Outlaw Heaven: Why States Become Tax Havens

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Abstract

States become tax havens as a conscious economic development strategy. These states – more properly referred to as “jurisdictions” because some lack the sovereignty of the traditional Westphalian state – do not have the natural resources or the population to pursue more traditional economic development strategies, but they do have the ability to write and implement laws that create a virtual resource: banking secrecy. These jurisdictions are able to carry out this strategy because they tend to be well-governed, stable, and relatively wealthy, making them attractive partners for the international banking, legal, and accounting firms that drive offshore finance, and then for their customers - both individual and corporate - as well. The qualities tax havens possess also enable them to calculate that the benefits they reap from pursuing this strategy outweigh any penalties assessed by anti-tax haven international collective action activities, such as the naming and shaming campaigns of 2000.

Keywords: tax havens, economic development, international collective action

For my family

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# Chapter One

## Cuba, The Bahamas, Jamaica, the Cayman Islands, and the Paths They Took

The Bay Street Boys had had a good run, but it was coming to an end. The ruling elite of the Bahamas, so nicknamed because the men met at a club in Nassau on Bay Street, had taken what was a relatively quiet, if willing, outwardly focused economy with a modest amount of activity in the 1930s and turned it into a major hub of banking and gambling activity by the early 1960s. The Boys did not accomplish this feat all by themselves – they had help from two people: Marshall Langer and Meyer Lansky (Brittain-Catlin, 2005; Lacey, 1991; Palan, Murphy, & Chavagneux, 2010; Shaxson, 2012).

Langer was an American tax attorney who started practicing in 1951 and consulted with the government of the Bahamas in rewriting its tax laws to encourage an increase in investment from outside the islands. The Bahamas already had a reputation in America as having a favorable tax environment, but Langer helped create an atmosphere of supercharged international development in the late 1950s (Brittain-Catlin, 2005; Palan, Murphy, & Chavagneux, 2010; Shaxson, 2012).

Lansky, on the other hand, was one of the most powerful members of the “Outfit,” the Chicago organized crime syndicate once run by Al Capone. In fact, after Capone went to jail for tax evasion in 1931, Lansky became one of the first Americans to start using Swiss banks to launder money in 1932. Lansky would fly to Switzerland with suitcases stuffed with cash, jewelry, bearer bonds - anything of value that was portable and could be reconverted into cash quickly. He would deposit the funds into a Swiss bank, and the bank would then loan an equivalent amount to one of the companies Lansky had set up in America. The bank got its money back when Lansky repaid the loans which, since they were from his businesses, were tax deductible. This technique – soon to become standard practice – was called “loaning back” (Brittain-Catlin, 2005; Palan, Murphy, & Chavagneux, 2010; Shaxson, 2012).

The money Lansky was laundering mainly came from different forms of gambling – casinos and horse racing – which had the disadvantage of being illegal in America. Cuba, on the other hand, was a different story, and Lansky’s operations in Cuba in the 1950s turned the island into “the most decadent spot on the planet” (Robinson, 2004: 37). Lansky’s success in turning Cuba into a louche vacation spot for Americans was so great, in fact, that it led in part to the 1959 revolution that installed Fidel Castro, necessitating a new island paradise for Lansky to transform (Brittain-Catlin, 2005; Lacey, 1991; Palan, Murphy, & Chavagneux, 2010; Shaxson, 2012).

Enter the Bay Street Boys. They were all too willing to partner with Lansky and together the Boys and Lansky created the Grand Bahamas Development Corporation (DEVCO), which gave Lansky and his partners a foothold on the island. Lansky also paid Bahamian finance minister Stafford Sands a $1.8 million bribe to help make the island’s government more cooperative, the result of which was stricter laws pertaining to banks releasing information about their customers to anyone, including criminal investigators. These laws made the Bahamas an even more attractive destination for money launderers and tax evaders, and development on the island boomed (Brittain-Catlin, 2005; Lacey, 1991; Palan, Murphy, & Chavagneux, 2010; Robinson, 2004; Shaxson, 2012).

Until 1967. As in Cuba, popular discontent with the way the mafia and the local elites were despoiling the island led the Bahamians to revolt, albeit peacefully. The 1967 election was won by Lynden Pindling, a populist who ran on a reform platform calling for an end to gambling and corruption. This platform was not as threatening to what would become known as the “offshore” crowd – bankers, accountants, and lawyers like Langer who make their living creating new tax avoidance and evasion strategies for wealthy individuals and multi-national corporations (MNCs) – as the fact that Pindling was black and was calling for end to white minority rule; an end, as it were, to the rule of the Bay Street Boys. While the Bahamas remained, and would continue to remain, prosperous and relatively unaffected by the Pindling movement that led to independence in 1973, the smart money went elsewhere (Brittain-Catlin, 2005; Palan, Murphy, & Chavagneux, 2010; Robinson, 2004; Shaxson, 2012).

There were two choices. Two nearby islands with the British legal pedigree that allowed for the passage of banking secrecy and foreign ownership laws necessary to create a safe haven for offshore money and its handlers: Jamaica; and Jamaica’s former dependent the Cayman Islands. Jamaica was more developed and in the throes of a growing economy thanks to high demand for the bauxite it mined and exported, and definitely more advanced than the backwater the Cayman Islands was at the time. Jamaica was also politically more sophisticated, having declared its independence from Great Britain in 1962. More disturbing to the offshore community was the election the following year, which was won by William Alexander Bustamante and the Jamaican Labor Party. It didn’t seem to matter that the Labor Party was not socialist in the manner of the English political party of the same name; the Jamaicans seemed determined to control their own political and economic destiny (Brittain-Catlin, 2005; Library of Congress, 1989).

As it turned out, the ruling elite of the Caymans had no such pretensions. Granted, the Caymans declared itself independent of Jamaica in 1959 and created its own constitution, but chose to remain a British crown colony when given the option in 1962. This amount of soveriegnty turned out exactly what the Cayman elite desired: independent enough to write their own laws and levy their own taxes, but still tied to the body of British common law such that its precedents in cases like *Calcutta Jute Mills* and *Egyptian Delta[[1]](#footnote-1)* held, allowing the Caymans to create the most inviting investment and banking environment in the Caribbean, if not the world (Brittain-Catlin, 2005; Palan, Murphy, & Chavagneux, 2010; Shaxson, 2012).

The effect of the new attention on the Caymans was almost immediate. The island had never had taxes of any consequence on its citizens, raising revenue for the government through import duties, and the sale of postage stamps and banking licenses, as well as from the fees companies pay to incorporate there. Their one and only bank – a Barclay’s – had opened in 1953. The bank sat on the one paved road in George Town, the capital city of Grand Cayman, the largest island. It was likely that the bank’s customers – who would not be able to call ahead because the island had no phone system – would encounter cattle wandering the streets on their way to patronize the bank. This was life in the Caymans until 1966, when bankers like the newly arrived Jean Doucet helped convince the legislature to pass a series of new laws, including the Banks and Trust Companies Regulation Law, the Trusts Law, the Exchange Control Regulations Law. These laws were created mostly from ideas the bankers themselves suggested in committee meetings chaired by the Cayman Islands Financial Secretary and passed with minimal debate or opposition by the legislature after passing through the Private Sector Consultative Committee, a trade association made up Caymanian financial professionals who had to give any financially-oriented legislation its imprimatur before it was voted on. These laws made it much easier to create trusts like the Star Trust, which allows the owner of the trust to be protected in such a way that enables the owner to make investment decisions without having to worry about what impact those decisions will have on the beneficiaries of the trusts. Or to open banks like the Sterling Bank, which Doucet opened in 1966 as one of the first private banks on the islands (Brittain-Catlin, 2005; Palan, Murphy, & Chavagneux, 2010; Shaxson, 2012).

The offshore money began to pour in and by 1967 the Caymans was a state-of-the-art investment hub, with connections to the international telephone network and a new airport built specifically to handle jet traffic. Corporate lawyers like Bill Walker, who had moved from Guyana in 1963, had more business than they could handle. By the end of the 1960s, when the Caymans abolished their bilateral tax treaties with the United States in order to give their banking customers complete and total confidentiality from American law enforcement and tax authorities, they were on their way to becoming one of the world’s largest banking and incorporation centers (Brittain-Catlin, 2005; Palan, Murphy, & Chavagneux, 2010; Shaxson, 2012).

Her Majesty’s Government was initially positive about the Cayman Islands’ success. The British Colonial Reports acted as booster, reinforcing the initial opinion of the Bank of England and the British Overseas Development Ministry that any economic growth is good and that a colony that develops its own economic base is a colony that will no longer have to beg for British aid, thereby reducing costs to the British government. Official opinion within the British government was hardly united, and began to splinter further as the Caymans gradually abandoned all pretense about what they were doing, going so far as to establish a government Tax Haven Committee in 1970 to “expand and promote tax haven activities on the island” (Brittain-Catlin, 2005: 152).

