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**НОВЫЕ ИДЕИ В ОФФШОРНЫХ
ФИНАНСОВЫХ ЦЕНТРАХ**

Аннотация: Рассмотрены оффшорные центры с точки зрения их роста, практика корпоративного управления, право собственности на акции, и стоимость аутсорсинга. Описывается определение оффшорных центров, коррупция, отмывание денег в оффшорных финансовых центрах. Предоставлены различия между оффшорными компаниями и оншорными компаниями с более высокой деловой репутацией. Рекомендуется проводить оценку трансфертного ценообразования. Описана практика уклонения от налогов, качество правовой среды и мониторинга денежных потоков. Уточняется оффшоринг как коммерческая деятельность для выхода на иностранный рынок. Концентрируется внимание на оффшорные центры в Словакии.

Ключевые слова: оффшорные центры, аутсорсинг, трансфертное ценообразование, оффшорный рост.

Works of foreign scientists

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**NEW INSIGHTS INTO OFFSHORE
FINANCIAL CENTERS**

Abstract: This paper examines offshore centres in terms of their growth, offshore corporate governance in practice, ownership of voting shares, and cost of outsourcing. Therefore paper describes definitions of offshore centers, viewed in this light corruption money laundering. Secondly, we provide differences between offshore businesses and onshore service providers. We pointed out on cost of outsourcing. Thirdly, we clarify offshore growth, and lastly we focus on offshore centers in Slovakia.

Keywords: Offshore Centres, Outsourcing, Transfer Pricing, Offshore Growth

Introduction

In recent years, outsourcing of broader ranges of tasks by a larger number of firms has spread across the national boundary. Although the decision of offshore outsourcing by heterogeneous firms has become one

of the hottest research topics in international economics, empirical studies have been constrained by the limited availability of micro-data. The increasing offshore R&D activities performed by multinational companies have also attracted the interest of international and industrial economists.

1 What are Offshore Centres?

The IMF defines Offshore centers (OFC)s as follows: (i) Jurisdictions that have relatively large numbers of financial institutions engaged primarily in business with non-residents; and (ii) jurisdictions with financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and (iii) centers which provide some or all of the following services: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity.

The *number of offshoring firms* (the extensive margin) and the real value added per offshoring firm (the intensive margin) fluctuate over the business cycle, and thus affect output, prices and wages in both the parent and the host countries.

However, *Corruption money laundering* in offshore financial centers is further connected with another largely unexplored phenomenon in the world economy – round-trip investment, i.e. the transfer of funds abroad in order to bring some or all of the investment back to home country as foreign investment.

1.1 Offshore Corporate Governance in Practice

Under English or Swiss law - the leading hedge fund centers which we shall use by way of example - it is important that any *offshore company has its central management and control in its jurisdiction of incorporation, or that this is at least not carried out from the UK or Switzerland*. In other words, central management and control refers to the board of directors or management committee of the company according to the information from report of Laven Financial Services (2013, p. 3-4). Laven Financial Services offers corporate governance, international compliance and operational support services, as well as directorships to offshore management companies.

1.2 Ownership of Voting Shares

According to the Laven F. S. depending on the general structure, the (voting) shares of an offshore management company are often held by another offshore company or trust, or an individual shareholder who is

usually offshore domiciled. Onshore directors and persons may hold voting shares but this should be avoided as it will be deemed to add to the control that is exercised onshore.

Viewed in this light, with regard to the UK, as of 1 January 2013, new rules on *Controlled Foreign Companies* were introduced which brought about the need for any UK businesses with overseas subsidiaries to understand the relevant legislation as it may now have a direct fiscal impact on the group overall. In short, the rules on Controlled Foreign Companies determine whether a non-UK company is controlled by a UK person/company (whether by virtue of legal, economic or accounting control) and therefore a charge should be applied on its profits.. Irrespective of this new law, for many UK based managers it is still common for UK resident directors to hold controlling interests in offshore companies that are linked to asset management responsibilities. This is probably very likely to lead to the UK tax authority to re-qualify the domicile of the offshore companies. In practice, this happens especially if all the other considerations demonstrate control from the onshore jurisdiction.

