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Tax Havens Bending to the Will of Soft Law: A Case Study of the Cayman Islands' Response to the OECD and FATF Blacklists

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Tax Havens Bending to the Will of Soft Law: A Case Study of the Cayman Islands' Response to the OECD and FATF Blacklists

by

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Abstract

Tax Havens Bending to the Will of Soft Law: A Case Study of the Cayman Islands' Response to the OECD and FATF Blacklists

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In 2000, two international organizations—the Financial Action Task Force (FATF) and the Organization for Economic Development (OECD)—attempted to attack the problems of money laundering and tax evasion through coercive soft law. Both organizations attempted to induce state compliance with international standards by placing noncompliant states on publicly available blacklists. The FATF blacklist, Non-Cooperative Countries or Territories, documented states that failed to implement international anti-money laundering standards and the OECD blacklist, Uncooperative Tax Havens, documented states that failed to implement international tax information-sharing agreements. This report examines the Cayman Islands' quick compliance with these two international efforts. The report hypothesizes that the Cayman Islands' complied quickly with both the FATF and OECD initiatives because the Cayman Islands' had a strong financial institutional capacity and a high level of reputational risk from not complying. The report develops a methodology for testing this theory against other

jurisdictions placed on both of the original FATF and OECD blacklists. The testing reveals that while financial institutional capacity and reputational risk may have contributed to the Cayman Islands' and other states' compliance with the FATF and OECD initiatives, these factors were not determinative. The report concludes that better metrics for state institutional capacity and reputational risk are needed to accurately measure states' compliance with the FATF and OECD regimes.

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Introduction

In recent years there has been much academic and policy attention paid to jurisdictions deemed to be offshore financial centers (OFCs).[1] Much of the academic and policy analysis has focused on OFCs contribution to two problems in the global financial system: money laundering and tax evasion.[2] The majority of this attention evolved out of two international efforts to control these problems through the use of coercive soft law. In 2000, the Financial Action Task Force (FATF), an organization born out of the G-7 in 1989 to develop policy recommendations for anti-money laundering regulation, issued a list of Non-Cooperative Countries or Territories (FATF 2000). The list contained fifteen jurisdictions that were perceived not to be cooperative with the international community in adopting legislation and enforcement mechanisms to attack the problem of money laundering. Within the same year, the Organization for Economic Co-operation and Development (OECD) issued a list of Uncooperative Tax Havens to attack the international problem of tax evasion (OECD 2000). The OECD initially identified forty-one jurisdictions; many were unsurprisingly considered to be OFCs. Eleven jurisdictions—the Bahamas, the Cayman Islands, the Cook Islands, Dominica, Liechtenstein, the Marshall Islands, Nauru, Niue, Panama, St. Kitts and Nevis, and St. Vincent and Grenadine— appeared on both lists.

[1] The term here is used loosely to describe jurisdictions with low tax and regulatory burdens. Such low burdens are specifically designed to attract non-resident capital. For a more in-depth analysis of the argument regarding how to define OFCs see Palan (1999) and Zoromé (2007).

[2] Tax evasion is often confused with tax avoidance. The distinction is often very difficult to make. Essentially, avoidance is considered a means of legal planning to avoid paying taxes while evasion involves illegal means of not paying taxes, such as failure to report income. The distinction has been best described by Dennis Healey, the former UK Chancellor of the Exchequer: “The difference between tax avoidance and tax evasion is the thickness of a prison wall” (quoted in Elliffe 2011, 42).

The FATF and OECD lists were means of inducing states to comply with recommended policy through a name and shame approach—a form of economic coercion (Sharman 2006; Sharman 2010). The name and shame approach would work by publicly listing noncompliant jurisdictions. Listed jurisdictions would presumably suffer or be afraid of suffering reputational damage. Because of the mobility of capital, states suffering a reputational loss could also suffer a significant economic loss. Presumably, investors would simply invest their capital in a more compliant jurisdiction—one not on the publicly available blacklists. Thus, fearing these consequences states would comply with the FATF and OECD recommendations.

If measuring compliance is simply a matter of head-counting, then both the FATF and OECD lists were largely successful.[3] Of the eleven jurisdictions placed on both the original FATF and OECD lists, all have since been removed. In the case of the FATF list, all jurisdictions implemented legislation and enforcement mechanisms to attack money laundering. In the case of the OECD list, all jurisdictions have made commitments to reduce the problems associated with tax evasion.

While all jurisdictions eventually complied, not all agreed to comply at the same rate. For example, while Liechtenstein almost immediately complied with the FATF recommendations—it was de-listed from the FATF blacklist in 2001, a year after its name first appeared—it dragged its feet in agreeing to the OECD initiative—Liechtenstein did not make a commitment to the OECD until 2009, the last of the original eleven to make such a commitment. Nauru, on the other hand, was not de-listed from the

[3] This is not to suggest that the measures implemented by jurisdictions actually did anything to reduce money laundering or tax evasion. In fact, much research has been written to expose the weaknesses of the FATF and OECD policy recommendations (Addison 2009; Christensen 2011; Gravelle 2009; Masciandaro 2005, 2008; Schwarz 2011; Shaxson 2011).

FATF blacklist until 2005, but it made a commitment to the OECD initiative towards the end of 2003.

The most rapid to commit to both initiatives was the Cayman Islands. Like Liechtenstein, the Cayman Islands was removed from the FATF blacklist in 2001. However, unlike any other jurisdiction appearing on both the original FATF and OECD lists, the Cayman Islands made an early commitment to the OECD in 2000 prior to the OECD publicly issuing its blacklist. Originally, the OECD identified forty-one jurisdictions to be placed on its list. Six jurisdictions—Bermuda, the Cayman Islands, Cyprus, Mauritius, Malta, and San Marino—wanting to ward of the negative publicity of publicly appearing on this list, made early information-sharing commitments with the OECD (Gravelle 2010, 5). It is not yet clear why the Cayman Islands acted so quickly to comply with both the FATF and the OECD. This paper aims to examine that question and provide a research agenda for further studies regarding state compliance with international anti-money laundering and tax evasion regimes.

