

The Campaign Against Tax Havens: Will It Last? Will it Work?

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Abstract: This paper sorts out various issues connected with different types of tax havens and attempts to predict future policy developments. The first part attempts to explain the variety of state activity that results in a “haven” reputation. The second part looks at various explanations for their growth. This is followed by a sketch of the prevailing international tax regime and the current initiatives. Next, factors are examined that may explain why the OECD and other initiatives emerged when they did. The paper then looks at national interest positions of various categories of state and complications relating to the influence of special interests. Unilateral and cooperative policy options to deal with various kinds of havens are considered next, followed by a look at the interest of most of the developing world. The closing part briefly forecasts the future of unilateral and collective action toward the tax havens.

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The Campaign Against Tax Havens: Will It Last? Will it Work?

The radically transformed international environment since September 11, 2001 has focused international attention on secret international financial transactions, and has greatly increased attention to territories popularly known as “tax havens.” The use of secrecy by terrorists is a small, although lethal, part of the damage these anomalies in the international system inflict on the global community.

The Organisation for Economic Co-operation and Development’s 1998 report, *Harmful Tax Competition: An Emerging Global Issue*, presented the strongest and most specific collective attack ever made on “tax havens.” Global grumbling on this subject goes back decades, however, and informed opinion now divides sharply over whether the initiatives accompanying the *Report* will dramatically and permanently change the role of the tax havens in the global economy,¹ even with the additional impetus provided by the terrorist shock.

This paper will explore the issues connected with tax havens for predicting future policy developments. The first part attempts to explain the variety of state activity that results in a “haven” reputation. The second part looks at various explanations for their growth. This is followed by a sketch of the prevailing international tax regime and the current initiatives. Next, factors are examined that may explain why the OECD and other initiatives emerged when they did. The paper then looks at national interest positions of various categories of state and complications relating to the influence of special interests. Unilateral and cooperative policy options to deal with various kinds of havens are then considered, followed by a look at the interest of most of the developing world. The closing part briefly forecasts the future of unilateral and collective action toward the tax havens.

Tax Havens: Towards a Simple Taxonomy

Tax havens exist in an international tax structure that began from a general presumption of residence income taxation, i.e. that the ownership jurisdiction should be the principal site of taxation. The United States clings to the most consistent system: all worldwide income of U.S. businesses and individuals

¹ For recent literature on tax havens and offshore jurisdictions, see Richard W. Barrett, *Confronting Tax Havens, The Offshore Phenomenon, and Money Laundering*, 23 INT’L TAX J., 12 (1997); Peter Beard, *Offshore Financial Centers in Caribbean Basin Secrecy Jurisdictions: Current Trends and Developments in United States Anti-Tax Haven Policy*, 12 SYRACUSE J. INT’L L. & COM., 520 (1986); David W. Conklin & Darroch A. Robertson, *Tax Havens: Distortions and Policy Options*, 25 CANADIAN PUB. POL’Y – ANALYSE DE POLITIQUES (1999); Lorraine Eden, TAXING MULTINATIONALS: TRANSFER PRICING AND CORPORATE INCOME TAXATION IN NORTH AMERICA (1998); Charles F. Hermann & Lorraine Eden, *Renegade States In International Affairs: A Conceptual Exploration*, Address at the Southwest Region Section of the International Studies Association, Houston, 20-23 (Mar. 1996); FIN. ACTION TASK FORCE, REPORT ON MONEY LAUNDERING TRENDS FOR 2000-2001, (2001); FIN. STABILITY F., REPORT OF THE WORKING GROUP ON OFFSHORE CENTERS (Apr. 5, 2000); OFFSHORE FINANCIAL CENTERS AND TAX HAVENS: THE RISE OF GLOBAL CAPITAL (Mark P. Hampton & Jason P. Abbott eds., 1999); James R. Hines & Eric M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, 109.1 Q. J. ECON. 149 (1994); H.W.T. Pepper, *From Tax Haven To Fiscal Paradise, Parts I and II*, 31 BULL. INT’L FIS. DOC. 31, 75 (1977). Although “offshore jurisdiction” is often used synonymously with “tax haven,” the origins of the former term are too narrowly financial. In particular, “offshore” often suggests foreign banking operations in a currency not used in the territory of operation. PAUL R. KRUGMAN & MAURICE OBSTFELD, INTERNATIONAL ECONOMICS: THEORY AND POLICY 640 (1994). Alternatively, they may imply merely financial services to non-residents. INTERNATIONAL MONETARY FUND, OFFSHORE FINANCIAL CENTERS: THE ROLE OF THE IMF 1 (2000). Our focus is on tax avoidance and evasion.

