Treasure Island or Desert Island? Offshore Finance and Economic Development in Small Island Economies: the Case of Labuan

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At present there are over sixty jurisdictions worldwide that offer a variety of facilities for tax evasion and offshore financial services. From Belize in Central America to Vanuatu in the South Pacific, surrounding each of the major trading regions are a growing number of polities derogatorily referred to as 'tax havens'. Nonetheless, the provision of offshore financial services has lifted a whole host of small states from the poverty of the developing world to levels of affluence few would have believed within their grasp. Indeed, for many Small Island Economies (SIEs) the creation of a functional Offshore Financial Centre (OFC) is seen as a panacea for their economic disadvantages. While a number of OFCs conform to the stereotypical image of a tax haven — a quiet backwater populated by letterbox or brassplate companies with minimal financial regulation — increasingly many centres are exploiting particular niches in the global financial market, both in terms of the range of services they offer and the markets within which they operate.

One such centre is the Malaysian island of Labuan. For many years an economic backwater, in 1991 the Malaysian government adopted a strategy to develop the island as a 'premier' OFC in the Asia-Pacific region. From the beginning Labuan was envisaged as a well regulated OFC, aiming to attract both business from the world's leading international banks and legitimate funds rather than those from more dubious sources. Furthermore, to distinguish itself from competitors Labuan also sought to develop as an IOFC that also specialised in offshore Islamic banking. This article sets out to explore two questions. First, has the development of the Labuan International Offshore

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Financial Centre over the past nine years been a success? And secondly how appropriate is the promotion of offshore financial services to a small island economy? It works with primary data collected during a research trip to Labuan in 1997 and facsimile and e-mail communication with bankers and regulators in the OFC thereafter.

Background

Labuan is a small arrowhead-shaped island lying off the northwest coast of Borneo, close to the coastline of Sabah and not far from Brunei. Both its history and the aspirations of the Malaysian government for the island are disproportionate to its size. The fine anchorage and coal deposits on the island's northern tip attracted the interest of the British who acquired the territory in 1846 when it was ceded by the Sultan of Brunei to the British Crown. Keen to establish Labuan as a coaling station for passing steamboats the British made the island a free port in 1848 and in 1889 it was incorporated into British North Borneo.

The Second World War first brought international attention to Labuan when, only a month after the bombing of Pearl Harbour, the Japanese occupied the island and subsequently used it to launch their assault on British North Borneo. Three and a half years later in June 1945 Japanese forces surrendered to the Ninth Australian Division, and Labuan, along with the rest of British North Borneo, reverted to the British Crown from the chartered company. In 1963 the island was incorporated into the Malaysian state of Sabah, and for the next two decades Labuan retreated into obscurity, with its small population reliant on ship repair, fishing and barter trade as the main economic activities. Furthermore, it developed a reputation for illicit activities such as prostitution and smuggling. In 1984 the Federal government decided to take action to develop the island, declaring it part of the Federal Territory of Malaysia governed directly from Kuala Lumpur. Six years later after much needed investment in infrastructure it was inaugurated as an International Offshore Financial Centre.

Labuan as a Small Island Economy

The majority of OFCs and tax havens are located on small islands and in the opinion of a number of commentators (Baldacchino, 1997; Brock and Smawfield, 1988; Fabri and Baldacchino, 1999) this is no chance coincidence. Small Island Economies (SIEs) by their very nature have few domestic transactions and consequently turn to external sources for their markets, investment and income. Conversely, international financial clients are attracted to such states by their very insularity since this increases the likelihood of confidentiality (Fabri and Baldacchino, 1999: 142).

Although part of Malaysia, Labuan bears many similarities to SIEs with its relatively isolated economic structure. Hampton and Abbott, for example, argue (1999: 168) that SIEs are defined by their small population (normally less than 1.5 million) and the fact that they suffer a number of economic disadvantages as a result of their size, namely, diseconomies of scale, dysfunctional market structures, high transport costs, and shortages of professional/managerial skills.

Labuan has a population of only 65,000[1] and prior to the creation of the IOFC had few industries besides ship repair and duty-free tourism. Despite efforts to upgrade its transport facilities, interviews with the offshore financial community suggest that transport inadequacies hinder its competitiveness. In particular, Labuan suffers from having a small airport which requires connecting services from Kuala Lumpur or Kota Kinabalu.[2] Indeed, one of the principal reasons behind the Malaysian government's decision to set up an IOFC in Labuan was its commitment to regional economic development.

