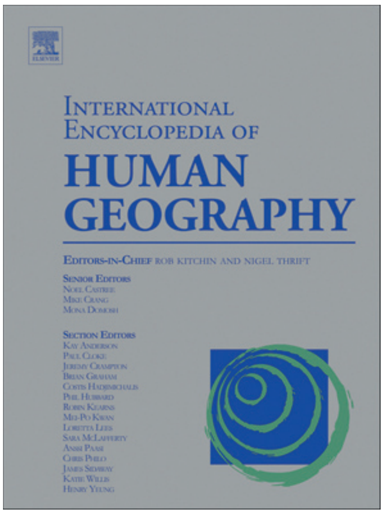

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Finance, Offshore

S. M. Roberts, University of Kentucky, Lexington, KY, USA

Glossary

Offshore Finance Financial activity that takes place in less-regulated jurisdictions, often with low or no applicable taxes.

Offshore Financial Center (OFC) A jurisdiction that has a deliberately less-regulated and less- (or un-) taxed financial sector and offers a range of financial services (corporate and personal banking, insurance, securities, financial management, trusts, and so on). Bigger OFCs host offices of major international banks and the big four global accounting firms.

Tax Haven A jurisdiction that either exempts foreigners from paying tax on savings or income from abroad, or has minimal rates of taxation so as to attract foreign companies and individuals seeking to avoid taxes.

Introduction

Offshore finance has become a major component of the international financial system. Although there are no precise figures available, it is estimated that at any time, over half of the world's money will be traveling in offshore circuits or located in offshore centers. Indeed, depending on how they are defined, there are now between 14 and 70 offshore financial centers (OFCs) scattered around the globe (see Figure 1). The Bank for International Settlements (BIS) estimates that for 2006 the largest five OFCs (Bahamas, Cayman Islands, Netherlands Antilles, Hong Kong SAR, and Singapore) together accounted for 12% of all international bank liabilities – a greater share than the US. In addition to offshore banking activities of a traditional sort, the offshore financial markets include a large and diverse financial services business offering innovative financial products or instruments in the bond markets, in the mutual funds sector (including hedge funds), in the trust business, and there is also a significant and very active offshore insurance industry. Every major bank, each of the big four global accounting firms and most, if not all, transnational corporations (TNCs) have extensive offshore networks.

By hosting offshore finance – turning themselves into OFCs – a number of small states have managed to establish successful economies. Some OFCs are in places (often small islands) that have few other options for economic development and hosting offshore finance has proven an attractive option. For example, the Caribbean islands with the highest gross national products (GNPs) per capita include the OFCs of the Bahamas, the Caymans, and the Netherlands Antilles. In Europe, a set of states have historically positioned themselves to host flight capital and now offshore finance, including Switzerland, Luxembourg, and Liechtenstein. Each has profited from its place in the offshore financial world. However, as is discussed below, offshore finance does not only take place in these havens, it also takes place in the world's supposedly 'onshore' financial centers – notably London.

Defining Offshore

As is already clear, offshore finance is not a sphere of activity that is completely separate from so-called onshore activities. Most analysis of offshore finance points out that offshore is deeply connected to onshore through flows of money and through institutions and other actors that work in both realms. The interesting attempts by BIS researchers to map international banking flows show that many international banking transactions between 'onshore' centers are routed through OFCs. More profoundly, though, offshore finance only exists as a relational category. Offshore is defined by its difference from onshore. Specifically, offshore finance takes advantage of less (or differently) taxed and regulated spaces in the world economy. OFCs are, as Ronen Palan describes, deliberately structured juridical spaces. Offshore finance is, in this way, distinctly geographical. Through innovative uses of offshore markets and centers, capital exploits the uneven global topographies of taxation and regulation to minimize its liabilities to the state (taxes) and accumulate profits. In general, offshore finance may be thought of as the 'constitutive outside' of finance. That is, while it may be regarded as very different from or even as working in opposition to onshore finance, even the briefest of analysis reveals that offshore is very much a part of onshore.