implies U.S. tax liability.² Most countries waive taxation of their citizens' labor income when it is generated abroad; the U.S. does not. A convention developed early in the last century, however, that the "source" state labor income or a firm's subsidiary income could take the first fiscal bite. The U.S. credits such payment against an individual's personal income tax liability and a firm's corporate tax liability. In addition, the Treasury defers payment of any residual corporate tax until the firm's earnings are repatriated. Foreign tax credits are limited by the amount due if the firm were operating at U.S. rates, but, under current law, the liability on repatriated earnings is not calculated on a country-by-country basis but overall (subject to certain restrictions). This means that corporations that have paid more than the U.S. rate in some jurisdictions have an incentive to average their taxes with those of low tax areas abroad. Other developed countries' practices vary; many simply exempt corporate taxation of foreign earnings.

The earnings on portfolio, i.e. non-ownership, capital have often been subject to local withholding taxes. Experts think that the worldwide supply curve of portfolio capital is now so flat into all markets, however, that most or all of that tax is shifted to the borrower. Most portfolio capital taxation has therefore disappeared in the OECD, although many poor countries continue to levy it as a vital source of revenue, even though the burden is borne locally. This contrasts with the general view that the volume of real corporate investment continues to vary among countries for a host of reasons, and considerable differences in tax rates are quite viable.

The very term "tax haven" suggests that a jurisdiction allows *foreigners* tax saving. (After all, a person or business that naturally resides in a low tax area is simply home.) Logically, this saving can take place in three ways. Activity can take place in the haven; activity can be assigned to the haven for fiscal purposes, regardless of reality; or the haven can mask reality through secrecy. Tax havens may therefore *produce* goods and services, they may *shift* claims among jurisdictions, or they may *hide* claims; frequently they do a bit of two or all three.³ Each function has generated negative reactions from other states.

The three tax haven functions rest on an even more fundamental distinction, that between real and financial activity. "Claims" are financial rather than real, and the term lumps together all kinds of flows and stocks of financial claims: profits, royalties, interest, and assets. The distinction between the real and

² For a concise historical discussion emphasizing the corporate income tax, see GARY C. HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 176-186 (1992). For a similar treatment of the personal income tax, see JAGDISH N. BHAGWATI & JOHN D. WILSON, INCOME TAXATION AND INTERNATIONAL MOBILITY 23-35 (1989). This can be contrasted with the view expressed by Daniel Mitchell of the Heritage Foundation who sees the OECD effort as an attempt "to overturn 200 years of international practice so that high-tax nations can impose taxes on assets and activities outside their own territory. Daniel Mitchell, *An OECD Proposal To Eliminate Tax Competition Would Mean Higher Taxes and Less Privacy*, Backgrounder No. 1395, The Heritage Foundation (2000). As former IRS Commissioner Donald C. Alexander has noted: "[T]he recent criticism of the OECD's tax haven project . . . seems to be based upon extreme libertarian notions founded in anti-government bias, and it even seems to claim that the U.S. tax system is territorial (or should be territorial) when it is not. Since 1913 U.S. citizens have been taxed on their worldwide income, and unless and until this tax system is abandoned, it should be enforced." Donald C. Alexander, Statement before the United States Committee On Governmental Affairs Permanent Subcommittee On Investigations (July 18, 2001).

³ Some writers (for example, RONEN PALEN ET AL., STATE STRATEGIES IN THE GLOBAL POLITICAL ECONOMY 175 (1996)) characterize jurisdictions with low consumption taxes aimed at increasing local sales to foreigners, for example, Andorra, as tax havens. This usage is not common, although electronic commerce promises to make consumption tax evasion a major international issue. Robert T. Kudrle, *Does Globalization Sap the Fiscal Power of the State?*, in COPING WITH GLOBALIZATION, (Aseem Prakash & Jeffrey Hart eds., 2000). In addition, there is the issue of residential havens, i.e. the haven becomes "home." Some havens have attempted to attract permanent residents, and a plan for an entirely new residential haven state is presented at <http://oceania.org/info.html>. This scheme for an artificial island, called "Oceania" may have been abandoned; the website does not appear to have been revised since the mid-nineties. Other schemes are mentioned in Robert Thomas Kudrle, *Nation States are Not Losing Their Power to Tax*, CHALLENGE, July-Aug. 2002, at 71.

the financial is fundamental. If a firm in Cincinnati shifts its activities to Ireland to take advantage of the lower corporate tax rates there, activity in the U.S. is changed and so is activity in Ireland. In sharp contrast, if a citizen of Cincinnati invests funds through a tax haven in the Caribbean instead of buying an American mutual fund, the funds might be re-lent to the U.S. with little real impact at all—except on the receipts of the Internal Revenue Service.

