Offshore Banking and Gresham's Law

adapted from 2 *Tax Notes Int'l* 819-821 (Aug. 1990)

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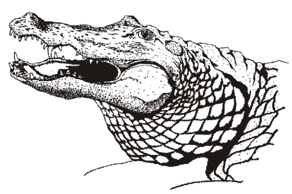
Sir Thomas Gresham (c1519—1579) was an English financier, merchant and government official under Elizabeth I. He is associated with Gresham's Law, an economic principle that states that "bad money drives out good." Sir Thomas founded the Royal Exchange and Gresham College, London. According to an entry in the *Encyclopedia Britannica*, Gresham served as royal financial agent in Antwerp after 1551, and, in that position "he proved himself very able, though his methods were frequently more effective than ethical." His entry goes on to report that he neither formulated Gresham's law nor gave it its classical statement.



Gresham's Law has been applied by analogy to a wide range of human conduct. In its expanded formulation, it stands for the proposition that greed tends to overwhelm refined human impulses for good in a marketplace economy. It is sometimes asserted, for example, that bad lawyers tend to drive out good ones. The point being made is that attorneys who hold and observe high ethical standards are hard pressed to compete successfully in the marketplace against attorneys who are prepared to lie and cheat on behalf of paying clients.

Bad Banks Are Driving Out the Good

My concern in this essay is with the application of Gresham's Law to international banking. Under Gresham's law, bad international banks — by which I mean banks and other financial institutions that connive with stock swindlers, money launders, tax evaders, and other reptiles — tend to drive out banks that adhere to community standards of decent conduct. The time has come, it seems to me, for responsible governments and private associations to devise institutional arrangements to counteract such an unwelcome tendency. The honorable profession of banking is facing significant and increasing market pressures to compromise its traditional standards of integrity, and it deserves and needs support, including the support of the international tax community, to withstand those pressures.

At one happy time, international banks faced rather modest competitive pressures to engage in corrupt practices. Undoubtedly banks had their aliquot share of crooks in high places. They were effectively audited by national governments, however, so the great majority of honest bankers had some assurance that the cheaters would come to a bad end. And the profession had major limits on access that prevented the full operation of Gresham's law. Just as bad money cannot drive out good if the supply of bad money is quite limited, so also bad international banks cannot drive out good ones unless there are enough bad international banks around to do the driving out.

Unfortunately, the modern trends have all been in the direction of increasing the supply of bad international banks. It is no longer necessary to have an established position in one of the major financial centers to engage in international banking. It is enough to have a communication link to one of those centers. Many international banks are little more than a computer terminal, a fax machine, and a nameplate on the door of a one-room office. Not so long ago, only a handful of banks were involved primarily in cross-border transactions. Now there are too many of them to count.

Sovereign States' Complicity

Another unhappy trend is the increasing willingness of sovereign states — often small island governments — to facilitate tax avoidance and evasion by residents and nationals of the industrial countries of Europe, North America and the Pacific rim. To appeal to tax cheats, these governments must promise and deliver a very high degree of bank secrecy. There have always been a few tax haven jurisdictions with bank secrecy laws. Now there are many dozens of them, most in fierce competition for the same deposits. The competition affects not just the offshore banks but also the major international banks located in London, New York, Tokyo, and the other traditional international banking centers.

And finally, there is the drug money. The international banking system is awash with it, and offshore financial centers are under pressure to structure their banking laws to protect the confidentiality of the banking records of individuals and companies with reason to fear prosecution on drug changes.

Several of the more famous offshore financial centers, including the Cayman Islands, have stated that they are unwilling to participate in money laundering for the drug barons and have taken some limited steps to cooperate with foreign governments in drug-related investigations. Their intentions are commendable. They have no real power, however, to distinguish tax-evasion money from drug money, and their announced policy of cooperating with drug investigations has simply been good for business in those financial centers where the banking authorities are not so squeamish. Without coordinated support from the international community of nations, the relatively good offshore financial centers are almost certain to be victims of Gresham's Law.

