TAX HAVENS:

RELEASING THE HIDDEN BILLIONS FOR POVERTY ERADICATION

EXECUTIVE SUMMARY

Tax havens and offshore financial centres (OFCs) have seldom figured as prominently in media coverage of economic affairs as they do today. Interest has focussed on the concerns of northern governments and the interests of powerful transnational corporations (TNCs). The main actors in the debate are revenue authorities, corporate lawyers, tax accountants and financial journalists. By contrast, the world's poorest countries are conspicuous by their absence. This is unfortunate because offshore tax havens represent an increasingly important obstacle to poverty reduction. They are depriving governments in developing countries of the revenues they need to sustain investment in basic services and the economic infrastructure upon which broad-based economic growth depends. This paper argues that off-shore centres are part of the global poverty problem - and that the interests of the poor must be brought onto the reform agenda.

It is impossible to calculate the financial losses to developing countries associated with offshore activity. Secrecy, electronic commerce and the growing mobility of capital have left all governments facing problems in revenue collection. The borderline between tax evasion and tax avoidance is becoming increasingly blurred. But at a conservative estimate, tax havens have contributed to revenue losses for developing countries of at least US$50 billion a year. To put this figure in context, it is roughly equivalent to annual aid flows to developing countries. We stress that the estimate is a conservative one. It is derived from the effects of tax competition and the non-payment of tax on flight capital. It does not take into account outright tax evasion, corporate practices such as transfer pricing, or the use of havens to under-report profit.

Revenue losses associated with tax havens and offshore centres cannot be considered in isolation. They interact with problems of unsustainable debt, deteriorating terms of trade, and declining aid. But there is no doubt the implied human development costs of tax havens are large. The US$50 billion loss is equivalent to six times the estimated annual costs of achieving universal primary education, and almost three times the cost of universal primary health coverage. Of course, ending the diversion of resources from governments into corporate profit margins and offshore bank accounts provides no guarantee that the funds released will be used for poverty reduction purposes. This will depend on governments developing effective poverty reduction strategies. But allowing current practices to continue will undermine the successful implementation of such strategies.

The extent of offshore financial activity is not widely appreciated. The globalisation of capital markets has massively increased the scope for offshore activity. It is estimated that the equivalent of one-third of total global GDP is now held in financial havens. Much of this money is undisclosed and untaxed - and the rest is under-taxed. Governments everywhere have become increasingly concerned at the implications. In Britain, the government's efforts to prevent the use of tax havens to under-report profit (and hence tax liability), has brought it into conflict with powerful transnational companies. At least one major corporation has responded by threatening to relocate their investments from Britain. Such problems have lead to a proliferation of initiatives designed to tackle various aspects of the problem. The OECD is leading an initiative to crackdown on harmful tax competition, UN agencies are trying to curb money laundering, and the Financial Stability Forum (FSF) is examining the impact of the offshore system on global financial stability.

These initiatives are useful up to a point, but they primarily reflect the concerns of northern governments. Ironically, these governments are in a far stronger position than their counterparts in developing countries. If revenue authorities in Britain and Germany feel threatened by offshore activity, how much more severe are the problems facing countries with weak systems of tax administration? And if governments in rich countries see tax havens as a threat to their capacity to finance basic services, how much more serious are the threats facing poor countries? After all, these are countries in which 1.2 billion people have no access to a health facility, in which 125 million primary school age children are not in school, and in which one out of every five people live below the poverty line.

Lack of attention to poverty is only one part of the problem with current initiatives. Another is their lack of balance. Some developing country havens justifiably see the actions of northern governments as being unbalanced and partial. Financial havens are part of a much wider problem that extends beyond the 'offshore' activity of small island states to ‘onshore’ activity in major economies such as the City of London and New York. Yet OECD efforts to address harmful tax competition have involved a crackdown on small state financial havens, while a far more light-handed approach has been applied to member countries engaging in harmful tax practices.

Tax havens may seem far removed from the problem of poverty, but they are intimately connected. There are three major ways in which offshore centres undermine the interests of poor countries.

- **Tax competition and tax escape**. Tax havens and harmful tax practices provide big business and wealthy individuals with opportunities to escape their tax obligations. This limits the capacity of countries to raise revenue through taxation, both on their own residents and on foreign-owned capital. This can seriously undermine the ability of governments in poor countries to make the vital investments in social services and economic infrastructure upon which human welfare and sustainable economic development depends. It also gives those TNCs that are prepared to make use of international tax avoidance opportunities an unfair competitive advantage over domestic competitors and small and medium size enterprises. Tax competition, and the implied threat of relocation, has forced developing countries to progressively lower corporate tax rates on foreign investors. Ten years ago, these rates were typically in the range of 30-35 per cent - broadly equivalent to the prevailing rate in most OECD countries. Today, few developing countries apply corporate tax rates in excess of 20 per cent. Efficiency considerations account for only a small part of this shift (as witnessed by the widening gap between OECD and developing country rates), suggesting that tax competition has been a central consideration. If developing countries were applying OECD corporate tax rates their revenues would be at least

US$50 billion higher. If used effectively, funds siphoned through tax loopholes into offshore financial centres could be used to finance vital investments in health and education. None of this is to argue for a return to high tax regimes that deter investment activity. Foreign direct investment has the potential to generate real benefits for development. But without reasonable levels of tax collection, governments cannot maintain the social and economic infrastructure needed to sustain equitable growth.

- **Money laundering**. The offshore world provides a safe haven for the proceeds of political corruption, illicit arms dealing, illegal diamond trafficking, and the global drugs trade. While some havens, such as the Channel Islands and the Cayman Islands, have introduced anti-money laundering legislation, the problem remains widespread. Havens facilitate the plunder of public funds by corrupt elites in poor countries, which can represent a major barrier to economic and social development. It has been estimated that around US$55 billion was looted from Nigerian public funds during the Abacha dictatorship. To put the figure in perspective, the country is today blighted by an external debt burden of US$31 billion. Northern governments justifiably press southern governments to adopt more accountable and transparent budget systems, but then create incentives for corruption by failing to deal effectively with tax havens and other tax loopholes.

- **Financial instability**. The offshore system has contributed to the rising incidence of financial crises that have destroyed livelihoods in poor countries. Tax havens and OFCs are now thought to be central to the operation of global financial markets. Currency instability and rapid surges and reversals of capital flows around the world became defining features of the global financial system during the 1990s. The financial crisis that ravaged east Asia in the late 1990s was at least partly a result of these volatile global markets. Following the Asian crisis, the Indonesian economy underwent a severe contraction and the number of people living in poverty doubled to 40 million. In Thailand, the health budget was cut by almost one-third. Nearly three years on from the outbreak of the crisis, the economies of Thailand and Indonesia continue to struggle under the huge public debt burden that it created.

The aim of this paper is to draw attention to the implications of tax havens for poor countries and poor people. For meaningful change to happen, the international community needs to adopt a more comprehensive and inclusive approach to the issue of financial havens and harmful tax competition. The paper does not seek to make detailed policy proposals, but rather puts forward a set of guiding principles and six key policy options that should receive serious consideration by the international community.

Oxfam believes that an international framework for dealing with the effects of financial havens and harmful tax competition should include: a poverty perspective; a genuinely inclusive approach fully involving developing countries in discussions; a multilateral approach to what are global problems; and strategies to help small, poor and vulnerable economies to diversify from a reliance on harmful tax practices and to comply with standards to prevent money laundering. The following policy options could be considered by the international community to help poor countries stem tax evasion and reduce the negative impact of tax havens:

♦ A multilateral approach on common standards to define the tax base to minimise avoidance opportunities for both TNCs and international investors.

♦ A multilateral agreement to allow states to tax multinationals on a global unitary basis, with appropriate mechanisms to allocate tax revenues internationally.

- A global tax authority could be set up with the prime objective of ensuring that national tax systems do not have negative global implications.

- Support for the proposal for an International Convention to facilitate the recovery and repatriation of funds illegally appropriated from national treasuries of poor countries.