2 Transfer Pricing

Moreover, well controlled and exercised corporate governance should also include an assessment of transfer pricing, where relevant. *Offshore businesses* (e.g. offshore management companies) and *onshore service providers* (e.g. onshore sub-managers) that are connected parties (for example due to links of ownership and/or common management) will need to consider issues which relate to the value of the services provided from onshore to offshore.

More to the point, a documented assessment should be carried out for the *purpose of determining a fair price for the services and in support of the transactions between the parties*. This process should establish an understanding of what is market practice for similar services and to limit therefore any potential for queries by tax authorities in relation to the transactions.

In terms of recent developments, the *Alternative Investment Fund Managers Directive* (AIFMD) entered into force on 22 July 2013 and introduced the Letter-Box Entity provisions which are relevant, for example, to structures where an offshore manager delegates certain activities to an onshore sub-manager. Where an offshore manager is deemed a letter-box entity, it can no longer be considered as the manager

of the fund in question and would therefore not be compliant with the AIFMD described by Laven F. S. (2013).

As a corporation, or body corporate, a private company is regarded in law as having a separate legal personality from its shareholders (owners) and directors (managers) (Courtney 2002). Such a legal entity may have been incorporated through a registration process established through legislation. Hence, an offshore firm is a legal entity which has *registered its headquarters or subsidiary through the laws of an OFC*. In his paper, he defines two types of offshore firms: Type I, *which have headquarters registered in OFCs*, while Type II *firms have set up subsidiaries in an OFC* (or in multiple OFCs) but have headquarters registered in 15 countries with the strictest legal regimes based on La Porta et al. (1998) (Austria, Australia, Belgium, Canada, Denmark, Finland, France, Germany, the United Kingdom, Japan, Netherlands, New Zealand, Norway, Sweden and the United States). Not all Type I offshore firms keep their headquarters in OFCs. About 53% of Type I offshore firms have headquarters registered and keep their headquarters in OFCs. The rest (47%) of Type I offshore firms have their headquarters in other countries or jurisdictions. After we control for the impact of OFC-registered and headquartered via OFC-registered but not headquartered of Type I offshore firms on financial reporting quality, the results are similar irrespective of the locations of offshore firms' headquarters.

3 Offshore Growth

If we look at the anonymity of the offshore centres, world makes it difficult to track the flow of money. A study by James S. Henry, former chief economist at McKinsey & Company, estimates that wealthy individuals have *\$21 trillion to \$32 trillion in 2013 in private financial wealth tucked away in offshore havens* — roughly equivalent to the size of the U.S. and Japanese economies combined.

Even as the world economy has stumbled, the *offshore world has continued to grow*, said Henry, who is a board member of the Tax Justice Network, an international research and advocacy group that is critical of offshore havens. His research shows, for example, that assets managed by the world's 50 largest “private banks” — which often use offshore havens to serve their “high net worth” customers — grew from \$5.4 trillion in 2005 to more than \$12 trillion in 2013.

3.1 Do OFCs make bad neighbors?

One might expect proximity to an OFC to be bad for the

neighborhood, since OFCs encourage tax evasion and other illegal activities. However, the presence of nearby offshore financial centers may also have beneficial effects. Most importantly, *the presence of an OFC with an efficient financial sector may increase the competitiveness of a source country's banking sector, though this benefit is tempered by transactions costs.*

3.2 Offshore bond issuance decision

The decision to issue in foreign currency or abroad is often affected by the desire to widen the investor base to include foreign investors. Thus the extent to which domestic markets are open to foreign investment is a critical factor in the domestic vs. offshore bond issuance decision. That withholding taxes are often a significant deterrent to investing in local markets for foreign investors, and thus can hinder the depth and liquidity of those markets, has been greatly emphasized by market participants in Asia (see Chan et al. (2011)). Similarly, the same report identifies restrictions on foreign investors *investing in domestic bonds as a further area for market development.* Where countries impede cross-border investment, they will enhance the offshore market. These factors are relevant to the static trade-off and the risk management theories as well as the market depth hypothesis, therefore we consider how the tax incentives for foreign investors affect the depth of the market, and its development. Chan et al. (2011) document that countries in Asia have varied the application of withholding taxes over time, and this *potentially has an influence on the attractiveness of local currency bonds to foreign investors.*

