United States) or the laws of the Cook Islands tax haven, where the deals and transfers were made by their subsidiaries (Davison 1997, Wishart 1995, 1999). One may see tax havens as either enhancing sovereignty in small nations or eroding it in metropolitan states.

Why are small nations such congenial environments for offshore financial centers? There are four structural reasons. OFCs make significant contributions to small local economies; they play an important role in small nations' domestic politics; they often turn small states into legal laboratories; and small states contain few interest groups which are inclined to oppose tax haven development. Selected (sometimes extreme) examples will illustrate these general points.

Relative Contributions

Firstly, revenues from such services may contribute greatly to a small jurisdiction's national and governmental incomes and provide substantial per capita benefits, particularly to local elites. In Monaco, which became one of the first small state tax havens, an offshore gambling casino (which is still legally off-limits or prohibited for Monegasques) was established by an absolute monarchy eager to exploit foreigners. It became so profitable that it allowed the small population to enjoy freedom from taxes. Monte Carlo's tax haven attracted rich tax exiles and bank depositors, whose demand for financial services in the microstate led to even greater per capita benefits for the residents (Mount 1991).

The structural similarities of small tax haven nations stem partly from diffusion. OFCs tend to imitate each other and there may be a feeling among the leaders of a small nation that it should have an OFC because it has limited economic alternatives. Prominent politicians in newer havens usually cite the decline of some important economic sector or an over-reliance on traditional industries such as tourism, and the need to create new opportunities. The government of Luxembourg, for example, has relied increasingly on its OFC to produce jobs, foreign exchange receipts and government revenues to replace the ones which had been lost when its economic mainstay, the steel industry, collapsed in the early 1970s (Naylor 1994:120).

In the Caribbean in 2000 OFCs contributed 54.6% of central government revenues in the British Virgin Islands, 14.6% in the Cayman Islands and 7.2% in Antigua and Barbuda. They employed 15% of the labour force in the British Virgin Islands and 12% in Antigua and Barbuda (Williams *et al.* 2005: 1179, 1182). In Anguilla the offshore financial center provided a few clerical jobs for people in a poor country, but it conferred great benefits on the political leaders who facilitated it and on the rich expatriates who managed it (Robinson 1998: 145). In 2003 in the Pacific Islands OFCs directly generated 6.1% of government revenues in Vanuatu and 4.0% in the Cook Islands, and these and other offshore center revenues were extremely concentrated in the capital, where local elites have concentrated (van Fossen 2008).

On Jersey, Guernsey and Sark the financial industries have been hegemonic, since the state has largely depended on their cooperation to deliver the services that the electorate demanded. Jersey's very successful OFC, which employed most educated workers on the island and contributed an estimated 90% of government revenue directly or indirectly. It has crowded out other industries and development alternatives, captured the public service and political system, and dominated popular thinking about the identity of the island (Christensen and Hampton 1999: 179, 183, 186). The offshore financial sector on Guernsey has, accounted for about 50% of the island's income and directly employed about one-third of its school-leavers. A large proportion of the adult population on Sark received considerable income from serving as nominee officials in numerous offshore companies. Virtually no consideration of policy and structural reform in the Channel Islands can take place without the issue of the tax haven insinuating itself into discussions (Massey 2002).

Microstates tend to rely on a small number of foreign-owned industries which are granted special privileges and operate in enclaves largely exempt from local control (Baldacchino 1993: 32). While revenues from tax haven activities may appear to bring a great boost to small nations' economies, they also represent a form of dependency and a threat of adversity if, for any reason, the OFC declines or falls.

The economic contribution of havens is important in explaining their persistence in small nations, but it is not a sufficient explanation. Under international pressure the Pacific Island OFC of Niue was destroyed, even though it was directly providing

12.8% of government revenues in 2001-2. By contrast, other offshore centers in Oceania (the Marshall Islands and Samoa), which in 2001-2 directly contributed only 3.1% and 3.7% of government revenues respectively, stood up to blacklisting by international organizations and have subsequently become far more successful. Their offshore promoters were far more committed and better organized to influence the OFC country's government (van Fossen 2002a, 2008).