Offshore finance has recently come under a great deal of pressure and the pressure has largely been aimed at the key juridical spaces through which it works: the OFCs. Long suspected of providing shelter to money launderers and super-rich tax dodgers, the OFCs are now suspected of providing terrorists with a financial network, and with assisting corporate fraudsters whose companies pay tiny amounts of taxes in their major countries of operation while hoarding corporate and personal fortunes offshore.

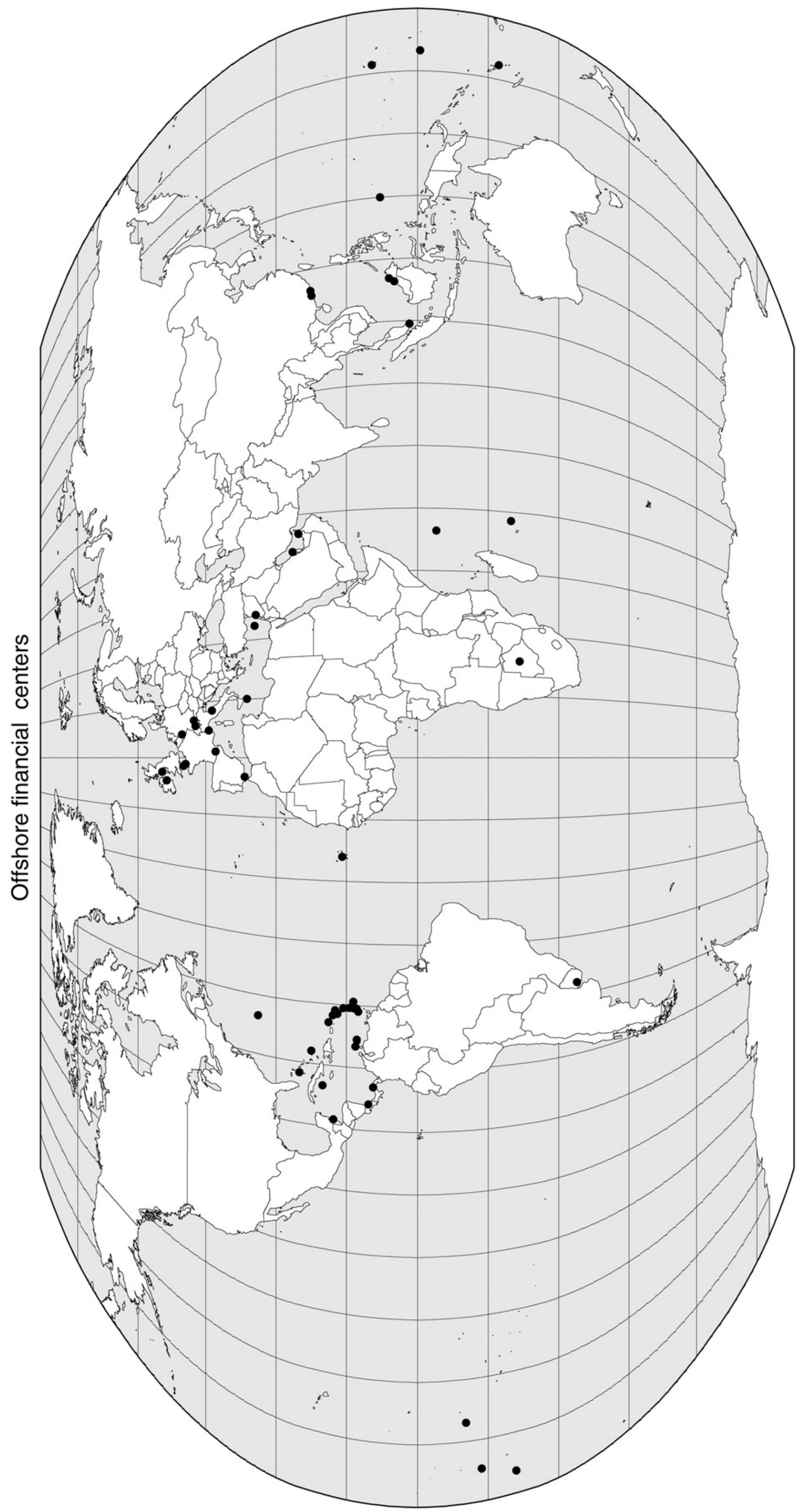

Figure 1 Offshore Financial Centers. Source data: IMF 2006.