The paper is divided into four sections. The first section formulates a hypothesis regarding the behavior of the Cayman Islands and other states in complying with both the FATF and OECD initiatives. The second section outlines the methodology used for the analysis of what factors induced states to comply with the FATF and OECD initiatives. This section defines the variables for compliance, institutional capacity, and reputational risk. The third section uses the methodology to provide a focused analysis of the Cayman Islands. Data between the eleven jurisdictions initially appearing on both the FATF and OECD blacklists are compared to test the hypothesis. The final section draws conclusions from the analysis and develops a brief research agenda for further examination into states' reactions to the FATF and OECD regimes.

Hypothesis

A cursory examination of state compliance with the FATF and OECD regimes highlights the Cayman Islands as an outlier. It reacted quicker than any other state in responding to have its name removed from both blacklists. Neither the Cayman's "quick" compliance nor the varied rates of other states' compliance can be easily explained. An examination of academic literature, media reporting, government assessments, and international organizations' assessments regarding the Cayman Islands reveal that the Cayman Islands was a successful and sophisticated OFC before the FATF and OECD regimes were launched (Suss et al. 2002; Palan et al. 2010, 137; GAO 2008; IMF 2005). When the FATF and OECD blacklists were released, the Cayman Islands had strong government institutions and was considered the fifth largest financial center in the world (Sullivan 1999). Thus, the Cayman Islands had a high (1) institutional capacity—i.e., a strong cadre of financial professionals (lawyers, accountants, and bankers) (GAO 2008) and strong government institutions (see Table 2 below for World Governance Indicators)—and (2) a high reputational risk—a lot to possibly lose from not complying.

From this observation, I speculated that these two factors—institutional capacity and reputational risk—were possibly determinative in explaining the Cayman Islands "quick" compliance. Thus, the hypothesis arose in the form of two questions. The first directly applies to the Cayman Islands: Did the Cayman Islands comply so quickly because it had a (1) high degree of institutional capacity—making it easier for its government to implement legislative and enforcement requirements—and (2) a high reputational risk? If this could be answered in the affirmative, could this present a predictive theory that could be tested to other jurisdictions; i.e., could other jurisdictions'

rates of compliance be determined by their levels of institutional capacity and reputational risk? The following sections aim to test these hypotheses.

Data & Methodology

To test the above hypotheses, I perform cross-jurisdictional comparisons of the eleven OFCs found on both the FATF and OECD blacklists. This section is divided into three parts. The first part defines "compliance" with regards to the FATF and OECD initiatives. The second part defines "institutional capacity" and provides proxy measures for this variable. The third part defines "reputational risk" and provides proxy measures and statistics for this variable. Discussions in each of the first three parts focus on the difficulties in defining and measuring the variables. In addition, each part concludes with a cross-jurisdictional table of the variables. The final section attempts to coalesce the findings of the previous three sections into a more understandable but very approximate cross-jurisdictional comparison.

The cross-jurisdictional comparison is far from exacting. This stems largely from the lack of data regarding and the difficulty in measuring compliance, financial institutional capacity, and reputational risk. Thus, the comparison is meant only as a supplement to reveal whether patterns emerge from the data. The comparison is not meant as a precise analytical and predictive tool.

COMPLIANCE

Compliance in the context of the FATF and OECD blacklists is defined as removal from either list. Removal is a signal by the organization—the FATF or OECD—that the state made a commitment to legislative and regulatory reform. In the case of the OECD initiative, states submitted letters of commitment, which can be found on the OECD website. These letters represent a commitment by the state to initiate OECD

reforms for information sharing regarding tax evasion/avoidance. Once the OECD received a commitment, the state was considered to be cooperative—no longer on the blacklist. The FATF, having broader regulatory and monitoring powers, removed states from their blacklist only after auditing the state's progress in implementing legislation and regulatory reforms.

Admittedly, removal from the lists is an imperfect measure. Institutional requirements for removal may have been weakened from the publication of the original lists. For example, by the time Liechtenstein committed to the OECD initiative in 2009, the OECD had significantly reduced the recommendations/requirements it placed on states. As Sharman details, this weakening of the OECD initiative was brought about by states challenging the legitimacy of the OECD initiative (2006). Thus, when the Cayman Islands committed to the OECD initiative it was held to higher tax-sharing standards, representing a higher degree of compliance than Liechtenstein who agreed to comply later.

Moreover, a state's commitment to FATF or OECD policy does not necessarily represent actual enforcement of recommended or implemented legislation and regulations. As Masciandaro notes, a state may implement the required policy to be removed from the international blacklist, but may do nothing to enforce such policies (2005). He calls such behavior the "false friend" effect. Despite these weaknesses, removal from the lists provides the best and easiest proxy of state compliance. The eleven jurisdictions and the dates of their compliance are listed in the table below.

Jurisdiction	FATF de-listing	Commitment to OECD Tax Measures
The Bahamas	6/22/01	3/15/02
The Cayman Islands	6/22/01	5/18/00
The Cook Islands	2/1/05	3/22/02
Dominica	10/11/02	6/25/05
Liechtenstein	6/22/01	3/12/09
The Marshall Islands	10/11/02	7/17/07
Nauru	10/1/05	12/3/03
Niue	10/11/02	4/11/02
Panama	6/22/01	4/15/02
St. Kitts & Nevis	6/21/02	3/5/02
St. Vincent & Grenadine	6/11/03	2/26/02

Table 1: Dates of Compliance

INSTITUTIONAL CAPACITY

Several measures exist for state institutional capacity. Most often these measures look to the ability of the state to implement and enforce laws. These measures also have a tendency to coalesce around democratic accountability—are citizens allowed to speak and gather freely, is the bureaucracy captured by corruption, is there political stability with the governing regime? Broader measures such as these may be capable of indicating exogenous decision-making. For example, investors are more likely to move capital to jurisdictions with overall high governance ratings. However, such broad measures are likely to be insufficient for judging a state's capacity to comply with financial

regulations, like those of the FATF and the OECD. For example, a state may have very low accountability measures—e.g., citizens may lack the ability to criticize the government—but may have a very advanced financial system. One need only look to several of the Middle Eastern states for such an example.