- Standards on payment of taxation in host countries should join environmental and labour standards as part of the corporate responsibility agenda. Standards requiring TNCs to refrain from harmful tax avoidance and evasion should be factored into official and voluntary codes of conduct for TNCs and for the tax planning industry.

- A multilateral agreement to share information on tax administration to help countries, especially poorer ones, to stem tax evasion.

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1. INTRODUCTION

Tax havens are rarely out of the news these days. This is not surprising considering that wealth equivalent in value to one-third of global gross domestic product (GDP) is estimated to be held offshore, and a large share of globally mobile capital makes use of tax havens. Some of the recent stories indicate the breadth of the problem: the millions stolen from Nigerian public funds by the Abacha regime and sitting in bank accounts in Europe; the diverted International Monetary Fund (IMF) funds to Russia which ended up offshore; hedge funds registered in the Cayman Islands that cause havoc moving undisclosed levels of funds through global markets; and the ongoing debate between the European Union (EU) and the UK government on how best to stem tax avoidance on interest income. In the recent budget, Gordon Brown reflected the concerns of governments everywhere when he introduced measures aimed at recapturing some of the tax revenue lost through the extensive use of offshore havens by internationally active firms.

Governments around the world are concerned by the ever-growing share of global finance which has gone beyond the reach of national or international authorities. There is no shortage of international initiatives aiming to tackle various aspects of the offshore problem. The Organisation for Economic Co-operation and Development (OECD) and the EU have led efforts to address problems in taxing both firms and individuals, while the UN Drugs Control Programme and the Financial Action Task Force (FATF) set up by the Group of Seven (G7) and located at the OECD have been leading efforts to tackle money laundering. The Financial Stability Forum (FSF), set up in the wake of the Asian crisis, released its report looking at the impact of offshore financial centres (OFCs) on the global financial system earlier this year.

While containing useful elements, these efforts address the problem from a northern perspective. Concerns over development and poverty eradication do not figure prominently on their agendas. This is unfortunate since some of the negative impacts of the current system are felt most forcefully in developing countries. There are three major ways in which developing countries are affected:

- Tax havens provide companies and wealthy individuals with a way to escape their tax obligations. This limits the capacity of individual countries to raise revenue through taxation, both on their own residents and on foreign-owned capital. This undermines the ability of governments in poor countries to make vital investments in social services and economic infrastructure upon which human welfare and sustainable economic development depends. It also gives those TNCs which are prepared to make use of international tax avoidance opportunities an unfair competitive advantage over domestic competitors and small and medium size enterprises.

- The offshore world provides a safe haven for the proceeds of political corruption, illicit arms dealing and the global drugs trade, thus contributing to the spread of globalised crime and facilitating the plunder of public funds by corrupt elites. This contributes to increasing criminality and hampers the development of transparent budget processes in poor countries.

- The offshore system has contributed to the rising incidence of financial crises that destroy livelihoods in poor countries. Tax havens and OFCs are now central to the functioning of global financial markets. Currency instability and the rapid surges and reversals of capital flows to developing countries have become defining features of global financial markets in recent years and have contributed to financial crises. Following the recent crisis in East Asia, the Indonesian economy underwent a severe contraction and the number of people living in poverty doubled to 40 million.

The sheer scale of tax escape (including legal avoidance and illegal evasion) through the offshore system and tax competition has not been widely recognised. Developing countries could be missing out on tax revenues of at least US$50 billion a year; roughly equivalent to the global aid budget. This severely limits the capacity of developing country governments to finance economic development and provide vital social services. Recouping even some of this revenue could make a significant contribution to the internationally agreed target of halving world poverty by 2015.

In order for this to happen, global capital has to be made taxable again by governments. In a global market, a multilateral approach to taxation and other forms of regulation is essential. If the benefits of globalisation are to reach poor people, governments have to regain the capacity to finance redistribution through tax revenue. Public investment will be needed to achieve a more equitable distribution of opportunity in global and national markets. This does not mean common tax rates, but it does mean agreeing on common rules of the game to empower countries to stem tax avoidance and illicit activities.

However, developing country havens are unlikely to want to co-operate with current initiatives unless they are fully involved in the discussions and their particular concerns are addressed. Some small, poor and vulnerable economies have found that establishing themselves as tax havens is an attractive economic option partly because of the lack of economic alternatives open to them. Countries in the Caribbean, for example, have found it difficult to compete effectively in traditional agricultural products due to the obstacles they face such as high transport costs, small economies of scale and domestic markets, and dumping of subsidised exports such as dairy products by rich countries. Many developing country havens are highly distrustful of the motivations of rich countries, believing the OECD initiative to be merely another attempt to prevent competition from developing countries undermining their own economic interests. Strategies will be needed to help these economies diversify from harmful tax practices and comply with standards to prevent money laundering, including financial assistance and broader reforms to the international trading system.

The aim of this paper is to draw attention to the implications of tax havens for poor countries and poor people. Part 2 examines the impact of the offshore system on developing countries, looking first at taxation issues, then corruption and money laundering, and lastly financial stability. Part 3 proposes that future work on tax havens and offshore centres by the international community adopts a genuinely multilateral and inclusive approach, and puts forward six proposals for addressing the various problems associated with the offshore system that should receive serious consideration.

2. THE IMPACT OF FINANCIAL HAVENS ON DEVELOPING COUNTRIES

Say the words 'tax haven' and most people will visualise small sun-drenched islands in the Caribbean or South Pacific, populated by crooked tax accountants and corporate lawyers, drug smugglers and a full range of shady characters. This is all part of the mythology that surrounds tax havens and that serves to cloud the real issues.

Tax havens are part of a much wider problem.[i] As capital becomes ever more mobile in the globalised era, national governments are faced with fewer options on taxation. Transnational corporations and rich individuals have the freedom to move their money wherever they choose and, unsurprisingly, many choose places where they can avoid or minimise tax, such as tax havens. For governments everywhere, their capacity to levy corporate and business tax is constrained, while offering competitive tax rates is increasingly seen as a necessary means of attracting and retaining foreign capital and funds.

The rapid growth of the internet represents an added pressure which will further reduce the taxation options open to governments. More widespread use of the internet will make it harder to tax 'virtual' goods and services. There are concerns that the anonymity provided by the internet could lead to more vanishing taxpayers and increased opportunities for money launderers. The internet could also intensify tax competition between states by making it easier for TNCs to shift activity to low-tax regimes, particularly as the geographical location for many activities becomes increasingly irrelevant.[ii]

Markets have globalised, yet tax structures have remained largely national. As the pressures of globalisation are brought to bear, national tax regimes become locked into a competitive battle. A number of states, facing limited options for pursuing economic growth, have turned their economies over to this competition.

The world is now littered with a variety of opportunities for capital to escape taxation and regulation, with tax havens playing a pivotal role. Due to the secrecy that surrounds tax havens, it is only possible to reach an approximation of the levels of money involved. Recent estimates put the amount held in offshore centres at between US$6 and US$7 trillion, which is approximately equivalent to the annual world trade in goods and services or about one third of total global GDP. Much of this, perhaps between US$3 and US$4 trillion, consists of savings held abroad by wealthy individuals. In terms of flows of funds passing through tax havens, financial and non-financial companies are thought to be the most significant players. A recent IMF survey of portfolio investment attributes a discrepancy of US$1.7 trillion between global assets and liabilities to the portfolio investment that is channeled through offshore centres.[iii] In addition to this is the use of offshore banking facilities by international firms.

While the exact sums involved remain something of a mystery, it is clear that financial havens attract capital far disproportionate to the size of their levels of economic activity. Tax havens account for only 1.2 per cent of world population and three per cent of world GDP, but a staggering 26 per cent of assets and 31 per cent of profits of American multinationals.[iv]

Havens and OFCs typically exhibit some or all of the following characteristics: (i) bank secrecy, which prohibits the provision of information about a client to enforce another country's tax and other civil and criminal laws; (ii) professional or commercial secrecy obligations, preventing lawyers, accountants or company employees from revealing confidential information about clients, even about violation of other countries' laws; (iii) company and trust laws with very low disclosure requirements, for example allowing shares to be issued to bearer, so that the true owner is concealed; and (iv) a low or no tax regime for non-residents or companies doing business outside the jurisdiction.