It did not take long, however, for even the Caymans’ hardiest supporters in British government to recognize what the islands had become. As the Bank of England noted on April 11, 1969, “the smaller, less sophisticated and remote islands are receiving almost constant attention and blandishments from expatriate operators who aspire to turn them into their own private empires. The administrations in these places find it difficult to understand what is involved and resist tempting offers” (Shaxson, 2012: 92). Condescending language aside, the Bank correctly analyzed the increased attention the Caymans were receiving from the outside world, both licit and illicit. By the early 1970s, every major American bank had a branch in the Caymans to compete for the rapidly growing deposit business there, some of the money literally being flown in on Lear jets in suitcases carrying millions of dollars in cash. Not only did the banks and the Caymanian officials not worry about where the money came from, but the island’s police force would happily provide an escort from the airport to the bank for customers carrying large amounts of cash (Brittain-Catlin, 2005; Palan, Murphy, & Chavagneux, 2010; Shaxson, 2012).

Where the Bank was wrong was in its interpretation of the Caymanian officials being victimized by their more-worldly peers in the offshore business. From the beginning in the mid-1960s, the intention of the Caymanian officials was to create a very specific niche, hosting tax law and accounting experts from the offshore world to help them create laws that would allow them to compete with the likes of Liechtenstein and Switzerland. There was a conscious effort that led to the legislative jewel in the crown: The Confidential Relationships (Preservation) Law of 1976. This law, in response to increased pressure from American banking and law enforcement authorities, made it a crime punishable by prison to reveal any financial or banking client information regardless of who made the request. In fact, the law also criminalized the request for information by anyone other than clients. This was the culmination of a ten-year collaborative effort by the Cayman government and offshore interests to, as a 1973 British Foreign Office confidential memorandum correctly concluded, “set up as a tax haven” (Brittain-Catlin, 2005; Palan, Murphy, & Chavagneux, 2010; Shaxson, 2012: 91).

## The Puzzle, the Literatures, and the Contribution

Why do states become tax havens? Is the Cayman experience typical? Is this combination of political will and outside influence the way that states become tax havens? If the potential benefits are so great, why do other states like Cuba or Jamaica not also become tax havens? These are the primary questions I will attempt to answer. Tax havens exist in the international system despite nearly universal official disapprobation. States recognized as tax havens are classified as, if not exactly pariahs, then not exactly members of the community of nations in good standing, either. Phrases in common parlance like “Swiss bank account” have almost exclusively negative connotations; indeed, one popular rumor is that millions in gold stolen by the Nazis during World War II is still hidden in Swiss banks, with the complicity of amoral Swiss bankers (Guex, 2000). Since the late 1990s, in fact, there have been concerted international efforts to deter what the Organization for Economic Cooperation and Development called “harmful tax competition” (OECD, 1998), an effort that evolved to include anti-money laundering and terrorism financing efforts. It became common knowledge that tax evaders, criminals, and even Osama bin Laden and other terrorists were using tax havens (Baker, 2005; Naylor, 2004).

The prevalence of these efforts raises another question: how is it that tax havens continue to operate? While every tax haven complies, in one form or another, with the requests of the international organizations tasked with shutting them down, very few tax havens have ceased operations in the face of such concerted effort. And these states are hardly regional powers, much less hegemons; most are small – 4 million people or fewer – and, in security terms, weak. A good portion of tax havens don’t even provide for their own defense, instead relying on timeworn colonial relationships for domestic security. Yet most of them have taken a stand against the most powerful states in the world – both in economic and military terms – and have persevered, continuing to attract hundreds of billions of dollars each year in foreign direct investment. How have the Seychelles, for example, a state independent only since 1976 and with a population of around 96,000, able to withstand the collective efforts of the US, the EU, and Japan and continue to thrive economically? Just as important, how did states like the Seychelles become tax havens in the first place? What is it about these srates that enabled them to make the relatively sophisticated moves required to achieve tax haven status, and then to remain tax havens in the face of almost universal disapprobation?

I will attempt to answer these questions by locating my argument in a nexus of three literatures: tax havens; small states; and regimes. I will use tax haven and small states literatures will to take previous operational definitions of tax havens and differentiate a distinct group of jurisdictions that shares characteristics of - but is different from - non-tax haven small states. Tax haven literature, exemplified by the work of Christensen (2011, 2012), Dharmapala & Hines (2009), Eden & Kudrle (2005), and Palan, Murphy, & Chavagneux (2010), among others, is useful for pinning down what a tax haven is, what distinguishes tax havens from other states, and defining the tax haven’s place in the international system. There has not yet, however, been a large-scale systematic examination of the process by which states become tax havens. Examinations exist, but they tend to be case studies, or focused on one particular region, or both. I will attempt to fill this gap in the literature by taking the existing work and broadening its scope, creating an understanding of tax havens as rational actors in an anarchic international system, in effect applying principles of realism and macroeconomics to better understand the transformation these states undergo and the forces that impel them.

In order to accomplish this chracterization, however, it is important to understand how tax havens exist as small states, what differentiates small states from larger ones, how this differentiation affects tax haven formation, and what distinguishes tax havens as a separate group from non-tax haven small states. As my analysis will discuss in greater depth, tax havens are states with populations of fewer than four million people in all but a handful of cases. In addition, a significant number of tax havens are located on islands. It is therefore critical to understand the small states literature, in particular the Small Island Economy (SIE) work of Armstrong, De Kervenoael, Li, & Read (1998), Cobb (1998, 2001), Hampton (1996), and Vlcek (2008, 2009), among others. These works delve into the role small states play in the global economy, and why small state governance enables that role. This literature, combined with classics of political development such as Acemoglu & Robinson (2006), Bueno de Mesquita, Smith, Siverson, & Morrow (2004), Jackson (1990), and Lipset (1959), provide a solid theoretical foundation understanding the nature of tax havens both as small states and as a *sui generis* phenomenon.

Finally, in order to understand why states become tax havens in the face of international anti-tax haven regimes formed by the world’s strongest states, it is critical to understand the nature of international regimes themselves, and why states comply with them. This understanding must of necessity start with the seminal 1982 issue of *International Organizations* that included the landmark work of Keohane (1982), Krasner (1982), and Puchala & Hopkins (1982), and progress to Abbott & Snidal (1998) and Nadelmann (1990), among others, to understand why states create international regimes, especially international prohibition regimes, and why states would relinquish sovereignty to join one and act collectively.

This is the first half of regime theory that needs to be understood in order to solve the tax haven puzzle. The second half is why target states would comply with regime edicts, especially punitive ones, what the consequences of non-compliance are, and how effective international regimes are at accomplishing their goals. This literature involves studying the conquences of compliance in general as well as naming and shaming campaigns and includes Barry, Clay, & Flynn (2013), Chayes & Chayes (1993), and Dai (2005), while literature specifically addressing tax haven compliance includes Blanton & Blanton (2012), Kudrle (2009), and Simmons (2000). The final piece in understanding compliance is reputation theory, of which Tomz (2007) is the exemplar.

My argument has three basic components based on three literatures: what about states compels them to become tax havens; what influence their being small, sometimes isolated, states has on this process; and the relationship between these states and the international regime created to dissuade them from tax haven behavior. This argument builds on the contributions made by the tax haven, small states, and regime literatures by taking a global systemic approach and integrating it with an understanding of individual state behavior and the role of elites in both states and regime formation and implementation. This work represents the first attempt at a study of this combination of theoretical and quantitative rigor and interdisciplinary flexibility, a combination necessary to answer questions concerning the process by which tax havens form, thrive, and continue to operate in an international political and economic system despite their significant deleterious impact on that system and the states that form the regimes to eliminate them.

## What is a Tax Haven?

Before answering these questions, however, it is important to define what the term “tax haven” means, and to discuss its basic characteristics and the literature surrounding that definition.

### Sovereignty: from Westphalia to Vanuatu

Most definitions of the term “tax haven” involve four separate concepts: tax havens are 1) jurisdictions that offer customers 2) low or no taxes, 3) transactional secrecy, and 4) ease of registration and relatively low corporate activity requirements (Addison, 2009; Ambrosanio & Beard, 1985-1986; Caroppo, 2005; Christensen, 2011; Cobham, Jansky, & Meinzer, 2015; Dharmapala, 2008; Gregory, 2012; Irish, 1982; Murphy, 2017; OECD, 1998; Palan, Murphy, & Chavagneux, 2010, among others). It is instructive that, when describing tax havens, the legal term “jurisdiction” rather than “state” is used in both academic and non-academic texts. This distinction is a critical one to draw: going back in Western law to the Treaty of Westphalia in 1648, the state is an independent unit that enjoys both legal and actual self-determination (Patrick, 2011: 22-3).

Strictly speaking, almost half of all tax havens do not fit this definition: they are not states. Several of the states generally considered to be tax havens are under the protection of a full-fledged state, either as a colony, dependency, or protectorate. Of the 51 jurisdictions I classify as “tax havens” for the purposes of this study, 17 are not fully independent states, or 33%. For the purposes of their customers, however, these jurisdictions don’t need to be fully sovereign; they just need to be sovereign enough to provide the two dimensions of soverieignty necessary to create an effective tax haven: 1) geographic; and 2) legal.