Four categories result from further refinement. Where a jurisdiction's tax attraction induces a significant change in real haven value added, it can be called a **"production" haven**. Ireland, until it recently changed its laws, was cited as the prime example. Although some complain that jurisdictions with generally low taxation should be called "havens" because they attract real foreign activity, most observers look only at discrimination: are foreigners treated differently from otherwise similar domestic persons and businesses? If they are not, then one is simply looking at a low tax state.

There are three other principal categories: "headquarters" havens, "sham" havens and "secrecy" havens. Although some might quarrel with boundaries, the actual dominant functions of particular havens are fairly well agreed. **"Headquarters" havens** lower corporate taxes by providing tax advantages to firms that incorporate in that jurisdiction, wherever their shareholders are located. Examples usually offered are Belgium and Singapore.⁴

"Sham" havens host low corporate-tax financial intermediaries that may be little more than an address for investment activity directed from elsewhere. Nearly all of the Caribbean and Pacific tax havens fall into this category. Some sham havens have also emerged as headquarters havens. The low value-added activity may not be a subsidiary of a foreign firm but independent and legally based in the haven despite negligible local ownership. Some Liberian and Panamanian shipping firms and some Bermudan insurance companies serve as examples. In addition, there is the rapidly rising phenomenon of "corporate inversions," in which corporations based in high-income countries simply shift their declared nationality to a sham haven.

Although haven location often involves little more than jurisdictional sequestration, only some territories have succeeded as sham havens. Law and order are prerequisites to maintain effective coordination and predictable behavior towards the outside world, as are high quality communications and transportation. A reputation for corruption damages sham haven status and serves as a reminder that the rest of the world has leverage over the havens beyond taxation. Behavior judged sufficiently unacceptable by other states could ultimately result in attacks on external financial linkages or even physical connections such as air service.

Nearly all "sham" havens are also **"secrecy" havens**, but the reverse is not true. Havens that exist only because of secrecy can coexist with any level of corporate taxation. Secrecy havens specialize in allowing personal income tax evasion by reinvesting funds that have been provided without the knowledge of authorities at home. The classic practitioner has been Switzerland; more recently Luxembourg, Austria, and a number of smaller rich territories have also employed banking secrecy for this purpose. They have also been used in various ways to launder funds from illegal activities. Many havens, however, are anxious to cooperate with the authorities of other countries on money laundering. Reputation plays a role here similar to that found in sham havens. Cooperation on selected matters such as money laundering can avoid big international relations problems, while allowing a very lucrative business with those whose only crime is tax evasion.

⁴ Reuven Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV L. REV. 1573, 1601, 1666 (2000).

The Secretary General of the OECD, Donald Johnston, has suggested a common thread among all of these categories. Tax havens are “regimes whose principal effect is to frustrate the laws of other countries.”⁵ Inevitably, not all observers see all of the categories as malign. For example, some see discriminatory taxation as a legitimate tool of economic development. Nevertheless, the U.S. and many other countries in the GATT and WTO have generally pushed for trade and investment policies that grow from countries’ comparative advantage rather than policy manipulation.⁶ Insistence that a state apply the same corporate tax rate to foreign and domestic firms appears consistent with that basic posture. But the situation is not simple. Special export zones in developing countries, with their own trade rules and tax practices catering largely to foreign firms, are seen by many as a legitimate development tool, but as discriminatory “ring fencing” from the local economy by others.

The Growth of the Tax Havens

The Ur-haven, Switzerland, after already establishing a reputation for financial discretion, passed legislation in 1934 making the violation of bank secrecy a crime and extending protection to the accounts of foreigners. In the following decades, many other European jurisdictions followed suit, frequently attempting to make their practices even more impenetrable.⁷

Alternative Explanations

Palen⁸ presents four factors that the literature has advanced to explain the growth of tax havens in recent decades. One suggested cause is increasing regulation and taxation in the post-war OECD economies. In fact, however, direct regulation of capital movements, which clearly spawned some havens, has virtually disappeared, and both corporate and individual income tax rates are lower now, sometimes much lower, in most jurisdictions than they were in 1970 or 1980. In addition, because of permissive prudential regulation, banking in some tax havens may carry risks considerably greater than depositors would face elsewhere.

