

HAVEN AS A BARRIER TO HEAVEN? THE CYPRUS OFFSHORE FINANCIAL CENTRE AND EUROPEAN UNION ACCESSION

Louiza Odysseos

Abstract

The aim of this paper is twofold. The first is to examine whether efforts of the Republic of Cyprus to establish itself as an offshore financial centre present any problems for its desired accession and integration to the European Union. The second objective is to discuss the solutions available to Cyprus as an Offshore Financial Centre (OFC). It attempts to outline the 'problematique' of the OFC through a theoretical debate known within the field of International Political Economy as competing or alternative forms of capitalism. This theoretical exposition aims to reflect on how OFCs affect onshore activity in the nearby mainland(s) and in the regional financial system. The second objective of the paper, that of introducing the options available to Cyprus, is discussed within the context of a second debate. This lies in the subfield of economics known as Institutional Economics, and discusses issues of unilateral liberalisation and harmonisation of institutional frameworks and policies, both from the perspective of an integrated global environment.

Introduction

The aim of this paper is to ask whether efforts of the Republic of Cyprus to establish itself as an offshore financial centre (OFC) present any problems for its desired accession to and integration with the European Union (EU). The future of the OFC, in light of Cyprus' attempts to accede with the EU, has thus far been neglected by policy-makers planning the accession strategy. Bureaucratic circles admit, however, that it remains a pivotal issue (interview, Iakovou, 1997; interview, Lykourgos, 1997). The final decisions will unravel through 1998, after the completion of the EU intergovernmental conference (IGC) in July 1997 (Featherstone, 1995).

The analysis will be centred around two debates which provide the arguments through which we will investigate, first, the *problematique* of the OFC and, second,

the available solutions. The first debate is one known within the field of International Political Economy (IPE) as *competing* or *alternative forms of capitalism* (Thurow, 1992; Turner and Hodges, 1992; Hutton, 1995). In the context of Cyprus' accession to the EU it asks,

...does the way in which (tax havens and) OFCs act in the emerging global economy have a broad historical analogy as the "new pirates," acting within the International Financial System as fast-moving raiders, preying on sluggish, older forms of nation state capitalism? (Hampton, 1996a:3)

Is the above quote by Hampton an accurate description of how OFCs affect onshore activity in the nearby mainland and the global financial system? If so, should the EU approach Cyprus as a "pirate" actor? It is the contention of this paper that Cyprus' OFC status presents a *problematique* for its potential accession and integration into the single market in case of future accession into the EU.¹ The following section examines the evolution and history of OFCs, followed by a scrutiny of the OFC regime on Cyprus and the major problems it creates for accession.

The options available to Cyprus are discussed within the context of the second debate, which lies in the subfield of economics known as Institutional Economics. It deals with issues of (unilateral) liberalisation or harmonisation of institutional frameworks and policies in an integrated global environment. The single market process within the EU, the future prospects of the EU as an unified entity, and the *problematique* of Cyprus' accession as an OFC, offer an excellent background (and battleground) for the debate's analytical framework. The penultimate section outlines the debate and places the accession problems of the OFC within the EU context, illuminating the possible solutions available to Cyprus. The final section presents the conclusions.

Offshore Centres and Onshore Relationships

The debate of *competing capitalisms* is usually dominated by two or more models of capitalist organisation, which differ culturally, historically and socially. Within the field of IPE it shifts the focus away from a rational state model, towards a model which allows for situated differences and for divergent actors (states, bureaucracies, multinational and domestic corporations, non-governmental and inter-governmental organisations, etc.) to partly determine the potential of these forms of capitalism (Strange, 1995). The models commonly depicted are the Anglo-Saxon (*laissez-faire*) model, the continental European (communitarian) model and the Japanese (developmental capitalist) model. Different taxonomies do exist, reflect-

ing authors' preferences and modes of analysis, but in general the debate consists of the merits, demerits and the future prospects of the variant forms of capitalism. The prospects are usually discussed in detail, but tend to congeal around *convergence* or *continued coexistence* of the various forms.

It is not the aim of this paper to engage in a debate of the actual models. It merely wishes to borrow the images and terrain of the debate to examine the relationship that Cyprus, in its function as an OFC, has had and will have with the EU. For the purposes of this and the following section, we intend to assume that the EU represents one unified model of capitalism, in order to accentuate the relationship between offshore economies (OFC capitalism) and onshore economies (EU capitalism). This also highlights the potential relationship likely to emerge from accession. The liberalisation *versus* harmonisation debate within the EU, renders the unified EU model of capitalism problematic. It shows, instead, competing forms of capitalism placing themselves on opposite sides of the debate and having widely different expectations for the future.

Next, a brief history section offers explanations for the emergence of OFCs and their recent proliferation. This enables us to create the right framework for fitting Cyprus in a wider historical context and to understand the perspectives facing the EU when it deals with Cyprus as an OFC. The history illuminates the perceptions behind the evolution of the offshore interface.

History of Offshore Centre Evolution

Four main explanations have been offered for the recent proliferation of OFCs. First, OFCs and tax havens are seen as having merely responded to the increased regulation and taxation in the Organisation for Economic Cooperation and Development (OECD) in the post-1945 era, offering a zero-friction response to a high friction business environment in the major onshore economies (Johns, 1983). An often cited example is the expansion of activity in the Cayman Islands after increased regulation in the US in the 1950s and 1960s.

Second, the increase in OFCs is viewed as by-product of the transnationalisation of economies. As states did not swiftly accommodate the needs of transnational trade, by eliminating the restrictions that hindered growth of the global economy, OFCs arose to perform this function, as did, for example, Hong Kong and Singapore. This explanation offers the "demand and supply" answer for the increase in offshore jurisdictions in the world economy. The major distinction with the first explanation is that this takes an organic world economy at its centre, as opposed to "onshore" versus "offshore" responses to regulation (Johns and Le Marchand, 1993).

Third, the pessimist view is that the mushrooming of transnational criminal net-

works have caused a proliferation of accommodating havens through which such criminal activities are hidden and laundered (Naylor, 1987; Palan *et al*, 1996). Strange, in a recent article in the *Nikkei Business News*, emphasises the dangers of the underground world economy and implicitly gives credence to Naylor's explanation (Strange, 1996). Recent offshore legislation in the Seychelles, for example, has been perceived as an invitation to money launderers (interview, Lykourgos, 1997).

Fourth, OFCs are perceived as a state strategy pursued by small or micro economies, for development purposes; an institutional approach using OFCs as a development strategy, competing for capital and business with larger and less flexible economies through the use of regulatory manipulation (Palan *et al* 1996: 174-176; Baldacchino, 1993).

Defining the Beast: Tax Haven or Offshore Centre?