The demand for geographic separation by tax haven customers is made plain in the common usage another term used to describe tax havens: “Offshore Financial Centers (OFCs)” (Cobb, 1998; Hampton & Levi, 1999; Hudson, 2000). OFCs are generally referred to as “offshore” for short, as is the whole industry and the professionals employed therein. The term reflects a desire by its customers to withdraw, to hide their funds and their activities away from prying eyes. Regulators make the onshore/offshore distinction in the following way: the state where the customer makes her home or has her primary citizenship is “onshore;” the state where the customer transacts her business or has accounts or corporations established for the purpose of obscuring their activities is “offshore.” This nomenclature holds regardless of whether the OFC in question is an island or not: Switzerland, Costa Rica, and Latvia are all OFCs, but they are also landlocked.

The above states may not be islands in the geographical sense of the term “offshore,” but they are in the second, or legal, sense. The laws that characterize a state as an OFC/tax haven[[2]](#footnote-2) provide its customers with a legal wall of secrecy behind which they can hide their financial transactions. The key to understanding a tax haven’s importance is that it is a physical entity that has sovereignty, and it uses that sovereignty to create laws and regulations for the benefit of its financial services customers who generally live elsewhere. These laws include protecting bank employees who refuse to disclose information about their customers, as well as an institutionalized lack of curiosity about those customers’ identities and the purposes of the transactions undertaken. The goal of offshoring is to create both physical and legal space between financial activities and the government agencies charged with regulating and taxing those activities (Christensen, 2011: 183; Cobb, 1998: 8; Hampton & Levi, 1999: 646; Hudson, 2000: 270; Palan, Murphy, & Chavagneux, 2010: 21).

One condition both necessary and sufficient to define a tax haven is that the jurisdiction offer a tax regime that includes zero or very low rates of taxation. These regimes are set up primarily to benefit foreign investors, and some tax havens in the past have practiced “ring fencing,” or levying zero or very low tax rates to individuals or companies based in another conducting financial transactions while based in another jurisdiction, while levying higher tax rates on its own citizens. The idea is to create something of value to attract foreign capital where there previously had been none or very little. That “something” in the case of tax havens is the opportunity to conduct business or to open a bank account without having to pay the taxes such activities would attract in their home countries. There are other benefits a jurisdiction can provide to foreign individuals and corporations without offering zero or very low tax rates – secrecy and ease of incorporation (more below) – but when the literature or the outside experts refer to “tax havens,” the jurisdictions to which they refer almost always offer at least preferential tax regimes to foreign investors. Finally, a tax haven may create an income tax regime that gives breaks to a specific type of industry, such as insurance or banking (Ambrosanio & Caroppo, 2005: 686; Desai, Foley, & Hines, 2004: 1; Dharmapala, 2008: 662; Gregory, 2012: 863; Irish, 1982: 453-4; Johannsen, 2010: 254; Palan, Murphy, & Chavagneux, 2010: 30-1).

The second condition that defines a jurisdiction as a tax haven is its use of secrecy to attract foreign investors and other customers, and to protect them once they become customers. Secrecy is so important as a concept to tax havens that another term of art used to describe tax havens is “secrecy jurisdictions,” a term that emphasizes the importance of the tax haven as a legal construct, that is, as a set of laws, regulations, and legal procedures set up explicitly to benefit foreign investors and customers. The concept of “secrecy” with regards to tax havens has two dimensions: a) confidentiality; and b) lack of cooperation. Tax havens create laws that permit financial institutions to keep information regarding their account holders and their transactions completely confidential, to the extent of, in the case of The Confidential Relationships (Preservation) Law of 1976 discussed above, making it a criminal offense to both request and to reveal information about an account holder in a Cayman Islands bank. The more common, less aggressive version of this type of secrecy is for financial institutions on tax havens to require their account holders provide them only the bare minimum of information, and requiring an official request from a law enforcement agency from the account holder’s home country to divulge that information (Ambrosanio & Caroppo, 2005: 686; Cobham, Jansky, & Meinzer, 2015: 2-9; Irish, 1982: 453-4; OECD, 1998: 23; Palan, Murphy, & Chavagneux, 2010: 9).

For example, if an American drug dealer deposited one million dollars US in an account in a Cook Islands bank, the only way the bankers would divulge that information is if the American Drug Enforcement Agency was able to officially request that release based on information conclusively demonstrating that the one million dollars was the proceeds of a specific crime. Note that it is not sufficient for, say, the Internal Revenue Service to request the drug dealer’s account information on the grounds that they avoided paying taxes in the United States, as they haven’t broken any tax evasion laws in the Cook Islands. This behavior by tax haven authorities is also an example of the second dimension of banking secrecy: a general lack of cooperation with non-tax haven countries in enforcing their laws or assisting them in any significant way. This non-cooperation has its legal basis in British common law precedent established by *Tournier v. National Provincial and Union Bank of England, [1924] 1 K.B. 461 (1923)*, which allows financial institutions to keep account holder information confidential unless they are required to divulge it by a law enforcement agency under extraordinary circumstances. Most tax havens are or were British Crown Colonies, and as a result British common law applies to them, and British common law has several precedents, including *Tournier*, that allow tax havens to establish secrecy laws, thereby allowing them to function as secrecy jurisdictions.

The third condition that defines a jurisdiction as a tax haven is a legal and regulatory structure that either permits the existence of, or actively encourages, business or financial operations within their physical borders that enable individuals or firms to conduct their business offshore. These regulations can manifest themselves as: an absence of exchange control restrictions, making it possible for non-residents to trade in resident currency, or transfer their holdings from one currency to another; or an absence of a requirement that any corporate activities be substantial, i.e. anything other than the recording of transfers of goods or services on paper. The regulations – or their absence – indicate that the jurisdiction is interested primarily attracting customers interested in tax avoidance or evasion rather conducting actual business. Another term for these types of tax havens are “booking centers,” because the transactions taking place elsewhere are merely recorded or “booked” as occurring within the subsidiary located in the tax haven. Another way tax havens use regulations to create competitive advantages for themselves is by making it relatively easy or inexpensive for customers to form corporations or register subsidiaries, allowing customers to maintain operations in their resident jurisdictions while still recording transactions in the tax haven. The flexibility this ease of incorporation affords allows tax havens to, ultimately, become *entrepot* centers for the rest of the world, enabling enormous flows of foreign direct investment (FDI) both into and out of tax haven financial institutions (Becht, Mayer, & Wagner, 2008; Dean, 2006-2007: 926 fn 66; Gravelle, 2015: 3; Irish, 1982: 453-4; Maingot, 1995: 5-6; OECD, 1998: 23; Palan, Murphy, & Chavagneux, 2010: 21-56).

None of this effort on the part of the tax havens would amount to much if not for the final condition: self-promotion. Tax havens have to advertise themselves as being tax havens, to cultivate a global reputation as a jurisdiction in which customers have access to tax-free secrecy and ease of operation. Part of this promotion is cultivating a modern technology infrastructure permitting sophisticated financial transactional activity, as well as a workforce skilled enough and dedicated to financial service provision, but primarily the key distinction here is that the jurisdiction deliberately sets about creating a certain image. That image is one of a laissez-faire attitude towards attracting actual investment, focusing instead on promoting tax avoidance, unrestricted business operation, and a devotion to protecting the customer’s secrecy. In effect, tax havens are easy for Intergovernmental Organizations (IGOs) dedicated to their reform like the Organization for Economic Cooperation and Development (OECD) to find because they have to make their presence known (Addison, 2009: 706; Beard, 1985-1986: 524 fn 19; Dean, 2006-2007: 926 fn 66; Gravelle, 2015: 3; Irish, 1982: 453-4; Maingot, 1995: 5-6; OECD, 1998: 23; Palan, 2002: 154).

## International Collective Action Against Tax Havens

The international community has not sat idly by as more and more jurisdictions moved to become tax havens; there have been several large-scale organized international efforts to prevent tax havens from passing and implementing the laws and regulations that attract foreign capital, and to counteract the deleterious effects of this attraction. These efforts can be comfortably classified as attempts to impose regimes of appropriate financial state behavior on the global tax marketplace. A regime is a group of principles – both explicit and implicit – norms, rules, and a set of operating procedures generated from the understandings the participants have about appropriate, effective, and moral behavior in a particular issue area (Keohane, 1982: 334; Krasner, 1982: 185-6; Puchala & Hopkins, 1982: 246). Regimes exist to solve a problem or series of problems, not least of which is the problem of collective action in a community of sovereign states. Explicating these problems and developing their solutions requires from the states involved that they: agree on the nature of both the problems and the solutions; and that they commit to acting to implement those solutions. Both of these actions require that a group of elites emerge around these issue areas, both within the states and internationally. These are the people with the expertise to both understand the problem and implement the solution, and whose involvement is necessary for the regime to succeed (Keohane, 1982: 354; Puchala & Hopkins, 1982: 246-7).

