

The Bark *is* the Bite: International Organizations and Blacklisting

Abstract:

This article argues that public blacklisting by international organizations can be an effective means of bringing about compliance in otherwise recalcitrant states. This contention is examined in light of overlapping campaigns by the Organization for Economic Co-operation and Development and the Financial Action Task Force to pressure targeted states to adopt costly financial reforms. In a constructivist vein, blacklisting is held to be a form of speech act that changed the world by damaging states' reputations among investors, and thus produced pressure to comply through actual or anticipated capital flight. To be removed from blacklists, thereby preventing future economic damage, those targeted have had to comply with stringent regulatory standards mandated by these international organizations. Evidence is taken from interviews, press accounts, official documents and quantitative data relating to seven affected tax havens as well as Austria and Switzerland.

Key Words:

International organizations, tax havens, constructivism, regulation, speech acts, reputation

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How can international organizations induce unwilling compliance from reluctant states without the threat or use of material sanctions? This quandary has arisen in a particularly stark form for those international organizations tasked with inducing states to reform their tax and financial laws and regulations in line with new global standards. From 1998 the Organization for Economic Co-operation and Development (OECD) has sought to tackle “harmful tax competition,” as practised by member states but especially by a group of 41 non-member tax havens. The Financial Action Task Force (FATF) has sought to combat financial secrecy in offshore and onshore centers vulnerable to being used by money launderers. Both organizations have attempted to pressure states into regulatory reform by publicly blacklisting those judged to be non-compliant with new standards.

Many scholars and observers of international relations hold that talk is cheap. With direct reference to the tax competition campaign, the *Economist* notes: “Few countries wish to end up on the OECD blacklist, but the group’s bark might be much worse than its bite. It has no legal authority, and can only issue recommendations” (27 February 2002). The assumption is that blacklists by themselves, unsupported by sanctions or binding legal decisions, are ineffectual. Yet this article finds the opposite: blacklisting has indeed been an effective means of applying compliance pressure to tax havens and other states. As such, blacklisting is very different from the consensual processes of socialization or reasoned debate that non-realist studies of international organizations have explored. The primary goal of the argument is to show how blacklisting can be an effective stick with which international organizations can threaten and beat

states to effect policy change. To this end, the article explores the processes by which international organizations' speech acts can result in (grudging) state compliance. In line with recent calls for empirically-focused synthetic studies of international organizations, this article deliberately positions itself in the "gray area" between rationalism and constructivism. It combines an emphasis on language and identity with an account based on materially-derived preferences and strategic interaction (Tierney and Weaver, 2004: 3, 13). It presents a hybrid constructivist-rationalist answer to the question "why comply?" Furthermore, this study aims to in part remedy the lack of attention given to the role of international organizations in policy implementation (Joachim et al., 2008). Finally, it responds to recent calls to employ broader notions of power in global governance, especially discursive power (Barnet and Duvall, 2005).

Blacklisting generates compliance by one of two related causal mechanisms. Either decision-makers in targeted jurisdictions observe and then react to material economic losses resulting from the reputational damage caused by blacklisting (reactive compliance). Or, they anticipate material economic losses from being blacklisted and thus comply to pre-empt this damage (pre-emptive compliance). The result is the same, in that the reforms mandated by the international organization are implemented, but the pathways are distinct. In all but one instance examined in this article (see Table 1), and in 38 of 41 cases for the OECD initiative and all 23 for the FATF, the actual or anticipated negative consequences of blacklisting have been sufficient to induce compliance with international organizations' demands. The argument for the effectiveness of blacklisting can be extended further by comparing the experiences of two much larger states:

Austria and Switzerland. While Austria was forced to reform banking laws after being blacklisted by the FATF, Switzerland has stayed off the lists and thus managed to keep its financial secrecy substantially intact.

Different intervening variables distinguish the two paths to the dependent variable (compliance): the experience of actual material loss for reactive compliance, and the anticipation of such for pre-emptive compliance. Which path is followed can be explained by the nature of the financial sector. When targeted jurisdictions rely on high profile, institutional business particularly sensitive to reputation they opted for pre-emptive compliance. But those that depend on secretive private client banking, trusts and companies were somewhat less concerned with reputational issues and instead complied only as a reaction to disinvestment and material economic losses.

The research design includes variation on the dependent variable (compliance versus non-compliance) with regards to Liechtenstein and Switzerland. Liechtenstein has refused to adopt OECD demands relating to tax information exchange, despite being blacklisted. Even in this case, however, blacklisting has been effective in damaging the Principality's reputation as an investment destination and has caused financial losses. But the government has decided that the costs of reform would be even greater than the costs of continued defiance; it is not a case of blacklisting merely being empty rhetoric. The case selection also includes variation on the independent variable. In contrasting the Swiss and Austrian experiences the aim is to show that regulatory compliance results from blacklisting, and is not an artefact of size or membership of

the international organizations in question. Austria and Switzerland have very similar populations and economic size and are both members of the OECD and FATF. Both countries were in violation of international financial and fiscal standards. Austria was blacklisted and forced to comply. Switzerland has not been blacklisted and thus has not complied.

Understanding the effectiveness of blacklisting in generating reactive and (especially) pre-emptive compliance is crucially dependent on the perceptions of those in blacklisted jurisdictions. In terms of reactive compliance, the opinion of those in targeted jurisdictions avoids the problem of having to isolate the actual causal effect of individual blacklists from such other factors as cyclical changes in the world economy, or unrelated corporate re-structuring. But emphasizing perceptions is a methodological virtue rather than just a necessity. If targeted jurisdictions are ignorant of damage resulting from blacklisting this will not create any pressure to reform. Conversely, if those targeted mistakenly attribute a decline in business to the effect of the listing, then the blacklist will have been effective regardless of the material consequences. The role of perceptions in targeted jurisdictions is even more important with reference to pre-emptive compliance. Here by definition there is no material economic damage to observe. Some jurisdictions experienced no actual reduction in business despite being blacklisted, but nevertheless introduced the reforms demanded. This decision reflected a desire to avoid future costs decision makers believed would result if their jurisdictions were to remain blacklisted. Thus relying solely on economic data gives a considerably under-stated picture of the pressure generated by blacklists. To get at these perceptions, evidence is drawn from material on the

public record, but also “triangulated” with evidence from confidential interviews with representatives from both government and the financial sector in the Cayman Islands, the Isle of Man, Mauritius, St Kitts and Nevis, Vanuatu, the Cook Islands, Liechtenstein and Austria as well as officials from the OECD and FATF.