The third measure by Mizen, P., Packer, F., Remolona, E., Tsoukasp, S. (2012, p. 11) use to indicate *market development is the scale of the derivatives market.* The development of FX markets and derivatives in EMEs usually depends on the depth and liquidity of local debt markets as a proxy measure for the ability to swap easily in and out of the domestic and other currencies and has also been used as a market specific factor that might determine the extent of bond issuance. To the extent that firms can transform their interest payments on foreign (or domestic) bond issues into synthetic domestic (foreign) payments that can be serviced by domestic (foreign) cash flows, better developed swaps and derivatives markets could in principal enhance the growth of both foreign currency and domestic currency bond issues.

They combined these market-level data with firm-level data in an

unbalanced panel for the eight countries (China, Hong Kong SAR, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand) covering the period 1995 to 2007. They control for variables representing agency, static trade-off and risk management theories of the capital structure.

The question is: What difference have such reforms made to the actual financing decisions of firms in the region? Answers provided by Mizen, P., Packer, F., Remolona, E., Tsoukasp, S.(2012, p. 33-34) show that for many such borrowers, deep and liquid offshore markets have long provided *financing for debt denominated in US dollars or euros*. How do firms decide between offshore and onshore markets? Has the emergence of access to two parallel corporate bond markets changed the capital structure decision? More generally, do the observed choices between local and foreign currency shed light on the various theories of capital structure, including costly monitoring and agency theories, pecking order, market depth and risk management theories?

Their results provide the strongest support for the market depth hypothesis, i.e. the hypothesis that the choice of market will be determined to a large extent by the ability of the scale and depth of the market in question to accommodate borrower demands. *Measures of domestic market scale and (relative) liquidity have a positive and highly significant impact on overall issuance, while measures which proxy for the probability of issuers overstressing local currency lending markets, such as firm size, leverage and long-term debt ratio, increase the likelihood of going offshore.* The market depth hypothesis was also supported by the importance of the existence of a larger foreign investor base as well as the exemption of withholding taxes for non-resident investors. Issuers from countries with a large foreign investment presence are more likely to issue bonds, and more likely to do so onshore. Once the depth of the market was increased via withholding tax exemptions for non-residents, corporations were more likely to issue onshore as well.

Confirmation of the *risk management theory* - i.e. the hypothesis that firms that are more able to control the exchange rate risks should be more likely to issue offshore in a foreign currency - was evident based on tests utilizing data from a recently updated central bank survey on derivatives markets in different currencies. The size of currency hedging markets in each country - including FX swaps, currency swaps and options markets and other instruments covered by the BIS Triennial Survey - clearly

increases the probability of issuance in foreign currency.

However, beyond investors and securities regulators, offshore firms' financial reporting practices also preoccupy many government and public officials. From a public policy perspective, the opaque and *poor financial reporting of many offshore* firms has enabled them and their managers to evade paying taxes and to loot money from investors presented by Durnev, A., Li, T., Magnan, M., (p.3).

Therefore, we expect offshore firms to exhibit low quality financial reporting since managers have greater incentives to manage earnings in ways that mask diversion activities or hide poor performance (Kim et al. 2010).

Durnev, A., Li, T., Magnan, M., (2013, p. 5) describes that consistent with both the agency theory of tax avoidance and the quality of the legal environment, we find that offshore firms exhibit lower quality financial reporting through higher accruals management, lower accruals quality and less earnings persistence than non-offshore firms. Moreover, firms that have their headquarters registered in OFCs engage in more real earnings activities than non-offshore firms. In contrast, firms with OFC subsidiaries have less real earning activities than non-offshore firms.

If we focus on, *The Offshore Attitude Index*, definition is as follows - a comprehensive code of taxation, legal regimes, potential national benefits, political stability, and economic crime pollution for OFCs (Masciandaro 2008). Higher values of the Offshore Attitude Index for an OFC indicate more OFC-orientation (i.e., lower taxation, less potential national benefits and more flexible financial regulations).