To guard against this, I have chosen four measures that attempt to more narrowly construe each jurisdiction's "financial institutional" capacity. I believe and the literature suggests that successful OFCs require an advanced cadre of professionals—lawyers and accountants (Sharman 2006, 2008; Palan et al. 2010). Such professionals are needed to develop and maintain regulatory gaps to exploit the movement of global capital. With the focus on these professionals as the backbone of an OFC, I have chosen GNI per capita and three World Governance Indicators—"Rule of Law", "Regulatory Quality", and "Government Effectiveness"—as measurements of each jurisdiction's institutional capacity to respond to international pressures to reform their financial system. These four variables are not perfect proxies, but they were the best available for this case study—i.e., there were sufficient data points for most of the jurisdictions to make a cross-jurisdictional comparison possible.

GNI per Capita

GNI per capita reflects the average income of a state's citizens. I have chosen this measure based on the assumption that a successful OFC with strong institutional capacity will have a strong community of financial professionals. These financial professionals—lawyers, accountants, and bankers—will likely require high incomes for their services (Sharman 2006, 2008; Palan et al. 2010). GNI per capita, while not a perfect indicator, is provides a window into the strength of this sector. GNI per capita for the Cayman's is more indicative of this capture than, for example, Panama. The Cayman Islands has an

undiversified economy—mainly financial services and tourism—and a small population (54,878). Thus, the high incomes ($52,500) of Cayman citizens in 2000 likely represents capture by high-income professionals. On the other hand, Panama has a much more diverse economy and a much larger population (3,595,490). Panama's GNI per capita figure ($3,730) is likely to indicate much less about the robustness of its financial professionals.[4]

World Governance Indicators

The WGI are "a research dataset summarizing the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, international organizations, and private sector firms" (World Bank 2012). Admittedly, the WGIs are not perfect proxies for institutional capacity because they represent survey respondents' perspectives rather than a jurisdiction's reality.[5] Moreover, some jurisdictions' WGIs are made more robust by the number of surveys conducted. For example, the WGIs for the Bahamas are derived from multiple sources, whereas the WGIs for the Cook Islands are derived from a single source.[6] Despite these weaknesses, the WGIs of each jurisdiction

[4] An IMF Assessment of Panama in 2007 did find that "there [were] about 9,000 lawyers and company service providers and 12,000 accountants" engaged in servicing the formation of corporations and trusts for both domestic and foreign clients (IMF 2007, 7).

[5] Because of this gap between perception and reality, I originally considered using the WGI metrics as measures of each jurisdictions reputation. The lack of capacity indicators and the Murray et al. study led me to believe that the WGI would best serve as proxies for institutional capacity rather than reputation.

[6] A state's WGIs can readily be found by conducting a search on the following World Bank website: http://info.worldbank.org/governance/wgi/sc_country.asp. Each WGI indicator will reveal the sources from which it was obtained. The Bahamas' WGI for "Government Effectiveness" was obtained from *Global Insight Business Conditions and Risk Indicators* (2000) and *Political Risk Services International Country Risk Guide* (2000). The Bahamas' WGI for "Regulatory Quality" was obtained from the latter two sources in addition to the *Heritage Foundation Index of Economic Freedom* (2000). The Bahamas' WGI for "Rule of Law" was obtained from the latter three sources and the *Cingranelli Richards Human Rights Database*

provide a good proxy for institutional capacity—the IMF has used the WGIs as proxies for measuring "institutional absorptive capacity", the ability of a jurisdiction to absorb IMF technical assistance (Murray et al. 2009, 8–9).

Of all the WGI measures, I have chosen Rule of Law, Regulatory Quality, and Government Effectiveness because I feel that these best represent factors affecting a jurisdiction's financial sector. The Rule of Law indicator "captur[es] perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence" (Kaufmann et al. 2010, 4). The Regulatory Quality indicator "captur[es] perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development" (Ibid.). The Government Effectiveness indicator "captur[es] perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies" (Ibid.).

The figures for institutional capacity are listed in the table below.

*& Political Terror Scale (*2000). On the other hand, the Cook Islands' WGIs for "Government Effectiveness", "Regulatory Quality", and "Rule of Law" are all derived from a single source, the *Asian Development Bank Country Policy and Institutional Assessments* (2000).

Jurisdiction	GNI per capita 2000 (current $US)	WGI—Rule of Law 2000 (Raw Score/Percentile Rank)	WGI—Regulatory Quality 2000 (Raw Score/Percentile Rank)	WGI—Government Effectiveness 2000 (Raw Score/Percentile Rank)
The Bahamas	20,350	1.25/86.6	1.13/85.3	1.25/87.8
The Cayman Islands	52,500	1.49/91.9	1.23/88.7	1.94/95.1
The Cook Islands	N/A	0.66/70.8	0.36/63.2	0.07/60.5
Dominica	3,410	0.62/68.9	0.44/65.7	0.39/67.3
Liechtenstein	79,660	1.50/92.3	1.48/92.6	1.68/90.7
The Marshall Islands	2,850	0.01/51.7	(-0.70)/22.5	(-0.84)/19
Nauru	N/A	0.85/78.0	N/A	N/A
Niue	N/A	N/A	N/A	N/A
Panama	3,730	(-0.20)/44.5	0.56/69.1	0.24/62.4
St. Kitts & Nevis	7,340	0.85/75.6	0.21/59.8	(-0.09)/53.2
St. Vincent & Grenadine	3,070	0.85/75.6	0.21/59.8	0.06/59.5

Table 2: Institutional Capacity

REPUTATIONAL RISK

Reputational risk "is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions" (Federal Reserve 2011, 4.5).[7] As defined by the Federal

[7] The Bank of International Settlements provides a very similar definition of reputational risk: "the risk arising from the negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators that can adversely affect a bank's ability to maintain existing, or establish new, business relationships and continued accesses to sources of funding" (BIS 2009, 19).

