THE EVOLVING RELATIONSHIP BETWEEN OECD COUNTRIES AND IFCs: A CASE OF ASYMMETRIC CONFLICT

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INTRODUCTION

It is a great honour for me to give the keynote address at a Symposium of an organization as worldwide and prestigious as the Society of Trusts and Estate Practitioners (STEP). On behalf of international financial centres (IFCs) here represented, let me recognize the invaluable support of STEP in our efforts to fend off the attempts of the OECD to exclude us from the market for international financial services in which the "death of distance", to borrow Frances Cairncross' felicitous term, has to a large extent levelled the playing field.

Let me say up front that I do not, in any respect, represent the Government of Barbados, the land of my birth and citizenship. I must, however, declare a personal interest in the success of IFCs. As Governor of the Central Bank at the time, I was the lead technocrat in launching Barbados as an IFC in 1977. Indeed, I drafted the first official policy statement delivered by the Attorney General, Mr. Henry Forde, now Sir Henry Forde. He read my text word for word.

Ironically, Barbados received crucial assistance in the launching of our IFC from OECD members and from institutions that they control. The IFC was seen as a replacement for our declining and subsidy-dependent sugar industry. A Harvard-trained

American lawyer was paid by the IMF to draft the first version of the legislation; a former Canadian civil servant, paid by the Commonwealth Fund for Technical Cooperation, drafted the Bill that was later enacted. A group of experts, including representatives of OECD, developed the United Nations model tax convention that guided the policies of our and other IFCs. I myself was once employed by UNDP to prepare a paper on how to establish an IFC. Incidentally, Barbados' IFC regime specifically excludes bearer bonds and numbered accounts, practices still observed within OECD.

As fate would have it, I happened to be the Barbados Ambassador to the USA and Permanent Representative to the OAS when the OECD launched its illegal "**Harmful Tax Competition**" initiative in 1998. I was therefore deeply involved in my country's diplomatic response. As the midwife, if not the parent, of the Barbados IFC, you will forgive the passion I bring to this exercise.

Over the last seven years the contest between the IFCs and the OECD has developed into a stalemate. The 2002 commitment of several of the former to provide transparency and exchange of information on the basis of a "**level playing field**" embracing both parties has not yet been met. The purpose of this Symposium is to determine whether cooperation in advance of a "level playing field" might induce OECD member states to remove discriminatory measures, and lower tax and regulatory barriers to free trade in international financial services.

I accept the premise of the sponsors of this event that IFCs should seek to move beyond stalemate to a mutually advantageous arrangement with the OECD. As a non-practitioner in the field of IFC operations, I have not been involved in the ongoing give-and-take of the conflict, and so I must paint with a broad brush. My presentation

therefore focuses on the dynamics of the negotiating process itself, leaving the selection of specific plays to those sitting at the gaming table.

This paper treats the current impasse as a conflict (game) between unequal opponents (players), and draws on the Theory of Games for insights towards its resolution. It starts with a brief and basic exposition of the Theory of Games. It then recalls a historical case of a "game" between unequal "players" - the Cod Wars between Iceland and the UK from 1958 – 1975. Thirdly, I review the progress of the game between the OECD and IFCs to date, and assess the current state of play. Fourth, I offer the outlines of an IFC negotiating strategy for bringing about a satisfactory resolution of the current stalemate. I conclude with a few personal observations.

Basic Elements of Game Theory

Game Theory is the basic paradigm for studying situations in which two or more parties (players) compete (play) against each other. The theoretical foundations of Game Theory were laid in 1928 by **John Von Neumann**; its formalization came in 1940 with the joint publication by Von Neumann and **Oskar Morgenstern**, **Theory of Games and Economic Behaviour,** for which they jointly won the Nobel Prize for Economics. However, they were able to find an equilibrium solution only for zero-sum games between two persons, in which one player's gain (+) was the other's loss (**-**), thus yielding a total sum of zero, (e.g. chess and some military conflicts), and only under certain restrictive conditions, e.g. both players are rational and aware of the strategies available to the other opponent. They did demonstrate that in **two-person zero sum** games a unique equilibrium could be reached if both players sought to maximize their minimum gain, i.e.

if they both adopted the **maximin** – the pessimistic criterion of rationality associated with the name of Abraham Wald.

The Allies used Game Theory successfully in two-person zero sum situations during World War II, especially to increase the strike rate against German submarines. Game Theory is also used in certain business situations, e.g. a duopolistic market, where the conflict of interests between two players approaches completeness. However, for n-person non-zero sum games, which constitute the vast majority of human, social and international conflicts, Von Neumann and Morgenstern came up short.