4 Cost of outsourcing

There are costs to services outsourcing, and these costs are familiar from the literature on how trade in goods affects labor markets. While trade provides benefits for the nation as a whole, some people face dislocation. For example, workers with low skills within certain occupations such as data entry and low-end computer programming appear to have been affected by increased trade in services. The appropriate policy response is to help affected workers adjust to change rather than give up the gains from trade in the first place. Policies aimed at preventing trade, including outsourcing, would mean lower standards of living for both Americans and the citizens of developing countries.

Durnev, A., Li, T., Magnan, M., (2013) in their paper used a sample that includes *firms that have their headquarters registered in 18 OFCs*,

firms that establish subsidiaries in OFCs but their headquarters are registered in 15 non-OFC countries with the strictest legal regimes, and firms without OFC operations from 37 non-OFCs. According their results, evidence shows that offshore firms engage in more accrual-based management, exhibit lower accruals quality and less earnings persistence than non-offshore firms. Firms that have headquarters registered in OFCs with a higher Offshore Attitude Index prefer accruals to increase their reported earnings but use real earnings activities as a supplement. Finally, using a U.S. sub-sample we distinguish that U.S. multinational firms with OFC subsidiaries exhibit poorer financial reporting quality compared to not only U.S. multinationals with non-OFC subsidiaries but also to U.S. domestic firms.

Zlate, A., (2010, p. 37) examines *the effect of offshoring on the cross-country transmission of business cycles*, while focusing on its extensive and intensive margins as separate transmission mechanisms. His paper considers a model of offshoring with heterogeneous firms that is consistent with the empirical patterns of offshoring from U.S. manufacturing to Mexico's maquiladora sector. First, following an *aggregate productivity increase in the country of origin* (North), the value added per offshoring firm jumps on impact and then returns to its initial steady state. However, domestic firm entry causes a gradual increase in the relative cost of effective labor (i.e. the wage adjusted by aggregate productivity), which in turn generates a gradual increase in the number of offshoring firms (the extensive margin), as in the data. Second, *offshoring enhances the cross-country co-movement of output relative to the model with endogenous exports*. The result is consistent with the empirical regularity documented in Burstein, Kurz, and Tesar (2009) that country pairs with larger shares of offshoring-related trade in bilateral trade also exhibit larger correlations of manufacturing output. Third, offshoring reduces the appreciation of the real exchange rate that follows an aggregate productivity improvement in the parent country, and thus dampens the Harrod-Balassa-Samuelson effect that occurs in the framework with firm entry and endogenously traded varieties.

There are a number of possible extensions to the model considered in this paper. First, the framework is useful to analyze *the impact of offshore production on employment in the parent and the host countries*. Second, *a possible extension with rich policy implications would involve the study of interactions between offshore production and labor migration in a*

united framework, in which both offshoring and labor mobility are driven by fluctuations in the relative wage across countries. Third, while his paper studies the fluctuations of offshoring over the business cycle, further research should address the long-run developments in offshore production and its implications for U.S. manufacturing.

5 What includes offshoring?

Offshoring refers to the process of sourcing and coordinating tasks and business functions across national borders. Offshoring may include both *in-house (captive, or international in-sourcing) and outsourced activities, which are delivered by an external provider* – that is from outside the boundaries of the firm. Outsourcing, in turn, may occur both domestically (onshore) and abroad (offshore). Further, offshoring refers to sourcing rather than sales activities, and it supports global or domestic rather than local operations. It is not primarily intended for entering a foreign market nor for supporting the company's local activities. For example, setting up HR (human resources) departments in foreign subsidiaries in support of local operations (e.g. sales and distribution) is not what we mean by offshoring. Only if HR services (e.g. payroll services) are provided from offshore in support of global or home-based HR functions, does the term 'offshoring' apply. Though it used to be limited to simple codified and repetitive tasks, companies are now offshoring increasingly complex and advanced activities requiring more and more qualified workers (Lewin and Peeters, 2006).