After providing some background on the compilation of the blacklists, the article is broken into three parts. The first outlines the notion of speech acts, of which blacklisting is an example. Speech acts are statements that do not describe an action, but rather constitute actions in and of themselves, merely by having been performed. In this context blacklisting has constitutive and causal effects in generating new social kinds (Wendt, 1998), a means by which international organizations in many areas wield influence (Barnett and Finnemore, 2004). The second part moves to bridge the gap between the realm of speech and institutional facts. It traces the logic of just how blacklists damage tax havens’ reputations in the eyes of governments and investors. The third part matches the observable implications of my argument with independent streams of evidence (confidential interviews and publicly available data) to trace the effects of blacklisting. The experience of the ‘pre-emptive compliers’ (the Cayman Islands, the Isle of Man and Mauritius) is compared with the “reactive compliers” (St Kitts and Nevis, Vanuatu and the Cook Islands). This section then examines a case of non-compliance, Liechtenstein versus the OECD. Finally, broadening the coverage beyond small tax havens, the article contrasts the experiences of Austria, forced into compliance with FATF demands after being publicly named as non-compliant, and Switzerland, still not blacklisted and still not compliant.

*****TABLE ONE ABOUT HERE*****

Background

Both the OECD and FATF settled on blacklisting to deliver state compliance after becoming frustrated with the lack of interest shown by non-member tax havens and some members in regulatory reform. Because the defining metaphor was of the system being only as strong as its weakest link, there was a feeling that the efforts of those complying were to some extent wasted as long as others failed to follow suit, or even counter-productive if higher standards led to capital being moved to non-compliant states (Author's interviews, FATF and OECD officials, Paris, France, June 2004). There was a desire for more robust measures than the traditional approaches of dialogue, "seminar diplomacy," issuing guidelines and codes of best practice (Wechsler, 2001). Publicly branding non-members as derelict in their tax and money laundering standards would mark a break with prior practice in its confrontational character. But it promised a more direct approach without the need for any additional authorization (for the international organizations) or expense (for member states) associated with applying economic sanctions. Because co-ordinated blacklisting was untested, neither the FATF or the OECD quite knew what to expect in advance (Author's interviews, OECD and FATF officials, Paris, France, June 2004; US Treasury official by phone October 2002).

Discussions of how to pressure non-members to improve their anti-money laundering

laws had begun almost from the founding of the FATF in 1990 (Helleiner, 2000). By the end of the decade these had born fruit as the process of compiling a “Non-Co-operative Countries or Territories” (NCCT) list began in September 1999. Four regional review groupings (Americas, Asia-Pacific, Europe, and Africa and the Middle East) evaluated 29 non-member jurisdictions against FATF standards, releasing a list of 15 jurisdictions which failed to measure up. Further jurisdictions were added in 2001 and 2002. De-listing was conditional on the introduction and implementation of new regulations to the satisfaction of an FATF assessment group, with the decision formalised in a plenary meeting. For those on the list ‘the FATF recommends that financial institutions should give special attention to business transactions and relations with persons, including and companies financial institutions’ from listed jurisdictions (FATF, 2001: 18).

A 1998 OECD report on the issue of “harmful tax competition” similarly called for a list of tax havens to be drawn up by the new Forum on Harmful Tax Practices. Forty-seven jurisdictions were evaluated on the basis of public sources, member opinions and advice from the secretariat. The criteria for being judged as a tax haven were having no or low taxation, no information exchange with foreign authorities, a lack of transparency concerning tax and financial regulations, and hosting foreign entities that did not engage in “substantial” activity and were granted special concessions not available to domestic investors (OECD, 1998; Webb, 2004). Of the 47 jurisdictions surveyed, six did not fit the criteria. Six more (including the Cayman Islands and Mauritius, see below) made hasty “advance commitments” to reform their

regulations in line with OECD demands a week before the list was published. The remaining 35 were listed as tax havens, and threatened with the possibility of inclusion on an “even blacker list” of “Unco-operative Tax Havens” if they did not commit to financial and tax reforms (Doggart, 2002: 152). At the time of writing, only three jurisdictions are holding out (Andorra, Monaco and Liechtenstein), still listed as “Unco-operative Tax Havens” (OECD, 1998, 2000a, 2001, 2006).

Money laundering (disguising the illicit origins of criminals’ profits) and tax evasion (illegal under-payment of tax owed, in contrast to legal tax avoidance) are separate crimes. But despite combating “harmful” tax competition and tax evasion (the OECD) and money laundering (the FATF) being distinct enterprises, both organizations have demanded very similar reforms. One OECD official noted that once jurisdictions had complied with the FATF they had done ninety percent of what the OECD expected of them (Author’s interview with OECD official, Paris, France, June 2004). At their most simple, these reforms amount to collecting more information about investors, and being more willing to share this information with foreign authorities. Supervisory authorities must now practise due diligence and “know your customer” to identify the beneficial owner behind any particular financial vehicle, and are required to keep a record of “suspicious transactions.” This information must then be provided on request to foreign law enforcement bodies, and increasingly to foreign tax authorities as well.

The new standards impose major costs on tax havens. The reforms have involved direct costs as governments and firms have had to hire more people to collect and disseminate financial

information. Indirect costs are incurred as the selling points of these investment destinations, most notably secrecy provisions and light regulatory requirements, have been watered down, threatening new and existing business. Thus a 2001 IMF discussion paper notes that tax havens “in the [Pacific] region—as those elsewhere—will on the one hand face very substantial costs related to the unavoidable upgrading of their legal and enforcement systems while at the same time facing the prospect of a sharp decline in the number of their customers, as well as the income from licence fees and/or other revenue related to offshore activities” (IMF, 2001: 10). A report for the British overseas aid agency notes: “Improving supervision and regulation almost always requires more financial resources, whether for people, technology or both.... changes demanded from tax havens may involve Caribbean countries... in heavy costs” (Doggart, 2001: 13). Furthermore, neither the OECD nor the FATF have offered to defray these compliance costs or extend any compensation. Levin (2002: 59), notes tax havens “face a huge risk to their reputation if they do not comply, yet conversely, there is today little reward for compliance” while Doggart (2001: 13) concurs: “there are no rewards for ‘good’ behaviour.” Both the OECD and the FATF have relied on blacklisting to deliver compliance.