Similarly, despite its economic disadvantages, Labuan, like many other SIEs, possessed a number of features that made it logical to develop it as an OFC. It shares virtually the same time zone as most of the major financial centres of East Asia; it benefits from one of the most stable political regimes in the region (where the same political party, *Barisan Nasional,* has formed the government virtually since independence in 1957); it enjoys racial harmony despite Malaysia's ethnic diversity; and since both Labuan and Malaysia were once former British colonies, not only is English widely spoken but, more importantly, accounting standards, business practices and the legal system adhere to English standards (Sarver, 1998).

Many of the more successful OFCs are dependent territories (mostly UK Overseas Territories such as the Cayman Islands or British Virgin Islands)[3] that enjoy a quasi-independence by virtue of their autonomy in fiscal policy-making and internal legislative and judicial affairs, while 'maintaining close ties in areas such as monetary union, external affairs, education, language and culture'

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1. Labuan's population is equivalent to that of Guernsey (64,555)and approximately two-thirds that of Jersey (89,136) making comparisons with the Channels Islands particularly appropriate (figures from CIA, 1998).

2. By way of recognition the Malaysian government had, at the time of the fieldwork for this study in August 1997, committed itself to a multi-million dollar expansion of the airport and the provision of a high speed catamaran ferry service from Kota Kinabalu and Brunei. However, the onset of the Asian financial crisis and the continuing economic uncertainty in its wake look likely to delay such projects.

3. For example, of the ten leading tax havens listed by one US-based internet tax consultancy, four were dependencies, including the BVIs and the Cayman Islands, the others being the Cook Islands and Turks and Caicos (www.wzone.com/cozumel/taxhavens/index.html).

(Christensen and Hampton, 1999a:169). Labuan is no exception, being a federal territory of Malaysia, but with the Labuan Offshore Financial Services Authority (LOFSA) having wide-ranging powers covering everything from applications for banking licences and the supervision of the industry as a whole to co-ordinating work permit applications for foreign professionals wishing to work on the island. Indeed, the ambiguous constitutional status of many OFCs gives what Hampton (1996a) refers to as the 'offshore interface' — a situation of opacity which provides room for manoeuvre and renders these obscure SIEs useful to financial capital.

Labuan: OFC or 'tax haven'?

The term 'tax haven' is often used interchangeably with that of offshore financial centre and there is great difficulty in distinguishing between the two. Furthermore, the term is invariably used in a derogatory sense by critics of the activities of OFCs rather than by the governments hosting such centres. Nonetheless, as the 1987 Gordon Report to the US Treasury stated, 'there is no single, clear, objective test which permits the identification of a country as a tax haven' (OECD, 1987:21).

One way in which OFCs can be differentiated from tax havens is that they generally host a range of economic activities, whereas tax havens are based upon pure tax differentials with other countries. However, the growing complexity of modern taxation and financial regulation makes this somewhat problematic, since practically every country offers some form of haven from taxation and regulation for residents of other countries.

Hampton (1996b) presents a typology of OFCs classifying them into three groups: functional, notional and compound. A distinction between these categories is made on the basis of the type of activities that occur in the particular OFC, the contribution of financial activities to the GDP of the territory, and the proportion of local people employed by the centre (pp. 4–5).

Functional centres are classified as hosting a variety of financial activities, including banking, insurance, trust management, etc. In addition, there are comparatively few 'brassplate' operators, since most banks will operate fully functional branches. Such centres will contribute significantly to both the island's national income and employment, employing over 12% of the labour force and contributing in excess of 25% of GDP (ibid,. and Hampton 1996a). At the other extreme, notional OFCs generally lack the facilities of functional centres and are invariably inhabited by 'letterbox' or 'brassplate' offices of banks, with deposits merely going 'through' the centre. For example, although there were 584 licensed banks and trust companies in the Cayman Islands, only

114 had any actual physical presence.[4] Similarly, of the 9,969 international companies registered in Bermuda in 1997, only 327 (3.2%) had a physical presence (*Bermuda Economic Review*, 1998: 14). Likewise, the overall economic contribution of offshore activities was nominal, less than 10% of GDP, with few employees, less than 3% of the workforce (ibid.). Nonetheless, for some low-income SIEs the income from registration fees accrued from hosting offshore activities may be significant (Baldacchino, 1993).

Between these two lie compound OFCs. While these may still be home to many shell offices, the growing level of economic activity means that some banks will have established functional branches in the centre, while the increase in financial activity will bring the growth of support services. Such centres will contribute between 10 and 24% of GDP and employ 3–11% of the labour force (Hampton, 1996a, 1996b).

For many the notional OFC would conform to their image of a tax haven. Yet, regardless of the level of activity, the decision to host offshore financial services represents,

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

Indeed, it is the conscious strategy of minimising taxes and regulations in order to 'siphon' off the deposits and business of the international financial system that generates the image of OFCs as tax havens.