Domestic Politics

Secondly, in small countries bankers, lawyers, accountants and other financial service providers may be organised into a strong interest group promoting and defending the offshore sector--influencing the government, particularly the legislature. The small nation is an alternative society in which professionals may escape metropolitan taxation and regulation and build their own tax haven—with its own laws and practices supported by the local political elite. Although the promoters often “oversell” OFC development, once it is established they gain considerable influence over political power-brokers and state bureaucracies in relation its ordering and development. In a sense, they constitute the real offshore financial center—active, committed, sometimes insistent, and disproportionately powerful in the small state.

Vatican City's OFC is oriented around the Istituto per le Opere di Religione (the Institute for Works of Religion), known as IOR or “The Vatican Bank”. In the world's smallest sovereign nation-state, with an area of 108.7 acres and a population of fewer than one thousand, this monopoly bank has been easily accessible to wealthy

residents of Italy, which completely surrounds the Holy See but which conducts no border checks or effective exchange controls. This offshore merchant bank was intended to serve the purpose it has fulfilled—to be responsive only to the leadership of the Roman Catholic Church, which has rarely shown concern that many of IOR's clients are avoiding Italian taxes, laws and regulations (Cornwell 1984, Gurwin 1983, Reese 1996). In Liechtenstein the largest bank (LGT Bank) is wholly owned by the princely family there. The third largest (VPB Bank) was chaired by the Head of Government from 1978 to 1993 (Beattie 2004: 291-2).

It is relatively easy for financial capital to capture and use small legislatures. In many small jurisdictions, lawmakers do not comprehend offshore finance and defer to offshore promoters, who are often allowed to serve as regulators of the OFC operations from which they are profiting, as in Jersey and the Cayman Islands. In 1981 Giovanni Mario Ricci, an Italian businessman and unofficial financial advisor of President Albert René, was allowed to acquire full ownership of the Seychelles Trust Company, which held a monopoly on all the activities of the African state's OFC—in effect regulating itself. In Antigua and Barbuda B. Allen Stanford, the owner of an offshore bank received an appointment to run the agency regulating banks in that island state. Before Antigua's Russian-controlled European Union Bank collapsed amidst scandal, one of its directors, Clare Roberts, became the country's Attorney-General responsible for any of the government's possible litigation against the bank's management. In Hong Kong business pressure groups favoring the tax haven have long been strong, while other pressure groups have been weak in a highly

undemocratic form of “capitalist state”. In small states the civil service is unlikely to be independent and senior government bureaucrats tend to be tightly linked with politicians (Baker 1992, Christensen and Hampton 1999: 182, 187, Ellis 1996, Roberts 1995: 252, Scott 1989, Sharman 2006: 121).

In some small nations there may be conspiratorial collusions. Local lawyers were able to persuade Cook Islands government officials to issue certificates stating that their clients’ companies had paid substantial taxes in the Cooks. Almost simultaneously, the state-owned Cook Islands Government Property Corporation returned amounts (slightly lower than the taxes paid) to other Cook Islands companies owned by the same clients--in the form of profits on artificial tax-free “securities transactions”. This process resulted in tens (if not hundreds) of millions of dollars of tax deductions in their clients’ home countries, including New Zealand, Australia, Japan and the US (Davison 1997, Wishart 1995, 1999).

Legal Laboratories

Thirdly, a small state can quickly and effectively enact laws, which favour the interests of rich and powerful metropolitan clients, particularly as offshore activities have no apparent adverse consequences for the state itself. Small populations give a country more room to move in the tax haven business, unlike most other businesses. The proportion of political and economic emphasis on developing the OFC can be quite high, when competing interests are relatively undeveloped. This favors the frequent revision of laws—a versatility which may be crucial to an OFC’s success.