John Nash saved the day with a series of three papers in the 1950s that would win him the Nobel Prize for Economics in 1994. Nash, whom some of you will recognize as the hero played by Russell Crowe in the movie "**A Beautiful Mind**", extended the Game Theory paradigm to include "games" involving more than two persons, i.e**. n-person** games, and in which the conflict of interests between the players was incomplete, i.e. non-zero sum games. Note that non-zero sum games may be **positive-sum**, also known as a "**win-win**" situation; or they may be **negative-sum**, in which the value of the game is a negative quantity. A nuclear war between the USA and Russia during the Cold War would have been the extreme example of a negative-sum game since both sides would have suffered catastrophic loss.

Most importantly, Nash demonstrated that a solution could be determined for all situations of conflict, including both cooperative n-person games and non-cooperative n-person games. The Royal Swedish Academy of Sciences, in its Press Release on the Nobel Prize award to Nash, put it this way:

> … Nash introduced the distinction between cooperative and non-cooperative games. His most important contribution to the theory of non-cooperative games was to formulate a universal solution concept with an arbitrary number of players

> and arbitrary preferences (i.e. not solely for two-person sum games.) This solution concept later came to be known as the Nash equilibrium. In a Nash equilibrium all of the players' expectations are fulfilled and their chosen strategies are optimal….In addition to his contributions to non-cooperative game theory, John Nash has developed a basic solution for cooperative games, usually referred to as Nash's bargaining solution…

A game is **non-cooperative** if it is impossible for the players to communicate in anyway. In non-cooperative games, therefore, binding agreements are not feasible. In cooperative games, however, players may communicate with each other, and binding commitments, side deals and combinations with other players are quite feasible. The concept of the "**Nash equilibrium**" informed US strategic thinking during the Cold War, while the "**Nash's bargaining solution**" has been applied extensively in various branches of economics, for example in the conduct of auctions in commodity markets.

The Nash paradigm also drew attention to three critical aspects of interaction among competitors: first, it highlighted the importance of **information** possessed by participants; secondly, it revealed that players' decisions were, more often than not, motivated by concerns about "**fairness**"; thirdly, it observed that in real world situations "games" are usually **partly competitive** and **partly cooperative**.

The original OECD strategy sought to engage IFCs in a two-person zero sum game in which the latter would lose their 20% market share of global financial services, which would then be added to the 80 percent of the market the OECD financial centres already controlled. The OECD claim that it sought "dialogue" and "cooperation" was inconsistent with the threat of sanctions for non-compliance with their demands, and the "naming" and "shaming" that deterred investors from doing business with the targeted IFCs. Note also that there was no threat of sanctions against, nor "**namin**g" and

“**shaming**” of, the numerous financial centres within OECD, and that the pejorative term “**tax havens**” was applied to IFCs but not to similar OECD jurisdictions, such as Luxembourg, Delaware, Belgium or Switzerland. In short, the plan was to put IFCs out of business.

The distinctive characteristic of the “game” between the OECD and IFCs is its **asymmetrica**l character: thirty of the world’s richest and most powerful nations confront about 30 of the world’s smallest and politically weakest states. Nonetheless, Nash has demonstrated that a **“bargaining solution**” exists that would satisfy both the OECD and the IFCs, if they could collectively come up with the appropriate strategies.

A Case of an Asymmetrical Game

The “case study” is a standard pedagogical device at Business Schools for the reconciliation of theoretical models with real-world situations. The classic case of a “game” between grossly unequal players was the series of three “Cod Wars” fought over the period 1958-1976 between Iceland, an island nation of less than 250,000 people, and Great Britain; the British were supported at times by as many as six other major Western European countries. Analysis of this conflict with the use of Game Theoretic concepts provides useful insights and lessons for small IFCs in their ongoing “game” with the OECD.

Determined to conserve its most valuable natural resource - codfish in the sea around its shore - Iceland, which had gained independence from Denmark in 1944, extended its territorial limit from three to four miles in 1950, invoking the right of control over its continental shelf. Western European states, especially the UK, fiercely objected,

but several countries noted that Britain itself had claimed a portion of the continental shelf around its Caribbean colony - The Bahamas. The four-mile limit held.