Defining tax havens or offshore centres is a problematic endeavour at best, due to the secrecy and lack of transparency of their activities. Distinguishing between them is equally difficult. While authors attempt to clarify between OFCs and tax havens, most analyses tend to use the terms interchangeably. Providing a distinction is useful, but might create a false perception as to our ability to categorize jurisdictions as either tax havens or OFCs.

There seems to exist a tendency within the literature to assign largely normative definitions to tax havens and OFCs, although recent studies have attempted to provide more functional ones. In the latter category, tax havens are defined as areas "based upon taxation differentials between states and so are usually jurisdictions that have low or no direct taxes. Tax havens may or may not host financial services" (Hampton, 1996a:15). A classic definition often utilised is the one by Johns, where tax havens are defined as located in:

...economies which have made a deliberate attempt to attract thereto international trade-oriented activities by the minimisation of taxes and the reduction or elimination of other restrictions on business operations, such that within the jurisdiction of the centre, aggregate economic activity is substantially geared to the special global invisible trade needs of external enterprises and investors. (Johns, 1983:20).

Palan, *et al.*, take a much harsher approach towards tax havens, attributing to them parasitic functions which harm the notion of state sovereignty. "There is now a new category of state to which sovereignty appears to have become little more than an excuse to implement laws that are implicitly aimed at attracting business from their neighbours" (Palan *et al.* 1996:167). There is here an assumption that tax haven status is a choice to abuse the so-called sovereignty granted to "this new category

of states." Such a definition denies arguments that micro-economies do not have the ability to pursue normal development strategies out of the periphery, as larger states do. (Baldacchimo, *op. cit.*).

The perception within the literature remains that tax havens and offshore centres are the "paper tigers" of the financial centres, acting as parasites in the global financial system, but unable to truly challenge the Global Financial Centres, due to their failure in developing the local economy (Palan *et al.*, *op. cit.*).

Hampton distils the difference between tax haven and an OFC down to functionality: OFCs are centres receiving a wide range of economic activities, whereas tax havens are usually limited to paper transactions. It is obviously beneficial to be perceived as an OFC with legitimate activity to avoid the scrutiny and reprimands of neighbouring onshore economies. Therefore, OFCs are "centre[s] that host[s] financial activities that are separated from major regulatory units (states) by geography and or by legislation" (*ibid.*,4).

According to Hampton's taxonomy there are three types of OFC.² The first type is *functional*, which is defined as actual financial centres where activity takes place with fully functioning banks, trust and fund managers. Also the OFC tends to make a substantial contribution to the local economy, as in the islands of Jersey or Guernsey. The second type is *compound*, hosting a mixture of notional and functional activity, as do the Bahamas, Cyprus and the Cayman Islands. This category best exemplifies the evolutionary nature of OFCs as shell or brass plate³ branches assume real activity and begin to utilise local labour and expertise. The third type is *notional*, where activities tend to be dominated by shell or brass plate offices of banking institutions, with the centres contributing negligibly to both local labour markets and the local economy in terms of receipts. Examples of notional OFCs are Mauritius, Antigua and Labuan (*ibid.*,5).

Cyprus: a tax haven or OFC?

"[N]ot a tax haven, but a tax incentive country." This promotional logo is written conspicuously on a brochure advertising Cyprus' suitability as a centre for tax planning (Coopers and Lybrand, 1994:156). A recent survey concurs, "[c]ontrary to conventional financial shorthand, Cyprus is not a tax haven. It is very much a tax incentive country." (*Financial Times*, 1997b). According to Hampton, Cyprus is a compound OFC, hosting a combination of activities (Hampton, *op cit.*, 7). To fully understand the definitional exercise above and the statement that Cyprus is not a tax haven it is important to examine the historical backdrop of the OFC's evolution.

The development of the offshore sector occurred too late to benefit from the petrodollar surplus after the oil crises of 1973 and 1979. It did gather momentum, however, out of the unfortunate demise of Beirut as an offshore centre with the civil

war in the early eighties. The OFC has had a relationship with the Middle East, not so much as a pirate but as a courtier of it for export markets, after the oil crisis brought purchasing power to the oil exporting countries, and as a shelter of the 'refugee' banks of the Middle East which moved their operations to Cyprus. A look at the register for offshore banking units and offshore financial services providers, signals the importance of Beirut's collapse. The activities undertaken changed from largely *notional* to *compound* by the late 1980s.

A similar glance at the statistics from Eastern Europe shows that the end of the Cold War "liberated" capital, a blessing for the OFC. Cyprus has always had a special relationship with the Eastern European countries, with close cultural ties maintained throughout the Cold War, and religious ties currently being "revived". With the opening up of the Eastern European Economics to the OFC, there has been an outflow of capital from Russia and Eastern Europe to the OFC. Despite charges that offshore banking units (OBUs) launder this money back to Eastern Europe and Russia, the Central Bank of Cyprus has a lot of praise for the efforts of the Russian OBUs to conform to different operational standards (interview, Stavrinakis, 1997).

Whereas in the 1980s Cyprus' response to the Beirut collapse was haphazard and accidental, in the 1990s it fits the explanation put forth by Palan *et al.*, of OFC as a strategy of development. With its network of tax treaties, Cyprus posed as the natural basis for investment in Eastern Europe and Russia. The advent of large European banks which avail themselves of the double tax treaty network, has definitely established the OFC as an evolving *compound* centre.

The way that the economic press in Cyprus treats the offshore sector demonstrates that it is scripted as a strategy and as a path crucial for the island's development. Recently, reports in the press comforted the business community that Britain, Belgium and Luxembourg are resisting attempts by Germany for greater harmonisation in regulation and taxation, explaining that the OFC has nothing to fear from regulation watchdogs (Anastassiades, 1997).

Theoretical Adventures: Relationships with Onshore Areas

Hampton introduces the notion that there necessarily has to be a relationship between an offshore jurisdiction and an onshore economy. Relationship with a mainland onshore "state," is deemed central to the creation and success of an OFC, seen as underpinning the very possibility for the existence of an OFC, and enabling the OFC to enact legislation to attract financial capital (Hampton, *op.cit.*). If an OFC lies within the protection of a sizeable onshore economy, it is largely sheltered from opposition to its activities. The notion put forth by Hampton is one of tolerance, what appears to be, *symbiosis*.⁴

It seems apparent, however, that this type of relationship is mainly a function of

history between the OFC and the onshore "state," as in the case of the Channel Islands and the Isle of Man in their relationship to the United Kingdom (Hampton, 1996a). Nonetheless, the symbiotic relationship is a useful starting point to compare the historical, current and future relationship of Cyprus with the EU within the wider perspective of regional bloc and satellite OFC.