There are more than one hundred locations world-wide offering tax and other incentives to foreign firms and individuals; many are the traditional small island state havens, but many are not. The language of 'offshore' can itself be misleading, enforcing the commonly held view that the characteristics listed above can most readily be found in small states or island economies positioned close to the world's major trading blocks. Many havens, of course, do conform to this image. Europe, for example, has the established havens such as Jersey and Liechtenstein, as well as the newcomers like Cyprus and Malta. The Asia Pacific region has the Pacific Islands as well as centres such as Labuan and Singapore. India and Southern Africa are serviced by the Seychelles and Mauritius; and the Americas are served by the Caribbean and Central American havens.

However, many of the world's major havens are very much onshore. London and New York, for example, are both home to a substantial proportion of the world's offshore business activity.[v] This simple fact often appears to be overlooked when the international community addresses the offshore problem. The OECD, as part of its offensive against harmful tax competition, is drawing up a list of the world's tax havens. The FSF has categorised the world's offshore financial centres according to their levels of supervision and co-operation. London and New York do not feature on the FSF list. It is expected that the OECD list will single out the small state havens, and omit major players such as Singapore, Hong Kong, or Switzerland.

The reason for this apparent anomaly is that the OECD has made an important, though arguably academic, distinction between tax havens, on the one hand, and harmful preferential tax regimes in non-haven countries, on the other. Put simply, in a tax haven the whole system is geared up to offering a low or no-tax environment to geographically mobile capital. A preferential tax regime exists where a country with an otherwise 'normal' tax system offers special treatment to certain categories of incoming capital. You only have to compare the economy and regulatory environment in, for example, the Cayman Islands and the UK to see that this difference makes perfect sense on one level. However, if the aim of the OECD work is to stem the erosion of the national tax base and to ensure the fairness of tax structures, the distinction is rather counter-productive.

Moreover, the OECD crackdown on harmful tax competition has involved a very different approach for these two categories of jurisdiction. This year, the OECD releases the list of tax havens, next year a 'black-list' of unco-operative havens will be drawn up, and those jurisdictions that refuse to reform their regime could then face a series of sanctions. Member countries have gone through a less publicised and less hard-hitting review process, identifying potentially harmful preferential tax regimes within their jurisdictions. The OECD will publish a list of these practices, and the countries concerned will have until April 2003 to put their tax house in order.

Not surprisingly, the OECD process has provoked much criticism from the small states and island economies that feel they are being demonised and unfairly treated. When it comes to offering opportunities for global tax avoidance, St Kitts and Nevis must be a marginal player compared with Switzerland or Hong Kong.

By providing the right legal and regulatory environment, a number of countries have converted elements of their economies into havens for particular segments of the global market. The City of London, for example, hosts the offshore Eurobond market; Belgium has established itself as a haven for corporate headquarters; and the Bangkok International Banking Facilities (BIBF) in Thailand acted as a channel for short-term capital flows into East Asia before the recent crash. Others differentiate themselves by offering particularly low regulatory or reporting requirements or strict secrecy obligations. Switzerland, Austria, and Luxembourg are among the countries that have fought hard to protect their right to offer secret banking facilities.[vi]

Havens not only differ in the types of services they offer, but they also exhibit vastly different standards of regulation and supervision and varying levels of co-operation with other jurisdictions. Havens in the Channel Islands, for example, have been acknowledged as having high standards of supervision in the financial services industry and a number of havens in the Caribbean, such as the Cayman Islands and Bermuda, have recently made serious efforts to improve regulation and transparency. These efforts are being spurred on by the increased scrutiny on financial havens as a result of the OECD effort to limit harmful tax practices and the work of a number of international bodies, including the United Nations (UN), to address money laundering.

Higher standards of regulation and supervision in financial havens are welcome steps in the right direction and should be acknowledged as such. However, better regulated havens are not the solution to all the issues raised in this paper. First, the focus on improving the prudential supervision of financial institutions in havens ignores the issue of tax avoidance. In fact, these moves serve to strengthen the legitimacy of the offshore system itself, which will preserve the right of firms and individuals to escape their tax obligations through legal means. Secondly, the best efforts to create a well-regulated haven can have a perverse effect. Havens with tightly regulated financial institutions can be most attractive to money launderers, precisely because they provide the cover of respectability. This can be seen in the series of scandals that have rocked established financial centres and institutions, such as recent investigations into the role of the eminent Bank of New York in the Russian money laundering case. The best intentions of supervisory authorities in financial havens can be frustrated as the very nature of money laundering involves huge efforts to obscure the provenance of funds. Unfortunately, as long as the tools of tax planning - international business companies and trusts - exist, they are open to abuse by those seeking to launder funds.

Havens, then, come in a variety of guises, with very different levels of compliance with international standards, and offer a range of services. The tools created and the secret environment offered by financial havens serve a variety of legal and illegal purposes including the avoidance and evasion of tax and other regulations, and the laundering of illegally obtained funds. The proliferation of havens and offshore locations has coincided with a huge increase in the level of financial capital moving around the world. As much of it makes use of the offshore system, a large component of global capital has gone beyond the control of national governments or international agencies. The negative effects are felt most strongly in developing countries, as will be detailed in this section. Current efforts to contain the offshore problem, by routing out the worst havens and setting international standards for the better ones, will do little to address the real issues.

Tax

Tax is widely regarded as an essential component of a fair and efficient society. An essential principle underlying tax collection has been the liberal social obligation on companies and individuals to pay tax proportionately to their income in order to finance public goods and social welfare. However, the parallel processes of trade and investment liberalisation and the proliferation of tax havens have allowed many TNCs and wealthy individuals to escape their tax liabilities. The internationally integrated nature of TNCs allows them to choose between locations according to the different tax regimes or other benefits on offer. More importantly they can artificially attribute the ownership of assets or the locations of transactions to paper subsidiaries in convenient jurisdictions or havens. This enables them to minimise taxation of business profits at source, and defer home country taxation on retained earnings. Those TNCs willing to be exploit the opportunities for international tax avoidance can gain a significant advantage over domestic competitors and small and medium sized enterprises.

Liberalisation has led an increasing number of countries to engage in a battle to attract foreign investment through offering lower tax rates on capital. This has led to a widespread reduction in tax rates for foreign owned subsidiaries and affiliates of trans-national companies. Corporate tax rates for US affiliates operating in developing countries dropped from 54 per cent to 28 per cent between 1983 and 1996. The battle is often fuelled by TNCs that can threaten to stay away from any country that doesn't offer the right tax incentives. In Zambia, Anglo American has secured a lower level of company tax for a large-scale investment project (the Konkola Deep Mining Project). A tax rate of 25 per cent will be applied, compared to the normal rate of 35 per cent for foreign-owned companies.[vii] Meanwhile, the recent decision of the tax authorities in India to clamp down on the use of the Mauritius tax haven by foreign institutional investors for channelling funds into the country was quickly reversed because of threats that it would scare away future investment**.**

Pressures such as these seriously diminish the capacity of developing countries to finance development and poverty reduction. Oxfam estimates that developing countries as a whole may be foregoing annual tax revenues of at least US$50 billion as a result of tax competition and the use of tax havens. Recouping just some of this revenue could have enormous implications for development in poorer countries. If used effectively, these funds could be used to finance health and education and improve the lives of the 1.2 billion people around the world who live in extreme poverty. While not all governments would use the resources effectively or devote them to poverty reduction, it would be unfair to use this a reason to deny others the opportunity to do so.