The Cook Islands are perhaps the best example of a legal laboratory, where lawyers devise solutions to the problems of wealthy clients and use their immense influence over the parliament to have bills they draft passed quickly, sometime *in camera*. During the first twenty years of the Cook Islands OFC (1981-2001) offshore finance was the topic of about 10% of all Acts (and 20% of all pages of legislation) passed into law by the country's parliament, with most of the legal drafting having been done by the private sector (Asian Development Bank 2002: 116-117).

At the Bank of Bermuda Henry Tucker, often regarded as the “father” of the island's OFC, used his considerable political influence to get the local parliament to create the first offshore company there on July 8, 1935. In collaboration with Tucker and his Bank of Bermuda, the Hamilton law firm Conyers Dill & Pearman was able to push offshore financial legislation through parliament over the succeeding decades—with the rival Bank of Butterfield and the Appleby, Spurling law firm also providing significant support. In 1965 Tucker, while still at the Bank of Bermuda, co-founded the United Bermuda Party, which ruled (with Tucker at its helm) for the next seven years (Duffy 2004). This gave Conyers Dill & Pearman, the foremost offshore law firm, considerable direct political power. Crombie (1998: 54) comments—“To those unfamiliar with the ways of Bermuda the notion that the partners of a leading law firm might serve in the legislative and executive arms of government might suggest an irreconcilable conflict of interest.”

The economic elite in the Cayman Islands, while not been as directly involved, as proactive or as sophisticated in politics as the Bermudian establishment, monitors political developments and is inclined to enter politics reactively if it identifies any movement which threatens the island's tax haven or any of its other interests (Kersell 1987). In the Caymans opportunistic government officials were initially the quickest to develop and seize offshore opportunities, as when the Governor suggested that the Financial Secretary Vassel Johnson revise the Caymans' laws to create a climate favourable to the creation of an OFC in the 1960s—which Johnson did in collaboration with the Canadian lawyer James MacDonald (Kersell 1998).

The more persuasively politicians can guarantee passage of legislation, the more resources offshore promoters are likely to devote to it. On Antigua R. Allen Stanford, the country's leading offshore banker, financed the reform of its OFC legislation, which was swiftly enacted by the local parliament (*Houston Chronicle* July 16, 2000; *Wall Street Journal* April 27, 1999). Two large accounting firms on Jersey were reported to have spent more than one million pounds to draft Limited Liability Partnership bills for the island's lawmakers to pass (Christensen and Hampton 1999: 185-186).

Isolation from Opposition

Fourthly, in the small state, foreign oppositional forces claiming negative effects from offshore financial arrangements (such as tax offices, organised labour, environmentalists, Third World countries, public interest groups, or court plaintiffs)

usually have little political traction. In contrast, large states contain powerful interests opposing tax haven and related offshore development. Small states enjoy considerable immunity from outside pressures as a result of the “inertia” (Baldacchino 2005: 40) or “extantism” (Bartmann 2002: 371-2) of the global system—once autonomy and powers of independent action have been obtained by a small state, it is diplomatically very difficult for them to be taken away.

The IOR (the Vatican Bank) has been exposed as a leading accessory to massive frauds, tax evasion, political bribery, illegal arms dealing, as well as money laundering for the Mafia and a powerful neo-Fascist secret society (among others). It also contributed to the biggest bank collapses in the US and Europe in the forty-five years after the Second World War. Archbishop Paul Marcinkus nevertheless continued to head the Vatican Bank for many years after his and IOR’s deep involvement in these scandals had been exposed. He apparently enjoyed the protection of the Catholic hierarchy, while the sovereignty of tiny Vatican City offered him immunity from Italian authorities’ questioning, criminal investigations and charges (Cornwell 1984, Gurwin 1983, Reese 1996).