The Rise of Offshore Finance

Offshore financial centers developed, in many cases, out of tax havens. Tax havens themselves arose as places in which wealthy families could shelter their money in trusts or investment companies and avoid paying different kinds of taxes in their home countries. The revenue authorities in Great Britain and in the United States investigated such practices in the 1920s and 1930s. In subsequent decades, as the number of TNCs rose, corporations rather than individuals or families became the main users of tax havens. Indeed, the rise of TNCs during the 1950s and 1960s and more particularly the growth in the levels of foreign direct investment (FDI) activity by TNCs during these decades may be partly explained by the incentives provided for FDI under prevailing tax regimes. Essentially, TNCs' profits made abroad were not taxed in the companies' home jurisdictions until they were repatriated. Thus TNCs had every reason to reinvest profits made overseas in further rounds of FDI. To defer or avoid taxes on profits made overseas, TNCs established various subsidiary corporate entities in less-taxed (or differently taxed) jurisdictions. By using a suite of conduit and holding companies, along with old-fashioned transfer pricing techniques, a TNC could effectively minimize its tax liabilities worldwide. If that was the 'demand side', the 'supply side' was found in the growing ranks of tax havens where enterprising (often expatriate) lawyers, bankers, and accountants worked with legislators to structure the legal and regulatory systems of their countries to facilitate and attract TNCs wishing to set up various types of corporate entities. Many aspiring OFCs (or 'international financial centers' as these new and former tax havens often prefer to be called) found they could reap certain rewards, in the shape of fees and revenue, from the business of being an OFC. For otherwise quite desperately poor places, often without much scope for enacting economic development strategies, this potential revenue stream was very appealing.

A further and decisive boost to the fledgling offshore finance sector came during the late 1960s and 1970s. This was the period during which the international financial system underwent a profound transition. From the end of World War II until that time, exchange rates had been more or less fixed under the so-called Bretton Woods system. The US dollar acted as the *de facto* world currency and it was tied to gold (at $35 an ounce). The tremendous pressures on this relatively inflexible (but stable) system built up in the post-war decades as economic growth occurred unevenly. The US found itself in a deficit position (in part due to the costs of the Vietnam War) and in August 1971 President Richard Nixon suspended the convertibility of the dollar to gold, put a surcharge on imports, and demanded that the dollar be devalued. Eventually, the system of fixed or pegged exchange rates broke down and the world's currencies began to more or less float against one another. The rigidity of the post-war Bretton Woods currency regime was broken. Floating exchange rates were a source of uncertainty and risk for TNCs to some degree, but the movement of currencies against one another also provided scope for further profit making through speculation. Both aspects further fuelled the rise of offshore finance. To deal with currency risk, TNCs could park sums denominated in different currencies in OFCs. To take advantage of the potential for arbitraging in the currency or foreign exchange markets, TNCs could establish financial subsidiaries as profit centers in their own right and base them in OFCs.

As the world economy globalized further through the last three decades of the twentieth century with international finance taking an ever-more prominent role, OFCs became homes to financial institutions and other TNCs seeking to take advantage of uneven topographies of regulation, as well as taxation. Offshore markets became sites of innovation as new types of entities and new types of financial products or instruments were developed to allow corporations, including banks, to take advantage of the spatial differences in regulations on financial activities such as interest rate restrictions, reserve requirements, and reporting requirements. As the leading sectors in the US and EU became more identified with services and with intellectual property (rather than with production or trade in more tangible goods), the OFCs became central to the global strategies of technology and pharmaceutical corporations, for example. A corporation holding intellectual property (patents, copyrights, etc.) can structure itself so that the patents are held by a subsidiary based in an OFC and then the onshore corporation will pay its own subsidiary licensing fees or royalties and very effectively minimize taxes due onshore. For instance, by setting up an Irish subsidiary, Google arranged its finances so that a high proportion of its earnings were through the Irish entity, meaning they were taxed at 12.5% rather than at 35% as they would have been if they had been earned in the US.