For the purposes of this article a 'tax haven' will be distinguished from an OFC in the following way. It will be a notional OFC; it will either be a no-tax regime or will have exempted non-resident companies from a whole swathe of domestic taxation and regulations; and while it may or may not be associated with criminal activity, it will adhere strictly to the principle of bank secrecy and restrict the disclosure of company information. To what extent, then, does Labuan conform or deviate from this classification?

Treasure island or fools' gold? assessing the performance of the Labuan IOFC

Since the establishment of Labuan as an IOFC in 1990, the number of companies incorporated or registered under the Offshore Companies Act (OCA) 1990 as well as other legislation has risen steadily, from 11 companies in 1990

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4. E-mail correspondence with Mark Anthony McKenzie, Senior Policy Research Officer, Cayman Island Monetary Authority Policy & Research Unit, 13 August 1999.

to 1,870 by the end of 1998. These included 62 offshore banks, 40 offshore insurance and insurance-related companies and 20 trust companies. Concomitant with the growth in the presence of banks and trusts, there has been very strong growth in the financial industry as measured by deposits and loans. For example, between 1992 and 1998 the assets of the offshore banking sector soared from US $900 million to $22.3 billion (LOFSA, 1996, 1999).

By comparison with more established offshore financial centres this figure is quite modest. At the end of 1997, for example, total bank assets stood at $642bn in the Cayman Islands, $155 bn in Jersey and approximately $60 bn in Guernsey. Nonetheless, it exceeded the level of assets on the Isle of Man at $20bn, the Dutch Antilles ($6 bn) and Vanuatu ($5 bn) (see Table 1). In addition, unlike 'notional' OFCs, not only do a wide range of financial activities take place in Labuan but the branches of the international banks are fully functional.

Table 1
Comparative data on selected OFCs

Country	*Independent*	*Bank assets ($ bn)*	*Offshore finance as % of GDP*
Anguilla	no	n.a.	14 (1990)
Bahamas	yes	200 (1994)	16 (1994)
Bermuda	no	8.8 (1994)	37
BVI	no	n.a.	20
Cayman Islands	no	642	n.a.
Guernsey	no	60	50-55
Isle of Man	no	20	37
Jersey	no	150	55-60
Turks & Caicos	no	n.a.	9
Vanuatu	yes	5 (1988)	est. 10 (1993)
Labuan	no	22.3	est. 10

Note: All figures 1997 unless otherwise stated. n.a. - not available.

Cognisant of the danger of its becoming a mere booking centre populated by shell companies, the Malaysian government was keen from the inception of the IOFC that Labuan would develop as a fully functional offshore centre. To achieve this, applicants for a banking licence from the regulatory body, LOFSA, must commit themselves to establishing a functional operation in Labuan and to developing it subsequently into a fully-fledged offshore bank.

Obviously, given that Labuan is a federal territory of Malaysia, the contribution of offshore activities to Malaysia's economy as a whole is likely to be minuscule. In terms of the island's economy, while official figures are unavailable, interviews with employees in the offshore sector suggest that the figure is approximately 10%. Clearly Labuan has a long way to go before it reaches a level comparable to that of Jersey, where it is estimated that the finance sector accounts for at least 55% of GDP[5] and 90% of government revenue (Christensen and Hampton, 1999a:176), or Bermuda at 39% of GDP[6] However, the figure is not far below that of OFCs such as the British Virgin Islands, 20%[7] or Gibraltar at 15% (CIA, 1998).

In terms of government revenue, of the official figures available for 1998 the income from incorporation and registration of offshore companies, coupled with annual licence fees for banking and insurance and other related fees, stood at RM 8.46 million.[8] This enabled the regulatory body, LOFSA, to record a surplus for the year of RM 3.3 million (LOFSA, 1999) which allowed it to repay half of the RM 6 million loan granted by the central bank of Malaysia to set up the authority in 1996 (ibid.).[9]

In terms of employment, the impact of offshore financial activities is negligible. By the end of October 1996 a mere 543 were employed in offshore banking and insurance — less than 1% of the island's total population. Again this contrasts sharply with centres such as Jersey where 20% of the work force (approximately 10,000 people) are directly employed in the finance sector (Christensen and Hampton, M. 1999a: 176) or the Isle of Man where the figure is estimated at 6,000.[10] However, it compares reasonably favourably with the British Virgin Islands where the financial services sector employs 6% of the total population, Bermuda where international companies directly employed 2,667 islanders in 1997[11] (approximately 4.3% of the total population), and exceeds the 400 employed by the international financial centre in Port Vila, Vanuatu. (It should be noted that statistical comparison of the numbers employed directly or indirectly in offshore financial services is complicated by different data collation by the respective sites.)[12]

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5. See 'Survey - Jersey: Outsiders turn spotlight on thriving island', *Financial Times*, 27 November 1998.

