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Futurity, Offshore, and the International Political Economy of Crime

Ronen Palan

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Introduction

A report entitled From Illegal Markets to legitimate Businesses: The Portfolio of Organised Crime in Europe (Savona and Michele 2015) typifies the growing awareness that the proceeds of crime find their way into the legitimate econ-omy.[1] Following a thorough survey of seven European countries, the report concludes that the business sectors with the most cases of criminal investment are bars and restaurants; construction; wholesale and retail trade, particularly food products and clothing; transportation; real-estate activities; and hotels. The report suggests that the favorite route for "going legit" is through the opacity provided by tax havens. The report does not ask or seek to answer one puzzling question: why do organized crime syndicates seek to go legit? Most studies suggest that criminal organizations are highly profitable. Why should they be interested in investing their capital in what appear to be much less profitable legitimate business ventures? This is the question I seek to address in this chapter: what are the incentives for business organizations to re-enter the legitimate economy and why is the offshore world the preferred route for doing so?

In effect, I am asking two separate questions: the first refers to the incentives for criminal organizations to legitimize their business (goals), and the second asks why they do so using offshore platforms (means). The conventional answer is that the incentives to launder money (or "go legit") are self-evident. The proceeds of crime are among the key pieces of evidence used by

[1] I would like to thank Matias Dewey and Jens Beckert for their helpful comments on an earlier draft of this chapter.

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prosecutors and the courts to prove their cases; hence, criminal organizations have a strong incentive to eliminate such evidence. The use of offshore platforms is easily explained as well. The opacity provided by offshore juris-dictions ensures anonymity and a degree of freedom from surveillance that is not matched "onshore" (Palan 2003; Palan et al. 2010). I accept the above, but I note that it does not explain why criminal organizations reinvest in legitim-ate businesses.[2] To that end, I would like to add a more nuanced understand-ing of both the incentives and the means used by criminal organizations.

My argument in this chapter is theoretical. My approach is predicated on the proposition that the capitalist economy consists of co-habiting econ-omies. One of these may be described as the "economy of the present." It is an economy of exchange of goods and services that is described well (or not so well, depending on one's opinion) by standard economic models. This econ-omy is dwarfed today by an "economy of the future," or, as John R. Commons described it, "futurity." The economy of the future is an economy that trades in anticipated future earnings; it generates credit and value today on the basis of anticipated income streams.

However profitable, the organized criminal world operates largely in the economy of the present, either by trading in banned substances (including people) or the extraction of "value" out of current transactions. Organized crime cannot participate, however, in the far more lucrative economy of futur-ity. Organized crime business cannot trade, for instance, on its "goodwill"; it faces great barriers to extracting value—in the form of shares, bonds, or even loans—against future earning capacity and potential income streams. Organ-ized crime is caught, therefore, in the slow lanes of the modern economy. But as many criminal organizations are run by savvy businessmen, they seek to access the economy of futurity by "laundering" not only money, but the very organ-izations they operate. The ease of incorporation and the opacity provided by offshore secrecy jurisdictions allow criminal organizations to appear to be legitimate businesses and thus to access the realm of futurity.

Economies of Past and Future

The notion of economies of past and future is based on an interpretation of one of the main tenets of the school of evolutionary economics of Veblen and Commons (known otherwise as "old institutional economics," Commons

[2] Throughout this chapter I will use the term "business organization" in the same way as Diego Gambetta. Gambetta argues that the Sicilian mafia is a "specific economic enterprise, an industry which produces, promotes, and sells private protection" (Gambetta 1993: 1). The idea that cirminal organizations are businesses is well established in the literature. I will therefore discuss specifically what are known as "organized crime" syndicates.

1961; Commons 1959 [1924]; Veblen 1898). The old institutional economics school stresses that every economic transaction takes place simultaneously in two realms: an exchange of goods or services, or conversely, exchange of debt and risk instruments (or financial instruments) takes place in one realm. Correspondingly, all economic exchanges are replicated in a legal realm and logged as property rights exchanges. Conventional economics is concerned primarily with actors' motives on the "real" side of the exchange and seeks to develop accounts of the systemic effects of economic exchanges based on the aggregation of individual motives and preferences in entering such contrac-tual relationships. Old institutional economics, by contrast, pays great atten-tion to the legal realm, believing that it shapes the dynamics of exchanges and not the other way around.