OFCs are still used by rich individuals (known as 'high net worth individuals' in the trade) and wealthy families. Private wealth stashed in OFCs by rich individuals and families is reckoned by some estimates to be worth over US$11.5 trillion. This would generate an untaxed income of about US$850 billion a year. With the rise of a super-rich class most recently typified by, but not restricted to, the new cadre of cosmopolitan Russian billionaires, OFCs have become routine elements in transnational wealth management strategies. With political instability threatening economic insecurity, middle and upper classes have long sought 'bolt holes' should they need them. For example, during the build up to both World Wars, Switzerland and Liechtenstein were perceived as safe places to which those in other parts of tumultuous Europe could send their assets. Most OFCs still host flight capital of all sorts and many offer offshore services such as ship or aircraft registries that, while they are not financial, appeal to super-rich individual users of offshore finance.

The Geography of Offshore Finance

Identifying places that may be categorized as OFCs is quite difficult. In part, this is because the very term 'offshore' is somewhat ambiguous and in part because, as is explained below, offshore, while it operates in a distinctly geographical way, creates a convoluted geography. This is seen in the development of the onshore offshores in the early 1980s. In 1981, US authorities allowed banks to set up 'international banking facilities' (IBFs) in New York (and eventually other states) which operated free of the key restrictions on interest rates and reserve requirements – requirements that previously could only be escaped by setting up in an OFC. These efforts and related ones in Japan, designed to lure offshore business back onshore, plus the long-standing dominance of London in the Eurocurrency markets resulted in a major portion of offshore finance actually being conducted onshore. Indeed, there is much truth to the observation that London is the world's biggest offshore center. With the recent politicization of offshore finance (see below), the identification of places as OFCs has become a loaded issue. However, even acknowledging the definitional difficulties (political and otherwise) it is possible to identify places that host offshore finance.

Researchers at the Tax Justice Network (TJN) have compiled an expansive list of OFCs which contains over 70 jurisdictions they identify as tax havens (see Table 1). They usefully categorize the various centers into groups: major financial centers; premier havens; midrange havens; minor havens; and notional havens. Major financial centers are those that are typically regarded as 'onshore' and have a diversified financial services industry, but where certain tax and/or regulatory structures exist to permit their use as havens or OFCs as well. The premier group of centers are those which are the biggest in terms of the volume of offshore business they handle and, while they may be specialized (for example, the British Virgin Islands (BVI) in offshore companies formation) they offer a suite of offshore services and products. Every premier center also hosts offices for each of the big four global accountancy firms (KPMG; Deloitte; Ernst & Young; and PricewaterhouseCoopers). The midrange centers, in many cases, aspire to be premier centers but may lack the volume of business or the presence of major international players in the accounting or banking fields. The 'notional' centers are those whose legal and regulatory frameworks make them potential OFCs, but for various reasons they have attracted only a limited amount of offshore business. There is some concern that this class of centers is the most likely to attract illicit finance or those seeking to evade