6. Correspondence with Emeritus Professor B.Archer, School of Management Studies for the Service Sector, University of Surrey, 16 August 1999 (figures for 1997). Professor Archer is employed by the Bermuda authorities to conduct annual reports on the financial services sector.

7. E-mail interview with Deputy Director of Financial Services, Lisa Penn-Lettsome, British Virgin Islands, 12 August 1999.

8. For comparison, the OFC on Antigua and Barbuda earned approximately $1.5 million in fees in 1997. 'Antigua to sign legal treaty with the US', *Financial Times*, 4 November 1998.

9. The Malaysian Ringitt is currently fixed at a rate of RM3.80 to the US dollar.

10. See 'Doors open to reveal the secret world of Britain's offshore tax havens', *The Independent*, 20 November 1998.

11. See note 6.

12. Labuan's statistics, for example, only include those employed in banking and insurance and not those employed by trusts. Assuming a very conservative figure of one employee for each

While the direct contribution of offshore finance appears to be somewhat modest, situating the IOFC between Hampton's notional and compound OFC types, Labuan does generate specific indirect benefits for Malaysia. First, the principal benefit of the IOFC is that it creates a captive market. If there were no offshore facilities in Labuan, Malaysian residents would take their business and foreign currency deposits to other offshore financial centres. With the development of Labuan, the Malaysian government hoped that high net worth Malaysians would 'bring their money home', and indeed interview evidence from across the spectrum of offshore business does seem to support this. Secondly, as suggested by Hampton (1994), the offshore financial centre has led to an improvement in Malaysia's financial system. Indeed, the Malaysian government saw the IOFC as a way of nurturing domestic Malaysian banks, allowing them to develop both their international activities and the goods and services they offer. Finally, Labuan provides an alternative source of foreign funding for the financing of export-oriented projects.

Nonetheless, in respect of lending to Malaysian residents versus non-residents, Tables 2 and 3 demonstrate that the vast majority of loans are still for residents, although by 1996 there had been a notable increase in 'out-out' business. Consequently, one has to question the degree to which Labuan is a truly *international* offshore financial centre. The data reveal that the majority of the deposits as well as the loans come from Malaysian clients, presumably either high net worth individuals (HNWIs) or Malaysian companies. Furthermore, an amendment to the Offshore Companies Act 1990 which now permits Malaysians to own offshore companies looks set to maintain this pattern for the near future. Table 4 reveals that this situation is even more pronounced in the offshore insurance business where the foreign-held share of holdings is almost negligible.

Table 2
Deposits of non-bank customers by the offshore banks (US$ m.)

	1994	*1995*	*1996*
Total foreign currency deposits	2, 276.8	2, 409.1	4, 312.6
Residents' share	1, 902.2	2, 409.1	2, 748.4
Residents' share %	83.5	78.7	63.7
Non-residents' share	375.6	514.1	1,564.2
Non-residents' share %	16.5	21.3	36.3

Source: LOFSA (1996)

of the trust companies, auditors and other offshore companies would increase the proportion of the population employed in financial services to just under 3%.

Table 3
Loans of non-bank customers by the offshore banks (US$ m.)

	1994	*1995*	*1996*
Total offshore loans outstanding	5, 197.0	8, 378.7	11, 962.0
Residents' share	4,211.3	7, 012.7	8, 472.4
Residents' share %	81.0	83.7	70.8
Non-residents' share	985.5	1, 366.0	3 ,489.6
Non-residents' share %	19.0	16.3	29.2

Source: ibid.

Table 4
Paid-up capital of offshore insurance industry in Labuan (US$)

	1995	*1996*
Total holdings	24, 346, 000	105,858, 000
Malaysian held share	23, 846, 000	104, 498, 000
Malaysian held share %	97.9	98.7
Foreign held share	500, 000	1, 360, 000
Foreign held share %	2.1	1.3

Source: ibid.

Like most tax havens, in order to be internationally competitive Labuan does operate a low tax regime. In fact, the regulatory authority claims that the present tax rates on the island are among the lowest in the world (LOFSA, 1999). While no tax is imposed on the income of offshore companies which are non-trading companies, those which are trading companies enjoy a low tax regime with a rate of only 3% of net income or RM20,000, whichever the company chooses to adopt. Furthermore, there is no tax on offshore companies carrying on offshore non-trading activities such as the holding of securities, shares, immovable properties, the taking of loans and placing of deposits; no withholding tax; no inheritance, death or estate taxes; and no stamp duty on offshore business transactions.