Lewin, A., Y., Massini, S., Peeters, C., (2008, p. 30-31) their empirical study reported in this paper brought *together arguments of managerial intentionality, path dependence, and environmental effects to explain firms' decision to offshore product development work*. The results confirm that access to qualified personnel offshore is a strong determinant of such decisions, partly driven by a reduction in the supply of science and engineering talent in the US. The idea of cumulative experience building is also validated, although managerial intentionality seems to be a stronger determinant of PD offshoring decisions than firms' past experience with offshoring. Among the strategic objectives that may lead firms to offshore, speed to market is a key factor underlying decisions to offshore portions of their innovation process. Conversely, firms with growth objectives are less likely to offshore PD. Finally, the study offers a clarification of the role of cost savings in explaining innovation offshoring. *Firms do see PD offshoring as a unique*

opportunity to reduce the cost of their innovation activities partly through HBR strategies with labor arbitrage becoming a secondary driver. For small companies, access to lower cost S&E talent globally enables them to augment their limited in-house R&D resources (HBA strategies).

Their paper contributes to the debate about growing shortage of technical talent and globalization of human capital, by providing empirical support to the argument of an impending global race for science and engineering talent triggered by events such as the 2003 cutback in the H1B visa quota from 195,000 to 65,000 visas annually and the diminishing interest in entering the S&E careers as indicated by the decline in the number of US nationals earning advanced degrees in S&E. However, competing for science and engineering talent is unlike seeking markets or production platforms through FDI. Talent is different from other assets because it is highly mobile and because of high obsolescence. Accessing and managing talent in globally dispersed locations requires new recruiting and retention strategies as well as new organizational forms for managing, sharing, and exploiting knowledge. Although this paper sheds light on a few important questions regarding the determinants of firms' decision to offshore innovation activities, we wish to acknowledge some limitations and future extension of the present research. First, although this paper provides an analysis of the influence of three types of factors on companies' decisions to offshore product development, it is likely that these factors do not impact firms' decisions independently of one another.

Ito, B., Tomiura, E., Wakasugi, R., (2007, p. 21-23) presented in their paper factors as follows. Noticeably more firms are outsourcing offshore, compared with five years ago, but still only around one-fifth of the midor large-sized firms are active in financial operations. Production-related tasks outsourced within East Asia occupy the major share in financial operations, while service outsourcing remains limited. In more than one-third of financial operations cases, tasks are outsourced to own offshore affiliates within the boundary of multinational firm. These may indicate still serious obstacles for active outsourcing, especially of service tasks, beyond the neighboring low-cost countries, or at the same time, unsolicited ample opportunities of global sourcing ahead of many firms. They pointed out that *with respect to offshore R&D, the number of firms conducting offshore R&D are not large and different across industries.*

Electrical machinery and electronics, chemical, transportation machinery and general machinery are the dominant industries. The function of offshore R&D is not independent from headquarter. Two thirds of offshore R&D are incorporated in R&D at headquarter. The access to local market and the agglomeration of local firms and R&D institutions are major motivations of offshore R&D. We observe the high ratio of support-oriented R&D in every region as well as the high ratio of R&D collaboration in the U.S., EU and China. Most R&D are purposed to conduct the development, but one fifth is for conducting basic research in the U.S., EU and China. IPR protection is indispensable factor to determine the magnitude of offshore outsourcing and R&D. This survey presents how each firm perceives the protection of IPR in each country. The heterogeneous enforcement of IPR based on firm's perception is useful to analyze how the corporate decision of offshoring is affected by the enforcement of IPR.

Paper of Ledyeva, S., Karhunen, P., Whalley, J., (2013, p. 25-26) sheds light on a virtually unexplored phenomenon: *round-trip investment from Russia to offshore financial centers and back to Russia*. In particular they empirically study the link between corruption and round-trip investment. Their empirical test is based on the firm-level data on foreign-owned firms in Russia obtained from Rosstat. Their main results can be summarized as follows.

First, they found *quite robust evidence that round-trip investors tend to invest into more corrupt Russian regions than genuine foreign investors*. Their result gives support for the proposition of laundering the proceeds of corruption via round-trip investment (in particular it's high significance for the combined financial and real estate sector). It further indicates that round-trip investors may indeed be better equipped to cope with institutional deficiencies, e.g., corruption (in particular, the result's significance in manufacturing sector). Second, they found *evidence that round-trip investors invest more into regions with higher resource potential compared to their genuine foreign counterparts*. Their finding indicates that round-trip investors are better able to exploit the business opportunities provided by the Russian natural resources than genuine foreign investors. This often requires allying with authorities, which is obviously easier for round-trip investors than for genuinely foreign investors. Furthermore, round-trip investors might be themselves the representatives of the authorities who already have access to resources.