Speech Acts and Institutional Facts

In contrast to views that establish a strict separation between words and actions, is the work of J.L. Austin and John Searle. Austin begins by outlining the shortcomings of the view that language is just there to report facts and describe things. In addition to these roles, Austin

looks at utterances which he terms “speech acts.” Examples of such include promising, warning and apologizing. These are instances of “performative utterances,” in that by saying something the speaker is actually doing something, performing an action (Austin, 1975: 1-11). For Austin, these performatives are restricted in that they must be said in the right way, in the right circumstances, by the right person. Thus only for certain people in certain contexts in front of a certain kind of person does the statement “I do” count as getting married.

Following Austin, Searle creates a typology of speech acts, of which the class of “declarations” is particularly relevant to the practice of blacklisting by international organizations. The defining feature of declarations is that “the state of affairs represented by the propositional content of the speech act is brought into existence by the successful performance of that speech act” (Searle, 1995: 34). This may occur when a referee pronounces a player offside or a jury foreman declares a defendant guilty (Austin, 1975: 151-163). These utterances do not report on or describe whether a person is offside or guilty but instead they are acts of *making* that person offside or guilty. In the same way, blacklisting a person or country brings about a change in the condition of that referent solely by virtue of the blacklist having been published. A jurisdiction becomes blacklisted (whether fairly or unfairly, accurately or not), and by that action alone its reputation is changed. Thus rather than the declaration being a description, or a signal for an action that will change some part of the world, it *is* an action that changes some part of the world.

Searle analyses how speech acts can create “institutional facts” (facts which exist because

we collectively believe them to) via the equation “X counts as Y in context C” (Searle, 1995). Thus, returning to the wedding example, saying ‘I do’ (X term) counts as getting married (Y term) before an official with the proper authority (the C term). Marriage is an institutional fact that changes the status of those party to it. This change in status only occurs because of collective acceptance of the official as the proper authority, the institution (marriage) and the status it confers (husband or wife). Bringing this logic to the matter at hand, the equation might be as follows: saying “Liechtenstein is a tax haven” (the X term) counts as being blacklisted (the Y term) when part of an official OECD report (the C term). In turn, by collective acceptance appearing on a blacklist (the institution) changes how a country is perceived by others (reputation or status), making it a deviant and unattractive investment destination, while the OECD’s authority to successfully carry out such a performative also depends on collective acceptance. It is not a case of international organizations applying classifications in line with an already-existing reality, but international organizations shaping reality by their classifications, or, to use Barnett and Finnemore’s term, using “social construction power” (Barnett and Finnemore, 2004: 7).

It is worth establishing how this type of classificatory “social construction power” is different from rationalist accounts. Going back to first premises, blacklisting as a declarative is a self-contained action (speech act) sufficient to produce a new institutional facts. The speech is the action, the bark is the bite. A rationalist view tends to see the bark as noise or a signal, and then look around for a separate bite, the “real” action. This view that imposes such a separation

between words and action fundamentally miscues analysis of the way blacklists work. As useful as it is for understanding the material stakes of the conflict and the play of strategic interaction in generating compliance, a purely rationalist approach poses the wrong questions about blacklisting: What action is this declaration a signal for? What new information does this declaration communicate? These questions miss the point (Barnett and Duvall, 2005).

Speech acts and “social construction power” certainly can have material consequences; classifications can be a matter of life and death. The negative social status constituted by a speech act (such as that of condemned criminal) may well have economic effects. Being publicly labelled a child-molester could well jeopardize one’s job and finances. But the financial damage is secondary and derivative of the change in status effected by the accusation, the speech act. To reduce stigma to a simple dollars and cents proposition is to mistake a fundamentally social problem for an economic one.

Tax Havens, Reputation and Blacklisting

Conceptually, reputation plays a key role in the explanation presented, acting as an intervening variable between blacklisting and compliance. An IMF report on offshore centers notes: “it is most likely that the major competitive factor in the current international environment is a country’s established reputation” (IMF, 2002: 18). Jurisdictions with more established financial centers obsessively cultivate their image as

secure and stable investment destinations, and as a direct consequence are able to attract a greater volume of more lucrative business. The Caymans Islands has marketed itself with the slogan “Reputation is our most important asset” (Hudson, 1998: 928). After dozens of interviews Hudson reports that “reputation” was the most often used word by his informants in the Caymans and Bahamas in discussing selling points for a particular location. While successfully cultivating a favorable image pays dividends, it also leaves countries very vulnerable to scandals or adverse publicity. The extreme sensitivity in relation to reputation is evidenced by the ‘Grisham effect’ with reference to the Cayman Islands, whereby the government felt moved to issue an official refutation of John Grisham’s popular novel *The Firm*, dealing with a nefarious law practice based in the Caymans.

Blacklisting by the OECD and FATF damaged reputations as it reverberated on two levels: states and financial intermediaries. As noted above, being named as a “tax haven” or “unco-operative tax haven” by the OECD or being placed on the NCCT list did not create any obligations under international law, nor under the domestic laws of member states. Yet in practice these blacklists were rapidly reproduced among member and non-member states. Thus when St Kitts and Nevis, the Cayman Islands, the Cook Islands and Liechtenstein were blacklisted by the FATF in June 2000, the United States Financial Crimes Enforcement Network (FinCEN) issued advisories against all four the following month, each of which was only withdrawn after FATF de-listing. Other countries, both members and non-members, have often

issued similar advisories in line with FATF listing. The OECD 2000 list of tax havens has been incorporated in national blacklists in countries including Argentina, Australia, Brazil, France, Italy, Mexico, Peru, Portugal, Spain, Venezuela and the United States. These countries have often neglected or refused to remove those jurisdictions that later made commitments to the OECD (Sharman and Rawlings, 2005).

The reputational effects of blacklisting have also reverberated via financial intermediaries like accountancy, insurance, banking and legal firms. These private actors may have been taking their cue directly from international organizations, or indirectly from national governments re-broadcasting these listings. Large multinational financial services firms maintain their own informal blacklists and methodologies for practising due diligence, keen to preserve their reputations. Some foreign financial service firms have withdrawn from particular blacklisted jurisdictions rather than be tainted by association and suffer a decline in share prices. Once particular jurisdictions are listed they may be placed as key terms on privately produced anti-money laundering software, designed to raise red flags and trigger enhanced scrutiny. Particularly with regards to wire transfer and correspondent banking, this means that transactions are slowed, and banks and other financial intermediaries have to spend resources applying extra scrutiny. Firms may simply refuse to process transactions from listed jurisdictions as such transactions become more trouble than they are worth. And like many national lists, jurisdictions may not be removed from private lists even after being given a clean bill of health by the relevant international organization.