Another requirement of the regime’s success is that it is legally binding to its participants. Since states are sovereign, they will not limit their sovereignty voluntarily, so they must agree to join the regime – as international law only applies to those parties who agree upon its application – either willingly or by force (Chayes & Chayes, 1993: 180; Keohane, 1982: 330; Krasner, 1982: 189). Regime theorists agree that states will reduce their sovereignty in order to willingly join a regime if it is in their own best interests – or the collective best interests of their allies – to do so. Joining a regime unwillingly – having a regime imposed upon a sovereign state is, by contrast, not an indicator of that state’s best interests, but rather of that state’s power relative to the states demanding membership from it (Keohane, 1982: 330; Krasner, 1982: 191).

Given that a regime’s purpose is to reinforce a set of principles, i.e. “beliefs of fact, causation, and rectitude,” norms, i.e. “standards of behavior defined in terms of rights and obligations,” and rules, i.e. “specific prescriptions or proscriptions for action” (Krasner, 1982: 186), and that the behavior of some of the states subject to the regime behave in ways that violate these principles, norms, and rules, it stands to reason that regimes will be coercive in applying these principles, norms, and rules to these states in ways that do not benefit them. These weaker states are then faced with a choice: comply, and act in a way that does not benefit them as an individual state but benefits the other members of the regime; or become what Eden and Kudrle (2005) refer to as a “renegade” state, not complying and facing potential punishment by the regime members for breaking the rules. If we further take as given that these states are rational, then the reason a state does not comply with the regime is if that state believes the benefits of not complying are greater than either the penalties sustained for not complying or the benefits for complying.

This logic is consistent with Downs, Rocke, and Barsoom’s (1996) finding that regimes succeed – that is, states comply or are effectively punished – when these behaviors resemble what the states would have done in their absence. That is, regimes exist to codify and routinize behavior states already find beneficial. Reinforcing this finding is Simmons’s (2000) conclusion that states are more likely to comply with a regime if their neighbors do, and that this condition has more impact on state behavior than the content of the regime itself. In addition, if, as Abbott & Snidal (1998) argue, “powerful states structure such organizations to further their own interests but must do so in a way that induces weaker states to participate,” then this modified realist interpretation explains why regime enforcement efforts like those put in place by international organizations like the OECD: 1) focus on punishing tax haven states, which are weaker; and 2) aren’t effective in constraining tax haven state behavior. Because it serves the interests of elites in regime participant states for the tax havens to continue to operate while at the same time maintaining power by appeasing pro-reform elements in government pushing for these regimes.

Dai (2005) provides the theoretical bridge that connects the general theories about state compliance to the specific behavior of tax havens within the global financial system. Dai finds that a state’s compliance with a specific regime is as much a question of domestic influence as external pressure, pointing out that individuals within a state do not benefit uniformly from that state’s compliance with a specific regime. Similar to the argument by Bueno de Mesquita et al. (2004) underpinning selectorate theory, Dai finds that domestic elites will use their leverage to force states to either comply or not comply with a regime depending on which outcome is in their best interests. This logic can also apply to the elites within the states in charge of compliance enforcement: if it is in their best interests for a state not to comply with a regime – even though they themselves were instrumental in the regime’s construction – then the state is less likely to comply either through elite pressure or through a sort of regulatory sabotage, whereupon the elites build in ineffective compliance mechanisms to the regime (Krasner, 1982: 193; Puchala & Hopkins, 1982: 247), or simply change the rules to suit the “exigencies of the moment” (Keohane, 1982: 331). Applying this essentially Grotian logic to tax haven behavior, the reasons why a state might not comply with tax fairness or anti-money laundering regimes: either the state – or the elite within the state – has more to gain from not complying and remaining a renegade state; or the penalties threatened or imposed by ostensibly more powerful non-tax haven states are ineffective as punishments or deterrents.

Furthermore, liberal international relations principles to the contrary, a tax haven’s political status as democratic is no guarantee of compliance with regime edicts. While Simmons (2000: 832) states that “regimes based on clear principles of the rule of law are far more likely to comply with their commitments,” this tendency in itself does not guarantee compliance with regimes either. If tax havens see their commitments to their elite or to other states’ elites as more important than their commitment to any abstract “international community” which, after all, asks only that the state cease those activities that comprise its economic livelihood without offering much in return, then it is all the more likely that they will comply with those commitments to their customers rather than to the regime. This tendency is more likely, according to Simmons (2000), if the tax haven’s neighbors react in a similar way, as she concludes that state behavior is more likely to be influenced by the behavior of other states in the region than by the edicts of an regime. As we will see below, tax havens tend to cluster geographically, and this argument could be one explanation for that phenomenon. Another structural characteristic explored in depth below is the relative stability and sophistication of tax haven governance, enabling them to pass laws and engage in evasive or minimally compliant behaviors that render anti-tax haven regimes “mostly symbolic in nature” (Addison, 2009: 704).

Symbolism, it turns out, is a weapon that regimes frequently deploy against tax havens. Specifically, international organizations like the OECD have resorted to “naming and shaming” tactics like the creation of blacklists[[3]](#footnote-3) in part to force weak states to behave in a manner the strong states would prefer, while succeeding at creating norms of international financial behavior (Abbott & Snidal, 1998: 8). Naming and shaming campaigns are created in the absence of the regime participants’ inability or unwillingness to take more direct action against the subjects of the campaign. One way these campaigns work is by negatively affecting a state’s reputation, thereby constraining its future behavior such that states are forced into compliance (Tomz, 2007). For example, the OECD has used a blacklisting campaign to attempt to get tax havens to raise corporate income tax rates and loosen secrecy laws. As I demonstrate below, however, states can comply with blacklisting campaigns merely by agreeing to adhere to the strictures the regime is attempting to impose.

This shadow compliance has three different purposes: 1) it allows the blacklisted state to repair its reputation without actually making any significant changes; 2) it allows the transnational elites who have created the regime to be seen to be acting affirmatively; and 3) it creates and transmits the norms that define unacceptable state behavior. In the OECD case, for example, tax haven states can agree to comply with OECD dictates while not changing their behavior to get their names removed from the blacklist, but the OECD is at least able to transmit the message to the wider international community that tax competition is harmful and unacceptable. Finally, a naming and shaming campaign can have long-term effects on the states that appear on the blacklist, even briefly: if they acquire the global reputation as a renegade or pariah state, this will negatively affect the way they are treated by other individual states and other regimes, and could end costing them more than the initial action leading to blacklist was worth. Symbolic actions in this case can have real consequences (Abbott & Snidal, 1998: 8; Keohane, 1982: 354; Krasner, 1982: 193; Puchala & Hopkins, 1982: 247).

## Benefits vs. Costs of Being a Tax Haven

The question for jurisdictions that considered tax haven status then is: if they run the risk of becoming pariah states, why become a tax haven? Are the benefits of weaponizing sovereignty and becoming a tax haven worth the risks associated with stepping outside the bounds of acceptable state behavior in the eyes of the international community?

### Benefit: Increased FDI[[4]](#footnote-4) Inflow

According to James Henry (2016), senior advisor at the Tax Justice Institute, tax havens currently house at least $24 trillion in private wealth, most of this booked through offshore branches of global banks such as UBS, Barclays, and Bank of America, making the money instantly accessible to its holders but unaccountable to government tax authorities, resulting in what Zucman (2015) conservatively estimates as $200 billion in lost tax revenue. According to World Bank data, in 2015 FDI inflows to the jurisdictions identified as tax havens by the author totalled nearly $190 billion, or an average of $5.8 billion per year per tax haven with populations of four million or fewer.[[5]](#footnote-5) By contrast, non-tax haven countries with populations of four million or fewer averaged $549 million the same year. As a first cut analysis, tax haven jurisdictions appear to generate inbound FDI an order of magnitude greater than non-tax haven jurisdictions of similar size. This finding is consistent with Blanton & Blanton’s (2012) that FDI is attracted to well-governed states.

An additional benefit to attracting FDI inflows with what are essentially financial services is that startup costs and additional capital outlays to transform a jurisdiction into a tax haven are much lower than other economic development strategies like boosting natural resource extraction or industrializing. Because these states are typically small, with small populations, their public expenditures tend to be relatively low at the outset,[[6]](#footnote-6) and instituting a low-tax regime has limited impact on public policy. Similar to the point made above concerning regime theory, one reason small states adopt a low-tax regime is that it doesn’t require a radical change in daily life. In addition, a low-tax regime makes the tax haven economic development strategy appealing to the state’s elite as their taxes either stay low or get lower, ensuring that their support for the government implementing the strategy will continue, increasing the state’s political stability. Furthermore, the tax haven economic development strategy is a relatively inexpensive one, especially if the jurisdiction is already positioning itself as a tourist destination, which many tax havens do. In addition to passing the necessary laws, the jurisdiction needs an airport that can handle both private and commercial air traffic, a modern telecommunications grid including high-speed Internet capability, and relatively skilled workforce in law, accounting, and banking as well as clerical work. Unlike the other economic development strategies available to small islands, becoming a tax haven does not require extensive public expenditures for mining equipment, or the direct and associated costs of heavy industry. Despite its myriad faults, the tax haven economic development strategy can appear to be one with high returns for low expenditures (Brittain-Catlin, 2005; Bueno de Mesquita, Smith, Siverson, & Morrow, 2004; Persaud, 2001; Vlcek, 2008).