Table 1 Typology of offshore financial centers and tax havens

Major financial centers	*Premier havens*	*Midrange havens*	*Minor havens*	*Notional havens*
Belgium	British Virgin Islands	Aruba	Andorra	Alderney
City of London	Cayman Islands	Bahrain	Anguilla	Campione d'Italia
Frankfurt	Cyprus	Barbados	Antigua and Barbuda	Ingushetia
Hong Kong	Dubai	Bermuda	Belize	Liberia
Netherlands	Guernsey	Costa Rica	Grenada	Marshall Islands
New York	Ireland	Dominica	Madeira	Melilla
South Africa	Isle of Man	Gibraltar	Monaco	Montserrat
Switzerland	Jersey	Hungary	St. Lucia	Nauru
Tel Aviv	Liechtenstein	Iceland	St. Vincent and the Grenadines	Niue
	Luxembourg	Labuan	St. Kitts and Nevis	Samoa
	Singapore	Lebanon	The Cook Islands	Sao Tome e Principe
	The Bahamas	Macau	The Maldives	Sark
		Malta	Trieste	Somalia
		Mauritius		The Marianas
		Netherlands Antilles		The Seychelles
		Panama		Tonga
		Taipei		Turkish Rep. of N. Cyprus
		Turks and Caicos Islands		Vanuatu
		Uruguay		
		US Virgin Islands		

Source: Tax Justice Network (2007). Closing the floodgates: Collecting tax to pay for development. Report commissioned by the Norwegian Ministry of Foreign Affairs. Edited by R. Murphy. TJN London (http://www.taxjustice.nl/dialogs/download.aspx?oid=8ad013e9-1df9-4f2a-a400-4fbd6700f0fd) (accessed 3 August 2007).

taxation. However, in terms of their overall contribution to offshore finance, these centers are negligible.

There are identifiable clusters of OFCs. Using the shorter list of OFCs used by the International Monetary Fund (IMF), the map in Figure 1 shows the global distribution of OFCs (see also Table 2 above). The major clusters are found in the Caribbean, Europe, and the Pacific. In terms of volume of business, the Caribbean and European centers outrank the Pacific centers, although if Asia and the Pacific are taken together it is reasonable to expect that the centers in this region will continue to grow as Asian economies experience high annual economic growth rates. This is because the clusters of OFCs each tend to operate in connection to their nearby onshore economies. Thus the Caribbean centers are most closely linked into North American circuits of capital and in much the same way the European centers tend to operate as adjuncts to the EU even as they attract business from all over the globe. In part this clustering may be explained by the time zone factor since OFCs tend to be closely associated with onshore financial centers and economies with which they share some portion of the business day. However, it is also a result of relic geographies of empire – many of the Caribbean OFCs are Dependent Territories of Britain, for example – in which small islands found themselves with minimal legal structures ripe for adaptation to the needs of offshore finance and with little democratic or political pressure to do otherwise. Within each cluster there has tended to emerge a hierarchy of centers. For example, in the Caribbean, the Cayman Islands and the Bahamas are much more significant OFCs than St. Lucia or Dominica, say. Each center has developed specializations within the broad category of offshore finance. Bermuda, for example, is well known as a global center for the 'captive' insurance business and as such competes with regional rival The Caymans but also with Guernsey, the Isle of Man, Luxembourg, and Vermont. The BVI, on the other hand, have specialized in offshore company formation and are home to over 300 000 so-called international business companies. They compete not only with other Caribbean centers but also with Ireland, Gibraltar, Luxembourg, and Delaware in this niche. Despite the fact that individuals and corporations establishing offshore entities typically establish several in different locations so as not to 'put all their eggs in one basket', centers within a cluster also tend to compete for business. They keep a careful watch on the other centers within the region in order to counteract (or preempt) any innovations or adjustments others might be making with regard to the products or services they offer and the fees they charge. This intense competition has led some commentators to regard this as another example of a 'race to the bottom' since it is most commonly expressed as competitive deregulation.

Table 2 shows all the OFCs under IMF scrutiny. The IMF is one of a number of institutions seeking to exert some control over offshore finance. Since the 1990s, offshore finance has come to be seen as a problem by many, and there was an intense effort to clamp down on OFCs in the 1990s. It is to this issue that we now turn.