Johns describes an onshore/offshore relationship quite distinct to Hampton's one based on the "frictions" of operating onshore that lead to the genesis of the 'zero-friction' OFCs, as mentioned above (Johns, *op. cit.*). A sort of location advantages, or rather, lack of locational disadvantages (Caves, 1996). More specifically, Johns classifies the structure revolving around the regional bloc as Global Financial Centre at its core, primary OFCs and secondary OFCs at its semi-periphery and periphery. The periphery and semi-periphery act essentially as 'turntable centres' both regionally and inter-regionally, supporting and promoting transnational investment and business activities" (Johns, *op. cit.*, 225). "Turntable centres" refer to centres used as platforms to reinvest or "pass[ed] through to the deeper capital markets in the Global Financial Centers" (Hampton, *op. cit.*, 5). This framework espouses a frictional or *antagonistic* relationship between OFC and onshore economies.

It is important to understand the difference between the two frameworks, as they offer substantially different relational options to the OFCs. I would like to note, however, that OFCs do not always have the option to choose the type of relationship they wish to pursue with their onshore neighbours. Despite their limitations these frameworks will facilitate our discussions on the problem of Cyprus' accession, and most importantly, will shed light on the treatment of offshore centres within the EU to date.

The implications of the two frameworks have a significant bearing for the future of OFCs. As is the logical evolution of the *antagonistic* framework, institutional and tax competition will eventually lead to the *convergence* of regulatory and taxation systems, diminishing the ability of individuals and corporations to engage in regulatory arbitrage (Cassard, 1994). Convergence might slow down due to gradual harmonisation, but in the absence of concerted action, results might be suboptimal for the countries themselves (Tanzi, 1996b). However, the important difference between the two frameworks is that one engages the world in a race towards convergence (and diminishes competitiveness of OFCs). The other affords OFCs a protective environment which might shelter their operations and extend their existence.

Cyprus' Onshore Relationship

For the last 20 years, Cyprus has considered that it has a "rightful place" in the EU (Papaneophytou, 1994: 83). Cyprus' future onshore relationship lies by choice with the EU, pending the negotiations for accession. The historical backdrop above

showed the peculiarities of the evolution of the offshore regime. Despite political choices, the optimal relationship with a proximate onshore economy might lie with the other two contestants: the Middle East and Eastern Europe. This is not within the scope of this paper, and rather opens the way for future research. A very brief exposition follows below.

Middle East

"The obvious locational advantage of Cyprus is in relation to economies of the Middle East" wrote Wilson, emphasising that Cyprus' location could be useful to Western companies with a Middle East presence or to 'refugee' companies from the Middle East. Cyprus could act as a regional maintenance base staffed with engineers, technicians, *etc.* (Wilson, 1992:82). While a reasonable suggestion post-1989, the OFC has evolved in the direction of Eastern Europe, CIS and lately, the EU.

Eastern Europe

The 1989 "bloodless revolution" has had a large impact on offshore finance in Cyprus. It segmented Eastern Europe in smaller delineated units, and caused major societal upheaval, often described as 'truncated societies' (Matejko, 1992), which "provide[s] new offshore business possibilities" (Johns and Le Marchand, *op. cit.*, 241). The political instability, and the big bang approach towards transition to capitalism, has left newly privatised enterprises in an unstable environment. Such new capitalists might take, and to a large extent have taken, advantage of the accessibility of offshore centres for reasons not related to taxation (Theodoulou, 1994:14). While a large portion of that capital is suspected to be related to criminal proceeds, capital fleeing from instability might utilise nearby OFCs. The Economist Intelligence Unit estimates capital flight at US\$60.9 billion in the years 1992 to 1996 (Wolf, 1997). This capital is not engaging in regulatory arbitrage, but is likely to have fled Russia and Eastern Europe to avoid instability.

Cyprus and the European Union: the changing relationship

An examination of the EU-Cyprus relationship since the 1960s shows that Cyprus' relationship with the EU has been a "troubled one" (Gaudissart, 1996; Ayres, 1996; Theophanous, 1995; Papaneophytou 1994).

Cyprus sought an Association Agreement in the early 1970s fearing that Britain's pending accession would negatively affect Cypriot trade with Britain, its largest trading partner. The invasion of 1974 left the economy in dire straits and the Association

Agreement had to be extended twice. A Customs Union was signed in 1987 between Cyprus and the European Economic Community, with Cyprus exhibiting changed trade patterns which now moved away from dominance of Britain, to include Germany and Italy. Cyprus applied for full membership in 1990. The off-shore sector has never played a role in negotiations, nor has it ever been mentioned by the European Commission in its 1993 opinion on the application of Cyprus.

The economic relationship of Cyprus with the EU has mainly involved the onshore economy. European Banks have utilised the Cyprus OFC primarily since 1989, largely due to the large network of double tax treaties that Cyprus has negotiated with Eastern European countries, and the mushrooming of opportunities in the region.

The issue that most concerns the OFC at this juncture, is the voiced intention of the Clerides government to harmonise most issue areas according to the *acquis communautaire*⁵ prior to the commencement of the accession negotiations. These are scheduled to begin six months after the completion of the IGC in Amsterdam in July 1997. The government has set up 22 committees to investigate the areas where Cyprus diverges from the *acquis communautaire* and to report the necessary action needed to conform (House of Representatives, 1997). Committee 17 deals with taxation issues and Committee 21 is concerned with state aid harmonisation, both being contentious issues for the OFC.

Therefore, Cyprus did not transform itself as an offshore center out of a symbiotic relationship nor out of a 'zero-friction' response to a high friction environment. Eastern Europe appears to fit the frictional onshore relationship rather well. Lack of political and economic stability in the region has led capital to flee to the Cyprus OFC, similar to the relationship that the Caribbean OFCs have had with Latin American capital. The Middle East relationship is more complex, having elements of both the frictional and symbiotic relationships. 'Refugee' companies have fled their unstable environment while also, the region tolerated Cyprus' offshore status despite the existence of Bahrain's offshore centre.⁶

The relationship of the OFC with the EU has thus far remained nebulous and primarily coincided with the opening up of Eastern Europe. This could be attributed to the existence of other OFCs within the EU, and due to the later development of the Cyprus OFC. Cyprus' desire to accede to the EU reveals the need to examine the problems the Cyprus OFC will face as negotiations approach.

Major Problematic Areas of the Cyprus OFC

The Cyprus Offshore Regime

Cyprus does not have a specific law or body of regulations that deals with off-

shore companies. Offshore companies are registered units which benefit from exemptions from the income tax law, customs law, social security law and value-added tax law. Offshore companies are defined as entities whose capital originates from abroad and owned by non-residents. The company may only deal with non-resident or foreign entities and derive its income from abroad. They are registered as Cypriot legal entities subject to the laws of the Republic unless otherwise exempted.