Tax competition and tax havens

A 1998 report by the OECD entitled 'Harmful Tax Competition: an Emerging Global Issue' identifies tax havens as a harmful form of tax competition because they ‘poach’ the tax base of other countries by providing an accommodating tax and legislative framework for essentially fictitious activities. Tax havens also spur on the battle for lower tax rates between countries, by offering foreign-owned capital a low or no tax alternative. This needs to be distinguished from other forms of tax competition aimed at attracting real investments which may or may not be harmful, and from differences in generally applicable tax rates. The need to curb harmful forms of tax competition needs to be balanced against the democratic rights of countries to determine their own generally applicable tax rates which frequently differ from state to state.

Tax escape on interest income

In a high proportion of cases, interest income from savings held abroad escapes taxation both in the country where it is invested or deposited, and in the home country of the investor or saver. The implications of this in terms of tax-base erosion in both industrialised and developing countries are even more far-reaching because of the sheer magnitude of cross-border savings and investments at the beginning of the twenty-first century. Some estimates put the stock of savings held abroad by wealthy individuals in the region of US$3 to 4 trillion. The scale of capital flight makes this a particularly pressing issue for developing countries, especially given their development financing constraints.

Capital flight is clearly a complex issue. Flight capital is made up of both legal money seeking a better investment climate, understandable given the environment in many developing countries, and the proceeds from illegal activities being laundered abroad. Given that capital flight can often be a rational reaction to local circumstances, such as mismanagement and lack of confidence in domestic institutions, the argument has traditionally been that it is a symptom rather than a cause of problems in many developing countries. However, seen in the context of the financing constraints in poor countries, it is clear that the huge levels of capital being drained annually from these economies, for whatever reason, is part of the problem. Equally, while offshore havens cannot be said to be the cause of capital flight, the existence of safe international channels through which this money can pass clearly exacerbates the situation.

Since the US move to abolish the withholding tax on foreign residents earning interest income on portfolio investments in 1984, no other major economy has been able to maintain a withholding tax for fear of losing out on foreign investments.[viii] Nearly all industrialised, and many developing countries, now impose no tax on interest earned on savings by foreign residents. Developing and transition economies integrating with the global economy cannot afford to impose taxes on interest income, as the tax would merely be shifted onto the borrower in the form of higher interest rates. In all countries the fear that money would simply shift elsewhere makes unilateral moves to tax interest income impossible. This problem is at the forefront of the UK's opposition to the EU proposal for a region-wide withholding tax. With strong interests in the City of London to protect, the UK government has warned that an EU-wide withholding tax would simply push investments to non-EU jurisdictions, particularly offshore centres.

In principle, income from savings should normally be taxed in the country of residence of the investor, but in practice this relies on the honesty of the taxpayer in declaring such income and effective exchange of information provisions. Tax authorities, particularly in developing countries, rarely have any effective means of knowing about the income their residents earn from abroad. It is also often the case that rules on taxation are made by those who stand to benefit most from them. In some developing countries, the tax regime permits or even encourages the non-payment of tax on foreign income. Even where this is not the case and tax treaties do contain adequate exchange of information agreements, the option of tax havens ensures that savers always have a way of escaping detection.

Tax escape from TNCs

The taxation of TNCs is also problematic. TNCs can take advantage of differences in national tax systems and loopholes in international tax arrangements to minimise taxation. They benefit from the offshore system both indirectly, as tax competition between countries is driven partly by the existence of havens, and directly, as TNCs invariably have `paper' affiliates in offshore jurisdictions which can be used for tax avoidance.

Competition among host countries to attract foreign direct investment leads many to offer special incentives and tax holidays, which are generally not available to domestic firms. Governments calculate that the benefits of attracting investment will offset the erosion in their tax base. Some developing countries see financial incentives as one of the few policy tools left to them to attract and retain direct foreign investment. However, the evidence suggests that while tax incentives may help attract foreign investment at the margin, they are not the key determinant of foreign direct investment which is attracted by large markets, natural resources, development infrastructure, a relatively cheap and efficient labour force, macro-economic stability and liberal trade regimes. Tax competition can be particularly costly for developing countries which cannot match the massive subsidies offered by rich countries and often lack the means to effectively monitor and tax TNCs.

Current measures do not adequately address these issues. The OECD countries have special provisions for taxing offshore affiliates that can be treated as Controlled Foreign Corporations (CFCs), although many companies and activities still fall outside this net. At the same time, developing countries do not generally have the resources to deploy sophisticated anti-avoidance rules, and are anyway more vulnerable to threats of disinvestment.

Box 1: News Corporation

In March 1999, the Economist reported that in the four years to 30 June of the previous year, News Corporation and its subsidiaries paid an effective tax rate of only around 6 per cent. This compared with 31 per cent paid by Disney. The Economist notes that "basic corporate-tax rates in Australia, America and Britain, the three main countries in which News Corporation operates, are 36%, 35% and 30% respectively".

The article points to the difficulties of finding out about the specifics of News Corporations' tax affairs because of the company's complex corporate structure. " In its latest accounts, the group lists roughly 800 subsidiaries, including some 60 incorporated in such tax havens as the Cayman Islands, Bermuda, the Netherlands Antilles and the British Virgin Islands, where the secrecy laws are as attractive as the climate".

The article continues, "This structure, dictated by Mr Murdoch's elaborate tax planning has some bizarre consequences. The most profitable of News Corporation's British operations in the 1990s was not the Sunday Times, or its successful satellite television business, BSkyB. It was News Publishers, a company incorporated in Bermuda. News Publishers has, in the seven years to June 30th 1996, made around £1.6 billion in net profit. This is a remarkable feat for a company that seems not to have employees, nor any obvious source of income from outside Mr Murdoch's companies."

Looking at the available information on the Newscorp Investments, the main British holding company with 101 subsidiaries, the Economist tried to discover how much tax the companies had paid. They found out that since June 1987, although the group had made £1.4 billion in profits, it had paid no net British corporation tax at all. This may partly be because of the company's extensive, but legal, use of tax loopholes to shelter profits in tax havens. As the article says, 'Nobody likes paying tax, but News Corporation's British arm is unusual in the degree to which it manages to avoid it ".

Economist, 20 March 1999

Even when companies are not reaping the benefits from tax competition, a foreign-owned firm can reduce its taxable profits by setting up affiliates in offshore jurisdictions, such as the notorious International Business Corporations (IBCs). TNCs can use these offshore vehicles to hold assets and route income in ways that reduce their exposure to tax in both the home and host country.

In addition, transfer pricing may involve the manipulation of intra-company transactions to decrease tax liability. For example, a multinational may choose to issue invoices for goods that have been manufactured onshore via an offshore company. This transfers profits to the lower tax jurisdiction. TNCs can also reduce their taxable profits by deducting charges, for example made for services provided from within the group and for interest on loans. These payments can be routed through a treaty-partner to a tax haven, which does not tax such foreign-source income and has no treaty for information-exchange.

Not only do these practices reduce the tax revenues available to governments, they also distort the way international firms organise their activities. Large firms recognise this problem, as a recent comment on transfer pricing by Phillip Gillett, group tax controller at ICI shows:

> *'Commercially, transfer pricing makes no sense. It forces us to spend a lot of time doing things that are pointless from a business point of view…Businesses want to organise as if there were a single global or regional product market. Instead tax is determining how they organise themselves'.*
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> *(The Economist, 29 January 2000)*

The development impact

It is difficult to estimate the full impact of tax havens and other harmful tax practices on developing countries, not least because the secrecy involved obscures the true extent of international capital movements and the use of havens by TNCs. However, it is clear that tax revenue losses are significant, especially in relation to the limited budgetary resources available in poor countries.

As we have seen, the increasing scope for foreign corporations to minimise tax obligations due to tax competition between countries and the use of tax havens has important implications for the tax base of individual countries. This causes particular problems for developing countries, some of which rely heavily on corporate income taxes.

Over the last twenty years, tax competition has resulted in 'race to the bottom' in corporate tax rates in many developing countries. The ability of investors to utilise offshore centres has been a key element in this competition. Whereas two decades ago tax rates in developing countries would have been comparable with, or higher, than those in OECD countries, in many cases they are now considerably lower. The end result is lower tax revenues. To estimate the tax loss to developing countries, one useful proxy is to calculate tax revenues based on figures for the stock of inward foreign direct investment.