Seychelles President Albert René and his close confidant and campaign contributor Giovanni Ricci controlled the country’s OFC and had used to country to expedite some offshore schemes associated with the Vatican Bank and South Africa’s apartheid regime. René and Ricci were the chief promoters of innovative legislation which the national assembly passed. The law guaranteed immunity from not only

taxation but also almost all forms of criminal prosecution and seizure of assets (as well as offering the possibility of acquiring a diplomatic passport) to a foreigner who invested at least \$10,000,000 in the country. Before coming to live, start businesses, and acquire a diplomatic passport in the Seychelles, Ricci had been convicted in Italy for fraud and in Switzerland for possessing counterfeit currency (Ellis 1996, *Financial Times* February 2, 1996; October 13, 2000).

In small states the media, universities and organized anti-corruption bodies are often weak or even absent. Where they are more developed, media frequently avoid or sanitize local offshore activities, especially if the media are owned by leading OFC promoters, as occurs with Jersey's only newspaper. Regulators in offshore centers often fear scandal and are prone to develop a "three monkeys" strategy. An OFC elite may encourage the small country's traditionalism and historic marginality as a device to resist pressures from metropolitan states—while emphasizing that the only suitable source of progress for the micronation is integration into global financial markets—no matter how high the risks of such a strategy may be (Mannin 2006). The residents of small islands may feel removed from the outside world and they are inclined to vilify, repress, intimidate, victimize or ostracize whistleblowers (Christensen and Hampton 1999: 168, 179, 184). In the Cook Islands, a prominent government auditor Richard McDonald received death threats and was forced to move to Australia after he was accused of revealing some of the details of some of the country's fraudulent tax schemes to New Zealand's Audit Office (Wishart 1995, 1999).

The most powerful promoters of the Turks and Caicos OFC—the *nouveau riche* elite represented by the Chamber of Commerce and the ruling Progressive National Party--fully supported two political leaders indicted in the United States in the mid-1980s for money laundering and drug trafficking. This local elite also resisted American pressures to reduce the strength of the tax haven's financial confidentiality laws (Kersell 1988).

In Saint Vincent and the Grenadines Thierry Nano, the head of two prominent offshore banks who had close ties to the government, was allowed to fly out of the country days after a Miami court had requested his arrest for money laundering. The governments of Egypt and Libya had large, long-standing claims on his family's offshore banks, which he had been able to avoid as a result of the protection offered by Saint Vincent and the Grenadines (*Miami Herald* January 30, 2002; *World Reporter* November 22, 2001).

Financial intelligence experts alleged that some senior government officials in Antigua and Barbuda were linked to Colombian drug lords who were laundering large amounts of money through the country's offshore banks (*Economist* January 4, 1997). Dominica's Finance Minister Ambrose George was travelling with Julian Giraud when this leading local offshore banker was arrested by the FBI on money laundering charges (Associated Press January 30, 2002; BBC January 13, 2004). On Cyprus the nation's president's law firm was allegedly involved in creating an offshore company which expedited the flow of at least \$800,000,000 which Slobodan Milosevic

removed from the former Yugoslavia. This and other activities in the Cyprus OFC reinforced the image that “The nation...has long been a way station for rogues and scoundrels, where officials have traditionally been willing to look the other way.” (Freedman 2006: 90)

The mainstay of the Cook Islands OFC, the asset protection trust, defends its beneficiary (who may also be the creator of the trust) against metropolitan plaintiffs and courts by shifting the forum for litigation to the Cook Islands, where a series of laws greatly privilege the beneficiary (van Fossen 2002b). In Vanuatu legislation has been oriented toward protecting domestic insurance policy-holders and domestic depositors in banks. There has been little concern about the interests of non-resident insurance policy-holders or foreign depositors in the country’s offshore banks, whose assets have, at times, been many times the size of domestic banks’ assets (International Monetary Fund 2003). Since the embryonic stages of Panama’s OFC, American officials have maintained that its development has been motivated by the amoral greed and ambition of the local elite, and that only metropolitan threats and pressures could serve as an effective ethical counter-weight to its victimization of foreigners (Carlisle 1981).