In addition, expatriate professionals and managers receive a 50% tax abatement, as do domestic companies dealing largely with offshore players such as trust companies and legal firms. Consequently, the corporation tax such companies have to pay is only 14%, as compared with 28% on the mainland. Among additional incentives there are a range of allowances for facilities including housing, and the island is a duty-free haven.

Another feature associated with tax havens is the principle of bank secrecy and the control of government/public disclosure of company information. While nearly all tax havens and OFCs provide some control on the disclosure of information, the principle of secrecy tends to be more closely adhered to in the former. This was not always the case, but in response to growing pressures for disclosure in the wake of financial scandals[13] and developed world initiatives against money laundering and unfair tax competition,[14] more established OFCs in such countries as Switzerland[15] and Austria[16] have become marginally more 'open' in their disclosure of information.

One consequence of the association of tax havens with secrecy is that in most people's minds they conjure up images of money laundering and criminal (usually drug-related) activities. Indeed, Naylor (1987) argues that practically every new centre of 'flight capital' has been the product of corrupt financiers. For instance, the emergence of the Bahamas as a financial centre, he contends, 'came in 1959, when Fidel Castro unseated one of Meyer Lansky's[17] principal business associates and closed the syndicate casinos and drug-trafficking facilities' (pp. 39-40). Today, although many jurisdictions have attempted to 'clean up' their act, laundered money, particularly from narcotics trafficking and fraud, remains a cause of concern for the United States and other developed countries.[18]

Again, from the inception of the Labuan IOFC the Malaysian government was determined that the centre would be strictly supervised, with applicants for trading licences closely vetted in order to ensure that the island did not become associated with illegal activities. It appears to have had considerable success, with entry to the IOFC limited to top-notch financial institutions and genuine investors; as one offshore banker dolefully commented, 'If you're not one of the top 200 banks in the world, they're not interested'.[19] By the end of 1998, for example, all of the top ten international banks had a presence in Labuan, while of the top twenty, eighteen were present (LOFSA, 1999).

As a matter of policy the regulatory body — LOFSA — imposes strict entry requirements and screening procedures to ensure that only 'fit and proper'

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13. For example the savings and investment scandal that shook the Isle of Man in 1982; the Barlow Clowes affair in Gibraltar, 1988; BCCI operating largely unregulated through holding companies in Luxembourg and the Cayman Islands until its liquidation in 1991.

14. For example, the Financial Action Task Force against money laundering set up by the Group of Seven (see Picciotto, 1999), and the United Nations Global Programme Against Money Laundering ('New attack on money laundering launched today', *Financial Times*, March 1999).

15. In 1998 influential Jewish groups in the US challenged the once sacrosanct principle of bank secrecy, exerting pressure on the Swiss government to reveal accounts and holdings of Nazi gold and other treasures acquired from Jews during the holocaust.

16. For example, on July 1996 Austria abolished anonymous securities trading.

17. Meyer Lansky was the infamous Miami-based Mafia boss.

18. The eastern Caribbean island of Antigua is regarded as a one of the most crime-ridden OFCs ('Antigua to sign legal treaty with the US', *Financial Times*, 4 November 1998.)

19. Interview, Labuan, August 1997.

persons are allowed to operate in the Labuan IOFC. For example, to be eligible for an offshore banking licence an applicant bank must meet the following criteria:

- It must be a well established bank of international standing. A regional or domestic bank must have a minimum of shareholders' funds of US $500 million, while an international bank must have funds of US $1 bn.

- The bank must be accorded a good credit rating by Moody's Investors Services, Standard and Poor's Corporation, or another established credit rating agency.

- It must have a good track record of financial performance, especially in the three years preceding the application for a licence.

- It must have the necessary expertise in international finance and foreign exchange.

- It must not have received any adverse report or announcement in financial journals or newspapers or any other reliable source.

- It must be supervised by a strong home statutory authority.

- It must have the support of the home monetary authority for its proposal to conduct offshore banking business in Labuan.