Such double exchanges serve to highlight the economic difference between legal and criminal economic activities. Property rights exchanges, or con-tracts, are specified in terms of time and place and are backed by a sovereign power. Sovereign power, therefore, is not only a political power but crucially also an economic power. Sovereign power provides the necessary "coding" for nearly all forms of economic exchange, defining the nature of the parties to a contract, including their rights and duties, as well as the salience of the contract itself. To achieve that, sovereign power encodes every single item or transaction located within a territorial space with its own sovereign barcode: individuals are defined as citizens, economic enterprises are licensed and follow certain rules of incorporation; social clubs or religious groups are licensed by the state and subject to rules of conduct. Every movable object, cars, airplanes, ships, or boats, must be licensed by states and display a flag or a license plate. In many countries pets and agricultural animals are numerated as well and given some sort of a passport, and so on. In this way the territorial space is populated by legally defined entities and items.

The system of coding is onerous, expansive, and fraught with ethical and normative questions of liberty and freedom. Why does it work? Sovereign power may be thought of in transaction cost terms: by providing a standardized system of coding and rules of exchange, the sovereign reduces transaction costs because most transactions are standardized. The state maintains an implicit contractual relationship with its citizens, whereby a certain degree of liberty is exchanged for economic welfare (North 1994). From this perspective the state can be seen as a "club good" in Buchanan's perspective (Buchanan 1965). The services of transaction cost reduction are explicitly withdrawn from criminal activity. "When a market is defined as illegal," write Beckert and Wehinger, "the state declines the protection of property rights, does not define and enforce standards for product quality, and can prosecute the actors within it" (Beckert and Wehinger 2013: 6). Because all economic exchanges are exchanges in property rights, transactions must be backed by some dimension of sovereign

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power. Criminal organizations tend to replicate certain aspects of sovereign economic power by the use of implicit or explicit coercive "privatized" power (Gambetta 1993). This renders criminal economic transactions far more expen-sive to maintain. The criminal organization spends considerable resources doing exactly what the sovereign does: coding the parties to the exchange and the rules of exchange as they go along, and maintaining coercive power to back up exchanges. The criminal world even maintains a certain "culture" and codes that serve to lower transaction costs.

Criminal organizations are, therefore, at a great disadvantage vis-à-vis legit-imate organizations that are able to share in the lower transaction costs offered by a well-maintained polity. On the other hand, criminal organizations have certain advantages vis-à-vis legitimate businesses. Most importantly, criminal organizations typically do not pay tax towards the upkeep of the state, which amounts to an average of about 60–70 percent (or more) of a transaction, once we add up income tax, corporate tax, VAT, custom duties, and so on. Criminal organizations are able to extract, in addition, monopoly rent from their businesses which are not protected by various anti-trust legislation or other consumer-protection legislation (that is why they tend to be highly territor-ial). At the same time, criminal organizations "free-ride" on the sovereign by using its currency, rules of conduct that sustain other aspects of life, security, and so on. Presumably, the trade-off is beneficial, otherwise traditional crim-inal organizations would not exist.

Territorial states contain, therefore, two sets of economic organizations: (i) those working within the boundaries of the state-club rules, paying dues and being regulated, but benefitting from its sovereign power, and (ii) those who do not. It is noteworthy that criminal organizations tend to recruit personnel from the poorly educated, less privileged sections in society. This suggests that criminal businesses are not as lucrative as assumed.

This dichotomous picture is complicated further by the large grey area "in between," which contains legitimate organizations seeking to reduce their contribution to the sovereign, primarily to avoid and even evade tax, while remaining, overall, on the right side of the law, and criminal organizations seeking to benefit from sovereign protection but changing the apparent nature of their organizations. The offshore economy is a favorite hangout for these "in betweeners."