A second claim, attributed to Johns and LeMarchant, suggests that the havens have played a critical role in the development of the global economy, in particular by acting as “*agents provocateurs* for the promotion and expansion of boundless financial services.”⁹ But to the extent that this hypothesis can be distinguished from the first, it looks like questionable attribution. Just because haven financial activity pioneered certain activities before the major economies felt comfortable making them legal at home does not demonstrate that the havens were necessary for the ultimate development of financial globalization; still less does it explain their persistence in the face of greatly increased competition.

Third, Naylor¹⁰ argues that corruption and crime have driven haven proliferation, citing Meyer Lansky’s post-Batista decision to shift the investment of shady earnings from Cuba to the Bahamas as the exemplary case. This cause seems undeniable in light of the fact that all secrecy havens are not alike.

⁵ Donald Johnston, *Organization for Economic Cooperation and Development Letter to U.S. Congressman Johnson on Tax Compensation*, 22 TAX NOTES INT’L, 1247 (2001).

⁶ Nevertheless, the traditional U.S. position that investment should be driven by the relative productivity of capital, reflected in the credit approach has clearly been compromised by deferral to make U.S. firms more competitive.

⁷ See Palen, *supra* note 3, at 172.

⁸ See Palen, *supra* note 3, at 174-76.

⁹ See Johns & Le Marchant, *supra* note 1, at xi.

¹⁰ R.T. NAYLOR, *HOT MONEY AND THE POLITICS OF DEBT* (1987).

Each has various thresholds for cooperation with foreign authorities and, as some become more malleable, demand increases for others.¹¹

Finally, Palen himself suggests considering haven activity as a “state strategy” for economic development. The possibilities were apparent not just to locals but also to previous colonial powers that saw a means to make previous dependencies more self-sustaining.

The last argument appears sound as far as it goes, but it explains only the supply of havens and not the demand for their activity. On the other hand, the third argument about demand seems to be in need of considerable augmentation by the consideration of additional factors:

- The growth of multinational corporate activity (at rates higher than most national economies) and international trade as a whole has generated an increasing demand for lightly taxed profit reallocation.
- The growth of incomes subject to substantial personal taxation has greatly increased the total pool of funds that could be tempted by illegal tax-free earnings as well as the absolute number of potential participants who face costs of using the system that are largely independent of the size of transactions involved.
- Improvements in transportation and especially communications have made the use of havens for all purposes ever easier.

Approaches to Estimating Losses

Current initiatives must be seen in light of the estimated losses that have been claimed to result from haven activities. In a recent attempt to summarize all of the major empirical studies, Avi-Yonah¹² finds absolutely large estimates of lost corporate tax earnings; however, these estimates appear for most countries to be quite modest relative to the total yield of the corporate income tax as a whole, and very modest by comparison with total national tax receipts. The tax loss resulting directly from the deferral of the tax on the earnings of all U.S. subsidiaries was \$2.2 billion in 1997 estimated to rise to \$3.4 billion in 2003. This was less than two percent of estimated corporate tax receipts in the first period. Comparable data for France suggest a loss closer to 2.5 percent.¹³ These are not impressive figures and would scarcely seem the impetus for major international initiatives.

Turning to personal tax receipts, estimates are very difficult because they involve illegal activity. Nearly all empirical work has estimated only the total amount of tax evasion and not that part resulting from foreign investment. Recent work by Schneider and Enste¹⁴ finds a considerable “shadow economy” in OECD countries at the beginning of the nineties with an unweighted average between 11.3 and 15.1 percent for all members, depending on which of four alternative methodologies is employed. Most states, including the U.S., have results that fall within that range; Italy and Greece have estimates that are

¹¹ A sense of the variation in probity among Caribbean havens in various dimensions can be gained from ESTHER C. SUSS ET AL., CARIBBEAN OFFSHORE FINANCIAL CENTERS: PAST, PRESENT, AND POSSIBILITIES FOR THE FUTURE (Int'l Monetary Fund Working Paper WP/02/88, Revised 6/26/02).

¹² See Avi-Yonah, *supra* note 4, at 1597-1603.

¹³ Calculated from data. See Avi-Yonah, *supra* note 4, at 1600; ORG. FOR ECON. COOPERATION & DEV., IMPROVING ACCESS TO BANK INFORMATION FOR TAX PURPOSES (2000).