According to UNCTAD figures for 1998, the FDI inward stock for all developing countries was US$1219 billion.[ix] An approximation of the tax revenues that developing countries should be receiving can then be calculated by using an average rate of return on investment and a reasonable corporate tax rate. The World Bank figure for the rate of return on FDI in developing countries as a whole is between 16 and 18 per cent, with considerably higher rates for countries in Africa. However, this rate of return figure excludes the effect of transfer pricing and other practices that companies employ to reduce pre-tax profits. It is therefore reasonable to use a rate of return on FDI of at least 20 per cent. While it is difficult to establish a reasonable corporate tax rate, the OECD average of around 35 per cent is a useful proxy. Although average corporate tax rates tend to be much lower than 35 per cent in many developing countries today, this figure would probably have been below average twenty years ago.

Supposing a rate of return on FDI of 20 per cent, and a tax rate of 35 per cent, developing countries should be receiving tax revenues of around US$85 billion a year from foreign corporations. They actually receive around US$50 billion per year at most. This implies that developing countries as a whole could be missing out on tax revenues of about US$35 billion a year as a result of tax competition. This is likely to be an extremely conservative estimate as, not only do official figures tend to understate the true value of FDI stock, but also these figures fail to take account of the financial transactions of large firms.[x]

Even harder to quantify, although almost certainly more important in terms of lost tax revenues, are the various methods employed by TNCs to reduce their taxable profits. The example of News Corporation in Box 1 illustrates an extreme case of the creative use of 'paper' affiliates in tax havens by large internationally-active companies. However, the practice of manipulating intra-company transactions in order to reduce taxable profits is clearly widespread. In an UNCTAD survey assessing the significance of income shifting by TNCs, eighty-four per cent of the developing countries taking part thought that the affiliates they hosted shifted income to their parent companies to avoid tax liabilities.[xi] The tax revenue figure of US$85 billion takes some account of the effect of these practices by using a pre-tax rate of return slightly higher than those estimated by the World Bank.

Foregone tax revenue on interest income on savings held abroad could also be depriving developing countries of much needed finance. In order to estimate possible foregone revenue, figures for capital flight can be useful. It is fairly safe to assume that most capital flight goes to countries where it is not subject to taxation at source and that it also escapes taxation in the country of residence. By 1990, the stock of capital flight from developing countries was estimated at around US$700 billion. Again, estimating an average rate of return on these funds, and a reasonable tax rate, allows us to quantify possible lost tax revenues. Wealthy individuals who use tax havens are likely to have a sophisticated portfolio of investments that will give a relatively high return overall. A 10 per cent rate of return on investment is therefore a reasonable assumption. As this paper has shown, interest income from savings held abroad is rarely taxed. If it were, however, a tax rate of 22 per cent would be reasonable. Under the EU proposal for an EU-wide withholding tax on interest income, a minimum rate of 20 per cent has been proposed.

Supposing a rate of return of 10 per cent, and a tax rate of 22 per cent, tax on interest income from the US$700 billion in capital flight could be contributing to developing country tax revenues to the tune of around US$15.4 billion each year.

The combined figure for tax loss for TNCs and interest income on savings in developing countries could therefore be well above US$50 billion each year. This figure is particularly shocking in relation to financing needs in these countries. For example, the World Bank has estimated that it could supply a basic health package at an annual cost of US$12 per person for low-income countries and US$21.5 for middle-income countries. On 1996 population figures, the total cost for all low and middle income countries would be approximately US$73 billion.

This tax loss is also particularly significant given that poor countries face a range of additional difficulties in relation to the collection of tax revenues. In addition to the problem of capital flight, low and middle-income countries have a more narrow domestic tax base and hence low revenue/GDP ratios. Many developing countries also have weak tax administrations. As a result, many developing countries have low tax revenues as well as resource constraints in form of large debt burdens, declining taxes from trade, and reduced aid flows. These constraints result in poor provision of public goods in the countries that have the greatest need. United Nations Development Programme (UNDP) figures show that in 1997, in developing countries with a low human development level, tax revenues made up 11 per cent of GDP, while public expenditure on health and education stood at four per cent of GDP (or US$11 per head). The corresponding figures for industrialised countries were 26 per cent for tax revenues, and 12 per cent for public expenditure on health and education (or US$3,261 per head).

Tax revenues are needed to fund public goods, which contribute to the development of the social and economic infrastructure. Most countries raise revenue by taxing both capital and labour. Tax competition among countries and the exponential growth in the use of tax havens has meant that states find it increasingly difficult to tax income from capital. This implies either that tax revenues will decline, or that the burden of tax will have to shift more heavily onto labour.

In recent years, governments world-wide have increased the proportion of GDP that they collect as tax revenues. Revenues from individual and corporate taxes have been flat over this period, with the increase funded by increases in consumption taxes (e.g. value added tax) and payroll taxes, (e.g. national insurance). This constitutes a shift of the tax burden from capital onto labour. This has a regressive effect because capital income is disproportionately earned by the rich and taxed less, whereas consumption that is taxed more accounts for a larger share of poor people's expenditure. This, in turn may go some way in explaining the worsening income inequality in a number of regions of the developing world. Moreover, there comes a point where any further increases in taxation on labour would be infeasible or politically impossible, and this may force governments to reduce government expenditure.

Choice and responsibility

Supporters of tax competition argue that it encourages the reduction and rationalisation of tax systems and provides taxpayers and companies with a choice between different combinations of taxes and public goods. In this context tax planning is seen as a legitimate way for companies and individuals to avoid unfair tax burdens and regulations. However, this assumes that all citizens and companies are equally mobile which is not the case. It also ignores the reality of tax competition. Companies can locate in a country that offers tax breaks to foreign firms, but has a normal or high tax on residents. Such a company then benefits from high standards in infrastructure and education levels, for example, but does not pay through taxation - the 'free-rider' problem.

While elements of tax planning are undoubtedly legal this does not imply that it is legitimate from a poverty perspective. Internationally active companies have a duty to shareholders to minimise their tax obligations, in order to maximise post-tax profits. However, they should also act responsibly towards the societies that make up their markets, and therefore contribute to their profits. This is not just good for development, but it is also good for the companies themselves. TNCs need to realise that it is in their longer-term commercial interest to contribute to financing the infrastructure, communications, and education levels upon which strong markets depend. Moreover, tax planning can create great inequalities between companies and industries as to their tax liabilities, depending on their opportunities or willingness to exploit such devices.

Corruption and money laundering

> *'As interdependence increases - each country is as vulnerable to financial crime as the weakest link in the chain.'*
>
> *(Larry Summers, US Treasury Secretary[xii])*

Financial havens are used to launder the gains from corrupt and illegal activities, including narcotics trafficking, various types of fraudulent activity, public corruption, tax evasion, smuggling, and arms and diamond trafficking. Financial havens can be the weak link to which Larry Summers refers, and again, it is the world's poorest countries that are most severely affected by much of this illegal activity.

The secrecy space provided by the 'offshore interface' between criminal activity and the world of legitimate financial transactions has become a crucial element of modern crime and a vital enabling mechanism for corruption.[xiii] Offshore centres, by combining the tools to obscure the origins of funds with an environment of non-co-operation with the international community in criminal and tax investigations, provide a 'Bermuda triangle' for obscuring assets and disguising the money trail from criminal activities. The tools used are often the same as those used for tax avoidance: offshore bank accounts and company registrations protected by secrecy laws; offshore trusts; transfer pricing and intra-firm property transactions. As the line between legitimate and illegal uses of offshore is blurred, it is very difficult for law enforcement investigations to detect crime from money laundering activity. The United Nations Office for Drug Control and Crime Prevention (UNDCP) 1998 report on Financial Havens states:

> *'The common denominator in money-laundering and a variety of financial crimes is the enabling machinery that has been created in the financial havens and offshore centres.'*[xiv]

Money laundering facilitates public corruption, a serious problem in a number of poor countries. While the international community decries corruption in developing countries, there is less attention paid to the destination of much of the illicitly obtained money. The enabling machinery in financial havens allows corrupt leaders and officials, who are taking bribes or plundering the public finances of their countries, to hide the origins of the funds they acquire. Evidence of the extensive use of private banking facilities and offshore havens by political and economic elites is largely derived from attempts to investigate the affairs of deposed politicians and their relatives. In 1999, The Economist estimated that African leaders have US$20 billion in Swiss bank accounts alone. To put this in context, this is twice the amount that sub-Sahara Africa spends on debt servicing.