As the blacklists reverberated at each level they threatened to constrict the flow of new investment, and precipitate capital flight, in turn causing a decline in government revenue and general economic activity. Being on a blacklist is also costly for jurisdictions because of the enormous amounts of time and energy of legislators, bureaucrats and business leaders that are taken up with efforts to get off the list, rather than market the jurisdiction or design new products. Finally, to the extent that correspondent banking relationships and wire transfers were attenuated or severed by risk-averse firms onshore, blacklisting threatened to wreck not just the offshore sector, but also every other internationally-connected sector as well, from tourism to remittances from citizens working abroad.

Why Two Paths to Compliance?

Looking at six tax havens, it may seem puzzling that there was a common level of compliance among two different groups of targeted states: those that suffered material loss due to being blacklisted and those that did not. Why would countries that suffered no material loss as a result of international organization blacklisting nevertheless acquiesce to costly reforms mandated by these organizations? For these two groups different causal mechanisms intermediated between blacklisting and compliance. The key difference was the nature of the financial sector. Those that reacted to damage after the fact (reactive compliance) rely on private clients that generate “brass plate” rather than substantive activity, where the most important feature is probably secrecy. Those jurisdictions that complied in advance of material loss (pre-

emptive compliance) rely on institutional clients that generate substantive activity and where a greater attraction is the concentration of financial professionals. Institutional business involves a public link with a particular jurisdiction, known to the community, and is thus more vulnerable to the play of social sentiments like reputation. The predominant rationale for private client business is to form a link with a jurisdiction that should be known only to the individual private client and the financial service provider. As such, the sentiment of the community and reputation are less important.

Compared with private client business, institutional business is more complex. It generates more substantive economic activity, and is thus more public, but also more lucrative. Such business may involve captive insurance arrangements, collective investment schemes like pension funds, real estate investment trusts, mutual funds, hedge funds and special purpose vehicles (Doggart, 2002). These forms are not merely a matter of selling a convenient legal address for assets and activities practically located elsewhere. Instead, they demand a team of highly-skilled (and remunerated) financial professionals on site. Because such expertise is concentrated, this entails an institutional relationship with large international banks, accountancy firms and legal practices. In turn, this involves a public link with the jurisdiction in question. The institutions that sell complex financial products are under legal requirements to make public their activities to their shareholders and their home-country regulators onshore. Because complex financial products are often bought by large publicly listed firms, these too must disclose their activities to shareholders and onshore regulators, including links with tax haven jurisdictions.

Private client business is generally used for tax minimization and asset protection purposes. Perhaps the simplest way of achieving these ends is to deposit money outside one's country of residence in a secret bank account. Probably the most common product with which tax havens seek to attract foreign investors is the International Business Company (IBC), which can be formed on line for as little as a few hundred dollars. One of the main attractions of IBCs is the ability to keep assets and income hidden from creditors and/or tax authorities. Offshore Asset Protection Trusts often fulfil the same function. Those setting up such trusts have had to provide little information as to their beneficiaries, and private and public officials that reveal this information have been subject to criminal prosecution. These products typically involve little or no physical presence and few jobs.

The distinction between jurisdictions based on non-resident private client business and those relying on institutional business should not be overstated. Nevertheless, after assessing 33 offshore financial centers, the IMF makes this same binary distinction, and emphasises that those centers dealing with large, institutional clients are particularly concerned with their reputations (Darbar et al., 2003, 35). Supporting this distinction with regards to the current sample of cases, all of the 'big four' accounting firms (PriceWaterhouse Coopers, Deloitte Touche Tomahatsu, Ernst & Young and KPMG) have offices in each of the three jurisdictions taking the pre-emptive route, but not one of the four has an office in those following the reactive path. Any one of the Cayman Islands, the Isle of Man or Mauritius has vastly more institutional business and substantive business presence than the combined total of the Cook Islands, St Kitts and Nevis

and Vanuatu.

Before presenting the detailed empirical findings below, it is worth spelling out the observable implications of the argument presented so far. The key empirical differences between the path of pre-emptive or anticipatory compliance and the path of reactive compliance relate to the duration of events, and the sequence of events. Jurisdictions with institutional business will comply with international organizations' demands quickly and thus will be blacklisted for a shorter time if at all. They will not wait to see evidence of economic losses before agreeing to reform. Jurisdictions with predominantly private client business will comply more slowly and thus will be blacklisted for a longer period. They will not agree to reform until they have seen evidence of economic losses.

*****TABLE 2 ABOUT HERE*****

Pre-emptive Compliance: The Cayman Islands, the Isle of Man and Mauritius

The Cayman Islands is home to hundreds of banks and financial service firms (Palan 2003). In June 2000 the government made an advance commitment to the OECD just before the Caymans would have been included on the list of tax havens. The week before the Islands had been classified by the FATF as unco-operative in the fight against money laundering. The OECD-mandated reforms reflected significant sacrifices. The government promised to work towards abolishing all special concessions to non-resident investors and business without a

“substantial presence.” It further agreed to exchange tax information on request with all OECD member states, at a time when very few of its major competitors had agreed to either concession. Interview data confirm that this decision to comply with OECD demands was motivated by concerns that, were the jurisdiction to appear on another blacklist in addition to the FATF, the financial sector could be seriously damaged. This was all the more so as the United States had followed the FATF’s lead in issuing an advisory to apply enhanced scrutiny to all transactions with the Caymans. In particular, worries about potential damage centered on the possibility that banks in New York might terminate their correspondence relationships with the Islands.