Futurity and the Twilight Economy

So far I have presented an annotated description of criminal organizations as understood from a conventional economic perspective. Once we put on old institutional economics lenses, however, and examine these businesses more

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closely from the perspective of the dominant realm of legal transfer of prop-erty rights, a slightly different picture emerges. The legal realm of property transfer reveals a surprising divergence in the behavioral orientations of indi-viduals and corporate entities towards wealth already accumulated and wealth to be accumulated (Palan and Mangraviti 2016). Consistent with its past orientation, standard economics is concerned, as John R. Commons argued, primarily with wealth-already-accumulated, while business, in contrast, is interested primarily in wealth-to-be-accumulated: the ownership, control, and leverage of future wealth. There are important distributional battles over wealth-already-accumulated, concerning the ownership of discrete assets, but wealth-to-be-accumulated is generated through organizations. As a result, investable assets are, strictly speaking, organizations or "going concerns" (Atkinson 2009). People invest, therefore, in organizations and not in assets. Only organizations are able to generate wealth that as yet is still to be accumulated.

Let us take an historical example that marked the development of an economy of the future. An illustration of the economic significance of intan-gibles can be inferred from the way the US Steel trust was organized by J.P. Morgan and Co., and one of the largest and least liked railway barons, James Hill, largely to prevent the ruinous competition that Andrew Carnegie was about to launch with his competitors in Pittsburgh (for an additional discussion see Palan 2012, 2015).

The area around Pittsburgh was at the epicenter of the steel sector during the late nineteenth century, contributing about 80 to 85 percent to US steel production. Andrew Carnegie, a successful steel magnate, in 1899 announced his intention to build a larger plant with the latest improvements on the shore of Lake Erie. J.P. Morgan and Co. was called upon by some of Carnegie's competitors to establish, in response, a holding company that would take over all the plants and form an integrated large company to avoid this "ruin-ous competition" from Carnegie.

It was imperative that the new trust would buy all of Carnegie's interests in the region. The value of Carnegie's holdings on a traditional valuation of reconstruction costs was estimated at 75 million dollars at the time. Carnegie, however, demanded and received 300 million dollars in gold bonds as his share value in the new trust. Carnegie's explanation for the not inconsiderable difference of $225 million, recalls Ida Tarbell, was that "[b]usiness on a grand scale required special talent for organization and management, and that talent was rare . . . If the right men were obtained, they soon created capital; other-wise capital soon took wings" (Tarbell 1904: 9). This "talent" was described in business lingo as "goodwill." The difference in valuation, writes John Commons, could not have been ascribed "on the traditional theory of economics, as the value of the corporeal property. Nor was it incorporeal property since it

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was not a debt owed to Carnegie. The only other name that could be given to it was 'intangible property', the name given by the financial magnates them-selves" (Commons 1961: 649–50). Carnegie charged, in effect, $225 million for his personal goodwill (Tarbell 1904).

But what exactly was the goodwill that Carnegie brought to the enterprise, considering that he henceforth withdrew from steel making? The value of his goodwill was the potential or anticipated future earnings that were to accrue to the new enterprise on the basis that Carnegie was removed from competi-tion. Carnegie was not alone in obtaining "goodwill" money during the creation of the US Steel Trust. The establishment of US Steel was such an audacious act that overnight $700 million of "corporeal" property held by the different steel barons who made up US Steel became $1,600 million (Albion and Williamson 1944). Or to put it in different terms, the new company was capitalized at an equivalent of one fourth of US GNP at the time. J.P. Morgan and Co.'s commission alone was $150 million, or nearly 2 percent of US GNP. This amounted to a huge injection of capital into the economy. So much so that Carnegie refused to accept shares in the new trust, which he considered "water," and demanded gold bonds. The creation of so much new capital under the banner of "goodwill," in and by itself, sparked the 1903 financial crisis (Jospehson 1962). But despite its stock being "water," US steel survived and flourished.

Today according to some estimates, the goodwill value of the Standard & Poor's 500 amounts to about 80 percent of their value. The consulting firm, Ocean Tomo, estimates that for the year 2009 the relevant value for the EU was 70 percent, 35.8 percent for Japan, and 73.5 percent for China (Ocean Tomo 2009). Wealth in modern economies is largely a denomination, there-fore, of goodwill.