Some of the most notorious clients of the international private banking industry have come from developing countries: Mobutu in the former Zaire, Sani Abacha in Nigeria, Marcos in the Philippines, Baby Doc Duvalier in Haiti, and Raul Salinas, brother of the former Mexican President. In one of the biggest money laundering scandals of recent years, it was alleged that Raul Salinas had accepted large bribes from drug traffickers. It was revealed that the proceeds were subsequently laundered via several Swiss based banks, including a Citibank entity in Geneva. It was later revealed that the Swiss authorities had frozen US$132 million in the bank accounts used by Salinas.[xv]

The use of financial havens to launder the proceeds from corruption is an important issue for national governance, as well as for global governance. Corruption and money laundering undermine efforts to introduce more transparent and accountable budgets in the poorest countries.

Box 2: Nigeria

Corruption is a world-wide phenomena, but in poor countries like Nigeria it represents a major barrier to economic and political development, and reduces the capacity of national governments to implement effective poverty-reduction strategies.[xvi] Over the years, billions of dollars have been siphoned off from Nigerian public finances and placed offshore. G7 governments and the International Financial Institutions put much emphasis on the problem of corruption in developing countries, but are less vocal on the offshore centres and private bank accounts that provide a safe-haven for much of the proceeds. Corruption, and the offshore system which facilitates it, deny people in developing countries the right to just public policies with devastating implications for the very poor.

It has been estimated that around $55 billion was looted from Nigerian public funds by Sani Abacha and his associates during his presidency and stashed in Western banks. The new Nigerian Government is seeking assistance from the British and American Governments and from the European Union to recover an estimated US$2.2 billion of these stolen funds. The government is doubtful, however, about the willingness of international banks and some European countries, particularly Switzerland, Luxembourg, and Ireland, to co-operate.

The Nigerian figures for stolen wealth are startling, particularly in a country classified as a Heavily Indebted Poor Country (HIPC), which is grappling with an external debt burden of around US$31 billion and where around 30 per cent of the population are living on below one dollar a day. The US$2.2 billion that the government is currently working to recover, representing US$19 per capita, would alone more than cover the annual education budget which works out at around US$16 per capita.

Financial stability

A large share of globally mobile capital now makes use of the offshore system as it flows around the world looking to maximise profits and minimise tax obligations. As the offshore world is largely beyond the reach of national and international authorities, its heightened role has contributed to the increase in episodes of financial turmoil that came to characterise the 1990s.[xvii] The recent financial crises in East Asia and Russia have evolved into devastating economic and social crises, causing serious setbacks to human development in the crisis-hit countries. In the aftermath of the crisis, efforts to tighten up the regulation of international financial markets have been frustrated by the offshore system.

According to the recent report of the FSF working group on offshore centres, OFCs do not seem to have been 'a major causal factor' in recent episodes of systemic financial instability. However, the report notes:

'But OFCs have featured in some crises and as national financial systems grow more interdependent, future problems in OFCs could have consequences for other financial centres. The significant growth in assets and liabilities of institutions based in OFCs and the inter-bank nature of the offshore market, together with suspected growth in the off-balance sheet activities of OFC-based institutions (about which inadequate data exist), increase the risk of contagion.'[xviii]

Tax havens and OFCs are now considered to be central to the operation of global financial markets. International banking activities, including the offshore currency markets (such as the Eurodollar market), are tightly inter-linked with the world of offshore finance. The growth of the offshore currency markets is a contributory factor in the huge growth in global foreign exchange trading, which had reached around US$1.8 trillion per day by 1998, and the corresponding increase in currency instability.

Havens and OFCs are also used by globally-active private financial institutions, such as banks and investment funds, as booking centres for short-term and speculative investment in developing and transition economies. Routing investments via the offshore system can be used to avoid regulation (for example, disclosure and capital requirements), to side-step a country's capital controls, and to reduce the levels of tax paid on profits.

It is no coincidence that derivative trading and the investment activities of hedge funds, two of the areas causing most concern in debates on the global financial architecture, are both closely associated with the offshore system. New and complex financial instruments, secretive investment vehicles, and the widespread use of offshore have very serious implications for global financial stability. The near-collapse of the US hedge fund Long Term Capital Management in 1998, and accompanying fears about the potential systemic implications, provided a warning signal that things had got out of control. The scale of the problem prompted Vito Tanzi, Director of the Fiscal Affairs Department at the IMF, to write:

'The complexity of the international financial market in which "rocket scientists" have been developing progressively harder-to-understand market and investment strategies, and the lack of clear national identity for the money invested or even for the institution that make the investment, renders the regulation of these activities very difficult or impossible.'[xix]

As well as the global link between offshore and instability, the use of offshore locations can also have a more direct impact on the stability of the economies of developing countries. Some countries, eager to attract foreign capital, encourage incoming flows by setting up offshore facilities close to their markets. One recent example of this was the establishment in Thailand of the BIBF.

Box 3: The Bangkok International Banking Facility (BIBF)[xx]

During the late 1980s and early 1990s the Thai authorities adopted a more aggressive policy of attracting capital inflows. In 1992, the BIBF was established with the aim of improving the access of domestic firms to international capital markets through the national banking system. BIBF banks could take deposits or borrow from abroad, and lend in foreign currencies in Thailand and abroad. The BIBF essentially functioned as an offshore centre, as BIBF banks were given tax incentives and were exempt from a range of regulatory requirements on their international business. These incentives may have facilitated the circumvention of existing capital controls in Thailand, and acted as a bias in favour of short-term inflows.

In the years leading up to the Asia crash, the BIBF was increasingly used by domestic banks to finance foreign currency lending to local firms, which was usually unhedged. As the domestic banking system became extremely vulnerable to foreign exchange risks, Thailand was accumulating an excessive build-up of short-term external liabilities. When the crisis in Thailand broke, the BIBF accounted for almost one-half of the country's foreign borrowing, with much of the funds having been channelled into speculative activity.

The crisis in Thailand entailed heavy economic and financial reversals that imposed severe hardship on Thai people. During 1996-98, Thailand's GDP fell by about 12 per cent with serious employment and wage impacts. As a result of the crisis, more than one million people in Thailand were pushed into poverty. Nearly three years on from the outbreak of the crisis, Thailand is struggling to deal with the huge public debt burden it created.

Episodes of global financial instability impact most severely on developing countries, and on poor people within those countries. During the 1990s private capital flows, and portfolio flows in particular, came to play an increasingly important role in the external financing of developing and transition economies. As these countries integrate with the global economy, their smaller, more fragile capital markets make them particularly vulnerable to economic shocks. As witnessed by recent events in Thailand, Indonesia, and Russia, financial crises can provoke sharp macroeconomic downturns that, in turn, result in rising poverty levels.

The crisis-hit Asian economies have undergone a brutal adjustment and a deep recession en route to recovery. In order to sustain the large-scale capital outflows, totaling 11 per cent of their combined GDP in the two years following the crash, these countries had to generate large current account surpluses. The IMF, which led the multilateral rescue effort in the crisis countries, demanded economic austerity. The adjustment was to be achieved by cutting domestic spending and investment through a combination of high interest rates, public spending cuts and increased revenue. As interest rates soared, and foreign capital continued to flee, investment collapsed and many companies were forced into bankruptcy.