The incentives offered by Cyprus are as follows (Coopers and Lybrand, *op. cit.*):

- 4.25 percent tax on corporate profits.
- No customs or VAT duties (other than those incorporated in the prices of goods purchased locally by offices or expatriate employees) on their imports, and on their office equipment and international communication.
- Expatriate personnel may be employed and are exempted from social security contributions.
- Expatriate salaries are taxed at half the tax rates paid by Cypriots employed by onshore companies. Normal rates are 20 - 40 percent, offshore rates being 10-20 percent.
- A large network of double taxation treaties enabling tax planning.

Having described the OFC's main characteristics, the next two sections will look at some general problems associated with incentive provision and then at the specific problems to accession arising from the OFC.

Disadvantages from Incentive Provision

As noted above, Cyprus is a tax incentive country, allowing for a stable but deregulated offshore environment. There are, however, a number of disadvantages to the country, and potentially to the region within which it chooses to operate, arising from the provision of tax and investment incentives. These are not directly related to the existence of an OFC but are of a more general nature, transforming the playing field.

First, the usual argument against the use of incentives is that they distort economic activity. Incentives cause the after-tax pattern of returns to diverge from the before-tax pattern. They therefore lead to an allocation of resources that differs from the efficient equilibrium the market is *assumed* to generate (Holland and Owens, 1997:259). This argument does not entertain the view that the market outcome before the incentives might not be efficient. Another element of the efficiency argument is that,

...the provision of a tax incentive merely shifts the private disadvantage from the investor in the particular activity to other economic agents in the country. It does nothing to change the total disadvantage to society as it does not affect the social rate of return which is the sum of the private after-tax return and the taxes from the activity (ibid., 289).

Second, incentive provision distorts the operational environment: once corporations and investors are granted the incentives, vested interests are created which will later resist their discontinuation or reform and lobby for their expansion. For example, the OECD countries faced tremendous resistance when implementing tax reforms. The creation of vested interests, therefore, transforms the regulatory landscape and can lead to anti-reform lobbies in the future (*ibid.*, 262).

Third, abuse of incentives is always a danger to the authorities which offer them, and requires astute planning and supervision by policy-makers. Supervisory efforts could lead to complicated regulatory practices and could have the opposite results from those intended, as investors are discouraged by their complexity.

Fourth, the issue of forgone revenues on behalf of the government is a serious one. Forgone revenues must be calculated and measured against the investment that qualifies for the incentives but would enter the market without their provision. Such calculations are difficult and remain a hidden cost, or at best one measured ineffectively as total forgone revenue. Creating new companies to take advantage of the incentives, without engaging in new activity is another important concern.

Finally, the issue of tax competition should be noted at this stage. Arguments of 'a race to the bottom' arise from attempts to create or maintain a competitive position in a region or even in the world economy. If a country perceives that it lacks comparative or locational advantages that would attract investment, it offers tax incentives which are usually matched by neighbours or competitors offering counteractive incentives. At the end of this spiral, the measures have not altered the relative incentive to invest in the countries involved, but have increased the costs (where investment does take place) in the form of forgone revenues.

The next section examines the specific OFC problems and tries to situate them in the debate of *competing capitalisms*.

Accession Problems Specific to the OFC

The existence of what could be called the offshore interface has undermined national governments' abilities to impose higher taxes both on individuals and

companies, has facilitated money laundering and other illegal activities, and has weakened the power of both national and international supervisory bodies to regulate the financial system. (Hampton, 1996a:1}

The *problematique* of Cyprus' accession to the EU is an example of the difficulties of placing OFCs in the international framework of regional blocs. The question of the viability of cohabitation affects not only OFCs that wish to join regional blocs, but also the coexistence of OFCs with regional trade blocs. "The EU seems to be taking an issue-based approach towards OFCs, rather than having any particular overarching policy" (Hampton, *op cit.*, 222). Yet, approaching the end of the IGC, the EU might consider a change in that stand.

The five problems facing the Cyprus OFC in light of potential accession are discussed below.⁷ Within each subsection the problem is highlighted and placed in the EU context where appropriate. The arguments are diverse in nature, ranging from institutional to legal to developmental. While diversity can appear haphazard, it allows the reader to grasp the complexity of the OFC *problematique*.

Fiscal degradation

Fiscal degradation describes the erosion of the tax base and, potentially, of the fiscal sovereignty of a country when subjected to intense tax and, generally, regulatory competition. Regulatory competition refers to attempts by states or jurisdictions to attract mobile factors of production through incentives. These usually are in the form of lower taxes or special tax treaties which allow for tax planning, and generally a lax regulatory environment, ranging from bank secrecy to environmental laxity.

In a study of tax systems in the EU, Valenduc discerned a number of institutionalised discrepancies leading the EU member states towards fiscal degradation. Among the obvious contenders were Belgian 'co-ordination centres' with their special tax regimes, taxation of headquarters as in the case of Luxembourg, the special incentives for financial centres, as in the case of the Dublin International Financial Services Centre (IFSC) and, of course the Channel Islands with their special relationship with the United Kingdom (Valenduc, 1994). These centres and special regimes facilitate the flight of capital from the home base, leading to loss of revenues for the member states. The states then are forced to excessively tax immobile factors such as labour in an effort to replace the lost revenues. This raises labour costs, potentially exacerbating the already acute unemployment problem.

The 'Monti Referendum' on taxation in the European Union states that liberalisation of financial markets within the Union has exacerbated tax avoidance, tax

evasion and has led to the erosion of EU member states' tax bases. Monti, the internal market commissioner, has called for concerted action to put an end to the erosion, but does not propose any specific measures to be taken (Easson, 1996).

Cyprus' accession as an OFC will presumably worsen fiscal degradation if EU firms choose to use the offshore facilities for tax avoidance and tax planning. However, one should note that the concern with fiscal degradation in the EU is not new. Next we return to some of the studies on fiscal degradation within the EU, in order to accentuate that the problem existed without special reference to OFCs.

In 1990 the European Parliament conducted a study on the need for, and economic consequences of, fiscal harmonisation in the European Community. The experts lamented the lack of a rational taxation system, one meeting conditions of neutrality in respect to the export and import of capital. This principle requires that capital is treated (taxed) in a consistent fashion, irrespective of its source or destination (European Parliament, 1990). The group of experts felt that the standardisation of tax systems would lead firms to make rational choices based on real *locational* and *market* advantages to investment, other than taxation, thus preventing the erosion of tax bases among EU states.

In 1991, Frenkel, Razin and Sadka, concurred that tax competition among member states was still possible in the absence of full harmonisation of the (income) tax systems, and could have serious implications for the national tax structures of the EC (1991:197).