¹⁴ FRIEDRICH SCHNEIDER & DOMINIK ENSTE, SHADOW ECONOMIES AROUND THE WORLD: SIZE, CAUSES, AND CONSEQUENCES 11 (Int'l Monetary Fund Working Paper WP/00/26).

much higher. Avi-Yonah¹⁵ cites Dooley as estimating tax motivated portfolio capital outflows from the U.S. in 1980 through 1982 at \$250 billion.¹⁶

Despite the paucity of good estimates for total national losses, compliance rate estimates suggest that they are substantial. The U.S. General Accounting Office has estimated that compliance rates of ninety percent on domestic income drop to thirty percent for foreign source income because of the absence of either withholding or effective information exchange. Similarly, in Germany, perhaps only twenty percent of foreign income is taxed. Even larger losses in relation to local GDP may plague some poorer countries, notably in Latin America.¹⁷ Recent econometric work by Huizinga and Nicodème also finds external bank depositing to be highly sensitive to variables such as taxation levels and the direct reporting of information for tax purposes.¹⁸

There are also aggregate estimates of tax haven activity. Chairman Levin of the Senate Governmental Affairs subcommittee has estimated that the size of “offshore havens” has grown from \$200 billion in 1983 (thirty jurisdictions) to \$5 trillion in mid 2001 (sixty jurisdictions), \$3 trillion of which are in bank accounts.¹⁹ The United Nations estimates about \$8 trillion in “offshore companies and accounts.”²⁰ Oxfam presents a total figure of \$6 to \$7 trillion in “offshore centres” in 2000, of which \$3 to \$4 trillion are thought to be the savings of the wealthy.²¹

Regulating the Havens: The Recent Initiatives

Eden and Hermann²² explain that the current international tax regime combines elements of bilateralism and a set of common practices largely refined by the Committee on Fiscal Affairs of the OECD. In fact, the dual purposes of most of the bilateral treaties are reflected in the title proposed by the OECD: “Convention Between (State A) and (State B) for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital.” The United Nations has assisted in extending much of the same content to fiscal relations among the developing countries.

The OECD’s 1998 Report focuses on the tax treatment of “geographically mobile activities such as financial and other service activities.”²³ It takes aim at tax havens and “preferential tax regimes.” The former can be recognized by four characteristics: 1) only nominal taxes on foreign owned investments or none at all; 2) no effective information exchange with other jurisdictions; 3) lack of transparency in legislative, administrative, or legal issues connected with foreign investment; and 4) little substantial

¹⁵ See Avi-Yonah, *supra* note 4, at 1599.

¹⁶ Dooley’s work makes clear that he is arguing for the peculiarity of those years by contrast with the period that followed; he is not suggesting a representative flow. Nevertheless, the annualized figures are far larger than estimated corporate tax losses. Michael Dooley, COMMENT TO CAPITAL FLIGHT AND THIRD WORLD DEBT 79 (Donald R. Lessard & John Williamson eds., 1987).

¹⁷ See Avi-Yonah, *supra* note 4, at 1598-99.

¹⁸ Unfortunately, the highly significant results differ so much between specifications as to cast doubt on the point estimates of the coefficients. Nonetheless, this kind of research is overcoming data limitations and will become increasingly valuable. Harry Huizinga & Gaetane Nicodeme, *Are International Deposits Tax Driven?*, in DIRECTORATE GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS, EUROPEAN UNION, ECONOMIC PAPER NO. 12 292/01 (2001).

¹⁹ Sen. Carl Levin, *Opening Statement At Senate Government Affairs Committee Investigations Panel Hearing on Tax Havens*, TAX NOTES TODAY, July 19, 2001, at 139.

²⁰ DANIEL MITCHELL, THE HERITAGE FOUNDATION, AN OECD PROPOSAL TO ELIMINATE TAX COMPETITION WOULD MEAN HIGHER TAXES AND LESS PRIVACY. BACKGROUNDER NO. 1395 12 (2000).

²¹ OXFAM POLICY DEP’T, TAX HAVENS: RELEASING THE HIDDEN BILLIONS FOR POVERTY ERADICATION 3 (2000).

²² See Hermann & Eden, *supra* note 1, at 20-23.