Table 2 Offshore financial centers under IMF scrutiny

Europe	*Middle East, Africa, and Indian Ocean*	*Caribbean, Atlantic, Central, and South America*	*Asia and Pacific*
Andorra	Bahrain	Anguilla	Brunei
Cyprus	Botswana	Antigua and Barbuda	Cook Islands
Gibraltar	Dubai	Aruba	Hong Kong SAR
Guernsey	Lebanon	Belize	Macao SAR
Ireland	Mauritius	Bermuda	Marshall Islands
Isle of Man	Seychelles	Barbados	Malaysia (Labuan)
Jersey		British Virgin Islands	Nauru
Liechtenstein		Cape Verde	Niue
Luxembourg		Cayman Islands	Palau
Malta		Costa Rica	Samoa
Monaco		Dominica	Singapore
San Marino		Grenada	Vanuatu
Switzerland		Montserrat	
		Netherlands Antilles	
		Panama	
		St. Kitts and Nevis	
		St. Vincent and The Grenadines	
		The Bahamas	
		Turks and Caicos Islands	
		Uruguay	

Source: International Monetary Fund (2006). Offshore financial centers: The assessment program – a progress report (http://www.imf.org/external/np/pp/eng/2006/020806.pdf) (accessed 3 August 2007).

The Crackdown of the 1990s and the Reconfiguration of Offshore Finance

Since the mid-to-late 1990s there have been a plethora of efforts to 'crack down' on OFCs. The origins of the crackdown lie in the huge expansion of the offshore markets through the 1980s and 1990s. As the flows of offshore capital grew, various onshores started to become concerned about offshore markets and specifically about the role of OFCs. The onshores had two major classes of concern. First, they were upset that they were losing business to OFCs, despite considerable onshore offshores in centers such as London in the UK and Delaware in the US. This competitive concern evolved into the discourse of 'unfair tax competition'. Second, onshore elements were worried about the uses of offshore markets and centers for hiding and washing dirty or illicit money. This concern was not new and continued, as it had been, to be typically referenced by the label 'money laundering'. Since 9/11 this issue has been allied with a generalized concern about the funding of terrorism with which it is now always discursively twinned. Both discourses – unfair tax competition and money laundering – cast OFCs as particular 'problems' or 'suspects' to be disciplined.

In an attempt to reduce the opportunities for criminals to hide their money behind the confidentiality guarantees of the OFCs, the US authorities exerted considerable pressure on Caribbean OFCs through the 1970s and 1980s. In 1986 they succeeded in badgering the Cayman Islands, for example, into signing a Mutual Legal Assistance Treaty. However, in the 1990s the pressure was stepped up and became more multilateral in character. In 1996 the Offshore Group of Banking Supervisors (a group formed in 1980 and connected to the BIS) issued a report critical of OFCs. Then in 1989 the Financial Action Task Force (FATF) was established by the G7 with the main focus on money laundering. The Organization for Economic Cooperation and Development (OECD) began their investigations into 'unfair tax competition' in 1996, producing the report '*Harmful tax competition: An emerging global issue*' in 1998. In 1999 the BIS established the Financial Stability Forum (FSF), apparently following the wishes of the G7 finance ministers and central bank governors, and this group (inevitably) issued a report of its own. Since 2003 the IMF has had its own Offshore Financial Center Program which, in coordination with the FATF, the FSF, and the International Organization of Securities Commissions (IOSCO), monitors OFCs compliance with 'supervisory standards'.

Along with the rise in the number of multinational organizations scrutinizing the OFCs, onshore states continued their own efforts to discipline them. The UK Government produced the Edwards Report in 1998, focused on the OFCs that were British dependencies. This was followed by an officially commissioned report in 2000 carried out by KPMG that focused again on Bermuda and British overseas territories in the Caribbean. The EU Savings Tax Directive, which came into effect 1 January 2005, is a system for exchanging information between member states about savings held by EU nationals in accounts based outside their jurisdiction of residency in order to collect taxes on interest earned. This directive affected not just EU member states but also nonmember European OFCs such as Andorra and Monaco, as well as the Caribbean OFCs that are dependencies of Britain (Anguilla, BVI, Turks and Caicos, Caymans) and the Netherlands (Aruba, Netherlands Antilles). Despite protests, particularly from the Caymans and from Switzerland, the directive's terms have been adopted by most OFCs in Europe and the Caribbean dependencies. The EU Savings Tax Directive is just one of a set of recent efforts by the authorities in rich countries to counter cross-border tax evasion and crackdown on OFCs.