The Asia crash led to severe declines in GDP in the crisis-hit countries; in 1998, GDP fell by 14.3 per cent in Indonesia and by 12 per cent in Thailand. The macroeconomic shock was channelled to poor people as real wages fell and unemployment rose, prices increased, and cutbacks were made in government spending and the provision of basic services as part of austerity programmes. Between 1996 and 1998 in Indonesia the number of people living in poverty doubled to 40 million.

Crises cause not only deterioration in the current living standards of poor people, but also often provoke responses that can have long-term negative implications for equity and poverty reduction. During crises, children are frequently removed from school and sent to work, reduced food consumption often leads to malnutrition and poor health, and the sale of assets may prevent households from continuing with productive activity. In Indonesia, the recent financial crises become an education crisis, especially for the poorest children. School enrollment rates at the secondary level declined by four to five per cent, with the decline largest in urban areas and among the poorest sections of the population. Dropout rates for children also rose in both rural and urban areas, with the largest increases among the poorest people. Education workers in Indonesia reported that parents were having difficulties paying fees, that absences had increased as children spent more time helping parents with economic activities, and that children who did come to school were eating less. The impact of macroeconomic shocks on education in crisis-hit countries, as the Indonesian experience shows, hamper both economic recovery in the short-term and the longer-term goal of achieving equitable patterns of growth.

3. OPTIONS AND RECOMMENDATIONS

This paper has reviewed the international debate on harmful tax competition and secrecy and drawn attention to the profound relevance this has for poor people. Private banking and international tax planning remain the preserve of a small handful of wealthy individuals and large multinational corporations. Reduced government revenues, public corruption, and economic instability all impact disproportionately on the 1.2 billion people living in poverty.

A development approach

For meaningful change to happen, the international community needs to adopt a more global approach to the issue of offshore finance. It is imperative that this approach incorporates a development perspective and includes developing countries fully in discussions. Recent years have seen a wealth of international initiatives, almost entirely led by OECD countries, designed to contain the problems associated with offshore rather than question their legitimacy. However, it is necessary to take a step back from this activity focused on shoring up the current system, and question what place offshore finance and tax havens have in the global economy and who are the winners and losers. Future work on offshore could be guided by the following principles:

§ **An inclusive approach**. Offshore is a global issue, and discussions should involve all countries from the outset. Current offshore work housed at the OECD and FSF is in danger of being perceived as yet another example of rich countries defining the terms of the debate, agreeing standards, and then bringing in poorer countries at the implementation stage.[xxi] Work on offshore should have poverty reduction and human development goals at the centre.

§ **A multilateral approach.** Taxation, corruption, and instability are global issues that require global approaches. Anything less than a global approach risks being ineffective, as the problems will simply shift to the next weak link in the chain. A multilateral framework is needed which balances the need to curb tax competition with a respect for the ability of democratic governments to set generally applicable tax rates and which empower countries, especially poorer ones, to stem tax evasion.

§ **Burden sharing.** Small, poor and vulnerable economies, due to their lack of economic alternatives, have found establishing themselves as tax havens an attractive economic option. Some small economies may depend on their offshore business for as much as 20 per cent of their GDP. Strategies are needed to help these economies diversify away from reliance on harmful tax practices and comply with standards to prevent money laundering, including financial assistance as well as broader reforms to the international trading system, with sanctions as a last resort.

The UK is well placed to take a leading role in promoting a more inclusive and multilateral approach to the offshore problem with a genuine focus on poverty reduction and equity. The UK government has pledged its support for international action to achieve the 2015 international development targets and is an influential force in the many international groups debating offshore. It also has a special responsibility on this issue as the UK is home to the City of London, a tax haven for some financial market instruments, and is also responsible for the international affairs of a number of Crown dependencies and UK overseas territories that operate as tax havens.

Policy options

This paper does not seek to make detailed policy proposals. However, the following policy options should receive serious consideration by the international community as ways of helping countries stem tax escape, address money laundering and corruption, and foster a more stable economic environment. Taken together, they represent a co-ordinated set of measures that would eliminate the more harmful aspects of financial havens and tax competition.

Improved information sharing arrangements

A multilateral agreement to share information on tax matters would help countries, especially poorer ones, stem tax evasion and illicit activities Effective information sharing arrangements between jurisdictions would be one of the most important steps to address tax escape, money laundering and financial instability. While information sharing is a major element of initiatives proposed by the OECD and other bodies, the emphasis has been on combating the use of the offshore system for laundering the proceeds of crime or concealing criminal activity. This may also cover tax fraud, but that is a very narrow category, since deliberate evasion of taxes is hard to prove. Co-operation to combat crime is clearly important, but will not on its own end the culture of secrecy which is the hallmark of havens, and which facilitates tax avoidance.

A more comprehensive multilateral approach is needed under which states agree to use their normal administrative and legal powers to obtain and exchange information necessary to prevent international tax avoidance and to ensure that the proper tax has been paid to each country. An important step in this direction was taken in the multilateral Convention on Mutual Administrative Assistance in Tax Matters, negotiated in the Council of Europe and the OECD, agreed in 1988. However this is only open to member states of those organisations and, among them, only six have ratified the convention to date. It should also be further developed to define minimum standards of transparency and disclosure by companies. A multilateral assistance convention would enable the development of wider networks of co-operation, extending to developing countries. This could be accompanied by measures to discourage the use of uncooperative jurisdictions and worldwide standards to define the tax base.

International Convention on the recovery of stolen wealth

The international community could also support the proposal for an International Convention to facilitate the recovery and repatriation of funds illegally appropriated from national treasuries. The proposal was adopted by the ACP heads of state and government in November 1999 as part of the Santo Domingo declaration. An International Convention would assist countries such as Nigeria, which often come up against the brick wall of tight bank secrecy laws in Europe in their efforts to recover funds looted and kept abroad.

Global standards to define the tax base

A multilateral approach on common standards to define the tax base could be agreed. Unless liberalisation and globalisation are accompanied by broad agreement on basic standards defining the tax base of internationally operating businesses, tax competition between states will provide plentiful opportunities for avoidance, and for pressures on states to limit anti-avoidance measures. A number of provisions have been introduced, mainly by developed countries, to counter international tax avoidance. These have increasingly been co-ordinated through the OECD Fiscal Committee, and essentially consist of a loose set of standards defining the tax base, so as to limit opportunities for international avoidance. These are steps in the right direction, but their legitimacy and effectiveness are limited by being confined mainly to OECD countries and by the low-key way in which they are presented.

A multilateral approach on common standards to define the tax base could help combat tax avoidance by trans-national corporations, and could also be extended to other proposals which have been hard to agree among a smaller group of countries for fear that the offshore system would make them ineffective. Thus, the EU has so far failed to agree on proposals to ensure that interest income is adequately taxed, either by improving information exchange or by introducing a minimum withholding tax at source. Common standards to define the tax base would not jeopardise the sovereignty of individual countries' in setting the tax rates on business and individuals. A multilateral approach would be especially useful to developing countries because they are often handicapped by a lack of resources and the expertise needed to adequately monitor and claim tax liabilities. Also they are often unwilling to put in to place a system that rigorously scrutinises the tax liabilities of TNCs because of their desire to attract FDI.

Taxing TNCs on an unitary basis

The international community could agree to allow states to tax multinationals on a global unitary basis, with appropriate mechanisms to allocate tax revenues internationally. A major problem for governments taxing TNCs is how to deal with the way TNCs manipulate transfer pricing in order to under-report their profits and thereby reduce their tax liabilities. The standard method is for tax authorities to require companies to use the arm's length principle. This principle requires that prices charged between subsidiaries are equivalent to those charged between unrelated parties for comparable transactions. However, this depends on being able to find similar transactions: TNCs often have unique technology, or benefit from economies of scale or scope. Also, this method requires sophisticated audit techniques which few tax administrations are able or willing to apply on their own. Many developing countries in particular are handicapped by the lack of resources and expertise to adequately monitor and claim tax liabilities. Also, because they are often anxious to attract FDI, they may be unwilling to establish rigorous scrutiny of transfer pricing.