The associated income benefits are high enough that tax havens are more likely to become wealthy states than non-tax haven states. Of the ten states with the highest gross domestic product (GDP) per capita (PPP) in 2016, five – Luxembourg, Macao, Singapore, Switzerland, and Hong Kong – are tax havens. The number of tax havens in the 2016 top 10 drops slightly to four - Luxembourg, Macao, Singapore, and Malta – when a population cap of four million is introduced. The bulk of the other states on the top 10 list are classfied by the IMF as “resource dependent,” including petrostates Qatar, the UAE, Norway, and Equitorial Guinea and gas state Brunei (Baunsgaard, Villafuerte, Poplawski-Ribiero, & Richmond, 2012). In fact, the only states in the top 10 that are neither tax havens nor resource dependent are Ireland,[[7]](#footnote-7) Slovenia, New Zealand, and Iceland. Of the last three, Slovenia and New Zealand have balanced industrial economies, while Iceland depends to an extent on its fishing industry – as do most small islands (see Table 1.1).

|  |  |
| --- | --- |
|  | Table 1.1: Top 10 States 2016 GDP Per Capita, (PPP) By Population Range (\* = tax haven; x = resource dependent state) |
|  | *All*  | *0-4 million* |
| 1. | Qatarx | Qatarx |
| 2. | Luxembourg\* | Luxembourg\* |
| 3. | Macao\* | Macao\* |
| 4. | Singapore\* | Singapore\* |
| 5. | Bruneix | Bruneix |
| 6. | United Arab Emiratesx | United Arab Emiratesx |
| 7. | Ireland | Iceland |
| 8. | Switzerland\* | New Zealand |
| 9. | Norwayx | Malta\* |
| 10. | Hong Kong\* | Slovenia |
|  | *5 Tax Havens* | *4 Tax Havens* |
|  | *4 Resource Dependent States* | *3 Resource Dependent States* |
|  | Data Source: UN Population Division, World Bank |

Looking in greater detail at small states that are not tax havens (see Table 1.2), of the 61 states on which data was available, 16 are resource dependent. Of the resource dependent states, 9 are petrostates, 2 are gas states, and the remaining are mining, either iron, copper, diamonds, gold, or bauxite. Of remaining 45 small states that are neither tax havens nor resource dependent, 17 are agriculture-based (most of those being subsistence agriculture), 10 are basically industrial, 10 are tourism-based, 6 are fishing-based islands, Namibia, which manages to be have a mining-based economy without being classified by the IMF as resource dependent, and Djibouti, which the CIA World Factbook lists as having a “port services” based economy, which is a polite term for piracy (Baunsgaard, Villafuerte, Poplawski-Ribiero, & Richmond, 2012; Central Intelligence Agency, 2017). Based on this descriptive analysis, and with a few exceptions, small states that are wealthy are either tax havens or resource dependent states. Since, by definition, states either have natural resources on which to be dependent or they do not, tax havens are, in effect, creating a virtual resource on which they become dependent. This conclusion is supported in part by the observation that only two states out of 51 tax havens and 47 resource dependent states are classified as both tax havens and resource dependent states: Bahrain and Malaysia. Either the prosperous small state develops the resources it has, or it creates its own through lowering taxes and stiffening secrecy laws.

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| Table 1.2: Non-Tax Haven Small States, by Economic Base  |
| *Resource Dependent*  | *Non-Resource Dependent*  | *Non-Resource Dependent* |
| *Botswana (diamonds)* | Albania (agriculture) | Lesotho (industry) |
| *Brunei (gas)* | Armenia (agriculture) | Lithuania (industry) |
| *Congo, Rep. of (oil)* | American Samoa (fishing) | Macedonia (industry) |
| *Equatorial Guinea (oil)* | Bhutan (agriculture) | Micronesia (agriculture) |
| *Gabon (oil)* | Bosnia & Herzegovina (industry) | Moldova (agriculture) |
| *Guyana (gold and bauxite)* | Cabo Verde (tourism) | Montenegro (tourism) |
| *Kuwait (oil)* | Central African Republic (agriculture) | Namibia (mining) |
| *Mauritania (iron ore)* | Comoros (agriculture) | New Caledonia (industry) |
| *Mongolia (copper)* | Djibouti (port services) | New Zealand (industry) |
| *Oman (oil)* | Eritrea (agriculture) | Nicaragua (agriculture) |
| *Qatar (oil)* | Estonia (industry) | Northern Mariana Islands (tourism) |
| *Suriname (minerals)* | Faroe Islands (fishing) | Palau (tourism) |
| *Timor-Leste (oil)* | Fiji (tourism) | Puerto Rico (industry) |
| *Trinidad & Tobago (gas)* | French Polynesia (tourism) | Slovenia (industry) |
| *Turkmenistan (oil)* | Gambia (agriculture) | Sao Tome and Principe (agriculture) |
| *United Arab Emirates (oil)* | Greenland (fishing) | Sint Maarten (Dutch) (tourism) |
|  | Guam (tourism) | Solomon Islands (agriculture) |
|  | Guinea-Bissau (agriculture) | St. Martin (French) (tourism) |
|  | Iceland (fishing) | Swaziland (agriculture) |
|  | Jamaica (tourism) | Togo (agriculture) |
|  | Kiribati (fishing) | Tuvalu (fishing) |
|  | Kosovo (agriculture) | Uruguay (agriculture) |
|  |  | West Bank and Gaza (industry) |

### Cost: Becoming a Tax Haven is Not a Foolproof Development Strategy

Becoming a tax haven does not always guarantee a state prosperity, however. It is not enough merely to change the laws and wait for the money to arrive: a tax haven must develop a reputation in the global finance community as a tax haven that is both stable politically and economically and competitive enough either in general or in a particular niche to warrant opening bank branches and shifting accounts around. *Pace* Hines (2005) and Armstrong et al (1998), averaging GDP per capita growth rates from 1970 to 2016 demonstrates that becoming a tax haven is not a guarantee that the economy will grow steadily. Three jurisdictions – Aruba, Liberia, and Andorra – had negative growth rates, while six more – Bahrain, US Virgin Islands, Vanuatu, Barbados, and Switzerland – had positive growth rates of less than 1%. Even so, 39 out of 42 tax havens had positive GDP growth rates for 1970-2016. And becoming a tax haven seems to make small states better off than being resource dependent or just not being a tax haven: the average GDP growth rate for resource depdendent states with populations of 4 million or fewer from 1970-2016 is 1.95%, compared the tax haven average of 2.59% over the same time period, while small states that were neither tax havens nor resource dependent had an average of 1.91%. Of the 17 small resource dependent states, three – Kuwait, UAE, and Brunei - had negative GDP growth rates, with three more – Suriname, Mauritania, and Qatar – having GDP growth rates of less than 1%. States with populations of four million or fewer who are neither tax havens nor resource dependent fared worse than either tax havens or resource dependent small states: of the 42 jurisidictions with data available, seven have negative average GDP growth rates while another eight have average growth rates of less than 1%. So, while the evidence provideded by this first cut suggests that becoming a tax haven is not a guaranteed path to financial stability for a jurisdiction, it does seem to be better than the alternatives with which small states are faced (see Table 1.3).