Furthermore, to try and prevent Labuan becoming a haven for laundered money, LOFSA also demands background information on bank directors and 'character' references for trust companies[20] and has sought membership of several international regulatory organisations.[21] For example, in 1998 the IOFC was accepted as a member of the Offshore Group of Collective Investment Schemes Supervisors, the Offshore Group of Insurance Supervisors and the

20. This is to prevent abuses such as the infamous Sark 'lark'. Sark (one of the smallest of the Channel Islands) with a population of 575 is home to thousands of company directors! As a result of inadequate regulation residents of the islet sell their names as nominee directors to foreign companies whose true owners remain concealed. One resident, Philip Crowshaw, entered the *Guinness Book of Records* for holding approximately 2,300 directorships! (see 'Sark Lark attacked', *Financial Times*, 28 November 1997; 'Doors open to reveal the secret world of Britain's offshore tax havens', *The Independent*, 20 November 1998, and 'Lucrative larks in dodgers' paradise', *The Guardian*, 26 September 1998.)

21. Ironically, one analyst commented that such measures might negatively affect Labuan's ability to attract new clients ('Observer: Hot Stuff', *Financial Times*, 12 June 1998).

International Association of Insurance Supervisors. In addition, LOFSA expects to become a full member of the Offshore Group of Banking Supervisors (an organisation affiliated to the Basle-based Committee on Banking Supervision) and the International Organisation of Securities Commissions. Indeed, membership of such organisations places Labuan alongside more established 'respectable' IOFCs such as Guernsey and Jersey. Finally, to enhance the status and expertise of the regulatory body, most of its employees are either ex-central bank employees or are seconded from the Malaysian central bank (Bank Negara). This is significant, since many analysts argue that regulation poses problems for SIEs. In particular, the ability of SIEs to regulate the offshore sector effectively is often constrained by the lack of relevant professional and managerial expertise required for effective scrutiny and monitoring (see Fabri and Baldacchino, 1999:141-2).[22]

From the evidence presented in this section it would be unfair to categorise Labuan as a tax haven. Although the contribution of offshore finance to the island's GDP is 'notional', other aspects of the OFC do not adhere to Hampton's categorisation. Unlike even well established OFCs such as the Cayman Islands, all of Labuan's international banks have a physical presence; in addition, the OFC has branched out into a range of financial activities including trust management, while the creation of the regulatory body early in the centre's development stimulated its growth and reputation. As one interviewee remarked:

> Prior to 1996 the government's attitude and the guidelines to the industry were very unclear, in practice nothing was outlawed but there was a lack of clarity as to what this actually meant in practice. With the creation of LOFSA the Malaysian government got their act together, improving the legislative framework and guidelines and boosting investors' confidence in the centre.[23]

Consequently, while the OFC certainly has a competitive low tax regime the efforts made to ensure a strict regulatory environment warrant Labuan being considered a 'hard' OFC which compares favourably with OFCs such as Bermuda, Guernsey, Jersey, Hong Kong and Singapore.[24]

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22. Christensen and Hampton (1999a) argue that in extreme cases the lack of sufficient expertise to scrutinise the regulation of the industry can lead to the effective 'capture of the state' – a situation where the OFC may create a sectoral imbalance, with the state effectively becoming merely an agent of global finance capital (pp.166-91).

23. Unattributed interview, 18 August 1997.

24. For a discussion of the regulatory strengths of offshore financial centres see Le Marchant, 1999.

Competitive outbidding and niche markets

There is a growing perception that, in an era of globalisation and further liberalisation of the international economy, states or polities wishing to remain internationally competitive are driven to ensure that their regulatory environments are as accommodating as possible to capital (Hudson, 1998: 916). Capital is increasingly mobile but states are not, consequently the competition for investment funds for economic development becomes increasingly fierce. As I have argued elsewhere (Palan and Abbott, 1996: 141–64; Abbott, 1997), much of this competitive pressure is downward, towards an increasingly lax regulatory environment, or what Vogel (1995) has termed the 'Delaware' effect.[25]

Because tax havens and OFCs aim to attract arguably the most liquid forms of capital, fictitious capital and paper assets, and given the growing number of polities offering offshore financial services of various descriptions, one would expect that there is a very real danger of competitive outbidding between such centres. Furthermore, competitive outbidding itself risks eroding the potential of using offshore finance as a strategy of economic development, since in Hudson's words, 'as the centres strive to create themselves as more attractive to offshore financial activity they end up undercutting each other offering looser and looser regulatory environments' (Hudson, 1998: 922).

Interviews with trust managers in Labuan suggested that there is already evidence that such competitive outbidding has begun in the Asia-Pacific region. Since the early 1990s, Singapore has allowed a limited number of companies to enjoy a tax abatement that effectively ensures that they pay corporation tax at a meagre 10%. In Malaysia by contrast, tax on company income stood until recently at 30% on the mainland, or 15% in Labuan because of the 50% abatement available to certain trust and other firms. There has been increased pressure from trusts in Labuan to reduce taxation in the IOFC further. In response, the Malaysian government announced that any company primarily engaged in business activities with offshore companies or banks in Labuan would be eligible for a 65% tax deduction, effectively reducing corporation tax for such companies to a more competitive 10.5%. More recently corporation tax as a whole has been reduced to 28%, effectively making Labuan more competitive than Singapore with a rate of 9.8%.