²³ ORG. FOR ECON. COOPERATION & DEV., HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 23 (1998).

activity. Preferential tax regimes may also have these characteristics, and, in addition, foreigners are singled out for tax advantages.²⁴ OECD members (except non-signers Luxembourg and Switzerland) agreed to remove all practices deemed to be “harmful” within five years or, in some cases no later than 2005. The Report suggested that virtually all OECD states employ some offending activities in their attempt to maintain policy competitiveness.²⁵

The Report made nineteen recommendations in three categories. It urged member states to move unilaterally to make abuse of their own tax codes more difficult. A specific suggestion was to tax more haven income of a state’s own controlled foreign corporations (CFCs) immediately at the full home country rate. Strict attention to transfer price manipulation was also suggested.²⁶ The Report urged that all bilateral agreements include the maximum possible exchange of tax relevant information. The report announced a new institution, the Forum, that involved interested parties—and not just OECD members—in consideration of tax practices alleged to be harmful. Between 1998 and 2000, the Forum oversaw extensive self-surveys of possibly offending domestic activity by OECD member states and also drew up a list of tax havens. Those jurisdictions were, in turn, given several years to bring their practices up to the standards developed by the Forum. The OECD released a follow-up report in 2000²⁷ outlining a variety of harmful tax practices, which were separated into two categories: preferential tax regimes and tax havens.

Very significantly, the Finance Ministers of the European Union acted shortly before the publication of the OECD Report to remove harmful tax regimes within its territory, using very similar criteria to those for the OECD’s.²⁸ A conscious attempt was made to keep the activities consistent.²⁹ In fact, the new U.S administration that took office in 2001 saw too much of Europe’s agenda in the OECD project, and began almost immediately to scale back the effort. In a statement issued in July, Treasury Secretary Paul O’Neill announced that the OECD had abandoned attention to “no substantive activities” and discrimination between foreign and domestic tax rates. The rationale for the former was that it was too vague to be operational and that “ring fencing” was being used as a proxy. The administration insisted that it would not oppose practices designed to encourage foreign investment and unconnected with the enforcement any other country’s tax law.³⁰ O’Neill interpreted this narrowing as an attempt to focus on the “core” issues of transparency and information exchange. Other changes included an extension from July, 2001 to February, 2002 for the havens to declare their willingness to cooperate and a shift from the

²⁴ See *id.*

²⁵ See *id.* For example, the U.S. foreign sales corporations (FSCs) that allow some exporters to escape the corporate income tax were criticized; these devices were also later condemned by the World Trade Organization. Several pieces of legislations considered in 2003 contained provisions replacing FSCs with other tax incentives for business. Martin A. Sullivan, *Economic Analysis: The Five Uneasy Pieces of International Tax Reform*, 31 TAX NOTES INT’L 418 (2001).

²⁶ U.S. negotiated transfer price agreements have been criticized as non-transparent See Lee A. Sheppard, *It’s the Bank Secrecy, Stupid*, 22 TAX NOTES INT’L 2018, 2020 (2001).

²⁷ ORG. FOR ECON. COOPERATION & DEV., TOWARDS GLOBAL TAX COOPERATION, (2000).

²⁸ Jacques Malherbe, *Harmful Tax Competition and the European Code of Conduct*, 21 TAX NOTES INT’L 151 (2000).

²⁹ See OECD, *supra* note 22. Spurred by the OECD report, there are now several organizations, national and international, involved in studying and developing regulations for tax havens and offshore financial activities. Information sharing on tax matters also served a related initiative undertaken at the 1998 Birmingham G-7 Summit to act more forcefully against money laundering. Hugh J. Ault & Joann M. Weiner, *The OECD’s Report on Harmful Tax Competition*, NAT’L TAX J. 608, (1998). The Financial Stability Forum, set up in 1997 by the G-7 to study methods for reducing global financial instability, in 1999 established a working group to study offshore financial centers. Eric Osterweil, *OECD Report on Harmful Tax Competition and European Union Code of Conduct Compared*, 39 INT’L BUREAU OF FISCAL DOCUMENTATION 6 (1999).

³⁰ Paul O’Neill, *Statement at Senate Government Affairs Panel Hearing on Offshore Tax Havens*, TAX NOTES TODAY, July 19, 2001, at 139.

sanctioning of “defensive measures” by OECD states to 2005, the date by which all OECD members were to have removed all of their own questionable practices. Of the thirty-five “potentially harmful” countries on the OECD tax haven list in 2000, only seven had failed to indicate cooperation by April of 2002.³¹ The Bush administration portrayed the results of its pressure as an OECD position that respects small and weak states more than did the original OECD demands. Many of the complying jurisdictions did so, however, only on the condition that all of the OECD countries meet information-sharing standards as stringent as those demanded of the non-OECD havens. This implied, inter alia, changes in policy by the U.S. to collect and share information on the earners of untaxed interest and by Switzerland to more readily supply a broader range of information.

In terms of the typology developed earlier, the U.S. declared a lack of interest in substantial coordinated attack on production, headquarters, and sham havens. Moreover, we will argue later that the modest information exchange demands that the U.S. does support cannot substantially reduce the havens’ current role in tax evasion.