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| *Table 1.3: Average Small State GDP Growth Rate, 1970-2016 for Tax Havens, Resource Dependent States, and Other Small States\** |
| *Jurisdiction* | *Tax Haven Rate (%)* | *Resource Dependent Rate (%)* | *Other Small States Rate (%)* |
| Albania |  |  | 2.70 |
| American Samoa |  |  | -0.53 |
| Andorra | -0.13 |  |  |
| Antigua & Barbuda | 2.98 |  |  |
| Armenia |  |  | 3.84 |
| Aruba | -0.92 |  |  |
| Bahamas | 0.12 |  |  |
| Bahrain | 0.25 |  |  |
| Barbados | 0.65 |  |  |
| Belize | 2.67 |  |  |
| Bermuda | 1.61 |  |  |
| Bhutan |  |  | 5.56 |
| Bosnia and Herzegovina |  |  | 10.93 |
| Botswana |  | 5.67 |  |
| Brunei |  | -0.71 |  |
| Cabo Verde |  |  | 4.74 |
| Central African Republic |  |  | -1.02 |
| Channel Islands | 1.01 |  |  |
| Comoros |  |  | -0.31 |
| Congo, Rep. of |  | 1.38 |  |
| Costa Rica | 2.21 |  |  |
| Cyprus | 3.37 |  |  |
| *Table 1.3, continued* |  |  |  |
| Djibouti |  |  | 0.11 |
| Dominica | 2.76 |  |  |
| Equatorial Guinea |  | 10.90 |  |
| Eritrea |  |  | 1.88 |
| Estonia |  |  | 4.53 |
| Fiji |  |  | 1.78 |
| French Polynesia |  |  | 1.72 |
| Gabon |  | 1.23 |  |
| Gambia |  |  | 0.44 |
| Greenland |  |  | 2.28 |
| Grenada | 2.85 |  |  |
| Guam |  |  | 1.14 |
| Guinea-Bissau |  |  | 0.60 |
| Guyana |  | 1.60 |  |
| Hong Kong | 4.23 |  |  |
| Iceland |  |  | 2.63 |
| Isle of Man | 5.68 |  |  |
| Jamaica |  |  | 0.40 |
| Jordan | 1.84 |  |  |
| Kiribati |  |  | -0.40 |
| Kosovo |  |  | 4.67 |
| Kuwait |  | -2.63 |  |
| Latvia | 5.31 |  |  |
| Lebanon | 1.43 |  |  |
| *Table 1.3, continued* |  |  |  |
| Lesotho |  |  | 3.14 |
| Liberia | -1.43 |  |  |
| Liechtenstein | 2.41 |  |  |
| Lithuania |  |  | 5.48 |
| Luxembourg | 2.60 |  |  |
| Macao | 3.77 |  |  |
| Macedonia |  |  | 1.24 |
| Maldives | 4.01 |  |  |
| Malta | 4.43 |  |  |
| Marshall Islands | 1.39 |  |  |
| Mauritania |  |  |  |
| Mauritius | 3.70 |  |  |
| Micronesia |  |  | 0.73 |
| Moldova |  |  | 3.22 |
| Monaco | 1.99 |  |  |
| Mongolia |  | 3.02 |  |
| Montenegro |  |  | 2.38 |
| Namibia |  |  | 0.95 |
| Nauru | 14.62 |  |  |
| New Caledonia |  |  | 1.44 |
| New Zealand |  |  | 1.41 |
| Nicaragua |  |  | -0.07 |
| Northern Mariana Islands |  |  | -2.60 |
| Oman |  | 1.76 |  |
| *Table 1.3, continued* |  |  |  |
| Palau |  |  | -0.30 |
| Panama | 2.71 |  |  |
| Puerto Rico |  |  | 2.12 |
| Qatar |  | 0.63 |  |
| Samoa | 1.64 |  |  |
| San Marino | 2.48 |  |  |
| Sao Tome and Principe |  |  | 2.58 |
| Seychelles | 3.30 |  |  |
| Singapore | 4.88 |  |  |
| Slovenia |  |  | 2.37 |
| Solomon Islands |  |  | 0.73 |
| St. Kitts & Nevis | 3.64 |  |  |
| St. Lucia | 2.26 |  |  |
| St. Vincent & the Grenadines | 3.18 |  |  |
| Suriname |  | 0.16 |  |
| Swaziland |  |  | 2.72 |
| Switzerland | 0.93 |  |  |
| Timor-Leste |  | 4.03 |  |
| Togo |  |  | 0.03 |
| Tonga | 1.59 |  |  |
| Trinidad & Tobago |  | 1.87 |  |
| Turkmenistan |  | 3.73 |  |
| Tuvalu |  |  | 1.52 |
| Vanuatu | 0.60 |  |  |
| *Table 1.3, continued* |  |  |  |
| United Arab Emirates |  | -1.97 |  |
| Uruguay |  |  | 2.08 |
| US Virgin Islands | 0.41 |  |  |
| West Bank and Gaza Strip |  |  | 1.66 |
| Average | 2.59 | 1.95 | 1.91 |
| All states on list – with the exception of Hong Kong, Malaysia, and Switzerland – have populations of 4 million or fewer. |

### Cost: Tax Havens Become Renegade States

One of the central ironies of the tax haven world is that in order to become a successful tax haven, a jurisdiction must develop a positive reputation in the international banking community while at the same time gaining a negative one in the international legal and diplomatic community. Reputation is critical to developing a clientele as a tax haven, but jurisdictions that do so – especially if they perceived to be doing so actively and eagerly – also develop the reputation as a “renegade” state (Eden & Kudrle, 2005) in the international community; that is, not quite the pariah status of North Korea or Iran, for example, but not a member in good standing of the international community either.

Generally speaking, a renegade state is one whose “practices are salient to an international regime but whose behavior does not comply with the descriptive norms and practices of that regime” (Eden & Kudrle, 2005: 106). A renegade state cannot just be written off and ignored; its behavior affects the behavior of the other states in the regime, and therefore the ultimate success of the regime itself. In the case of tax havens, they are renegades in the regime of international tax harmonization and cooperation the developed states of the world are attempting to create through IGOs like the OECD and the Financial Action Task Force (FATF). As the European states watched the unsuccessful US effort to attack the problem of lost tax revenue to Caribbean tax havens in the 1980s, they agreed to use existing IGOs to create tax harmonization regimes. These regimes had three stated goals: 1) international equity, or clarifying which jurisdiction can rightfully tax which income, and that tax revenue is distributed fairly among jurisdictions; 2) international neutrality, or creating a tax system that does not influence individual or firm investment decisions; and 3) taxpayer equity, or equal treatment of individuals within a jurisdiction regardless of the source of their income. The underlying idea behind the tax harmonization regimes was that these goals could not be achieved unilaterally, no matter how rich and powerful the state (Eden & Kudrle, 2005; Hampton & Christensen, 2002; Hines, 2005; Maurer, 2008).

During the 1990’s, the impetus to create tax harmonization regimes came from Europe. The Bank for International Settlements formed the Basel Committee in 1974 to improve financial stability by increasing cross-border banking supervision and cooperation. The Committee is essentially reactive, having been formed in the wake of the European financial crises of 1974 and spurred by the failure of BCCI in 1991, created the Working Group on Cross-Border Banking, which worked with two groups of tax haven-based bankers and insurers to create the Core Principles for Effective Bank Supervision in 1997. Following the Basel Committee’s lead, the G-7 created two working groups: The Finance Ministers’ Working Group on Financial Crimes; and the Financial Experts Group. (BIS, 2017; Eden & Kudrle, 2005; Hampton & Christensen, 2002; Hines, 2005; Maurer, 2008).

The reports by the Working Groups led to an increased effort on the part of the Financial Stability Forum (FSF) to focus on tax haven activity and on the operations of a specific group of jurisdictions. The efforts by the Basel Committee and the G-7 represented the more traditional collaborative method of addressing problems within the community of nations, i.e. working with representatives of the renegade states themselves to achieve specific policy goals. In the case of the FSF, and then the OECD and the FATF, the process used was more aggressive. By 2000, all three groups had gone the additional step beyond studying and consultation and released blacklists of tax havens whose practices did not conform to the standards the IGO created.[[8]](#footnote-8) In the case of the FSF, these were jurisdictions in various stages of non-compliance with regulatory standards of cross-border cooperation. For the FATF, the blacklisted jurisdictions were those that did not cooperate with them in implementing their list of best practices for fighting money laundering. Finally, and most significantly, the OECD created a Forum on Harmful Tax Competition after releasing a report on harmful tax comeptition in 1998. This forum then released a list of 41 tax havens, a blacklist whose impact was so great that six jurisdictions agreed to compliance measures before the list was even released. All three of these lists were released within a few weeks of each other in the spring of 2000, and as such represented the spearhead of the international effort to curtail tax haven activity. In terms of Nadelmann’s (1990) five stages of prohibition regime formation, the IGOs had progressed through stages one – legitimate activity – and two – redefining activity as a problem – and arrived at stage three – formation of criminal conventions. The list of tax havens in this study and their presence on the three blacklists is summarized in Table 1.4 (Eden & Kudrle, 2005; FATF, 2000; FSF, 2000; Hampton & Christensen, 2002; Hines, 2005; Kudrle R. T., 2009; Maurer, 2008; OECD, 1998).