In 1990, the Ruding Committee examined the need for company tax harmonisation in the EU. In a report published in August 1992, a number of far-reaching measures were proposed (Commission of the European Communities, 1992:193-221). In a climate charged with the problems of ratifying the Maastricht Treaty, the European Commission did not act upon the recommendations of the Report, which would have been perceived as a threat to fiscal sovereignty by the member states.

Germany is particularly concerned with fiscal degradation, as Germans invest substantial amounts in Luxembourg banks, which do not have a withholding tax or a tax on interest from savings. The losses for Germany amount to about \$12bn (£7.5 bn) a year (Helm, 1997). As the 1998 deadline nears, the need to qualify for the single currency has spurred members to "call an end to what they call 'unfair' competition" (*The Economist*, 5 April, 1997). The Commission is sympathetic to these calls but is anxious to distinguish between harmful competition and simply what lobbyists call 'unfair competition.' It hopes to do so by pointing to the erosion of Europe's tax base compared to its ability to tax mobile factors of production, such as capital.

To bring our attention back to the Cyprus as an OFC, it should be noted that the European Commission's 1993 report on the application of Cyprus, did not mention

the offshore sector as a potential problem. However, concerns for fiscal degradation directly affect the OFC and present potential difficulties for accession. As such they cannot be ignored.

Incompatibility with the Single European Market

i. State aid incompatibility

[A]ids which may distort competition between firms in different Member States are incompatible with the common market unless derogations are granted. (European Economy, 1991:13)

It is difficult to distinguish state aid from general measures aimed at the whole of the economy. The degree of *de facto* specificity of the measure usually characterises state aid. Where national aid is permitted, the EU expects it to be compatible with the improvement of social cohesion within the Union.

In the drive to harmonise Cyprus law and policies undertaken in 1996 by the Cyprus government, Committee 21 is engaged with the harmonisation of state aids. The incentives offered by the offshore regime, and especially taxation, are regarded as a form of state aid to foreign entities and non-residents. However, the committee has not yet reported to the House of Representatives as of April 1997. A preliminary report by Committee 17, dealing with taxation issues, briefly mentions that the taxation disparity between offshore and onshore entities and individuals is a potential problem and might have to be relinquished in the harmonisation process. A recent *Financial Times* survey on Cyprus, noted that the discriminatory tax regime offered by the Cyprus authorities would conflict with EU directives and was pessimistic as to the ability of the centre to remain in place.

ii. Nationality Discrimination

The offshore regime discriminates between offshore and onshore entities on the basis of nationality: the onshore economy is excluded from the privileges accorded to the offshore businesses. This is incompatible with the *acquis communautaire* (see Nicolaides, *op. cit.*).

Issues of development

Microstates⁸ tend to be characterised by a perceived shortage of capabilities and resources. In pursuit of development, despite the rhetoric, they display "... a continual attempt to distort and usurp the free market to one's perceived advantage

... [m]icrostates would be guaranteed losers if they were to abide by the official rules of the game" (Baldacchino, *op. cit.*, 33-39).

The development policies and prospects of microstates tend to further a rentier economy, one cut off from any directly productive activity. They are prone to follow 'a shameless survival strategy' in an attempt to maximise consumption and not production. Microstates are willing to exploit their comparative advantage in producing what the market demands, including tax haven services, "tourist-appealing plastic cultures,' flags of convenience and money laundering" (*ibid.*, 41; Miller, 1997). While the above description is colourful, it is valuable to examine the extent to which Cyprus conforms to Baldacchino's analysis. The problems associated with acceding a microstate are well known within the Union. Part of the IGC's task is to forge a strategy modifying EU institutions to prepare for the potential accession of Cyprus (and Malta, prior to the freezing of the Maltese application by the de Sant Government). However, we must distinguish between problems associated with the status of microstate and ones resulting from hosting an OFC.

Cyprus has had Industrial Plans long before the 1972 EU Association Agreement. Following the invasion by Turkey and the Association Agreement, it has experienced a sharp decline in manufacturing and agriculture as contributions both to GDP and the trade balance (Ayles, *op. cit.*). In the last decade, Cyprus has concentrated on becoming a regional financial centre for the Middle East and hopes to remain one within the EU upon accession. The question remains whether this u-turn from continued attempts to industrialise is detrimental or whether it is a reasonable attempt to specialise in the provision of services in which it has a comparative advantage. In other words, is the OFC creating development problems that will concern the EU, or should it be encouraged as a strategy for development?

The Central Bank of Cyprus encourages the use of the OFC as a specialisation strategy that presents Cyprus with its only viable alternative for development (interview, Stavrinakis, 1997). Arguments for 'flexible industrial specialisation' are often proposed within the bureaucracy, but have come under criticism as non-viable and over-optimistic (O' Donnell and Nolan, 1989).

Criminality issues

In the first months of 1997, Cyprus made the headlines with money laundering charges emanating from the US State Department (*Phile/eftheros*, 1997). Money laundering activities "maintain, to the extent possible, the value of the acquired assets and to transform them into more legitimate or more usable asset." (Tanzi, 1996a:3). Cyprus has enacted the Law on Laundering, Search, Seizure and Confiscation of 1996 to harmonise its legal framework with the relevant European Convention on Money Laundering passed in 1995, which recognised money laun-

dering as an activity not necessarily tied to the drug trafficking trade (Neocleous, 1996).

"Money laundering allocates dirty money around the world .not so much on the basis of expected rates of return but on the basis of ease of avoiding national controls" (Tanzi, *op. cit.*, iii). Money laundering imposes significant costs on the world economy by harming the effective operations of the national economies and by promoting poorer economic policies, especially in developing countries. It slowly corrupts financial markets and reduces the public's confidence in the international financial system, thus increasing risks and the instability of that system. Stemming from increased risk and instability, the rate of growth of the world economy is reduced (*ibid.*,2).

Central Bank officials emphasise the progress that Cyprus has made in criminalising money laundering and related activities in an attempt to promote a crime-free environment. There are substantial guidelines for offshore units, especially in the banking and financial services industries (Central Bank of Cyprus, 1997a-c). In 1980 Cyprus, together with other OFCs, set up the Offshore Group Banking Supervisors, a forum which participated in the Bank of International Settlement's discussions and sought to identify areas for co-operation among the OFCs in order to enact measures reflecting legislative and regulatory priorities of the OECD (Johns and Le Marchand, *op. cit.*, 89). In other words, Cyprus has taken action to harmonise and legitimise the OFC interface with internationally accepted practices.