What was the effect of the NCCT list? There was no noticeable decline in the volume of investment in or business through the Caymans in the year it remained on the list. More importantly, interview material from the public and private sector indicates that the listing had no effect on existing business, and little or no effect on new business. To the contrary, the Caymans recorded steady or better growth in the creation of mutual funds, trust companies, banks, insurance companies and off balance sheet vehicles in the year to 1 October 2000 (Reuters, 28 October 2000). With this lack of economic pain, it might be assumed that the response to inclusion on the NCCT list was one of defiance, or indifference. In fact both the government and the private sector responded with alacrity. From July 2000 amended legislation allowed for more international information exchange and made Suspicious Transaction Reporting mandatory, while in August the government introduced new record-keeping requirements. Shortly thereafter the Cayman Islands Monetary Authority (CIMA) was expanded and made independent, a new

Cayman Islands Anti-Money Laundering Group was set up, and a thorough-going check of beneficial owners' identities was set in motion. The Cayman Islands Monetary Authority expanded from 48 people in 1998 to 90 in 2004 (CIMA, 1998: 15; Author's interview, CIMA official George Town, Cayman Islands, March 2004). Because of fierce price competition, rather than being able to pass these increased costs on to customers, the government and financial intermediaries have had to take on the extra cost, said in press accounts to range up to \$30 million (Cayman News Net, June 2001).

Given the lack of material damage caused by the FATF listing, why did the Caymans act so quickly and spare almost no expense, not only to comply with FATF standards, but to exceed them, especially once worries about correspondent banking relations had receded? Government officials point out that even if the listing had not done any damage by the time de-listing occurred in June 2001, this would have changed in the future if the Caymans had remained on the list. Those in the private sector also believed that in the medium- to long-term, continued blacklisting was not compatible with continued growth. The Caymans' success depends on its image as one of the world's leading financial centers, especially given its slogan ("Reputation is our most important asset"). Thus the jurisdiction's extreme sensitivity to reputational slurs, whether it be the OECD or FATF lists, or Grisham novels.

The Isle of Man was only just behind the Cayman Islands in committing to the OECD in December 2000. Again, interviewees in government and the financial services industry agree that the industry was continuing to grow in the six months that the jurisdiction was blacklisted,

particularly in the area of investment funds (see also *Isle of Man Financial Supervision Commission Annual Report 2000-2001*). Unlike the Cayman Islands, there was no pressure from the FATF, which had earlier given the island a clean bill of health. There is thus all the more reason to wonder why, in the absence of economic damage, the Isle of Man made an early commitment to the OECD, despite extensive misgivings about the wisdom and fairness of the initiative. Even before the June 2000 listing, the government had been coming to the conclusion that the new multilateral initiatives were segmenting the offshore world into two groups. One group would co-operate with initiatives like the OECD tax competition project, adopt expensive regulatory reforms, maintain a strong reputation, and survive. The other would resist the OECD and FATF, maintain a lax regulatory regime, suffer a decline in reputation, and probably be squeezed out of the market in the following decade (*Isle of Man Financial Supervision Commission Annual Report, 1999-2000; 2000-2001*; Author's interviews, FSC officials, Douglas, Isle of Man, January-February 2005). This kind of thinking was made public: "the Isle of Man's position in the offshore financial center sector depends on being perceived as meeting the 'international norm.' If some practices are widely seen as unhealthy and harmful, then the island will have to fall into line" (*Financial Times*, 15 July 1999). After committing to the OECD, the Manx Financial Supervision Commission confirmed the importance of being delisted: "A major uncertainty was... removed when the OECD confirmed that the steps to be taken by the Island would be sufficient to insure that it will not be included in any list of unco-operative jurisdictions" (*Isle of Man Financial Supervision Commission Annual Report, 2000-*

2001: 4).

Like the Cayman Islands, Mauritius made an advance commitment to the OECD in June 2000. But, like the Isle of Man, this choice was not affected by concerns about the FATF. Rather than private client business, the Mauritian offshore sector acts as a conduit for foreign investment flowing from the outside world into India. Firms can take advantage of the tax treaty between the two countries to repatriate profits via Mauritius to their home country, tax-free. This route has been so successful that from 1994 more foreign investment in India has come from (or more accurately, though) Mauritius than any other country (*Offshore Investment*, October 2002). In this context, reputation is seen as crucial for the success of the jurisdiction; “Your reputation is all you’ve got” as one member of the offshore industry put it to the author. This is because the firms investing in India through Mauritius are typically large, publicly listed companies. In 2000 the government was determined not to jeopardize this institutional business by ending up on the OECD’s list. Harking back to Manx thinking on the subject, one official’s comment about the advance commitment sums up the attitude of all those who opted for pre-emptive compliance: “The writing was on the wall. We just read it sooner than others” (Author’s interview, FSC official, Port Louis, Mauritius, June 2005).

Reactive Compliance: St Kitts and Nevis, Vanuatu and the Cook Islands

After being included on the FATF blacklist in June 2000, the government of St Kitts and Nevis denounced the initiative as a “sinister plot” which it would oppose (Johnson, 2001: 214).

The same attitude was in evidence toward the OECD. In 2000 and 2001 crucial figures in government and the private sector calculated that they could afford to ride out the OECD and FATF campaigns, rather than suffer the direct and indirect costs of the reforms demanded (Author's interview, government official, Basseterre, St Kitts and Nevis, January 2004). After seeing the economic damage caused by blacklisting, however, the reforms came to be judged as the cheaper option, and thus in 2002 St Kitts and Nevis backed down and complied with both initiatives.

Blacklisting by the FATF was followed by advisories, explicitly premised on this listing, issued by the United States, Canada and other OECD countries. Acting on the basis of the OECD list, some US banks refused to recognise entities incorporated in the country. After eight months on the blacklists, new incorporations had fallen off by approximately half, and customers complained about the taint to their reputation as a result of dealing with a blacklisted jurisdiction. The drop in confidence among clients is further reflected in the absolute decline in the number of IBCs and trusts, from 17,500 and 3000 in 1999 to 13,500 and 950 respectively in 2003 (Doggart, 2001: 24; State Department 2004). In 2001-02 the government came to the conclusion that to remain on either or both the OECD or FATF lists would be to endanger the continued survival of the offshore financial sector. The Premier of Nevis noted: "the listings by the FATF and the OECD posed severe challenges to the survival of the [offshore financial] sector" (http://www.nevisfinance.com/announce_detail.cfm?id=49). Just before de-listing by the FATF the Prime Minister spoke of the "massive threat to our economic survival" posed by blacklisting,

particularly as relating to correspondent banking: “The impact of blacklisting goes well beyond the offshore financial sector... No foreign investor would want to invest in a hotel, manufacturing or other real sector project in a country that does not have the capacity to facilitate the payment of dividends or repatriation of capital through normal banking processes” (Government media release, 12 June 2002 www.stkittsnevis.net/media.html).