In addition, over the past decade the number of jurisdictions in the Asia-Pacific region offering a variety of offshore facilities has grown, thereby increasing the possibility of fiscal and regulatory competition between sites. Following the withdrawal of US military forces from Subic Bay Naval Base in

25. The term refers to the success of the US state of Delaware in attracting corporate business by creating a lax regulatory environment.

1992, the Philippines government has begun to develop the facility into an International Offshore Financial Centre and Export Processing Zone. Furthermore, a growing number of South Pacific islands are either launching OFCs or are engaging in internet related banking and other services; to date these include the Cook Islands, Nauru, Niue, Tuvalu and Western Samoa.

Despite such developments, LOFSA stresses that, rather than engaging in competitive outbidding, it aims to avoid such pressures by carving a niche for itself in the international financial market.[26] One such niche is as a 'clean', closely supervised, and fully functional OFC; hence the concern from the centre's inception to ensure that it does not attract funds from illicit sources. Another important niche targeted for Labuan is to turn the IOFC into a centre of expertise in competitive Islamic offshore financial products such as Islamic financing, Islamic investment funds and Islamic capital market instruments. To this end efforts have been made to admit completely Islamic banks into Labuan as well as specialised management companies providing advisory services and consultancies in offshore Islamic instruments. Such steps are likely to be successful as they are a logical extension of the development of Islamic banking, insurance services and capital market instruments in the 'onshore' Malaysian financial sector.

Labuan's attempt to find a particular niche for itself is part of an increasing trend among OFCs. Indeed, despite the fluidity of international financial markets and the growing number of jurisdictions offering offshore services, there has not been the competitive outbidding between sites that many expected, apart from a few minor exceptions. As well as the growing differentiation between offshore financial centres, since the 1970s many states have devised specific arrangements for the avoidance of regulations other than just taxation. Among other types of low regulation environments, the most significant are Flags of Convenience, and in particular Export Processing Zones.[27] Indeed, several OFCs, such as Namibia, now offer a combination of offshore regulatory environments as part of a package explicitly designed to attract new business.[28]

In addition, the internet is already offering new opportunities for the extension of the principles behind OFCs. Although not an OFC as such, the tiny

26. Interview with Ahmad Hizzad Baharuddin, Manager, LOFSA, August 1997.

27. Export Processing Zones (EPZs) are effectively areas in which the domestic legal framework does not apply for manufactured goods produced solely for export. Within such zones goods can be imported duty-free, while concessions may also apply as regards trade union rights and health and safety legislation. In addition, factories may be provided at low-cost rents, etc. (see Abbott, 1997).

28. In 1995 Namibia passed legislation creating both a designated EPZ at Walvis Bay and allowing for the creation of EPZ factories across the country as a whole. Three years later it was decided to create a complementary OFC since 'EPZ manufacturers and other foreign investors require offshore banking facilities' (Styger et al., 1999: 244).

island of Tuvalu (population approx. 9,000) has hired a Canadian company to market its internet domain name as an internet brand. By chance Tuvalu's international domain name is .tv, consequently '.TV Corporation' is attempting to persuade media moguls to purchase .tv sites such as *kids.tv*, available for $1,000 with an annual renewal fee of $500.

Another potential growth area offered to SIEs by the development of the internet is internet gambling. Already internet gambling revenues in the United States are estimated at $470 million, with some forecasts predicting this will climb to over $7 bn by 2002. Seizing this new 'niche', SIEs such as St Kitts, Antigua and Curacao have offered internet companies tax-free status in return for licensing fees of approximately $100,000, while in Europe UK bookmakers have begun offering internet betting from the Isle of Man and Gibraltar in order to overcome betting duty of 6.75%.[29] The logical extension of such developments is that perhaps in the future 'offshore shoppers will be able to avoid paying local taxes by purchasing goods in "offshore shops" using offshore coupons' (Palan, 1999: 18).