The story of the establishment of the US Steel Trust is the story of the magic of the legitimate market. Considering that businesses seeks to capture future wealth (wealth yet to be accumulated), business will be prepared to pay for those future income streams today, if at a certain discount. In effect, investors are betting on those organizations they believe will generate future income streams. But current investments in future income streams create a value at the present time. The organization is valued above its current assets, or replacement value, and as a result the whole is more than the sum of its parts (Palan 2012). This additional value is described by Commons as "futurity" and it is entered in the books under the category of "intangible property" or "goodwill."

Criminal organizations cannot directly access the economy of futurity. Such organizations are not formally constituted; they have no formal share owner-ship structure supported by the sovereign, and their business interests are not protected by the state in such a way that future income streams are secured.

Criminal organizations may be able to generate great profits today, but they are not able to leverage their profits against the future. They are stuck, there-fore, in the slow lane of the economy. That is where the offshore economy comes into play.

The Offshore Economy

By "offshore economy" I refer to a combination of jurisdictions, entities, and economic transactions that are registered through the archipelago of jurisdic-tions described colloquially as "tax havens" or less pejoratively as "offshore financial centers" (Hampton 1996; Palan 2003; Wigan 2013). Offshore finan-cial centers are typically defined as financial centers that serve primarily a non-resident clientele. Non-resident clients are prepared to invest in the circuitous and often expensive route of registering through a string of "out of the way" jurisdictions, argue their defenders, because they offer superior and efficient services to their clients. Critics argue, by contrast, that offshore financial centers attract a non-resident clientele because they provide a deliberate, and legally backed, veil of secrecy that ensures that those from outside that jurisdiction who make use of its regulations cannot be identified.

Various types of crime are facilitated under such cover, including tax eva-sion, money laundering, embezzlement, and financing of international crim-inal organizations. The range of regulations that might be created by secrecy jurisdictions (a synonym for tax haven) for use by those not normally resident in their domain is wide. Such regulations might include:

corporate laws, including those on incorporation, company residence, the types of share in issue, the use of nominees, the filing of accounts and other information on public record, and the maintenance of records themselves;

trust law, including those on the registration and taxation of trusts, the use of nominees, the right of settlors to declare trusts for their own benefit, the filing of information and accounts with regulatory author-ities, and the need to maintain records;

banking laws, including the right to maintain bank secrecy for taxation, civil law, and criminal law purposes;

regulations with regard to competition law, labor issues, shipping, envir-onmental matters, health and safety, and other issues which might, either through their absence, level of obligation, or compliance obligations, give rise to a lesser burden than those commonplace in other jurisdictions;

information-exchange agreements relating to civil, criminal, and taxation law issues;

legal cooperation regulations, including the willingness of the jurisdic-tion to enforce obligations arising in other jurisdictions through its legal system;

accounting and other information-disclosure requirements of a non-statutory nature.

In combination, these regulations cover a large range of business activity and it is this, when combined with secrecy, that provides enormous scope for abuse. A number of related initiatives have been introduced in the EU and internationally in order to lift the veil of opacity (Palan et al. 2010).

Recent research has demonstrated that these jurisdictions serve the purpose of tax evasion, avoidance, and money laundering by facilitating arbitrage techniques. Arbitrage techniques operate through linked corporate structures located in different offshore financial center jurisdictions in order to take advantage of blind spots created through differentials in law, regulations, taxation, and/or transfer pricing techniques. One way firms can utilize these assets in multi-jurisdictional tax-minimization schemes is by separating tan-gible sources of income, such as the sale of hardware, from the intangible sources of income embedded therein, such as the sale of patent rights or intellectual property rights associated with the hardware. This is the technique used, for instance, by Apple Inc. (Apple 2014; Palan and Mangraviti, 2016; Permanent Subcommittee on Investigations 2013). Other typical arbitraging techniques in the real-estate sector operate through a series of entities owning property (typically commercial real estate) located in different countries. Vendors can avoid capital gains tax and purchaser's stamp duty simply by purchasing one of the linked companies in a foreign jurisdiction (Palan and Mangraviti, 2016).