Reserve, the concept of reputational risk seems very straightforward. However, measuring reputation, the exposure to a downgrade of reputation, and the economic costs of such a downgrade are much more difficult (for the difficulties of measuring and managing such risks in private firms see Eccles et al. 2007; Young & Hasler 2010). Indeed, there is a substantial lack of academic literature regarding the reputational risks states (rather than private firms) face when attempting to attract foreign capital.

Before explaining the measurements I have used, I must first address why reputational risk is an important consideration for OFC jurisdictions. Most of the literature regarding OFCs assumes that capital is mobile between jurisdictions; thus, OFCs are not only competing with onshore jurisdictions for capital but also with other OFC jurisdictions (Desai et al. 2004, 2006a, 2006b; Dharmapala, 2008; Johannesen, 2010). Another assumption follows from the notion that capital is mobile: to attract capital OFCs have a vested interest in appearing law-abiding (Masciandaro 2005, 2008). This latter assumption may seem counterintuitive for the two types of conduct the FATF and OECD initiatives were attempting to tackle—money-laundering and tax evasion/avoidance.

However, customers of OFC services are sensitive to an OFC's reputation because they have a strong interest in keeping their activities out of the limelight of national and international regulators. While these customers may prefer to hide their assets—e.g., in the case of laundering drug money, they want to be able to eventually utilize these assets in the mainstream economy (de Willebois et al. 2011). These customers will not be serviced to have their assets placed in a jurisdiction with such a poor reputation that the assets cannot eventually be mobilized.

Thus, OFC jurisdictions wishing to attract the most capital—this includes capital earned from legitimate and illegitimate activities—will wish to appear law-abiding. However, to be considered an OFC, the jurisdiction will want to situate its legal and regulatory regime between no regulation and the stricter regulations of onshore jurisdictions (Masciandaro 2008). I call the optimum spot between no regulation and strict regulation the "regulatory sweet spot". In a macroeconomic view of the "sweet spot", all OFCs will be driven towards the same point. A microeconomic view of OFC incentives may reveal that OFCs have different "sweet spots" because they cater to clientele with different preferences. For example, as I explain in more detail below, it is likely that Liechtenstein dragged its feet so significantly on the OECD initiative—it did not commit until 2009—because its client base valued bank secrecy much higher than the client bases of other jurisdictions. However, this does not mean that Liechtenstein had no incentive to appear law-abiding, simply that Liechtenstein valued bank secrecy over the information exchange required by the OECD initiative.

Ideally, to measure the risk question, I would ask two questions: (1) what is the likelihood that a reputational downgrade from the FATF and OECD blacklists would lead to a jurisdiction's loss of OFC business and (2) what is the potential loss—both in total value and as a percentage of GDP—from a reputational downgrade? However, answering these two questions is made difficult because of the inadequacy of data regarding (1) client preferences and (2) OFC activities. As mentioned earlier, clients of one OFC may have completely different preferences from clients of another OFC. These differences in preferences will also cause differences in exposure to risk. For example, if Liechtenstein clients value bank secrecy over compliance with international regulations, then

Liechtenstein will not be exposed to any risk from not complying with the OECD initiative.

Identifying client types and client preferences is made more difficult by the lack of data regarding OFC activities in the period prior to the FATF and OECD initiatives. Data regarding OFCs remains a point of difficulty to this day. While most OFC jurisdictions on this list have improved data reporting since the OECD and FATF initiatives, there are still many gaps in data regarding OFCs. For example, only three of the jurisdictions in this list currently report to the Bank of International Settlements (BIS)—the Cayman Islands, the Bahamas, and Panama (BIS 2012b). The Cayman Islands and the Bahamas have been members of the BIS since 1983, which may give some indication of their institutional capacity to monitor and regulate their financial institutions. Panama only began reporting to the BIS in 2002. While BIS reporting is not definitive, the reporting gives greater insight into jurisdictions' bank assets and liabilities (Palan et al. 2010). Without such aggregate reporting, it is difficult to quantify an OFC's bank holdings. Numbers of entities—banks, companies, trusts, hedge funds—may overestimate or underestimate the amount of wealth held in a particular jurisdiction. As Palan et al. have noted better data collection and transparency of OFC activities needs to occur (2010).

To simplify the reputational risk question, I have chosen to look to figures that attempt to demonstrate both the scale of OFC business in a jurisdiction and the possible sensitivity of the jurisdiction to a reputational downgrade. Unfortunately, data is not readily available regarding the OFC contribution to GDP of each jurisdiction. In its place, I have chosen to give a raw picture of the scale of each jurisdiction's OFC by using two metrics with sufficient data points to give a cross-jurisdictional comparison: (1) the

number of international business companies (IBCs) and (2) the number of licensed offshore banks. This data was collected and provided by the US State Department's *International Narcotics Control Strategy Report* (INCS Report) for the year 2000. The focus of the INCS Report is money laundering, rather than tax evasion/avoidance. Nonetheless, the data points give a good idea of the size OFC business in each jurisdiction for the year 2000. Admittedly the number of IBCs and offshore banks do not provide a complete picture of the size or type of OFC business in each jurisdiction. Notably lacking from the table below are figures showing the numbers of other types of offshore entities, i.e., insurance companies, trusts, mutual/hedge funds. Nonetheless, the two metrics give a strong proxy of the size of a jurisdiction's OFC business relative to others.

To measure a jurisdiction's sensitivity to a reputational downgrade, I have chosen two metrics: percent of government revenues coming from the OFC sector and employment statistics for each jurisdiction's financial sector. These measurements were gathered from multiple sources, including the excellent study by Suss et al. of Caribbean OFCs (2002) and IMF assessments of some individual jurisdictions. These measures should provide a strong proxy for how a jurisdiction will behave to a threat to its reputation. Presumably, a jurisdiction whose labor force is more tied into the financial sector and whose government revenues are more closely tied to its OFC sector will more readily react to a possible reputational downgrade.