Conclusion

To what extent is the creation of an OFC a suitable development policy for SIEs such as Labuan? On the one hand, the proliferation of OFCs worldwide is indicative of the continuing growth of offshore finance itself. Estimates suggest that international private banking wealth already exceeds $11 trillion (Timewell, 1995: 56), while more and more industries are seeking ways to avoid taxation in their home country. Furthermore, creating and hosting an OFC is relatively inexpensive as a development strategy. The benefits it brings include: increased government revenue from licence and incorporation fees; the stimulative effect of the operating expenditure of OFC firms in the local economy; direct employment of locals in the financial sector; and the forging of forward and backward linkages to other sectors such as hotels, restaurants, office suppliers, construction, etc. Indeed, from an orthodox economic perspective the lack of resources and market size necessitates SIEs adopting a liberal approach to foreign capital. In addition, the development of OFCs by SIEs is in many cases merely a natural consequence of the principle of comparative advantage. In this case the comparative advantages would be political stability, a well educated labour force and proximity to major industrial economies.

As a result of the promotion of Labuan as an OFC there has been rapid growth in the offshore financial services industry, employment has been

29. See 'Survey – Electronic Business: Virtual chips, real stakes: Many casinos are licensed offshore', *Financial Times*, 24 March 1999.

generated, the island's infrastructure has been upgraded and its leisure and recreational facilities improved. While Labuan has a long way to go before it is on a par with more established OFCs, one must bear in mind that its OFC has been in operation for only nine years.

Nonetheless, outside of centres such as the Channel Islands, the Isle of Man and a few of the Carribbean havens, offshore services appear to make a relatively small contribution to both GDP and employment.[30] Moreover, OFCs can incur significant costs for SIEs, including: the cost of creating or upgrading the economic infrastructure; the regulation of the centre (a task that may require foreign employees because of a lack of skilled and experienced personnel); limited employment prospects; and the possibility that investment in the financial sector may crowd out opportunities in other sectors.

Arguably of greater concern is that the SIE may become over-reliant, or indeed dependent, upon highly mobile international finance capital. Since 1992 the world has witnessed a long list of economies and government policies wrecked by speculation and capital flight, from the Exchange Rate Mechanism debacle that forced the UK government to take sterling out of Europe's fixed exchange rate system at a cost of $10 bn of foreign currency reserves to the Asian economic crisis of 1997-8. In such circumstances confidence and trust in the host state become crucial to maintaining the success of the OFC. One banking scandal, and investment could be relocated almost instantly with devastating consequences. As Christopher Le Marchant, a member of the Guernsey Financial Services Commission, argues,

> In many respects offshore supervision is more strict than its onshore counterpart... Offshore centres which value their good reputation have to be highly selective in their entry criteria for new business. Scandals and failures onshore are high-profile media events.. but it is seldom suggested that because these events occur in a particular onshore centre (such as London or New York) these centres are reprehensible and should at least not be trusted and preferably closed down. However, if scandals (invariably of smaller scale) occur offshore.. the centre involved is lambasted in the press and declared to be unsafe (1999: 220).

The Bahamas, for example, lost a lot of business in the 1970s as a result of negative publicity concerning alleged drug-trafficking and corruption. Consequently, it slipped from being the third largest international banking

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30. To some extent the indirect impact of the financial services sector in SIEs could be more significant, since the industry is closely linked with international tourism. Indeed, as I have argued elsewhere, successful tax havens effectively use their facilities as a form of tourist attraction since among the clients such centres attract are high net worth individuals with money not only to invest but also to spend (Palan and Abbott, 1996: 177-8).

centre to the eleventh by the end of the 1980s (Palan and Abbott, 1996).[31] Nonetheless, avoiding corruption and laundered money can be difficult for such SIEs, since

> the opening up of a small territory to the influence of powerful agents such as international banks and TNCs may bring opportunities for corruption and fraud... [since] in many small territories with a relatively small number of government officials and politicians the checks and balances are perhaps less developed and there is a greater possibility of serious damage (Hampton, 1996c: 310–11).

While capital flight and corruption are a concern for all OFCs, Labuan's position as a federal territory of Malaysia provides some degree of assurance against such concerns, and against corruption in particular. Despite operational autonomy, legislative and executive powers remain the preserve of the Malaysian government, unlike the situation in both the Channel Islands and the UK Overseas Territories.

Overall, there are few developmental choices available to SIEs. While the creation of an OFC may make the economy dependent upon external capital and exogenous agents, the aim of governments and regulators must be to manage the dependent relationship in such a way as to maximise the developmental gains (Baldacchino, 1993). In Labuan's case, while the island may not be a 'treasure island', despite the Asian crisis the government and bankers are optimistic that, as a long-term strategy, 'in ten to twenty years time Labuan will have developed into a mature IOFC with a niche in quality and tight supervision'.[32]

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31. Hanzawa, 1991, ranked the Bahamas 11th in a list of the world's leading international (onshore and offshore) banking centres. See p. 284).

32. Unattributable interview, banking sector, Labuan, August 1997.

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