Finally, their results enable *us to suggest that round-trip investors favor the development of the Dutch disease in Russia*. In particular they are very highly concentrated in the service sector (real estate and financial activities, in particular), seem to aim at exploiting natural resources in Russia, tend to establish manufacturing firms in resource-based industries and support the development of corruption in Russia by investing into corrupt Russian regions. On the contrary, genuine foreign investments seem to work against the Dutch disease as they are more concentrated in manufacturing industries and regions with higher educational potential of population but are not tied to resource abundant and corrupt Russian regions.

Rose, A. K., Spiegel, M. M., examined (2006, p. 22) both the determinants of *offshore financial centers and the consequences of OFCs for their neighbors*. Using both bilateral and multilateral samples, we find empirically that successful offshore financial centers encourage bad behavior in source countries, since they facilitate tax evasion and money laundering. At first blush, it thus appears that OFCs are best characterized as “parasites,” since their attraction stems in part from allowing their source-country clients to engage in activities detrimental to the well-being of their homes.

Nevertheless, offshore financial centers created to facilitate undesirable activities can still have unintended positive consequences. In particular, the presence of OFCs enhances the competitiveness of the local banking sector. Using a model of a domestic monopoly bank facing a competitive fringe of OFCs, we demonstrate that OFC proximity enhances the competitive behavior of the monopoly bank and may increase overall welfare. This is true despite the fact that deadweight losses are borne when funds are transferred offshore to an OFC. They test these predictions using a multilateral data set, and show that proximity to an OFC is indeed associated with a more competitive domestic banking sector, and greater financial intermediation. They tentatively conclude that OFCs are better characterized as “*symbionts*.”

6 Offshore Centres in Slovakia

The largest absolute increase in 2013 reached the United States (99 new firms in OFC), Seychelles (40) and Panama (32). From a relative perspective was interesting countries such as Bahamas (+114%), Cayman Islands (+100%) and Panama (+ 52%). But it still decreases the number of firms with owners from Luxembourg (-38) and Cyprus (-12). “*Unlike*

the Czechs, our entrepreneurs from Cyprus leave. They are affected by the crisis and unstable situation. Since the Luxembourg decided to alleviate its rules on banking secrecy and not to put more on the people who want to save on taxes for our business ceased to be attractive, "says current statistics Seliak Milan. For more details see Table 1.

Table 1 Numbers of Slovak firms in OFC

Countries	2013	2012	Change 2012- 2013	Change 2012- 2013 (%)	2011	2010
Bahamy	15	7	8	114.29	4	5
Belize	117	96	21	21.88	75	51
British Virgin Islands	88	78	10	дек.82	81	78
Gibraltar	8	7	1	14.29	17	23
Hong Kong	35	30	5	16.67	25	20
Jersey; Great Britain	13	16	-3	-18,75	9	11
Cajman Islands	6	3	3	100	3	2
Cyprus	755	767	-12	-1,56	600	535
Lichtenstein	32	28	4	14.29	18	15
Luxemburg	354	392	-38	-9,69	344	318
Malta	54	45	9	20	36	33
Marshall Islands	2	2	0	0	0	0
Monaco	21	18	3	16.67	16	11
Netherland's Antily	3	4	-1	-25	2	2
Netherland	1124	1110	14	январь.26	1052	1050
Panama	94	62	32	51.61	38	25
Seychell Republica	220	180	40	22.22	65	18
United Arab Emirates	53	41	12	29.27	37	32
United States of America	859	760	99	13.март	671	601
Total number	3853	3646	207	май.68	3093	2830

Source: According to the information from report of consulting firm Bisnode Slovakia, 2013

Conclusion

To a large extent, the issue of offshore outsourcing involves the same fundamental questions addressed by economists for more than two centuries concerning the impact of international influences on the domestic economy. To be sure, the world is different, as advances in technology have made it possible to trade a wider range of services. Services offshoring, however, fits comfortably within the intellectual framework of comparative advantage built on the insights of Adam Smith

and David Ricardo. This is contrary to the assertions of some non-economists, who see a new paradigm created by improved technology and communications that somehow undermines the case for free trade.

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