When its ground fish catch dropped by 16% between 1954 and 1957, Iceland extended its territorial limit to twelve miles in 1958. Once again the British protested, backed by France, Belgium, Denmark, Germany, Holland and Spain. However, by the August 30, 1958 deadline all foreign vessels had left the 12-mile limit, except for British trawlers accompanied by more than 40 ships of the Royal Navy. Iceland boasted only seven slow-moving coast guard vessels, but she would not be deterred from harassing the British trawlers, considerably limiting their catches. In 1961 the British conceded.

Ten years later, Iceland extended her territorial waters to 50 miles. This time, Britain and West Germany asked the International Court of Justice to intercede. Iceland refused to accept the jurisdiction of the Court. In the Second Cod War, the Icelandic coast guard used submarine wire-cutters to sever trawl cables, letting loose nets worth US$5000 each. In one year 69 British and 15 German trawlers lost their nets, while manoeuvres to avoid collision with Icelandic vessels made fishing unprofitable. Moreover, the British were reluctant to use the Royal Navy again, since Iceland and Britain were now allies within NATO. Some shots were fired, but fortunately no one was killed.

The Icelanders got even tougher, blocking British NATO planes from Icelandic air traffic control, and threatening to break off diplomatic relations. Pressured by NATO to avoid conflict within its ranks, Britain recognized a fifty-mile zone in exchange for limited catches by smaller trawlers, even before its case before the International Court could be heard.

Following the endorsement in 1973 by the UN Seabed Committee of a 200-mile zone, and the continued dramatic decline in cod stocks, Iceland extended its territorial limits to 200 miles in 1974. Once again the British and Germans defied the Icelandic declaration, but the Third Cod War lasted only one year. Allies advised British consumers to substitute other species for cod, and in the midst of negotiations between the two warring parties, the EEC left Britain in the lurch and established a European 200-mile territorial zone. The British had no choice but to concede, and the "Nash "bargaining solution" was achieved. Ironically, Iceland's cod conservation policy today involves the restriction of its own fishermen within a universally accepted 200-mile economic zone.

Why Iceland Won

There are five main reasons why Iceland won the Cod Wars:

1. The differing interests among the European states prevented them from forming a solid bloc and engaging in a two-person zero sum game, in which the stronger partner would have enjoyed a distinct advantage.
2. The conflict evolved into a cooperative n-person game in which the strategic scope of the weaker player was enhanced, and the stronger player more readily entered into negotiations.
3. The spectacle of some of the world's richest and most powerful nations stealing the "birthright" of one of the world's smallest and weakest clearly violated the principles of "**fair play**", and inhibited the UK from using maximum force against Iceland.

4. As the conflict wore on Iceland gained the sympathy of the international community and Britain found itself isolated. The "game" ended with a "Nash bargaining solution" with which both "players" could live.
5. Throughout the "game" Iceland remained open to negotiations, and occasionally made deals, but she never retreated from her fundamental position that she alone had the right to determine the economic exploitation of her continental shelf. And Iceland, as we have seen, did play "hard ball"! As the London *Financial Tines* wryly observed, "The Icelanders are, by any standards, very difficult to deal with."

There was one advantage that the Icelanders had that the targeted IFCs do not – they are European. But there are two advantages ICFs possess that Iceland did not: First, we live in a post-colonial world in which lip service, at least, is paid to the principle of self-determination; Secondly, the New Information Age makes it possible to instantaneously communicate our point of view across the world. Note the success of LDC NGOs in influencing the behaviour of the WTO, IMF, and World Bank – institutions historically dominated by the OECD!

The Evolution of the OECD - IFC Game

The OECD "Initiative on Harmful Tax Competition" is now seven years old, and the fact that the IFCs are still in business, is in itself a significant victory for them. The ferocity of the OECD's initial assaults has somewhat diminished, and there is an increased willingness on their part to negotiate. OECD bureaucrats obviously expected their *blitzkrieg* tactics to yield a swift victory. They certainly did not expect

such a spirited response – especially from Barbados. Moreover, there has been a considerable loss of cohesion within OECD ranks, which led its members in 2002 to commit to a "level playing field" for both OECD and non-OECD financial centres - even though the sincerity of that commitment is yet to be tested.