| *Table 1.4: Tax Havens on OECD, FATF, and FSF Blacklists, 2000* |
| --- |
| *Jurisdiction* | *OECD* | *FATF* | *FSF* |
| Andorra | X |  | X |
| Anguilla | X |  | X |
| Antigua & Barbuda | X |  | X |
| Aruba | X |  | X |
| Bahamas | X | X | X |
| Bahrain | X |  | X |
| Barbados | X |  | X |
| Belize | X |  | X |
| Bermuda | X (cooperating) |  | X |
| British Virgin Islands | X |  | X |
| Cayman Islands | X | X | X |
| Cook Islands | X (cooperating) | X | X |
| Costa Rica |  |  | X |
| Curacao | X (as Netherlands Antilles) |  | X |
| Cyprus | X (cooperating) |  | X |
| Dominica | X | X |  |
| Gibraltar | X |  | X |
| Grenada | X | X |  |
| Guernsey | X |  | X |
| Hong Kong |  |  |  |
| Isle of Man | X |  | X |
| Jersey | X |  | X |
| Jordan |  |  |  |
| *Table 1.4, continued* |  |  |  |
| Latvia | (OECD member) |  |  |
| Lebanon |  | X | X |
| Liberia | X |  |  |
| Liechtenstein | X | X | X |
| Luxembourg | (OECD member) |  |  |
| Macao |  |  | X |
| Malaysia |  |  |  |
| Maldives | X |  |  |
| Malta | X (cooperating) |  | X |
| Marshall Islands | X | X | X |
| Mauritius | X (cooperating) |  | X |
| Monaco | X |  | X |
| Montserrat | X |  |  |
| Nauru | X | X | X |
| Niue | X | X | X |
| Panama | X | X | X |
| Samoa | X |  | X |
| San Marino | X (cooperating) |  |  |
| Seychelles | X |  | X |
| Singapore |  |  |  |
| St. Kitts & Nevis | X | X | X |
| St. Lucia | X |  | X |
| St. Vincent & the Grenadines | X | X | X |
| *Table 1.4, continued* |  |  |  |
| Switzerland | (OECD member) |  |  |
| Tonga | X |  |  |
| Turks & Caicos | X |  | X |
| Vanuatu | X |  | X |
| Virgin Islands (US) | X |  |  |
| Sources: (Dharmapala, 2008; Eden & Kudrle, 2005; Gravelle, 2015; Haberly & Wojcik, 2015; Maurer, 2008; OECD, 2017)  |
| NOTE: The FSF also created a “Major Financial Centers” list at the same time, and this list includes Hong Kong, Luxembourg, Malaysia, Singapore, and Switzerland. These jurisdictions received FSF questionnaires regarding offshore activities and never responded. |

### Benefit: International Community Punishes Renegade States Ineffectively

The main problem with the blacklist effort led by the OECD is that it was compromised from the start. Part of the difficulty multi-lateral efforts to discipline tax havens face are the result of the historical relationships the enforcing states bear to the tax havens. Many of the existing tax havens started their Westphalian existences as colonies of the British Empire, giving them access not just to the English common law tradition, but also to a potential customer pool for their services. Of the 51 tax havens, 41 were on the OECD 2000 blacklist. Of these 41, 19 had a direct, legal link to an OECD member state, while three of the 51 (Latvia, Luxembourg, and Switzerland) were member states themselves. Perhaps unsurprisingly, none of the three OECD member states were blacklisted, although they were not the only ones to benefit: every other non-independent tax haven was blacklisted, although six chose to cooperate with the OECD almost immediately. In the end, everyone cooperated in one form or another, such that the OECD currently has no jurisdictions blacklisted as uncooperative, with European states Andorra, Liechtenstein, and Monaco being the last eliminated in 2009. With nearly half the tax havens on the blacklist linked to member states, blanket cooperation was the expected outcome (Eden & Kudrle, 2005; OECD, 2017).

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| Table 1.5: Tax Havens and their Relationship to OECD Countries |
| Jurisdiction | *Jurisdiction Type and Linkage* |  *OECD Link* | *On OECD List (2000)?*  |
| Andorra | Co-principality between France and Spain  |  France, Spain | Yes |
| Anguilla | UK overseas territory | UK | Yes |
| Antigua & Barbuda | Independent, commonwealth member |  | Yes |
| Aruba | Part of Netherlands |  Netherlands | Yes |
| Bahamas | Independent, commonwealth member |  | Yes |
| Bahrain | Independent  |  | Yes |
| Barbados | Independent, commonwealth member |  | Yes |
| Belize | Independent, commonwealth member |  | Yes |
| Bermuda | UK overseas territory | UK | Cooperating |
| British Virgin Islands | UK overseas territory | UK | Yes |
| Cayman Islands | UK overseas territory | UK | Yes |
| Cook Islands | Free association with New Zealand |  New Zealand | Cooperating  |
| Costa Rica | Independent  |  | No |
| Curacao | Autonomous within Netherlands |  Netherlands | Yes (as part of Netherlands Antilles) |
| Cyprus | Independent, commonwealth member |  |  Cooperating |
| Dominica | Independent, commonwealth member |  | Yes |
| Gibraltar | UK overseas territory | UK | Yes |
| Grenada | Independent, commonwealth member |  | Yes |
| Guernsey | British crown dependency | UK | Yes |
| Hong Kong | Special administrative region of China |  | No |
| Table 1.5, continued |  |  |  |
| Isle of Man | British crown dependency | UK | Yes |
| Jersey | British crown dependency | UK | Yes |
| Jordan | Independent |  | No |
| Latvia | OECD member |  Latvia | No |
| Lebanon | Independent |  | No |
| Liberia | Independent |  | Yes |
| Liechtenstein | Independent |  | Yes |
| Luxembourg | OECD member |  Luxembourg | No |
| Macao | Special administrative region of China |  | No |
| Malaysia | Independent |  | No |
| Maldives | Independent, commonwealth member |  | Yes |
| Malta | Independent, commonwealth member |  | Cooperating |
| Marshall Islands | Independent, free association with US | US | Yes |
| Mauritius | Independent, commonwealth member |  | Cooperating |
| Monaco | Independent |  | Yes |
| Montserrat | UK overseas territory | UK | Yes |
| Nauru | Independent, commonwealth member |  | Yes |
| Niue | Free association with New Zealand | New Zealand | Yes |
| Panama | Independent  |  | Yes |
| Samoa | Independent, commonwealth member |  | Yes |
| San Marino | Independent city state in free association with Italy |  Italy | Cooperating |
| Seychelles | Independent, commonwealth member |  | Yes |
| Table 1.5, continued |  |  |  |
| Singapore | Independent, commonwealth member |  | No |
| St. Kitts & Nevis | Independent, commonwealth member |  | Yes |
| St. Lucia | Independent, commonwealth member |  | Yes |
| St. Vincent & the Grenadines | Independent, commonwealth member |  | Yes |
| Switzerland | OECD Member |  Switzerland | No |
| Tonga | Independent, commonwealth member |  | Yes |
| Turks & Caicos | UK overseas territory |  UK | Yes |
| Vanuatu | Independent, commonwealth member |  | Yes |
| Virgin Islands (US) | US overseas territory |  US | Yes  |
| Source: Eden & Kudrle, 2005: 116-8 |

The irony here is that the campaigns to name and shame were not failures as such. The IGOs were able to get tax havens to successfully comply with their requirements and were able to either wind the programs down or shift the focus to terrorism financing and money laundering for organized crime by the end of the decade. From the six early adopters to the last holdouts, every jurisdiction on the blacklist made a commitment to increased transparency and improved exchange of information. The problem is that compliance required a relatively small amount of effort on the part of the tax havens. For example, a tax haven could get itself reclassified as “cooperative” by the OECD by issuing a press release stating that the government of the jurisdiction intended to adopt the OCED’s Memorandum of Understanding, i.e. by promising to change their behavior rather than actually changing it. In fact, 31 of the jurisdictions on the OECD blacklist had done just that by September, 2003. In addition, the FSF announced on March 11, 2005 that their own blacklist was “no longer operative” (Kudrle R. T., 2009: 36). Granted, this compliance has resulted in changes in tax haven behavior – the establishment of stand-alone financial services commissions, the creation of corporate registries where none had previously existed, the increased use of laws like Know Your Customer and other due diligence requirements. The impact of these regimes on tax haven behavior, however, has been limited, and the continued use of tax havens for tax avoidance and evasion, as well as money laundering and terrorism financing has not changed much (Eden & Kudrle, 2005; Maurer, 2008; OECD, 2017).

The preliminary analysis bears this conclusion out. Average GDP per capita growth rates for tax havens with a population of fewer than four million people decreased from an average of 2.62% for the period of 1970-2000 to an average of 1.90% for the period 2001-2016, for an overall average of 2.58%, meaning that, on average, growth slowed in tax havens after the naming and shaming campaigns, but did not reverse or stop. By contrast, resource dependent states experienced the opposite trend, increasing from an average GDP per capita growth rate of 1.38% for the period of 1970-2000 to an average of 2.33%, possibly as the result of Iraq War-era increases in oil prices, although an overall average increase of 2.03% suggests that the tax haven strategy might be a profitable economic development model. Finally, small states that were neither tax havens nor resource dependent demonstrated the same trend as tax havens, dropping from an average GDP growth rate of 1.97 for the period of 1970-2000 to an average of 1.82% for the period of 2001-2016, for an overall average of 1.92% for the entire period. That non-tax haven states experienced a similar, though less extreme, trend as tax havens in economic growth implies that perhaps other macroeconomic factors were responsible for the general decrease in tax haven growth rates in the 21st century rather than the blacklist campaign, but clearly more sophisticated analysis is necessary (see Table 1.6).