Events in the Pacific followed a similar course, with Vanuatu resisting the OECD until May 2003 and the Cook Islands being listed by the FATF into early 2005. Initial defiance based on a miscalculation of the costs of resistance compared with reform, was followed by economic damage resulting from the reputational costs of blacklisting. This in turn was followed by increasing pressure for compliance, culminating in the adoption of internationally-mandated reforms.

In explaining Vanuatu’s initial decision to oppose the OECD, a senior industry figure and member of the local regulatory body was explicit: “The government could not see how compliance could bring sufficient income to replace the loss which would occur in revenue, and on-flow benefits” (*Offshore Investment*, July-August 2003). Between June 2000 and May 2003 this calculation changed as the economic damage caused by blacklisting became apparent. Foreign banks cut the National Bank of Vanuatu off from international foreign exchange markets, and it had to buy US dollars via local subsidiaries of Australian banks, imposing increased transaction fees and delays. Banks such as Barclays, HSBC and Chase Manhattan refused to process electronic transactions from Vanuatu, and most major American banks still

accept transactions from Vanuatu only intermittently (Author's interviews, public and private sector representatives, Port Vila, Vanuatu, March 2004; *Offshore Investment*, September 2001). While in 2000 1226 new IBCs were formed, in 2001 the total was 557 and in 2003 only 447 (Reserve Bank of Vanuatu, 2004). The number of offshore banks, which had peaked at 120, was of late 2005 down to 7 (Author's interviews, public and private sector representatives, Port Vila, Vanuatu, March 2004). Fourth quarter revenues to the government from the offshore sector were down by 26 percent in 2003 on their 1999 level (Reserve Bank of Vanuatu, 2004). Little wonder, then, that the same senior figure in the offshore industry lamented that tax havens like Vanuatu "see their lifeblood being slowly drawn from their bodies" by the OECD blacklist (*Offshore Investment*, 2001). After May 2003 a follow-up piece on the OECD initiative (which again notes the "devastating effect" of the blacklist) summed up the result: "'Big Brother' Prevails and Vanuatu Reluctantly Succumbs."

In the Cook Islands too initial calculations relating to the cost of blacklisting encouraged a sanguine response. At a conference in January 2001 the Prime Minister noted that the Cook Islands would refuse to cave in to multilateral initiatives that infringed its "sovereign right to develop and implement policies" (Johnson, 2001). However, an industry representative noted that with its "reputation tarnished" the FATF (and OECD) listing "had an immediate detrimental effect" on the Cook Islands (*Offshore Investment*, October 2001). In the year following the initial listings, there was the same pattern of knock-on blacklisting by governments and firms, and reputational damage began to translate into material damage. In 1999 the offshore industry made

a net contribution of \$NZ 1.4 million to government revenues, but by 2004 this contribution had fallen to \$NZ 400,000. This reflects a drop in the number of offshore banks from 30 to 4, a halving in the number of IBCs, and decline in the number of trusts, which interviewees from industry and government attributed directly to the blacklisting (Author's interviews public and private sector representatives, Avarua, Cook Islands, June 2004, January 2005; <http://www.fincen.gov/advis15.pdf>). From 2003 the Cook Islands embarked on a burst of legislative activity relating to anti-money laundering measures, passing or amending 13 pieces of legislation and more than doubling its spending on regulating the offshore industry. After an inspection visit by the FATF in October 2004 approved these reforms, the Cook Islands was delisted.

The jurisdictions that opted to resist international organizations' demands at first guessed that, although there might be costs associated with being blacklisted (in reputational and material terms), these would be less than the direct and indirect costs of the reforms demanded of them. Why were they wrong, and why did they not foresee their mistake? They were wrong because they underestimated the extent to which the reputational damage of blacklisting extended even to individual investors. In particular, the threat to electronic banking networks was key. Short of moving cash in suitcases, even the most rudimentary offshore activity is hostage to these links. But this was an easy mistake to make. Before 2000 there was no precedent for international organizations seeking to impose financial reforms on non-member states by blacklisting those who refused to comply. There was a great deal of uncertainty as to what effect blacklists would

have (if any), even amongst the OECD and the FATF (Author's interviews FATF and OECD officials, June 2004, Paris, France). And for these small, poor states (poorer than the Caymans, Isle of Man and Mauritius), desperate for government revenue and economic viability, the choice between definite costs now (compliance and reform), or possible costs at some point in the future (resistance), was an easy one to make.

Non-compliance: Liechtenstein

Although like those following this second, reactive path, Liechtenstein suffered reputational and economic damage after being blacklisted by both the FATF and the OECD, it has consistently refused the OECD's demands. How can this anomalous result be reconciled with an argument about the effectiveness of blacklisting by international organizations in coercing state compliance? Reactive compliance occurs when states calculate that the costs of reform are outweighed by the costs of declining business brought on by the reputational damage caused by blacklisting. In the case of the OECD demands for tax information exchange, this point has not (yet) been reached. As predicted by the argument and confirmed by interview evidence, blacklisting has indeed damaged the country's reputation, and this reputational damage has resulted in material economic damage. The claim that blacklisting is an effective tool for international organizations to secure state compliance is not the same as saying that blacklisting will cause states to back down in every single instance.

In mid-2000 the Principality was blacklisted by both the FATF and OECD (FATF,

2000b: 6-7). The government worked strenuously to effect the reforms demanded by the FATF but has steadfastly refused any compromise with the OECD, to the point of being listed as an “Unco-operative Tax Haven” after missing the 2002 deadline for committing to information exchange. In contrast, after the FATF listing, regulatory responsibilities were passed from the Bankers’ Association to a new Financial Services Authority, Austrian and Swiss officials were hired to staff a new six person Financial Intelligence Unit, a Due Diligence Unit was set up, and an independent Financial Market Services Authority was established in 2005. Prince Philipp von und zu Liechtenstein became the founding director of the \$4 million Institute for Compliance and Quality Management, specialising in anti-money laundering, along with 10 KPMG officials (*Financial Times*, 8 June 2001). Former top Swiss and US anti-money laundering officials were taken on, as was the honorary secretary of Interpol. Ten new judges and six new prosecutors were hired (*Private Banker International*, 11 June 2001).