A more administratively simple and transparent approach for governments, especially for administratively weak developing countries, would be for the international community to agree to allow states to tax multinationals on a global unitary basis. This idea has been proposed for discussion at the forthcoming UN Special Session in Geneva which will review government progress towards achieving the international development targets. Under this approach governments would require TNCs to calculate the accounts of their local subsidiary as a proportion of the unified accounts of the group as a whole. This would eliminate the internal transactions among related subsidiaries of an integrated TNC, and make it far easier to ensure that all the profit is taxable somewhere.

States would be left free to choose their own tax rates and therefore this proposal would not pose a threat to national sovereignty. However, a unitary approach would provide a strong impetus towards closer coordination, both of the basic principles to define the tax base, as well as on an appropriate formula for profit allocation, an idea floated in a paper by the IMF Fiscal Affairs Department.[xxii] A formula allocation of profit would allocate total global profits among the various parts of the company on the basis of where economic activity takes place (for example, the value of assets, sales or employment in each of the operative countries). Independent auditors could be used to provide impartial validation of the implementation of this system. This could result in a much fairer proportion of global tax revenues reaching the governments of developing countries.

The unitary approach has been resisted by the OECD and business community since they argue it would result in excessive and/or double taxation unless international agreement could be reached both on definition of the tax base and formula for its allocation. However, significant progress has already been made in establishing international accounting standards, and the OECD countries' tax authorities are already using formula allocations for many elements of fixed costs, and as a check on arm's length profit assessments.

Equity and corporate responsibility

Standards requiring TNCs to refrain from harmful tax avoidance and evasion could be factored into the corporate responsibility agenda. A neglected aspect of current discussions on harmful tax competition is the possibility of using existing and future possible tax rules to promote equity or corporate responsibility goals.

TNCs have recently come under pressure to become more socially responsible by abiding by certain internationally agreed labour and environment standards. This should be extended to include a third requirement for TNCs to refrain from harmful tax avoidance or evasion. Existing official and voluntary codes of conducts for TNCs should contain clear standards on taxation including requirements to make available all necessary information and refrain from aggressive tax planning or making use of transfer pricing, thin capitalisation and the use of conduit and base companies for modifying their tax base. Similarly, the tax-planning industry could also be encouraged to draw up a code of conduct to provide a socially responsible, rather than merely legal, dimension to the tax advice that they offer to companies and wealthy individuals.

Governments in industrialised countries, where the majority of TNCs are based, could provide tax incentives to encourage good corporate behaviour. For example, tax credits could be awarded to companies that can show that they act responsibly with regard to taxation in the host country, as well as on environmental and labour standards. This would encourage companies to act in a fiscally responsible manner in the host country, and also to report and return profits to the home country. Similarly, governments could consider reducing tax credits or export credit guarantees for foreign source income from companies which failed to publicly sign up to the revised OECD guidelines for MNEs.

The institutional framework

A global tax authority could be set up with the prime objective of ensuring that national tax systems do not have negative global implications. Issues related to the offshore system, particularly those around the international implications of tax policies adopted by individual states, require an institutional home. The various initiatives currently in progress require proper co-ordination. It has been suggested that existing institutions, such as the World Trade Organisation (WTO) or the OECD, could provide an appropriate institutional home for this work. However, both these institutions are riddled with legitimacy and trust problems for developing countries and neither has the capacity to provide a broad overview.

Vito Tanzi, Director of the Fiscal Affairs department at the IMF, has proposed that a new authority be established.[xxiii] In this proposal, the prime objective of a World Tax Authority (WTA) would be 'to make tax systems consistent with the public interest of the whole world rather than the public interest of specific countries'. Clearly, there is a lack of political will for the creation of a global tax body at the moment. If that were to change, the mandate of a WTA would inevitably depend on the powers that its members are willing to give it.

In terms of specific responsibilities, a WTA could: follow global tax developments and gather statistics; be a forum for discussion on international issues related to tax policy; tackle tax competition; exert peer pressure on countries/jurisdictions that are tax free-riders; and develop best practices and codes of conduct on tax-related issues. If sufficient trust were built over time its mandate could increase to include the development of mandatory regulations and formal surveillance. Compliance with its rules could either be achieved by establishing an international dispute forum and/or by making the benefits of any future investment rules agreed at the WTO conditional on a county's compliance with its rules.

Endnotes

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[ii] See 'The mystery of the vanishing taxpayer' in Globalisation and Tax Survey, The Economist, January 29 2000.

[iii] 'IMF Publishing Global Portfolio Investment Survey', News Brief 00/8, January 2000 (IMF website). To give an indication of the scale of offshore holdings, Bermuda, which was the only offshore financial centre to participate in the IMF's survey, accounted for US$133 billion in portfolio investment holdings.

[iv] 'Fiscal Paradise: Foreign tax havens and American Business' by J Hines and E Rice. Quarterly Journal of Economics, 1994.

[v] London, for example, has been the largest and most important centre of Eurocurrency operations since the 1950s. The favorable regulatory environment in London has ensured that international banks continue to carry out a large share of their international lending and deposit-gathering there, despite the rise of other financial centres London is also the focal point of the Eurobond market.

[vi] All three countries have agreed to a recently published OECD report on improving access to bank information for tax authorities. It remains to be seen what impact this agreement will have.

[vii] Daily Mail and Guardian, South Africa, 7th April 2000. Memorandum prepared by Oxfam for the International Development Committee.

[viii] Portfolio investments here refers to government and corporate bonds, money market instruments, and bank deposits.

[ix] UNCTAD. 1999. World Investment Report. Given that the statistics are unreliable, the figure for FDI inward stock in developing countries is likely to be an under-estimate.

[x] David Woodward. 'The next crisis? Direct and equity investment in developing countries' (forthcoming, Zed Books).

[xi] UNCTAD. Transfer Pricing. UNCTAD series on issues in international investment agreements (1999).

[xii] 'The regional and global challenge of tax evasion, corruption and money laundering', speech by US Treasury Secretary Larry Summers at the Annual Meeting of the Committee of Hemispheric Financial Issues, Cancun, Mexico. February,3, 2000.

[xiii] Mark Hampton. 'The Offshore Interface: Tax Havens in the Global Economy', Macmillan, 1997.

[xiv] United Nations Office for Drugs Control and Crime Prevention, 'Financial Havens, Banking Secrecy and Money-Laundering'. Issue 8 of the UNDCP Technical Series (New York, 1998)

[xv] United Nations Office for Drugs Control and Crime Prevention, 'Financial Havens, Banking Secrecy and Money-Laundering'. Issue 8 of the UNDCP Technical Series (New York, 1998)

[xvi] Box 3 draws on the work of Rev. David Ugolor, President of the African Network for Environmental and Economic Justice.

[xvii] See 'Offshore banking: an analysis of micro- and macro-prudential issues', IMF Working Paper, prepared by L Errico and A Musalem, January 1999, for an examination of offshore banking and its role in recent financial crises.

[xviii] Financial Stability Forum. Report of the Working Group on Offshore Centres. April 2000. (point 36).

[xix] 'International Dimensions of National Tax Policy' by Vito Tanzi. Paper prepared for United Nations' Experts' Meeting on 'International Economic and Social Justice', November 1998.

[xx] On the BIBFs, see Bank for International Settlements 68th annual report.

[xxi] The OECD has begun to make efforts to open-up the debate. On 29-30 June 2000, the 29 OECD countries will meet with 30 other countries to discuss a global response to harmful tax competition.

[xxii] 'The Role of Allocation in a Globalised Corporate Income Tax', prepared by Jack M. Mintz, (September 1998, IMF Working Paper).

[xxiii] V Tanzi, 'Is there a need for a World Tax Organisation?' in A Razin and E Sadka (eds) The Economics of Globalization: Policy Perspectives from Public Economics (1999, Cambridge University Press).