Jurisdiction	Number of IBCs	Number of Offshore Banks	Percent of Government Revenues	Employment in Financial Sector (Number of Employees/% Labor Force)
The Bahamas	100,000	413	0.9[i]	14,000[i]/9%
The Cayman Islands	50,951	570	14.6[i]	2,959/11%[ii]
The Cook Islands	1230	25	4[iii]	80/>1%[iii]
Dominica	6596	6	0.7[i]	100/>1%[i]
Liechtenstein	75,000	15	30[iv]	2000/7%[iv]
The Marshall Islands	4,000	0	N/A	N/A
Nauru	N/A	400	N/A	N/A
Niue	5,500	5	N/A	N/A
Panama	372,667	34	N/A	27,300/3%[v]
St. Kitts & Nevis	19,500	1	2.8[i]	100>1%[i]
St. Vincent & Grenadine	11,000	28	1.4[i]	N/A

Table 3: Reputational Risk

i. These figures are taken from the excellent study on Caribbean OFCs conducted for the IMF by Suss et al. (2002, 16–31).
ii. The percentage comes from an IMF financial stability assessment from 2005 that states the following: “There are no current estimates of employment in the financial sector, but in 1998 the banking and insurance sectors together provided 11 percent of employment.” (10). The number of employees was extrapolated from the total labor pool as reported on the ILO website.
iii. (IMF 2004, 9).
iv. (IMF 2006, 60).
v. (IMF 2003, 10).

An Overview of the Cross Sectional Comparison

To present a clearer picture of all the data I have developed a simple table (Table 4) ranking a jurisdiction as High, Medium, or Low regarding its institutional capacity and

its reputational risk. The table below is meant to serve merely as a visual proxy for assessing each jurisdiction's institutional capacity and reputational risk.

Jurisdiction	Institutional Capacity[i]	Reputational Risk[ii]	FATF de-listing	Commitment to OECD tax measures
The Bahamas	**High**	**Medium**	6/22/01	3/15/02
The Cayman Islands	**High**	**High**	6/22/01	5/18/00
The Cook Islands	**Low**	**Medium**	2/1/05	3/22/02
Dominica	**Low**	**Low**	10/11/02	6/25/05
Liechtenstein	**High**	**High**	6/22/01	3/12/09
The Marshall Islands	**Low**	**N/A**	10/11/02	7/17/07
Nauru	**N/A**	**N/A**	10/1/05	12/3/03
Niue	**N/A**	**N/A**	10/11/02	4/11/02
Panama	**Medium**	**Medium**[iii]	6/22/01	4/15/02
St. Kitts and Nevis	**Medium**	**Medium**	6/21/02	3/5/02
St. Vincent & Grenadine	**Low**	**Medium**[iv]	6/11/03	2/26/02

Table 4: An Overview of the Cross-Jurisdictional Comparison

i. Institutional Capacity was measured as an average of the weights given to each individual variable, i.e., GNI per capita and the WGI indicators. Scores for each were assigned accordingly: High = 3; Medium = 2; and Low = 1. GNI per capita above $10,000 was scored as High; GNI per capita between $5,000 and $10,000 was scored as Medium, and GNI per capita of below $5,000 was scored as Low. WGI scores above the 80th percentile were considered High, those between the 60th and 80th percentile were considered Medium, and those that fell below the 60th percentile were considered Low. Aggregate scores were rounded up. For example, Panama's aggregate score was a 1.5 but was rounded up to a 2 making its Institutional Capacity appear as Medium.
ii. Reputational Risk was accumulated using only two variables—Percent of Government Revenues and Percent of Labor Force Employed in Financial Sector. Scores for each were assigned accordingly: High = 3; Medium = 2; and Low = 1. For both variables, percentages above 5% were coded as High, between 1% and 5% as Medium, and below 1% as Low. Aggregate scores were rounded up.
iii. I have scored Panama as Medium despite having no data regarding its OFC's contributions to government revenues.
iv. I have scored St. Vincent & Grenadine as Medium despite having no data regarding employment.

Analysis

If one were to look only at the Cayman Islands within the cross-jurisdictional chart (Table 4), the hypothesis that high institutional capacity and high reputational risk led to early compliance will be confirmed. However, other jurisdictions do not seem to follow this same predictive path. While the Bahamas, similar to the Cayman Islands, adopted the FATF best practices at the same time as the Caymans, it did not adopt the OECD initiatives until almost two years later. Furthermore, Liechtenstein, also quite similar to the Cayman Islands, adopted the FATF best practices at the same time but was the last to commit itself to the OECD initiative. These anomalies are explored after a more careful examination of the Cayman Islands.

A Closer Look at the Cayman Islands

Table 4 and the data in Tables 2 & 3 support the argument that the Cayman Islands had strong institutional capacity and a high degree of reputational risk at the time it was placed on both the FATF and OECD blacklists. To tease out whether these factors—high institutional capacity and a high degree of reputational risk—led to the Cayman's quickly complying with both international initiatives, the following section focuses in more depth on the Cayman Islands.

Currently, the Cayman Islands is considered the sixth largest financial center in the world in terms of assets. As of 2007, the Cayman Islands held over $1.9 trillion in external assets (Palan et al. 2010, 26). A study conducted by Sullivan in that same year revealed that the Cayman Islands had 62,752 international business companies (IBCs), 450 licensed banks, 740 captive insurance companies, and roughly 8,600 mutual/hedge funds (Sullivan 2007b). A 2008 study conducted by the US Government Accountability

Office found that of the 62,752 IBCs, nearly 19,000 were registered at a single address, the Ugland House (GAO 2008, 3). These figures are meant to illustrate the size of the Cayman Islands' financial sector; the Cayman Islands has more registered companies (62,752) than citizens (54,878).