The OECD’s list of potentially harmful tax regimes is provided in Table 1 along with two alternative lists from other sources.

Table 1 goes about here

Why has the Issue Received so Much Attention In Recent Years?

Although the quantitative role of the havens has steadily risen, at least as a source of estimated personal income taxes losses, what explains the OECD’s significantly heightened determination to resist even prior to September 11, 2001? One widely discussed hypothesis does not appear to stand up well against the evidence.

- “*The Fiscal Crisis of the Welfare State.*”³² Avi-Yonah employs this phrase in his important recent article on the world tax system. But the article reveals that no such crisis exists. It does a fine job of marshalling and criticizing evidence about the extent of fiscal loss for various states, but the overall picture is one of ambiguity. Corporate tax yields have fallen modestly if at all, and the decline of personal income tax revenue stems from multiple causes, most especially concerns about the incentive effects of high marginal tax rates. As national capital markets increasingly meld, allowing capital to escape local taxation, all experts forecast the that the incidence of nominal taxes on capital will increasingly fall on other factors, notably labor. The extent to which this has developed so far is unclear, however. Avi-Yonah criticizes the OECD for not providing a better empirical justification for its initiative,³³ but the new efforts need not rest on crisis. The obvious injustice of an escape of legislated tax rates by the rich through illegal activity, leaving more for others to pay, would seem grounds enough. And the tax evasion damage to poor countries is almost certainly relatively greater than to richer states. In addition, the failure to deal with tax avoidance and evasion now may increase

³¹ Robert Gouldner, *OECD Updates Tax Haven Blacklist, Claims Progress in Curbing Harmful Tax Competition*, 26 TAX NOTES INT’L 375 (2002).

³² See Avi-Yonah, *supra* note 4.

³³ See *id.*

the difficulty of dealing with it effectively in the future by increasing the stakes of the current beneficiaries of laxness.

Several other factors appear more important.

- *The contribution of tax havens to global financial instability.* The unevenness of prudential regulation of banking among states and its possible threat to the international system led to unprecedented international cooperation and pressure, resulting in the Basle Accord on banking standards that saw its final form in 1988.³⁴ The Asian crisis of 1997 triggered further concern and a continuing focus on non-transparent tax haven banking practices,³⁵ although the seriousness of the haven threat to international stability is disputed.
- *European unification.* The euro has permanently transformed adopting states into regions and turned comparative into absolute advantage in “Euroland.” Sharp controls on explicit national subsidies as a way of poaching activity are inconsistent with tax manipulation for the same purpose in an EU that remains almost completely fiscally decentralized. This explains the successful attack on Ireland’s discriminatory corporate income tax rate and continuing pressure on Belgium to abolish its long-standing attempts to lure corporate headquarters. Governments are understandably also concerned about tax losses through secrecy and regard internal permissiveness as inconsistent with the Community.
- *The end of the Cold War.* Just as Castro may have played a role in spreading haven activity, so did bipolarity undoubtedly lead to caution about thwarting the development ambitions of aspiring havens out of a fear of instability and an impetus to the left. That fear has largely disappeared, and former colonial ties have also typically weakened considerably over time.
- *The war on drugs.* Money laundering is inextricably bound with the drug trade, which is a significant problem in all of the OECD countries. The huge volume of resources devoted to combating drug trafficking and other elements of organized crime inevitably leads to a consideration of policy initiatives that may increase success.
- *The growth of electronic commerce.* The OECD’s term, “geographically mobile” activities, to describe the target of the first phase of its initiative does not quite capture how the service industries confront the tax categories of the current system. The issue is not so much locational mobility as locational ambiguity. When diverse service inputs are linked through global communication, it is very difficult to know where to assign value-added and, most importantly, the profit residuum once all identifiable factors have been reckoned at their opportunity costs. Most importantly, such communication facilitates purely sham activity, in which haven value-added is negligible.

The Tax Regime and Its Various Players

The largest developed countries claimed to find the tax haven situation of the late 1990s intolerable. But how strong and uniform is their opposition? Can a formal analysis of the motives of the various players help predict what action is likely now and whether it is likely to succeed?

³⁴ ETHAN B. KAPSTEIN, GOVERNING THE GLOBAL ECONOMY: INTERNATIONAL FINANCE AND THE STATE, 103-28 (1994).

³⁵ See Oxfam, *supra* note 21; OECD, IMPROVING ACCESS TO BANK INFORMATION FOR TAX PURPOSES (2000).