The assessment of the sponsors of this Symposium that a stalemate currently exists is a fair one. But a stalemate is not a "Nash bargaining solution", since neither party is yet satisfied with the *status quo;* IFCs are therefore by no means out of the woods. Using the concepts of Game Theory, we may summarize developments so far as follows:

1. The OECD original attempt to conduct an **asymmetrical** two-person zero sum game with IFCs, either as a bloc or separately, has not succeeded. Indeed, indications are that the OECD was prepared to conduct a two-person negative-sum game in which the losses would be intolerable for the weaker player, but quite tolerable for the stronger. The refusal of some IFCs to capitulate, as well as OECD's failure to maintain cohesion in its ranks, caused the conflict to evolve into a cooperative n-person, though still asymmetric, game.
2. As we have seen, a cooperative n-person game reduces the ability of either opponent to control the game. More importantly, it opens the way for a "Nash bargaining solution".
3. IFCs have succeeded to some degree in bringing the issue of "fair play" to international attention. Some American Congressmen, for example, have expressed concern about the OECD infringement on the sovereignty of IFCs, and a few OECD members of the Commonwealth, Canada in particular, are clearly uncomfortable with the OECD initiative.

4. Several other players have been drawn into the game, e.g. The Commonwealth, the United Nations Organization, the OAS, the IMF, the Heritage Foundation – a US conservative think tank, and most significantly, STEP, a vital source of technical assistance for IFCs. This has complicated the dynamics of the "game", causing the OECD to back away from some of its initial positions.

5. Negotiations have continued throughout the conflict. IFCs have made a number of concessions to the OECD, in particular the strengthening of their financial regimes against money-laundering and transfer of funds to terrorist groups. Although the OECD has committed to a "level playing field" as the basis of continuing negotiation with "cooperative" IFCs, it maintains the threat of **sanctions**, now renamed "**defensive measures**". "**Cooperation**" is the term in the OECD lexicon for "**coercion**".

The Way forward

My advice to IFCs, in a nutshell, is, "**Hang Tough**!" More specifically, there are five basic courses of action suggested by the above analysis:

1. IFCs should prepare for a long war with the possibility of defeats along the way. After all, the Cod Wars lasted for nearly two decades! However, with the right strategies and some luck, there is the distinct possibility of reaching a "Nash bargaining solution".

2. Using the platform of the **International Trade and Investment Organization** (ITIO), with its headquarters in **Barbados** (which has emerged as the leader of the pack), IFCs should build their capacity for strategy formulation and execution. And the more IFCs support ITIO the better! The most talented staff available

should be assigned to ITIO, and adequate funding provided. At the same time, cooperation between STEP and IFCs should be deepened so as to ensure continued access to the required technical expertise and most up-to-date information. How I wish that a document such as the superb STEP publication, *Towards a Level Playing Field*, had been available when I was fighting the cause of Barbados in Washington, D.C.

3. IFCs should stand ready to negotiate with OECD at anytime and in any forum, and to do bilateral side deals whenever possible. However, even if *force majeure* requires tactical concessions, IFCs should not concede the legitimacy of the OECD "Harmful Tax Competition Initiative", nor yield on their sovereign right to conduct their own fiscal policy. And the more players that are drawn into the game the better!

4. IFCs should play the "**fair play**" card to the hilt, and force the OECD states to defend the indefensible in all fora where IFCs and OECD states sit together as sovereign equals, e.g. the UN, IMF, World Bank and regional Development Banks, WTO, The Commonwealth, and OAS. And there is no reason why IFCs should not call on the OECD to compensate them for the administrative costs of accommodating OECD impositions.

5. IFCs should entertain any overtures from the OECD, remembering at all times the caveat stated in the program of this Symposium, that "though confrontation is dangerous, capitulation is worse." IFCs should especially seek reciprocal deals, e.g. double taxation treaties as a *quid pro quo* for any further information exchange concessions, thus guiding OECD toward a positive-sum solution.

Indeed, the search for such incentives is what this Symposium is about. I wish you the very best in your deliberations.

A Few Last Words

Back in 1998, I wrote Prime Minister Arthur from Washington D.C. urging him to fight against the OECD "Harmful Tax Competition Initiative". I quote my correspondence from memory:

> There are some battles that have to be fought even when there is no certainty of victory. For how you fight them will determine how the enemy approaches you the next time around – as he certainly will if you capitulate on this occasion.

Precious principles are at stake in this asymmetric "game". OECD nations are fervent evangelists of **democracy**, the **rule of law**, and **free markets** throughout the world; they should also recognize that the logical extension of democracy **within** nations is democracy **among** nations; that the principle of the rule of law also applies to relations **among** sovereign states; and that the unilateral application of sanctions violates the principle of **free markets -** for financial services as well as for goods.

As for **sovereignty**, both OECD and IFCs might recall the words of the 18th Century Swiss jurist, Emmerich Vattel in, **Law of Nations**, a work much quoted by the American founding fathers**: "Of all the rights possessed by a nation, that of sovereignty is doubtless the most important**." For small IFCs, this is certainly very true today!

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