Data relating back to the time of the OECD and FATF initiatives, reveal that, while the financial sector of the Cayman Islands was smaller relative to its current status, it was still extremely large in absolute terms. In 2000, Cayman banks held assets valuing $804.5 billion and liabilities valuing $786.1 billion (CIMA 2000, 7). In the same year, the Cayman Islands had 50,951 IBCs, 570 licensed banks (INCS 2000), 665 licensed insurance companies, and 3,014 registered mutual funds (CIMA 2000). Furthermore, not only was the raw scale of the Cayman Islands' OFC sector substantial, but it also played a large role in the Cayman's economy. As Table 3 notes, the Cayman's fees from the OFC sector contributed to 14% of government revenues. This contribution was the second largest in the Easter Caribbean Currency Union; only the British Virgin Islands received a larger share of government revenues (54.6%) from its OFC sector in 2000 (Suss et al. 2002, 16). Additionally, the Cayman's had nearly 11% of its labor force locked into the financial sector (Table 3).

The statistics available regarding the Cayman Islands are far better than those of most other OFCs. This is due in large part because the Cayman Islands has better regulatory and monitoring structures than most any other OFC. The majority of these structures were in place prior to the FATF and OECD initiatives, most likely allowing the Caymans to assess its own reputational risk from not complying with the initiatives and to comply quickly. Key Cayman public institutions include the following: Minister of International Financial Services Policy, the Portfolio of Finance & Economics, the

Cayman Islands Monetary Authority (CIMA), the General Registry, the Cayman Islands Stock Exchange, and the Financial Reporting Authority (Ridley 2007). In addition to these public institutions, the Cayman Islands issues its own currency—one of the only OFCs to do this.

The most significant of all the Cayman's public institutions is CIMA. CIMA "regulates the financial sector, (including monitoring for compliance with AML/CFT requirements), i.e. banks, money services providers, trust companies, securities (investment funds, fund administrators, brokers, investment managers), insurance (captives, general, managers, and agents), company managers and corporate service providers" (Ridley 2007, 4). CIMA was established in 1996 by the Monetary Authority Law to replace the Financial Services Supervision Department. CIMA was given broader powers to regulate and monitor financial institutions (GAO 2008). These powers were extended in 2003 when amendments to the Monetary Authority Law made CIMA operationally independent from the Cayman Islands government. CIMA serves as a significant monitoring and regulatory agency. Since its inception it has issued quarterly and annual statistics on the Cayman Islands financial sector.

In addition to strong public institutions, the Cayman Islands is perceived by outside investors as having a system of laws that support business development. For example, the Cayman Islands has "insolvency laws, which provide specific protections for creditors and investors" (GAO 2008, 4; Hout 2007). It is clear from public reports that the government of the Cayman Islands and Cayman professionals are sensitive to outsiders' perception regarding the jurisdiction's reputation as a business friendly environment. In its 2000 annual report, CIMA contributed the growth of its banking sector to the "continued confidence placed in the Cayman Islands by international

institutional investors" (CIMA 2000, 7). A 2004 article from *Cayman Financial Review* entitled 'Perception v. Perception' even went so far as to take aim at popular Western culture that "include[s] the obligatory negative mention of such [offshore financial] centers" (6). The article went further in highlighting the importance the Cayman Islands placed on perception:

> Traditionally, offshore centers have seemed to let the poor perceptions persist, with some hope that at worse [sic], they do not have a significant negative impact on business. More recently, we have seen a major change across jurisdictions with the use of marketing and public relations bodies and an increase in public-sector funding of such initiatives. There is a clear recognition that maintaining a financial center that is commercially successful means maintaining one that has integrity, enshrined not only in its laws, but also how it is perceived internationally.

The Cayman Islands' sensitivity to its perception as a business friendly and law-abiding jurisdiction have led it to openly balance international legal commitments with the interests of its clientele. This cost-benefit weighing is best described by the former Chairman of CIMA, Timothy Ridley:

> [T]he jurisdiction operates on the principle that, before a regulatory measure is introduced, we must be satisfied that it is necessary, it is appropriate given the nature of financial services business in the Cayman Islands, it is proportional to the identified risks, we understand the regulatory impact and its benefits outweigh its costs.
>
> (Ridley 2007).

All of the evidence listed above indicates that by the time of the OECD and FATF initiatives, the Cayman Islands was a sophisticated and massive OFC. The Cayman Islands had both a high degree of institutional capacity to manage new international commitments and a high degree of reputational risk should its reputation be harmed—i.e., the Caymans had a substantial amount of business that it could lose should its reputation

as a law-abiding, business-friendly OFC be downgraded. Thus, the OECD and FATF tactics of blacklisting were likely to bring about compliance by the Cayman Islands because it was a jurisdiction highly sensitive to reputational consequences. Moreover, the Cayman Islands was likely able to comply so readily with these initiatives because it had a sophisticated financial regulatory apparatus headed by CIMA.

A Deeper Cross-Jurisdictional Analysis

Looking at Table 4, one can easily note that the original hypothesis is not confirmed. The theory that higher levels of institutional capacity and reputational risk will lead to quicker compliance, while appearing valid with regards to the Cayman Islands, cannot be extrapolated to other jurisdictions. Some jurisdictions with Low and Medium scores complied more readily or near the same rates as those with higher scores. For example, Panama complied as quickly as Liechtenstein to the FATF initiative and more quickly with the OECD initiative. To tease out these anomalies, the following subsections look at Liechtenstein and the Pacific Islands—Niue, Nauru, the Cook Islands, and the Marshall Islands—as counterpoints to the Cayman Islands.

Liechtenstein

Liechtenstein presents a strong counterpoint to the study of the Cayman Islands. Both jurisdictions had high levels of institutional capacity and high degrees of reputational risk. In fact, Liechtenstein's GNI per capita is much higher than the Cayman's—$79,660 compared to $52,500 in 2000. Moreover, Liechtenstein appears to be more vulnerable to a reputational downgrade; Liechtenstein relies more heavily on the OFC sector for government revenues—30% of Liechtenstein's government revenues come from the OFC sector whereas only 14.6% of the Cayman Islands' government

revenues come from the OFC sector (Table 3). Nonetheless, Liechtenstein was the last jurisdiction of the eleven to comply with the OECD initiative.