The governments of several major industrial countries have publicly stated their conviction that many offshore financial institutions are being used to launder drug money. Officials in these countries are making appropriate noises about their commitment to some kind of crackdown on laundering activities. What they will find, if they do not already know it, is that the bad offshore banking centers will give them no help at all, and most, if not all, of the relatively good ones will demand an almost impossible level of proof that an individual is laundering drug money before they will cooperate with an investigation of that individual. This demand for overwhelming evidence of money laundering will be made to calm the fears of their tax-cheat depositors, not to protect the drug dealers.

Solutions to the Problem

So what is there to do? Is Gresham's Law too powerful to fight? Or is it, like David Ricardo's iron law of wages, just one of the several great misconceptions about market economies that caused economics to be called "the dismay science" and that led to the social pessimism of the 19th century?

Let me strike an optimistic note. Despite the concern for the integrity of the currency expressed by Gresham's Law, bad money has largely been eliminated from circulation in most industrial societies. Counterfeiting occurs, but it is not a feature of daily life, as it was in 16th century Europe. Except in old cowboy movies, for example, we almost never see someone bite a coin to verify its worth. Opportunities for counterfeiting have been reduced sharply by the substitution of checks, bank drafts, paper money, and coins made from common metals for the old coins made from precious metals. And counterfeiting has been suppressed by vigorous law enforcement efforts.

Top Ten Banking Havens, 1987

	Country	Foreign Deposits
1.	Cayman Islands	$200 billion
2.	Luxembourg	$160 billion
3.	Switzerland	$160 billion
4.	Singapore	$155 billion
5.	Bahamas	$145 billion
6.	Hong Kong	$115 billion
7.	Channel Islands	$60 billion
8.	Bahrain	$50 billion
9.	Panama	$35 billion
10.	Liechtenstein	$30 billion

Source: *Forbes Magazine*, April 1987

The legal profession has also been successful in restraining the tendency of the marketplace to corrupt its members. Market pressures for corruption have been reduced by restricting membership in the profession — through certification requirements, unauthorized practice statutes and similar monopolistic measures — and by using the coercive powers of the state to punish certain types of outrageous conduct, such as fraud. The most effective action has been taken by the organized bar itself, through its formal and informal codes of conduct, its educational programs, its disciplinary procedures, and similar actions.

The campaign to root out unethical lawyers has been less successful than the campaign against counterfeiting. A rich man is certainly more likely to find a bad lawyer in his pocket than a bad coin. Many lawyers continue to encounter market pressures to compromise their ethical standards. Lawyers cannot fairly claim, however, that they are unable to compete successful in their chosen profession without engaging in corrupt practices.

I have no detailed plan for limiting the effects of Gresham's Law on international banking. I think the basic strategy, however, should be to regulate conduct of the banks through voluntary codes of conduct and self-disciplinary measures, to limit the supply of bad banks through the use of governmental sanctions, and to reduce the potential gains from the use of offshore financial centers through more extensive withholding at source. Self-regulation is sometimes dismissed as unworkable, but, like the legal profession, the international banks have a powerful interest in ostracizing unethical members of their community.

Applying sanctions is not at all easy because sovereign governments, acting alone, do not have the power to regulate cross-border banking transactions. They do have the power, however, to prohibit their domestic banks from dealing with foreign banks that they deem to be unacceptable members of the international banking community. Not very many of the offshore banks can prosper if they are denied links with the major banking centers in the industrial countries. Of course the major industrial governments must act in concert or their own international banks will simply become victims of Gresham's Law.

Role for Tax Lawyers

The international tax community has a special obligation to be helpful to the international banks in avoiding the effects of Gresham's law. Virtually all of the offshore international banks are financed primarily with money drawn from tax evaders and aggressive tax avoiders. To help cure the problem of the bad international banks, the international tax community has to take the profit out of offshore tax evasion and aggressive avoidance. CFC regimes and offshore fund rules are some help, but they obviously have had limited impact. What is needed is more aggressive measures to withhold taxes at the source on income from moveable capital.

We should all have discovered by now that withholding at source is the only effective way, in the long run, to impose taxes on dividends, interest, rents, royalties, reinsurance, and other types of income from moveable capital. And withholding at source reduces opportunities for international tax evasion without excessive intrusion into the personal affairs of individual taxpayers. By giving support to the current efforts in the European Community and the United States to reach an international understanding on withholding at source, the international tax community can support good tax policy and the long-term interests of the international banking community. ◊