What evidence is there of economic loss because of blacklisting? The number of new establishments (*Anstalten*) being formed dropped off sharply and, as of early 2004 was still below its 2000 level (Author’s interview, government officials, Vaduz, Liechtenstein, January 2004). From 2000 to 2002 the net income of Liechtenstein banks fell from 549 million Swiss Francs to 251 million, taxes paid from 64 million to 27 million, and assets managed from 112 billion to 96 billion (Liechtenstein Bankers’ Association, 2003: 4). More importantly, interview material strongly attributes the majority of this decline to the blacklists. Prince Philipp noted “The danger of being on the blacklist is the risk of being put aside. You might find yourself with

few partners to work with or with only a certain type of client, which could drive away the few remaining good clients” (*International Tax Review*, 1 July 2001). Another official remembered of the listings: “It was a real disaster. Our foundations trembled” (*Guardian*, 3 July 2004).

In sharp contrast to their energetic compliance with FATF demands, the Liechtenstein authorities have been unyielding in their rejection of OECD reforms, and thus the country has stayed on the OECD blacklist. This is because public and private sector officials are frank in acknowledging the combination of secrecy and low taxes as the country’s primary attractions for foreign investors. The cost of compliance with OECD demands is still regarded as higher than the cost (including reputational cost) of non-compliance. The head of the Bankers’ Association described the OECD listing as “an image problem for the country’s 15 banks... [which has] increased political pressure on the country to relax its banking secrecy” (Reuters, 27 June 2000). Subsequently he has referred to the 2002 OECD listing as “unhelpful” and “destabilizing” (Author’s interview, Vaduz, Liechtenstein, January 2004). The steep decline in the financial sector’s fortunes from mid-2000 and the slow recovery since that time supports this judgement. The reputation of Liechtenstein’s financial sector has been further damaged by reports in 2008 that Germany’s intelligence agency has obtained bank data showing the country’s banks are complicit in major tax evasion. Although at the moment this remains an inter-state dispute rather than one involving international organizations, the unflattering publicity may further raise the cost of non-compliance with the OECD initiative.

Controlling for Power: Switzerland and Austria

So far the cases considered have been very small states or semi-states. Some might object that even if international organizations can push around such tiny polities, this is of little interest. Another possible objection to the argument presented here is that targeted tax havens may have ended up on blacklists as a function of their lack of power and political exclusion, and thus the result is an artefact of their general powerlessness rather than blacklisting as such. This last empirical section seeks to rebut both contentions. Responding to these contentions entails a brief comparison of the contrasting experiences of Austria and Switzerland, with very similar sized economies (Swiss GDP at \$252 billion and Austrian \$283 billion), orders of magnitude larger than the small states considered above (CIA World Factbook, 2007). Switzerland has standards that do not conform with internationally accepted practice on either the exchange of tax information or on anti-money laundering. It continues to openly defy the OECD harmful tax competition process. This is explained in large part by the fact that Switzerland has (so far) managed to avoid being blacklisted. In contrast, Austria also had financial regulations that did not meet international standards, but was blacklisted in 2000 and, as a result, was forced to reform its banking laws. Being on or off a blacklist was the single most important relevant difference between the two contrasting outcomes of Austrian compliance and Swiss non-compliance. Power as economic size or membership of exclusive political clubs did not play a significant role.

Since the launch of the OECD initiative in 1998 Switzerland has publicly refused to be

bound by any of its provisions, particularly the international exchange of tax information. Its delegation labeled the approach “partial and unbalanced” and “repressive” (OECD, 1998: 77-78). Switzerland’s consistently unco-operative and critical stance towards the initiative is a source of acute embarrassment to the rest of the OECD, asked how it can press others for concessions that it cannot secure from its own members. Switzerland has been similarly isolated on the question of tax evasion and anti-money laundering. From 1996 the G7, Bretton Woods institutions and the FATF have been at pains to emphasise that tax evasion is a crime, and thus that transactions stemming from evasion are subject to anti-money laundering provisions (OECD, 2002). Once again, the Swiss have refused to bring their national laws into compliance with international standards. Instead, they have steadfastly maintained that tax evasion is a civil, not criminal, offence, and that as a result AML provisions do not apply. Although this stance has attracted criticism from individual countries, and *sotto voce* grumbling from both organizations, neither the FATF nor the OECD has initiated a formal process to threaten to include Switzerland on either the “Unco-operative Tax Haven” list or the “Non-Co-operative Countries and Territories” list. Switzerland’s success in staying off the FATF blacklist owes much to a tacit understanding with Britain. After an aggressive campaign of Swiss complaints about the vulnerabilities of UK trusts for money laundering, the British agreed to stop pressuring the Swiss government on the subject of bank secrecy if the latter scaled-back its complaints about trusts. With regards to tax competition, the Swiss delegation had an ally in Luxembourg, which also has publicly rejected the OECD initiative. Though Luxembourg matters little in terms of material power, the moral

support it provided was important in bolstering Swiss. In contrast to Austria in the FATF, other members could not present the Swiss as completely isolated in defying the will of the OECD (Author's interview, former OECD official, Canberra, Australia, October 2002).

The conflict with Austria hinged on anonymous passbook (*sparbuch*) bank accounts. These accounts allowed whoever possessed the physical passbook to access the account, as the issuing bank recorded only the number of the passbook, not the identity of the person opening the account. This meant that banks were unable to link any such account with any particular person, providing perfect anonymity. Between 24 and 27 million such passbooks accounts had been opened (in a country of 8 million people) containing an estimated \$100 billion. Furthermore, by the late 1990s a lively internet trade in such passbooks had developed.

The FATF, of which Austria is a founding member, had signalled its disapproval of these accounts as far back as its initial meeting 1990. A FATF evaluation in 1992 noted positive developments but further observed:

Nonetheless, on current proposals, identification would still not be required for passbook and security deposit Schilling accounts held by Austrian residents—a very sensitive issue in Austria... [T]he retention of the two classes of anonymous accounts is a matter of concern, running directly counter to a very important FATF Recommendation (FATF, 1993: 13).