Liechtenstein remained committed to not cooperating with the OECD initiative even after suffering direct losses. From 2000 to 2002, government revenues from banks fell from 64 million to 27 million Swiss Francs and assets managed fell from 112 billion to 96 billion (LBA 2003, 4). As Sharman noted in 2006, "Service providers in Switzerland were less willing to advise clients to invest in Liechtenstein, and Singapore forbade some banks from the Principality from opening branches because the country was still blacklisted by the OECD" (125).

Despite these adverse consequences, Liechtenstein remained on the OECD blacklist until 2009, capitulating only after an international scandal. In 2008, an employee of LGT, one of Liechtenstein's largest banks, broke Liechtenstein's strict banking secrecy laws by selling customer details to Germany's foreign intelligence agency (Der Spiegel 2008; Economist 2008). The customer details revealed that several hundred German citizens were hiding funds in Liechtenstein to willfully avoid paying German taxes. The incident led to greater international pressure being placed on Liechtenstein to relax its banking secrecy laws. Only after the incident was Liechtenstein willing to commit itself to the OECD initiative and to begin to cooperate with foreign governments on information exchange agreements (Cain 2011).

Liechtenstein's differing behavior regarding the two blacklists presents a puzzle—i.e., why would Liechtenstein so readily comply with the FATF initiative but not the OECD initiative? It is clear from available data that Liechtenstein was not lacking in institutional capacity at the time the blacklists were made public. Moreover, Liechtenstein has made statements noting that it is sensitive to upholding its reputation as

a stable and law-abiding jurisdiction. Sharman quotes Prince Philip as stating, "The danger of being on the [OECD] blacklist is the risk of being put aside. You might find yourself with few partners to work with or with only a certain type of client, which could drive away the few remaining good clients" (2010, 113). Recent press releases also indicate that Liechtenstein has suffered from the 2008 scandal and is placing even more emphasis on burnishing its reputation: e.g., "The [Liechtenstein Bankers Association] were unanimous in their view that, given the current challenges the banking centre is facing, it is essential to continue with the work to uphold the reputation of the financial centre at home and abroad." (LBA 2013a; see also LBA 2013b for more statements concerning Liechtenstein's concern with maintaining its reputation as a sound financial center).

If Liechtenstein is sensitive to its reputation, then why did it take so long—waiting until an international scandal—to comply with the OECD initiative? One likely answer is that accepting the OECD initiative would have done more reputational harm to Liechtenstein's financial sector than not accepting the OECD commitments. The OECD commitments required jurisdictions to loosen their bank secrecy laws, agreeing to exchange client information with other jurisdictions' tax authorities upon reasonable requests.

One of Liechtenstein's primary financial instruments, the Anstalt, points to the inference that banking secrecy was of greater importance than being removed from the OECD blacklist. The Anstalt is a hybrid legal instrument—resembling the civil law foundation and the common law trust—unique to Liechtenstein (Palan et al. 2010, 94). Anstalt's are a favorite instrument of wealthy Europeans for avoiding inheritance taxes. Generally, the bankers and lawyers who create the Anstalt are the only ones who know of

its activities. Strict bank secrecy laws protect the identities of the beneficiaries. A tax of between 0.5% and 1% is placed on the capital earnings of each Anstalt. These taxes contribute a large portion—the exact amount is unknown—to the 30% of government revenues obtained from the financial sector (Ibid.). One can glean from the importance of the Anstalt to the financial economy of Liechtenstein that the government had a strong interest in it and the clients who used it. There was likely a fear that cooperating with the OECD initiative would loosen secrecy laws and thus damage the Anstalt's most attractive feature. Consequently, Liechtenstein likely reacted by rejecting OECD compliance until it was absolutely necessary.

The Pacific Islands

The question regarding the Pacific Islands—the Cook Islands, the Marshall Islands, Niue, and Nauru—is not why did they comply when they did, but why did they comply at all. The substantial lack of data, with the possible exception of the Cook Islands, appears to direct one away from answering this question. However, such a lack of data can also reflect institutional weakness. For example, Sharman reports that by 1998 Nauru suffered from 90 percent unemployment with its national debt reaching 1600 percent of GDP (2011, 114). A study by van Fossen also reveals that most of these jurisdictions received only the slightest of benefits from their OFC sectors (2003). For example, the Marshall Islands, relying more heavily on revenues from issuing flags of convenience than revenues from its OFC sector, resisted the OECD initiative until 2007 (Sharman 2006, 125).

Thus, it appears that most of the Pacific jurisdictions had neither the institutional capacity nor the reputational risk necessary to instigate compliance. However, as Sharman demonstrates with his case study of Nauru, compliance after the consequences

of a reputational downgrade may have had little to do with attracting OFC capital but rather with attracting other FDI and, in particular, foreign aid (2011, 113–17). Nauru, a small island republic of fewer than 10,000 citizens had come to the attention of international authorities because it had been used by Russian criminals to set up shell banks in the mid- and late-1990s. However, by the time the FATF and OECD blacklists were released, Nauru had virtually no OFC sector. Thus, it would seem that Nauru would have all the more reason for resisting compliance with the blacklists. And, indeed Nauru resisted up to a point, including vitriolic exchanges with FATF officials and authorities from other states. Nevertheless, Nauru was forced to capitulate as the reputational consequences of being placed on the blacklists tarnished its reputation to the extent that making foreign deals regarding aid or Nauru's other major economic sector, phosphate, were rendered nearly impossible (Sharman 2011, 116–17).

Conclusions

The argument that institutional capacity and reputational risk were determinative in the Cayman Islands' quick compliance with the OECD and FATF initiatives has been neither falsified nor verified. However, it is clear that this thesis cannot be extrapolated to apply more broadly to the other ten jurisdictions appearing on both lists. While institutional capacity and reputational risk may be contributing variables in determining why and when states complied with the FATF and OECD regimes, they are far from the only variables affecting a state's decision to comply. The following section identifies problems encountered during this study and briefly suggests a path forward for further study regarding states' compliance with the FATF and OECD regimes.