Opposition from other OFCs in the European Union

The Dublin IFSC, Madeira's special economic zone with its tax regime, and Luxembourg could, in theory oppose accession by a rival OFC. On the contrary, it is more likely that attempts within the Union to abolish OFCs and special regimes will be opposed by the areas holding special derogations. The conclusion of the IGC in July 1997, will decipher the approaches that countries with vested interests will pursue to retain their special derogations.

Solutions: Convergence or Coexistence?

In the absence of a coherent EU policy on OFCs it is difficult to discern what the EU's attitude will be toward the Cyprus OFC. Assembling the directives, clauses and derogations granted to other offshore jurisdictions is one step in the process, but holds no certainty of action. The 'choice' laid out below is one of convergence or coexistence, which falls within the debate of *competing capitalisms*.

EU Derogations for Existing Offshore Jurisdictions

Below we will briefly describe the characteristics of offshore jurisdictions and discuss the EU decisions affecting their continued existence.

Dublin International Financial Services Centre

The Dublin IFSC came into existence in 1987, with EU permitting Ireland to pursue industrialisation and development policies which would align it with the rest of the European member states. The IFSC aimed to decrease dependence on the agricultural sector, reduce unemployment and brain drain, and attract foreign investment. It was initially given a life-line until 2005 (companies could register until 1994) (Nicolaidis, *op. cit.*, 15). An extension of registration in the IFSC was granted until 2000 with a concomitant extension of tax relief until 2011. The decision to grant the extension was based on the success in achieving the set objectives: 152 companies had registered in the centre. The associated incentives helped to achieve the record growth of 10 percent in 1995 and 7 percent in 1996 (*The Economist*, 17 May, 1997). Ireland's recovery from a weak agricultural member of the EU to the 'emerald tiger' of Europe, has focused attention on the IFSC, with recent reports attributing part of this growth to the incentives installed by Irish authorities (Corroon, 1996; *The Economist*, 17 May, 1997). However, it is misleading to solely attribute the turnaround in the Irish economy to the IFSC. As McRae notes, education and a deregulated environment are all factors aiding the spur in growth (1996).

Madeira

As an autonomous region of Portugal, all Treaty provisions and directives apply to Madeira. The EU has allowed special measures for the social development of Madeira (and the Azores) since 1986, such as the Free Trade Zone of Madeira (FTZM) and shipping register to encourage investment. The general tax regime exempts registered companies from corporate or personal income tax. The regime was modified in 1993 and has a derogation to operate until 2011. It is the one which most closely resembles the Cyprus offshore centre allowing all kinds of companies to register.

Luxembourg

Luxembourg specialises in managing investment funds and private banking (Cassard, 1994). It is not considered an OFC as such, but has thrived on its proximity with Germany and its ability to acquire business fleeing the friction-laden German economy. The increase in mutual fund activity came in 1988 after Luxembourg implemented the EC directive on Undertakings for Collective Investment in Transferable Securities (UCITS) (Nicolaidis, *op. cit.*). The directive enabled the creation of 'umbrella funds' which allow investors to shift from one com-

partment to another without the burden of taxation. Luxembourg does not require a derogation as it does not discriminate between onshore and offshore sectors.

To conclude this section, the EU has tended to derogate incompatibilities with the *acquis communautaire* in a time-constrained fashion, where it has been proven that they improve regional economic condition and balance inequalities within the single market. Derogations are granted when a policy has been successful, when it seeks to discriminate in order to improve cohesion among the Union's regions, as in the case of the Dublin IFSC and Madeira. Hence, the positive contributions to the local economy have been the deciding factor for the EU (*ibid.*).

Strategies and Options for Cyprus

The accession strategy of Cyprus in general, and its specific policy towards the offshore centre, is being formulated in 1997 (interview, Iakovou, 1997). The Clerides Government has not publicised a particular strategy, other than its desire to harmonise the legal and policy frameworks prior to the commencement of the accession negotiations. In most issue areas, the government hopes to emulate a unified EU framework; the same cannot be said for the OFC. While the Union has allowed OFCs to operate within the single market, there is no one body of law and regulation with which to conform. The EU permits the operations of Madeira, and Dublin, and 'tolerates' Luxembourg, as discussed above. The options available to Cyprus are examined below. The *competing capitalism* debate assists us in categorising options as either *convergence or coexistence*.

Convergence with the EU

Option 1

Abolish all privileges to the offshore sector in order to ensure that the accession is not hindered by its existence. Given the contribution of the offshore sector towards the local economy, and the existence of derogation for offshore jurisdictions in the EU, this option of convergence is not advantageous (Nicolaidis, *op. cit.*). However, convergence is not tantamount to the abolition of the offshore sector: it can equally take the form of option 2.

Option 2

Unilateral liberalisation of the taxation and regulatory environment to eradicate any differences between the offshore and onshore sectors in Cyprus. It is often proposed that Cyprus could financially afford to offer tax incentives to both offshore and onshore businesses of about 10 percent, avoiding the discriminatory aspect of nationality and the need for derogation for state aids given to the offshore sector (for

exact calculations see *ibid.*, 34-35).⁹ Concerns over regulatory competition *will remain as long as the OFC still offers a more deregulated environment* than the EU member states. Option 2 merely deals with the incompatibilities of the OFC, i.e., *legal and official reasons for concern*.

Coexistence with the EU

Option 3

Negotiate derogation for the incompatibilities with the EU, in other words, try to retain the OFC as it presently stands. To understand the attractiveness of this option, it is important to discuss the effects of the OFC on the local economy.

Advantages of the Offshore Sector in Cyprus

The contribution to current account receipts was 8.5 percent or 12 percent of all invisible receipts for 1996. Compared to receipts from exports, the offshore sector generated income of more than a third of all export earnings (*ibid.*, 29). The contribution to the economy is expected to double in the next five years. EU derogations for state aid have been usually granted for contributions lower than this. However the offshore sector, with its focus on service provision, seriously affects the socio-economic environment in Cyprus (Vassiliou, 1996).

First, the sector enlarged and largely maintained the professional classes in Cyprus, invigorating employment opportunities where the onshore service industry was saturated. A *World Bank* report of 1987, noted the potential in utilising the "large pool of university graduates" in order to expand the service sector as a potential export winner in the economy (*World Bank*, 1987:xvi). Ten years later, the offshore sector has provided employment to lawyers, accountants, surveyors, engineers, software programmers; professions not easily absorbed by a mini-economy. It has employed educated people who in the past succumbed to brain drain. The OFC created alternative employment possibilities for educated persons whose only opportunity used to lay with the already burgeoning civil service.

Second, the offshore sector is rationalising the service industry, away from the highly clientilistic spectrum of government employment and procurement of contracts. Service providers are being chiselled into competitive practitioners as they obey the quality demands of the offshore sector.