Six years later, the FATF president visited Vienna only to be told again that passbook accounts remained “a very sensitive issue.” The Austrian Council of Ministers wrote to the FATF in mid-

January 2000 acknowledging the need for reform, but failed to provide any specific assurances. After this long campaign, the FATF lost patience and on 3 February 2000 issued a public ultimatum that unless by 20 May the government both made a public commitment to abolish the accounts and introduced a bill to prohibit the opening of new anonymous accounts, its FATF membership would be suspended effective 15 June of that year (FATF, 2000a; Johnson, 2001). Although lacking any formal legal consequences, in suspending one of its members the FATF could make an official declaration sufficient to change the status or reputation of the country. Fearful of the reputational and material consequences should this threat be carried out, Vienna quickly backed down. The Austrian government rapidly complied with FATF demands to the letter. It issued a public commitment 22 February to eliminate the accounts and introduced the legislation to parliament 20 March. After a short transition period, all anonymous accounts for which ownership had not been established were frozen.

Why this sudden about-face, given the very large legal, financial and emotional stake the Austrians had in the continuation of anonymous accounts? The Austrian banking industry realized that suspension from the FATF would be a disaster for the reputation of Austria in the international financial system, and consequently for their profitability. Specifically, the bankers believed the public threats from the head of the FATF that suspension would damage Austria's sovereign debt rating, as well as the ratings of individual banks, with agencies like Standard and Poors and Moody's (*International Money Marketing*, 7 June 2000). But because of popularity of the accounts the banks were unwilling to be seen to side with the FATF and against public

sentiment. Instead bankers lobbied hard behind the scenes in early 2000 for the government to abolish anonymous accounts. Up until 2000 sovereign and bank credit ratings and the fortunes of the bank and financial sector had not been affected by the slow-burning dispute with the FATF. But the private sector believed this would change with continued escalation, and the government was persuaded by these fears (Author's interview, Austrian Bankers' Association, Vienna, Austria, July 2005). Thus despite the huge power differentials with the Cayman Islands, the Isle of Man and Mauritius, Austria pre-empted the economic damage that local sources believe would have resulted from continued defiance in much the same way as these small tax havens.

Conclusions

The cases above have demonstrated how blacklisting as a form of speech act, mediated through damage to listed jurisdictions' reputations, caused or threatened material economic pain. Blacklisting by international organizations is not just cheap talk or signalling, but is a stick that can be used to beat small tax havens and much larger states into regulatory reform. The lists compiled and released by international organizations reverberated among national authorities and private firms. The causal route from blacklisting to compliance took one of two forms. St Kitts and Nevis, Vanuatu and the Cook Islands complied after seeing material economic damage that they interpreted as being caused by the effect of blacklisting on their reputation with foreign investors. Austria, the Cayman Islands, the Isle of Man and Mauritius anticipated that defying international organizations' demands would result in future economic damage caused by the

effect blacklisting would have on their reputation with foreign investors. The difference between the two causal chains depended on the nature of the financial sector. Institutional investors are particularly sensitive to reputational concerns, and thus jurisdictions dependent on such business did not try to face down international organizations. Because individual investors are less sensitive to reputational concerns, jurisdictions relying on this type of business initially believed that confrontation was cheaper than compromise, a decision reversed in all but one case (Liechtenstein versus the OECD) as reputational damage accountable to blacklisting caused material losses to mount.

This method of employing speech acts is practically and conceptually very different from material economic sanctions. It is a constitutive process with both constitutive and causal effects. These effects are primarily intangible (damage to reputation), but may also include derivative tangible consequences (disinvestment). As a coercive process blacklisting is also fundamentally distinct from compliance through socialization with predominant norms of behavior, or persuasion through reasoned debate. Blacklisting is thus a tactic by which even international ‘talk shops’ can seek to implement their policies in the absence of conditional loans or hard law. This finding has considerable political and policy significance, though how positive or negative development it might be depends upon one’s view of the fairness and inclusivity of international organizations and global governance more generally. From one point of view, international organizations could potentially use this new compliance tool to solve international collective action problems, disciplining free-riders and renegade states that would otherwise imperil

socially beneficial global regulatory regimes. Compliance problems that currently hobble joint approaches to pressing challenges to the international community could be ameliorated. Less favorably, this discursive form of coercion could be used by clubs of powerful states in a self-interested fashion to further entrench existing inequalities by marginalizing small, vulnerable states.

The article has also attempted to achieve two broader goals in line with recent suggestions for progress in the field (Fearon and Wendt, 2002; Tierney and Weaver, 2004; Joachim et al., 2008). Firstly, to provide an empirically-based account in response to a particular puzzle, in this case the compliance puzzle of regulatory reform. And secondly, to provide an explanation that integrates insights from constructivism and rationalism to deal with the large portion of political life in which both discourse and self-interested choices are important. The explanation incorporates key elements of each approach, rather than running each off against the other in a winner-take-all contest, or using one as an afterthought to clean up the residual variance not covered by the other. For although the idea of actors making and re-making their world through speech is clearly constructivist, materially-derived preferences, cost-benefit calculations and strategic interaction are equally essential to rationalism. The field will probably never reconcile the contrasting philosophical underpinnings of current alternative approaches to international relations, but world politics may be a little less baffling with a few more pragmatic and empirically delimited joint ventures between them.

TABLE 1: Blacklisting and Compliance

	Blacklist threatened/ applied	Small state	Investor type	Economic damage	Compliance
Cayman Islands	Yes (FATF, OECD)	Yes	Institutions	No	Yes
Isle of Man	Yes (OECD)	Yes	Institutions	No	Yes
Mauritius	Yes (OECD)	Yes	Institutions	No	Yes
St Kitts and Nevis	Yes (FATF, OECD)	Yes	Private	Yes	Yes
Vanuatu	Yes (OECD)	Yes	Private	Yes	Yes
Cook Islands	Yes (FATF, OECD)	Yes	Private	Yes	Yes
Liechtenstein	Yes (FATF, OECD)	Yes	Private	Yes	Yes (FATF) No (OECD)
Austria	Yes (FATF)	No	Institutions	No	Yes
Switzerland	No	No	Institutions	No	No

TABLE 2: Time Spent on FATF and OECD Blacklists

	FATF NCCT	OECD Tax Haven	OECD Unco-operative Tax Haven	Combined Total
Cayman Islands	12 months	0	0	12 months
Isle of Man	0	6 months	0	6 months
Mauritius	0	0	0	0 months
St Kitts and Nevis	24 months	20 months	0	44 months
Vanuatu	0	20 months	13 months	33 months
Cook Islands	54 months	21 months	0	75 months

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