Problems of Measurement

The absence of data regarding OFCs is inherently problematic, making cross-jurisdictional comparisons all the more difficult (Palan et al. 2010, 46–47). The gathering and publication of data has been aided by international governance initiatives, such as the FATF and OECD blacklists, and the rapid development of information technology. Nonetheless, statistical reporting is often clouded by variation across jurisdictions. While some countries such as the Cayman's may report extensively on most elements of their financial sector—including IBCs, insurance companies, and hedge funds—other countries, such as Panama, may report only data regarding registered banks (IMF 2006). Cross-jurisdictional comparisons are challenging because of these variations in the availability and types of data reported.

Moreover, when approaching the two variables—institutional capacity and reputational risk—one cannot find a ready definition of either in the academic literature.

Institutional capacity is often defined using the World Governance Indicators (WGIs). In fact, my approach borrowed from that of Murray et al. in an IMF evaluation of Pacific Islands (2009). However, there are severe limitations with the WGIs, particularly when used in conjunction with assessing reputational risk. Since the WGIs measure perceptions rather than reality, they may be more appropriate for assessing reputation. Moreover, the WGIs are aggregated from multiple sources; these sources vary across jurisdictions, making comparisons using the WGIs far from perfect (see footnote 6). Nevertheless, if one were to use the WGIs for measuring reputational risk, then measuring institutional capacity would be very difficult as there are no truly independent metrics for institutional strength.

Measuring institutional capacity is made more difficult by the broad reach of the term. When studying OFCs, the concern is with only one sliver of a state's economy and its institutional apparatus. Thus, the focus of institutional capacity should really be redefined, as attempted here, to mean "financial institutional capacity". Is the state capable of implementing legislation and enforcement mechanisms to support and monitor the stability of its financial system? Such a question has become all the more relevant after the fallout from the global financial crisis of 2008–09.

Reputational risk is even harder to define; the literature provides no clear definition. This is made more problematic by conflicting views on how to define reputation. Most political scientists and economists treat reputation as an objective form of social capital, developed over time in something resembling an iterated game. This view holds that states have a high degree of control over their reputations and can monitor and control it simply by altering their behavior with regards to other states (Sharman 2006, 110). This view is best stated by Downs and Jones:

> According to the standard argument, a major—if not the major—reason why states keep commitments, even those that produce a lower level of return than expected, is because they fear that any evidence of unreliability will damage their current cooperative relationships and lead other states to reduce their willingness to enter into future agreements. (2002, 95–96)

However, as Sharman points out reputation may be more intersubjective than objective; i.e., the role of third party perceptions may play a larger role in determining reputations rather than the state's actual behavior (2006, 109–12). Thus, reputation may be far removed from objective reality (Eccles et al. 2007). The case of Nauru, as detailed above, seems to highlight this point. Despite complying with the FATF and OECD initiatives and having virtually no OFC sector, Nauru continues to suffer from a poor reputation.

The risk associated with a reputational downgrade is also difficult to assess. As the comparison between Liechtenstein and the Cayman Islands highlights, states may be facing different consequences from compliance or noncompliance. Liechtenstein may have made a rational choice in choosing not to comply with the OECD initiative, whereas the Cayman Islands may have also made a rational choice by complying. This is not to say that the FATF and OECD blacklists did not create risks for all the named jurisdictions, merely that the risks faced by each jurisdiction for compliance versus noncompliance were likely different.

Unfortunately, most of the economic literature regarding OFCs suggests that there is one global OFC market and that jurisdictions are homogenous in their desire to attract foreign capital (Desai et al. 2004, 2006a, 2006b; Dharmapala 2008). This line of thinking tends to ignore specialization and variation across OFC jurisdictions. OFC jurisdictions may specialize in a particular OFC product, such as the Cayman Islands' focus on hedge funds. Moreover, such products may be strengthened and or determined by local law. For

example, the Liechtenstein Anstalt is a financial and legal instrument that can only be found within Liechtenstein.

These variations across jurisdictions are likely to mean that each jurisdiction is servicing a different client base with different preferences. Each client base may be more or less sensitive to a reputational downgrade. A criminal attempting to launder money may care very little about an OFC's reputation so long as the reputation does not hinder the ability to move money into the global economy. On the other hand, New York investors and corporations engaged in tax planning are likely to be very sensitive to an OFC's reputation as stable and law-abiding. To obtain a better grasp of each jurisdiction's reputational risk, one would need a deeper understanding of each jurisdiction's specialization and the corresponding preferences of their client base.

MOVING FORWARD: A DEEPER UNDERSTANDING OF STATE COMPLIANCE WITH SOFT LAW

The hypothesis of this paper should not readily be abandoned. Institutional capacity and reputational risk may have been contributing variables to each state's decision to comply with the OECD and FATF initiatives. Moreover, while difficulties in data collection and defining contributing variables may continue, cross-jurisdictional comparisons between OFCs, though strained, should not be wholly discarded. Even if cross-jurisdictional comparisons do not reveal a predictive theory, they tend to reveal a more nuanced understanding of individual state behavior, as was the case with this study.

Moving forward, to better grapple with institutional capacity and reputational risk, a broader empirical study across jurisdictions can be conducted. More empirical data regarding states' financial sectors, legal regimes, and government institutions are likely to lead to more conclusive outcomes. Where empirical data are not available a more robust

understanding of reputation can be garnered through interviews of persons involved in both the supply and demand side of OFC services. Interviews, where and if available, are likely to be limited in their scope of information, as the FATF and OECD regimes are nearly fifteen years old, and participants may be unwilling to admit true interests or motives. To supplement these gaps, information regarding jurisdictions' reputations should be gleaned from public statements both from the jurisdiction and by third parties about the jurisdiction. A more robust understanding of state compliance with the FATF and OECD initiatives will not only service the literature regarding OFCs, but will also aid in understanding state compliance with other types of soft law regimes. Presumably, a better understanding of state motivations to comply or not comply may lead to improvement in the design of future soft law regimes.

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