Third, the offshore sector helped to attract foreign direct investment (FOi). The positive effects of foreign investment are reinforced in the context of the Cyprus market. Export-led growth is not only a choice but a necessity, given the size of the

internal market. The OFC hopes to attract integrative FDI in the fields where Cyprus has a comparative advantage: banking, insurance and shipping. New products and services are created as the market responds to the demands of the off-shore sector, and as managerial skills are transferred to Cypriot professionals employed by offshore companies. Also important, though more limited, is the transfer of technology.

Fourth, revenues from the offshore sector diversify the receipt base of the public budget. It 'weans' the Cypriot economy away from tourism and towards less seasonal, if not less sensitive, sectors.

Thus, the success of the OFC, its role in the local economy and the creation of vested interests, provide sufficient reasons for maintaining a focus on service provision to foreign companies. Both Option 2 and Option 3 could maintain this specialisation. In order to decide between them, however, we need to engage in the institutional economics and IPE debate of liberalisation versus harmonisation.

The Liberalisation versus Harmonisation Debate

The options available to Cyprus can be better understood in the theoretical framework of the liberalisation versus harmonisation debate. Cyprus will either seek a derogation that will allow its offshore sector to remain within the EU upon accession or will choose to liberalise, transforming itself from an offshore centre to a low regulatory environment without discrimination.

Harmonisation of policies on reciprocity are enshrined in the post-1945 international economic order, in an historic compromise known as 'embedded liberalism'¹⁰ (Ruggie, 1983). However, in the last two decades a paradigm shift has replaced the narratives of the post-war Keynesian order, with a neoliberal paradigm, one surpassing the classical liberal tradition which accepted the role of government as provider of market parameters (the playing field) and its maintenance (Gilpin, 1987, esp. Chapter 3; Sally, 1997). "[C]lassical liberalism has to offer an alternative policy programme for a liberal international economic order" (Sally, *op. cit.*, 27). The post-1945 order assumed/rested on reciprocity (benign coercion towards liberalisation). On the one hand, unilateral liberalisation is now being argued as more effective for the attraction of mobile factors, leading to spontaneous adjustment of immobile factors such as national law and government policy. Reciprocity and harmonisation, on the other hand, are "conceived as a 'construct' of co-ordinated bargains between governments" signalling a reluctance to liberalise unilaterally (*ibid.*).

...competition - whether among firms, among markets and exchanges, or among national regulatory regimes - ought to be the 'default option'... in the

absence of. . .substantial market failure. . .the competitive outcome should prevail. (White, 1996:30)

Yet the proponents of reciprocity argue that "[c]ontingent liberalisation, i.e. opening up one's own market in return for concessions... is the only effective way of getting domestic producers to go along with market-opening measures at home." (Roessler quoted in Sally, *op. cit.*, 28).

Let us try to apply the debate to the Cyprus OFC and the accession *problematique*. There are two separate issues which may be addressed within the debate. First, the issue of incompatibility: the offshore sector is incompatible with the *acquis communautaire*, because Cyprus offers offshore businesses a more favourable tax and regulatory environment than it allows the onshore sector. The offshore regime is both a state aid in need of derogation, and discriminatory on the basis of nationality. It is a state aid because it benefits a specific sector of the economy through deregulation and special incentives, while the government remains heavily involved in the onshore economy. The OFC is discriminatory on the basis of nationality as it applies only to foreign entities and individuals. The discriminatory nature of the regime distorts the theoretical debate. The OFC is a case of unilateral discriminatory liberalisation, meeting demands for 'reverse harmonisation' (Nicolaidis, *op. it.*, 8). Option 2 would transform the offshore sector from 'state aid in need of derogation' to a unilateral liberalisation without discrimination. It would also spur growth in the onshore economy, which would be similarly free to avail itself of the deregulated environment.

Second, there is the issue of institutional (and **tax**) competition. This is one of the deepest concerns of the EU and brings back the imagery of OFCs as 'fast-moving raiders' attacking 'older forms of nation-state capitalism' (Hampton, 1996; *The Economist*, 15 March and 5 April, 1997). Only Option 1 would eradicate any concerns regarding institutional competition.

Policy-makers view institutional competition or 'regulatory arbitrage' through a normative view of government, as shown below in Chart 1:

Chart 1

State as Leviathan	State as Benevolent Maximiser of Citizens' Welfare
tax and regulatory competition as a constraint on policy makers' exploitation of citizenship	tax and regulatory competition as a source of inefficiency calling for tax co-ordination

While the above distinction is still helpful, the aforementioned paradigm shift changes the normative parameters of the debate: there is a tendency to consider the state as a harmful and encroaching agency, unnecessary to the welfare of the citizens (Hobsbawn, 1996). Arguments of 'race to the bottom' are becoming less meaningful to policy makers and their advisors. The worrisome practice of tax 'base-stealing' is now being interpreted as efficiency-maximising and reform-inducing. "[T]ax competition [is seen] as serving a valuable purpose in supplementing inadequate constitutional constraints on the intrinsic pressures towards excessively high tax rates implied by policy makers' pursuit of their own interests." (Edwards and Keen, 1994:2).

Among the apparent losers of the debate different views hold reign. "[T]ax competition is an essentially straightforward instance of the presumption that non-cooperative behaviour will lead to inefficient *outcomes*" (*ibid.*, 1). Applied to the EU, it is feared that "fiscal competition will wipe out redistributive taxes on mobile factors and reduce the tax system to one of merely benefit taxation." (Sinn quoted in *ibid.*, 2). Official circles in Brussels worry that,

...if the current system of capital systems are left untouched, European governments are likely to find it very hard to collect revenue form the internationally mobile capital. Indeed, Europe may transform itself into a single (large) tax haven. (Giovannini and Hines, Jr., 1991:172).

In the absence of sufficient co-ordination, tax competition could diminish taxes to zero, the immobile factors of production, labour and land carrying all the revenue burden of governments, as previously noted. The outcome is still efficient (resulting from the play of unobstructed market forces) but welfare-inferior when compared to the outcome of states having the ability to tax their mobile factors (Razin and Sadka, 1989:4). Other effects are deficient levels of savings and investment, and their inefficient allocation. 'Unfair' tax competition leads to the distortion of the playing field,

inducing allocations that may substantially differ from what market mechanisms would otherwise apportion. (The counter argument, however, is that the market does not set tax rates, and hence, the existing tax rates may be inefficient).

The concepts of *government failure* and *market failure* must inform the debate. There is a marked difference between the distortions brought about by inter-governmental bargaining and harmonisation (political distortions) on the one hand, and inter-governmental competition (economic distortions) on the other (Frey and Eichenberger, 1996).