These initiatives, despite pitting the richest countries on Earth against a motley collection of small states and quasi-states, did not succeed in shutting down the OFCs. In fact the results, so far at least, of all these efforts have been rather minimal. There was, for a start, considerable backlash against the 'name and shame' strategies adopted by the authorities who, in their various reports, generated lists of uncooperative jurisdictions. Many in the OFCs pointed out that the lists smacked of older geographies of empire with their racist undertones as to who was, and who was not, on the so-called 'black lists'. Caribbean leaders pointed out that it seemed unfair at best that Switzerland and Luxembourg were often left off the lists while The Bahamas and The Caymans were nearly always on them. With support from the Commonwealth, Caribbean OFC leaders established the International Tax and Investment Organisation which became the International Trade and Investment Organisation (ITIO). Its members are 17 'small and developing states', 11 of which are Caribbean OFCs. The ITIO has issued its own reports to counter the OECD-led crackdown, pointing out that all the efforts are led by essentially the same group of powerful countries, and that they target offshore business only as it occurs in non-OECD member states. As Jason Sharman explores, the OFCs' objections to the crackdown were bolstered by the intervention of several prominent libertarian and neoliberal think tanks, especially in the US, whose arguments about the benefits of and moral righteousness of tax competition and privacy resonated with many in the US administration. The views of groups such as the Cato Institute, the Center for Freedom and Prosperity, the American Enterprise Institute, and Canada's Fraser Institute also appealed to many in the corporate world for whom OFCs provided lucrative opportunities. For all these reasons at least, the rich countries pulled back from any direct action and appear, for now, to have settled for a regulatory regime that permits offshore finance to continue playing a major role in international capitalism and may have actually strengthened the position of the OFCs.

Recent Developments

Meanwhile, the OFCs have become the focus of attention for campaigners of a different variety. Citizens' groups in France and Britain, among others, have increasingly mobilized the discourse of corporate social responsibility to object to the use of OFCs by corporations that do business in their countries but pay little or no tax in them. Tax dodging by the newly numerous cadre of cosmopolitan super-rich also fuels populist complaints that hardworking middle and working classes are shouldering an increasing share of the tax burden; dutifully paying their taxes and effectively subsidizing the super-rich and the corporations who can avail themselves of OFCs. Organizations such as the Association for the Taxation of Financial Transactions to Aid Citizens (ATTAC), which was established in France in 1998, and the TJN, set up in Britain a few years later, have publicly denounced OFCs and the multinational accounting firms that promote them. Such groups found common cause with antipoverty and development organizations. For example, Oxfam has worked to raise awareness of the links between offshore finance and poverty in the developing world. In their 2000 report titled '*Releasing the hidden billions for poverty eradication*', they estimated that tax havens were responsible for at least US$50 billion in revenue losses from developing countries. This amount, the report points out, is roughly equivalent to annual development aid flows to the developing countries. In 2005 the UK charity Christian Aid, working with the TJN, issued a briefing paper making very similar points. In the US, populist politics concerning the uses of OFCs by individuals and corporations waxes and wanes. Every corporate scandal seemingly contains an offshore element. Enron, for example, is reported to have had 881 offshore subsidiaries, 692 in the Cayman Islands alone. Such corporate behavior coupled with tax dodging by individuals results in an estimated loss of over $100 billion a year in tax revenues due to offshore. Citing such figures, US Senators Carl Levin, Norm Coleman, and Barack Obama have introduced a Stop Tax Havens Abuse bill to counter the industry that they say permits tax cheats to offload their responsibilities onto ordinary working people. With such efforts raising awareness of the offshore finance, it may be that OFCs will come under renewed attack. On the other hand, they are places that the world's biggest corporations and wealthy people are very literally invested in and whether they will allow their greed to be compromised is another issue.

See also: Capitalism; Financial Centers, International; International Organizations; Transnational Elites.

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