Even when the local legislature may sometimes appear to be acting ethically, against the interests of tax haven promoters, the bureaucracy may be under their control. When the Swiss parliament in 1962 unanimously voted for a law to restore property to the heirs of Jews killed in the Nazi holocaust, banks and insurance companies did

not need to declare their opposition to the law, since they were confident in the loyalty of the official who was to administer the law (Bower 1997: 305-306).

The banking lobby has been so powerful in Switzerland that the government rarely initiates any move to restore money to Third World countries that have been plundered by dictators who have deposited the proceeds in Swiss banks. The Swiss government has only acted in cases when media exposure and international (particularly US) pressures have been damaging to the country's reputation. Even when the money is identified, the Swiss system often creates insurmountable obstacles to it being returned (even in relation to the proceeds from bribery scandals in neighboring First World countries such as Italy). Third World countries, which are being victimized, have very little influence on the Swiss political process, especially as the electorate in Switzerland has persisted in wanting to remain a small nation outside the more favourable climate of the European Union (Rechsteiner 1997).

Switzerland is the largest country to host an OFC and, partly as a result of its size, it has more complicated and diverse attitudes toward tax haven activities than many smaller states do. Yet the banking lobby has consistently overpowered moves to improve bank disclosure which have been proposed by the small Social Democratic Party, which has predicted that the country will continue to operate as a "pirates' lair" into the foreseeable future (Rechsteiner 1997: 45).

Conclusion

Small and often little-known nations have become remarkably powerful influences on the global political economy. They provide venues for the world's (often sensational) secret business and secret politics. Their offshore financial centers allow wealthy and powerful clients to escape from metropolitan taxation and regulation. Tax haven nations are part of a process in which competitive advantage has been moving from the bounded, regulated economies of scale within the borders of large metropolitan states to smaller political units oriented toward liberalized global markets (Alesina and Spolaore 2003). Small island nations and secluded continental mini-states have been prominent in this contemporary world-historical transformation.

APPENDIX 1: OFFSHORE FINANCIAL CENTERS

JURISDICTION	POPULATION (2004)	TOTAL LAND AREA (square miles)
Sark	600	2.1
Vatican City	932	0.17
Niue	2,156	100
Anguilla	13,008	33.4
Nauru	13,287	8
Turks and Caicos	19,956	166
Cook Islands	21,200	92.7
British Virgin Islands	22,187	59.1
Monaco	32,543	0.77
Liechtenstein	33,987	61.8
Cayman Islands	43,103	101.2
Marshall Islands	60,422	70
Bermuda	64,935	20.6
Guernsey	65,031	25
Dominica	68,910	291
Antigua and Barbuda	69,106	171
Isle of Man	74,655	220.9
Seychelles	81,541	176
Jersey	90,502	45
Saint Vincent and the Grenadines	117,848	150
Samoa	176,908	1133
Vanuatu	208,869	4710
Netherlands Antilles	219,958	370.7
Bahamas	303,770	5,382
Luxembourg	474,413	998
Bahrain	698,585	257
Cyprus	784,301	3,571
Panama	3,191,319	30,193
Ireland	4,062,235	27,135
Singapore	4,492,150	267
Hong Kong SAR	6,940,432	402
Switzerland	7,523,934	15,355

Source: Kashner 2007

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² A tax haven is a jurisdiction which allows residents or foreigners to minimize their tax payments. An offshore financial center is a tax haven jurisdiction which has at least one significant institution primarily oriented toward accepting deposits and investment funds, and where intentional government policy is oriented toward attracting the business of foreigners by creating legal entities and structures, or facilitating immigration, naturalization, residence, or the acquisition of passports to allow foreigners to minimize taxes, regulation, loss of assets, unwanted financial disclosure and forced disposition of property. All offshore financial centers are sovereignty businesses and all are tax havens. Not all tax havens are offshore financial centers (for example, the Federated States of Micronesia and Pitcairn Island are tax havens, but not offshore financial centers).