The third technique that may be facilitated by offshore financial centers (although not necessarily only through these jurisdictions) is so-called "finan-cial engineering." Financial engineering uses sophisticated financial instru-ments such as derivatives and swaps in order to ensure that the issuing business in charge of final transactions, or the business that appears to gain from the final transactions and hence where "profit" is logged, happen to be located in territories that levy minimal or no taxation on such entities. Hence, for instance, most hedge funds are registered in tax havens. Another popular technique is that final transactions are structured in such a way that they are logged or registered in political platforms that levy minimal taxation on a particular form of final transaction that is used for such cases—hence tax is minimized. Businesses set up holding companies and various types of special purpose vehicles in offshore locations for that purpose. They also use financial engineering to alter the character of income subject to taxation and minimize the relevant tax contribution. A third well-known technique is that the final

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transaction is structured in such a way that the maturity point of the transac-tion that triggers taxation is deferred to some point in the future, but the future never truly materializes, and/or the transaction is structured in such a way that it takes place in a simulated realm that is not easily recognizable by the tax authorities and hence the transaction may disappear completely from their radar. That is where derivatives come into play (Palan et al. 2016).

The archipelago of jurisdictions that offer such facilities can be organized into three conglomerations. One conglomeration has coalesced around what I described in a series of publications as the "Second British Empire." It is centered on the City of London, British-dependent territories such as Jersey and Guernsey, British overseas territories such as the Cayman Islands and Bermuda, and former British colonies, such as Hong Kong and Singapore. This conglomeration accounts for roughly 40 percent of wholesale inter-national financial transactions. The second is a European conglomeration that consists of the Benelux countries, Switzerland and Ireland, and accounts for about 15 percent of international financial transactions. A third one, now emerging, is an Indian Ocean conglomeration that consists of the Persian Gulf states, Mauritius, and the Seychelles. It is estimated that there are in excess of $25 or even $30 trillion of financial assets registered in such locations.

Offshore and Crime: The Conventional Story

There is a considerable literature documenting the association between tax havens and crime. Meyer Lansky, the legendary treasurer of the mob, is reputedly to have forged links from the 1930s between Switzerland, the Bahamas, and the large East Coast criminal groups. There is some debate about how precisely Lansky and Co. used tax havens, whether only for money-laundering purposes (Maillard 1998) or for general financial criminal activities (Blum 1984; Dupuis 1998; Naím 2005; Naylor 2002). There is agree-ment, however, that organized crime is strongly represented in some tax havens.

Maingot maintains that "some 75 percent of all sophisticated drug traffick-ing operations use offshore secrecy havens" (1995: 181). He also believes that drug money was the principal cause of the phenomenal growth of the Carib-bean havens in the 1970s and 1980s (see also Naylor 2002). Of the criminal cases identified in Internal Revenue Service investigations from 1978 to 1983 that occurred in the Caribbean, 45 percent involved illegal transactions derived from legal income (tax evasion on otherwise legitimate trade). In the other 55 percent, illegal income was involved, and 161 of cases dealt with drug trafficking. Of these, 29 percent involved the Cayman Islands, 28 percent involved Panama, 22 percent the Bahamas, and 11 percent the Dutch Antilles.

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These four offshore sites alone accounted for 85 percent of the cases involving transactions of illegal income (Maingot 1995).

In late 2005, Callum McCarthy, head of the UK's Financial Services Author-ity, publicly declared that he had information showing that organized crime groups had infiltrated some of London's best-known financial institutions. They did so to learn logistics and mechanisms and techniques to avoid detection.

Tax havens are also associated with money laundering. The International Monetary Fund estimates the magnitude of money laundering worldwide at 3–5 percent of the world's GDP (INCSR 2008: 5), a figure larger than the US federal budget. Not all money laundering operates through tax havens. Tax havens are, in fact, a minority of the countries that appear on the list of jurisdictions defined by INCSR as "major money laundering countries" (2008: 58).