Competition between Cyprus and the EU in taxation and regulation might be healthy if one assumes that government failure (in the choice and process of harmonisation) is more dangerous than market failure, because government failure distorts the very signals by which the market allocates capital. Advocates of harmonisation, on the other hand, rest their case that excessive regulatory and tax competition is a sign of market failure. In this view, government action prevents or benevolently regulates market failure.

Within the context of the EU single market, harmonisation has been debated for over a decade. It appears that there is an implicit contradiction between the Treaty of Rome and the Treaty on European Union (i.e. the Maastricht Treaty). The neutrality requirement (which concurs with the European Parliament 1990 report) is part of the Treaty of Rome. The Maastricht Treaty however, "enshrined subsidiarity as the guiding criterion in the discussions on the assignment of policy function in the Union" (Cnossen and Bovenberg, 1997:164). Tax neutrality requires extensive harmonisation while subsidiarity assumes that each member state will be accorded "as much tax sovereignty as is commensurate with the goals of free trade and free competition in the single internal market" (*ibid.*). Hence, 'race to the bottom' concerns exist within the single market and are not necessarily related to OFCs. As described below, action has been slow.

A recent article reports that the European Commission "[h]as quietly shelved a study on how countries in the planned single currency zone could co-operate more closely on tax harmonisation and social security" (Barber, 1997). Monti, the internal market commissioner, commented that tax harmonisation should be dealt with under the unanimity rule in the Council of Ministers (where it faces certain rejection).

Recently, German finance minister Waigel, increased pressures towards tax harmonisation, proposing the gradual abolition of 'resident' and 'non-resident' tax status for European citizens, and the creation of a single 'European resident' status (Helm, 1997). There are ideas for a code of conduct (as opposed to legislative harmonisation), that would stop member states from engaging in tax competition or 'tax piracy' (*ibid.*).

In other words, harmonisation is recognised as important, but the limitations are still unacceptable to many member states. The result of complete standardisation would be nothing short of the loss of fiscal sovereignty, the loss of power to alter tax rates autonomously, having instead to resort to community decisions on tax rates (European Parliament, 1990). Britain argues against tax harmonisation, as this "would set Europe on a federal path" (Helm, *op. cit.*). Fiscal federalism generates fear among most states, "...[t]hese proposals have gone nowhere chiefly because they require the unanimous approval of EU members, which remain jealous of their fiscal sovereignty" (*The Economist*, 5 April, 1997).

De Silguy has suggested that a core group of countries harmonise taxation first but Portugal, Italy, Spain and Greece specifically oppose such calls for a 'multi-speed Europe,' or 'Europe *a la carte*, as it would undermine, they claim, the internal market (European Parliament, 1996).

Competing Capitalisms Revisited

The unified model of capitalism previously discussed has disintegrated after the above discussion. *Laissez-faire* capitalism represented by Great Britain opposes harmonisation of regulatory environments, maintaining that competition should be the 'default option'. The communitarian model, associated with Germany pressures for harmonisation at concerted action.

As discussed above, OFCs provide the environment for regulatory arbitrage, forcing conventional forms of capitalism to converge towards a deregulated world economy. However, as convergence deepens, OFC capitalism is becoming obsolete. The comparative advantage of OFCs rests on the existence of two interfaces allowing for regulatory arbitrage by multinational enterprises. As the advanced industrial nations and, increasingly, developing counties, converge upon lower friction environments, the OFCs are losing their *raison d'être* (Cassard, 1994).

Conclusions

The debate of *competing capitalism* has illustrated that Cyprus has not had a symbiotic relationship with the EU. Certain incompatibilities and effects are problematic, but exist within the single market in the absence of Cyprus' OFC.

The EU has not yet agreed on harmonisation of the interfaces, allowing for a life extension for the OFCs operating in Europe's 'catchment area'. The extensions granted to the Madeira and Dublin IFSC until 2011, signal that at least for another decade the offshore interface is a reality. Member states are as yet unable to push forth with deeper tax harmonisation that would make the OFCs less competitive and eventually unnecessary.

The existence of the OFC will necessitate a special accession strategy on behalf of Cyprus. This paper has identified a number of problems and investigated whether Cyprus acts as a 'pirate' actor in its OFC capacity, forcing the EU to converge towards a suboptimal, welfare-inferior regulatory and tax interface, as the one dominated by OFCs. The analysis leads to the following conclusion: Cyprus in its capacity as an OFC is part of the offshore interface, and as such, is causing major onshore economies to converge to a de-regulated environment. Such pressures are already harboured within the EU through the existing OFC jurisdictions. The EU single market project requires harmonisation, which is currently opposed by EU member states which wish to retain their fiscal sovereignty and oppose the concept of a multi-speed Europe.

Regarding Cyprus' options in the accession negotiations, seeking a derogation is the less radical option. However, unilateral liberalisation would be the most beneficial option for the onshore economy, yet, the unilateral liberalisation option still forces nearby onshore economies to converge, if it remains more deregulated and offers greater tax incentives than the EU member states.

The debate on *competing capitalisms* provided a useful terrain in which to analyse the accession *problematique* and the liberalisation versus harmonisation debate illuminated the benefits of the strategies available, and the cost that they will have in an integrated regional and global economy.

Notes

1. This paper will not explore issues related to the Cyprus Problem, such as whether Cyprus should accede as a divided island, nor how a possible solution will affect chances for accession (see Redmond, 1995).

2. Throughout their development and evolution, OFCs may transform themselves from one type to another by increasing the extent and breadth of activities they undertake.

3. Branches where little actual activity occurs.

4. Symbiosis, defined as habitual cohabitation of organisms of different species. The term usually applies to a dependent relationship that is beneficial to both members (also called mutualism). Symbiosis, however, includes parasitism, a relationship in which the parasite depends on and may injure its host; commensalism, an independent and mutually beneficial relationship; and helotism, a master-slave relationship found among social animals (*The American Heritage Dictionary of the English Language*).

5. Defined by Nicolaides as "[t]he body of EU legislation and practice" (1996:1).

6. There are substantial functional differences, however, between Cyprus and Bahrain. See Phylaktis, 1995: 128-130.

7. In addition, OFCs "raise a specific problem for world capital flow statistics in that they omit from their balance of payments the large volume of financial flows that pass through their entrepot facilities." (IMF, 1992: 77-84).

8. Usually defined as a state having a population of less than one million (Baldacchino, *op. cit.*).

9. A question to be asked at this juncture is whether the extent to which future plans for tax harmonisation will render this option ineffective as a special regime.

10. Defined as a compromise intended to achieve both liberal economic order in the international sphere, and internal stability domestically (see Ruggie, 1983).

Source: Coopers and Lybrand, (1994), *Cyprus: The Way for Business and Investors*. Nicosia, Cyprus: Zavallis Litho.

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