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| Table 1.6: Average GDP Per Capita Growth Rate (%), 1970-2016, populations lower than 4 million  |
|  | Tax Havens (n=38) | Resource Dependent States (n=16) | Other Small States (n=42) |
| 1970-2016 | 2.58 | 2.03 | 1.92 |
| 1970-2000 | 2.62 | 1.38 | 1.97 |
| 2001-2016 | 1.90 | 2.33 | 1.82 |
| Data Source: IMF World Development Indicators |

The preliminary analysis also helps illustrate the reasons why a jurisdiction would choose to become a tax haven, even in the face of universal disapprobation: 1) in the absence of natural resources, it’s a comparatively successful economic development strategy; and 2) the practical impact of that disapprobation is relatively low. Only one jurisdiction – Malaysia – can be classified as both a tax haven and a resource dependent state, further reinforcing the argument that jurisdictions become tax havens in order to create a virtual resource as an economic base. Lacking any resources of their own to create inflows foreign banking and commercial activity, these jurisdictions choose an alternative in a process that one would be hard pressed to be called random. As is evident from Table 1.7, tax havens cluster in neighborhoods like the Caribbean, or the mountains of western Europe, or the South Pacific. This clustering behavior is to be expected, given that a jurisdiction’s response to a regime is dictated more by that jurisdiction’s neighbors’ responses than by the regime itself; that is, it follows logically that there would be groups of jurisdictions out of compliance with the tax harmonization regime IGOs like the OECD are attempting to impose (Eden & Kudrle, 2005; Simmons, 2000).

In addition, jurisdictional decision-making vis a vis becoming a tax haven might also be affected by their prior colonial relationships: approximately half of all tax havens were either British colonies or are still dependencies. In addition to providing them access to British common law precedents enabling tax haven behavior, these jurisdictions’ status makes them a natural market for British individuals and corporations seeking to avoid British corporate taxation. Since Britain is one of the world’s largest economies,[[9]](#footnote-9) becoming a tax haven for British citizens both individual and corporate can be a lucrative pursuit. In ranking the top five tax havens by average GDP per capita, two – the Cayman Islands and Bermuda - are Crown dependencies. In the case of the Caribbean tax havens, this colonial relationship with Britain meant that, once the colonies declared their independence, the tax treaty the US and Britain signed in 1945 now applied to them as well, allowing both American and British businesses to use these new jurisdictions to find the most advantageous tax deal legally. That tax havens have existing relationships with developed states also helps explain why citizens of those states would become tax haven customers, even as their governments’ official statements decry the practice. In fact, the bulk of tax havens’ incorporation and banking activity originates in OECD states, despite the OECD being the primary organization involved in blacklisting tax havens. The source of the ambivalence in OECD states is that decision-makers are trying to simultaneously accomplish two opposing policy goals: 1) create an international tax regime that doesn’t result in taxable income escaping to the tax havens; and 2) creating a business environment for businesses in which they can compete, both domestically and internationally. These goals became even more difficult to accomplish in the face of a distinct lack of official enthusiasm for punishing tax havens from the Bush administration in the US in 2001, as well as the continuing prominence of a brace of well-funded advocacy groups in both Washington DC and London arguing that unfettered tax competition was actually a net economic good (Eden & Kudrle, 2005; Maurer, 2008).

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| Table 1.7: Tax Havens by Geographic Region (islands in **bold**; n = 33) |
| *Europe (13)* |  |  |
| Andorra | **Cyprus** | Gibraltar |
| **Guernsey** | **Isle of Man** | **Jersey** |
| Latvia | Liechtenstein | Luxembourg |
| **Malta** | Monaco | San Marino |
| Switzerland |  |  |
| *Caribbean (17)* |  |  |
| **Anguilla** | **Antigua & Barbuda** | **Aruba** |
| **Bahamas** | **Barbados** | **Bermuda** |
| **British Virgin Islands** | **Cayman Islands** | **Curacao** |
| **Dominica** | **Grenada** | **Montserrat** |
| **St. Kitts & Nevis** | **St. Lucia** | **St. Vincent & the Grenadines** |
| **Turks & Caicos** | **Virgin Islands (US)** |  |
| *South Pacific (7)* |  |  |
| **Cook Islands** | **Marshall Islands** | **Nauru** |
| **Niue** | **Samoa** | **Tonga** |
| **Vanuatu** |  |  |
| *East and Southeast Asia (5)* |  |  |
| Hong Kong | Macao | Malaysia |
| **Maldives** | Singapore |  |
| *Table 1.7, continued* |  |  |
|  |  |  |
|  |  |
| *Middle East (3)* |  |  |
| **Bahrain** | Jordan  | Lebanon |
| *Central America (3)* |  |  |
| Belize | Costa Rica | Panama |
|  |  |  |

This ambivalence demonstrated towards tax havens by the developed world as a result of colonial legacy is a key variable in determining whether a jurisdiction will become – or remain – a tax haven, but there additional political and economic factors. Frequently, jurisdictions that become tax havens are islands; as Table 1.7 shows, 33 of the 51 tax havens are islands. Small island economies tend to have a series of economic disadvantages similar to remote areas, including “restricted comparative advantages, diseconomies of scale, dysfunctional market structures, high transport costs… limited natural resources, small labor markets, and deficiencies in professional and institutional knowledge and experience” (Hampton & Christensen, 2002: 1663). These disadvantages can limit a jurisdiction’s options for economic development; limited natural resources and a generally inability to industrialize or farm on a large scale makes the decision to become a tax haven an obvious one, as long as the jurisdiction believes the benefits outweigh the costs, and that the jurisdiction can profit from renegade behavior (Eden & Kudrle, 2005; Nadelmann 1990).

In addition, other attributes the jurisdiction may have may also prejudice their decision in favor of becoming a tax haven. First, and most important, they have their sovereignty which, even at its most limited in the case of the dependencies, is still sufficient to create the legal and financial institutions necessary to become a tax haven. While tax havens tend to be better governed than non-tax haven small states, they may lack certain elements of civic and political life that promote organized opposition, such as an independent media, organized opposition parties, or institutions of higher education. The stability created by this better governance is critical to tax haven development; investors are attracted to stability so states with more stable governments will have higher levels of FDI than states with less stable governments. In addition, states with more stable governments are more likely to become tax havens than states with less stable governments. This tendency could also be driving investment; rather than foregoing short term profits by investing in stable states, as Barry, Clay, & Flynn (2013) suggest, multinational corporations are actually seeking out higher profits by investing in states more likely to be tax havens. In addition, the remoteness of the islands can foster a culture of insularity, one that values unity and secrecy, and discourages whistle-blowing or outward transparency. This remoteness also creates a literal barrier between the islands and the ruling authorities, whether the colonizer or any mainland-based IGOs that give the islands a certain level of autonomy (Dharmapala, 2008; Hampton & Christensen, 2002).

All small states and islands have many, if not most of, these characteristics, but what makes the Bahamas and the Cayman Islands more likely to become tax havens than Cuba and Jamaica? Two factors, which this study will analyze in greater depth in the future: 1) stable governments that encourage foreign investment; and 2) the ability to benefit from renegade behavior despite the application of international regimes designed to curtail this behavior. The analysis carried out will focus mainly on determining the key political and economic differences between jurisdictions with small populations that are tax havens and ones that are not, as well as the nature of the impact the coordinated international anti-tax haven campaigns had on tax havens, and the foreign individuals and firms that patronized them.

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1. *Calcutta Jute Mills, Ltd. V. Nicholson (Surveyor of Taxes)* in 1876 found that, for tax purposes, a company’s residence is wherever its “central management and control” is located (Calcutta Jute Mills Ltd. v. Nicholson (Surveyor of Taxes), 1876). *Egyptian Delta Land and Investment Company, Ltd. V. Todd* in 1929 found that companies founded by British citizens but headquartered outside the UK were not liable for British tax (Egyptian Delta Land & Investment Company, Ltd. v. Todd, 1929). [↑](#footnote-ref-1)
2. For simplicity’s sake, I will use the term “tax haven” for the duration of this work. [↑](#footnote-ref-2)
3. Ironically, these blacklists play a role in research on tax havens, as they act as useful indicators of which countries have built up a significant enough reputation and clientele to warrant censure. [↑](#footnote-ref-3)
4. FDI = Foreign Direct Investment, or the amount of money flowing from an individual or business in one country into the business interests in another. This transaction usually takes the forms of incorporating a new business or buying a controlling interest in an existing one. [↑](#footnote-ref-4)
5. This population cutline excludes only Hong Kong, Switzerland, and Malaysia, all of whom have populations larger than 4 million. [↑](#footnote-ref-5)
6. Especially if, as in the case of the Cayman Islands, the population tends towards being culturally conservative and politically hostile to the idea of social welfare spending (Brittain-Catlin, 2005). [↑](#footnote-ref-6)
7. And a convincing case could be made that Ireland’s economy has benefited greatly from a preferential tax regime. [↑](#footnote-ref-7)
8. These standards, in their most basic form: little to no tax on income from financial services; different tax rates and regulations for financial services than for other industries in jurisdiction; laws enforcing a lack of transparency in financial service activity disclosure; and an absence of laws regulating information sharing with other jurisdictions or IGOs. (Maurer, 2008) [↑](#footnote-ref-8)
9. Great Britain had the fifth highest level of GDP of all states in 2016, behind only the US, China, Japan, and Germany, according to the IMF. [↑](#footnote-ref-9)