Rawlings and Unger (2005) argue that some tax havens specifically target criminal money as a developmental strategy. In 1995, the Seychelles govern-ment passed the Economic Development Act (EDA), which created a board that could give specified concessions and incentives to foreign investors. "One of these incentives was complete immunity from prosecution in criminal proceedings and the protection of assets from forfeiture even if investments were earned as a result of crimes committed outside the Seychelles" (Rawlings and Unger 2005: 5). To obtain this immunity an individual had to invest a minimum of $10 million in the Seychelles. The EDA was strongly condemned and the provision was repealed in 2000, but by then the funds were already in the Seychelles.

Pacific Island tax havens are strongly associated with money-laundering schemes. Nauru, a small Pacific atoll, was involved in the largest money-laundering case in history, the so-called Russiagate scandal of the late 1990s, which involved the Bank of New York. Victor Melnikov, deputy chair of the Russian Central Bank, stated that $70 billion had been transferred to Nauru from Russia in 1998, compared with total Russian exports of $74 billion. This is a figure remarkably close to the amount of International Monetary Fund credit advanced to Russia in July 1998 in response to the financial crisis that engulfed the country that year.

Palan et al. (2016) shows that the key destinations for Russian "investment" abroad are Cyprus, the Netherlands, the British Virgin Islands, and Luxem-burg. But while tax avoidance is a common drive for offshore schemes around the world, in Russia, intricate chains of offshore entities are constructed with the aim of hiding the ultimate ownership of assets. In Russian offshore "enve-lopes" Cyprus has historically been a popular node of initial incorporation of the offshore entity, which in turn would have financial and legal links to other financial havens in order to be able to tap into the onshore financial systems of Europe and North America.

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Offshore subsidiaries of the world's premier banks are also heavily impli-cated in embezzlement and money laundering. Oxfam estimates that from 1993 to 1998, during the reign of Nigeria's dictator Sani Abacha, about $5 billion disappeared from state coffers, of which $2.5 billion was embezzled by the dictator and his family alone (Hodess 2004: 5). The Swiss Federal Banking Commission released the names of the banks involved in manage-ment of the money embezzled by the former Nigerian dictator in September 2000. The list contains the names of some of the best-known international banks, such as Credit Suisse, Credit Agricole Indosuez, BNP, and Baring Brothers.

Tax havens undoubtedly facilitate tax evasion, tax avoidance, money laun-dering, and corruption, but no one is able to estimate the sums involved with any degree of accuracy. Consequently, no one is able to address the corruption that underpins this market.

Offshore Crime and Futurity

Money-laundering activities are typically understood to serve the purpose of hiding the proceeds of crime. I have little doubt that this is correct. But as this chapter argues, there are additional incentives for going legit. As the report by Savona and Michele (2015) shows, European organized crime syndicates are using tax havens in order to reinvest in certain types of business. Let us recall what they are: bars and restaurants; construction; wholesale and retail trade, particularly food products and clothing; transportation; real-estate activities; and hotels. It appears to me that these businesses possess the following characteristics:

they are relatively uncomplicated, primarily service economy types of business that do not require complex manufacturing or technological knowhow (such as hi tech);

they are often relatively small businesses, require relatively little initial capital and, considering the number of such businesses that are estab-lished every day in a modern economy, offer a degree of safety in numbers from the tax authorities' scrutiny;

they offer opportunities for further profit making through relationships with public officials, whereby additional profits could be made through the application of bribery or coercion;

they are the typical type of businesses that offer further opportunities for tax evasion and avoidance;

they can generate easily understandable "goodwill" value, which can be leveraged against future income streams.

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That last point is least understood or discussed in the specialist literature on crime. Money is not simply laundered in order to appear legitimate; money is laundered in order to gain access to the future economy. The leverage that the future economy provides, the ability to create "goodwill" value (associated with a discrete business enterprise such as a bar, restaurant, or hotel), which can then be used either to sell on, or in order to leverage credit in the legit economy is what organized crime syndicates are after. The great advantage of the future economy may explain the puzzling preference of criminal syndi-cates for turning away from supposedly highly profitable criminal business to much less profitable, and more risky, legitimate enterprises.

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