Eden and Hermann³⁶ and Eden³⁷ consider the tax haven situation as a case study of “renegade states.” Such a state is one “whose practices are salient to an international regime but whose behavior does not comply with the descriptive norms and practices of the regime.” In fact, the “norms and practices” of the tax regime are evolving, and the OECD initiative can be seen as a major attempt to paint bright lines where only vague and sometimes ambiguous boundaries had prevailed. The differing tax haven lists from various sources suggest alternative criteria.

Eden and Hermann divide renegades into “insiders” and “outsiders.” For present purposes, this means distinguishing states that are enmeshed in a broad range of bilateral treaties from those that are not. Most poor tax havens have little connection of this kind, often only one or a few at most. The reasons are straightforward. Host countries and their foreign investors seek such treaties to avoid double taxation while the home country gains some commitment for sharing tax information in return. Because the less developed havens have no corporate income taxes, the former problem is often minor, while the quid pro quo could be competitively crippling. The richer tax havens, however, often strike many such agreements; they typically have substantial corporate tax rates and have accepted arrangements for certain kinds of information-sharing. For example, although Luxembourg had only twenty-eight bilateral treaties in 1995, Switzerland had sixty-two, which can be compared to Germany’s seventy-one.

One obvious approach to classifying states rests on whether they are currently net gainers or losers from prevailing practices that violate the general spirit of the OECD Report. The typical rich state without substantial haven activity of its own loses wealth by haven tax practices. To the extent that the siphoning so far has been marginal and factor yields reflect opportunity costs, the wealth loss takes the form of foregone tax revenues. Where the relevant markets operate with important elements of rent or externality, the total diverted activity is large relative to the total size of the plundered economy, and when the diversion results in the underemployment of other resources, the losses are greater (and the converse is true for gainers).³⁸ As argued earlier, tax losses to the havens are now overwhelmingly of two kinds: foregone corporate taxes and escaped personal taxes. The latter looms larger now, is likely to grow more rapidly in the future, and, as we will argue, ultimately stands as the weakest point in the entire world fiscal system.

Logically, only small states handling proportionately large amounts of foreign-owned real or financial wealth could be net winners.³⁹ This is true whether the haven is production, headquarters, sham, or secrecy. Gains from haven activity can include increases in real activity from diverted direct investment or the processing of increased portfolio investment and gains in various taxes. A first cut at costs and benefits of a permissive regime would weigh benefits diverted inwards against external drains and would presumably do so over a number of future years with appropriate discounting. The latter exercise would be difficult to perform with much accuracy, not only because it involves projections, but also because the impact of the current system on outward leakage cannot be gauged with much certainty. Not only is illegal activity necessarily hard to estimate, but also at least some corporate taxation foregone arises as personal earnings and, hence tax liability at the individual shareholder level are increased (to the extent that these gains are not completely diverted as well). For poor havens with a small domestic income tax base of any kind, however, there is little to weigh against the increased wealth that tax sheltering brings.

³⁶ See Hermann & Eden, *supra* note 1.

³⁷ See Eden, *supra* note 1.

³⁸ Although quantification of some of the gains and losses would be possible, the necessary data have not been gathered.

³⁹ This conclusion ignores the ubiquitous libertarian argument that lower taxes always lead to more growth. This is completely undemonstrated with respect to the havens. More importantly, states’ interests should arguably best be considered as a representative informed citizen of the state would see them. This person would not be a libertarian in any state.

Although the streams of estimated gains and losses are subject to wide error, the overwhelming majority of rich states would find large and increasing losses from haven activity even if they engage in some sheltering activity of their own. From this perspective, and in the first instance treating each state as a rational unitary actor, four broad categories of state can be discerned.

First, there are overwhelming losers among the rich countries that have every interest in abolishing virtually all haven activity if possible. Second, there are current probable net gainers among the rich, but very few. Moreover, although their per capita incomes are high, these “inside renegades” have been states of low to medium overall power: Switzerland, Luxembourg and Belgium. This is not coincidental because the ratio of the attracted activity to regime abuse by residents turns on size, other factors being equal.

Outside the OECD regime, the situation is equally straightforward. A third haven category, the “outside renegade,” employs some of the same rhetoric that Switzerland uses about the necessity to weigh tax collection against personal freedom and privacy, but none has much political influence. All outsiders are ultimately dependant on the dispositions of the OECD countries that now provide homes for about three quarters of the world’s MNEs and whose citizens account for well over half of world income and wealth. Finally, the remaining non-OECD states are currently “freeriders” in terms of contributions to system maintenance, but, as noted earlier, they are also the greatest apparent relative losers from the current operation of the international tax system relative to reforms that would make capital export less profitable. The poor countries are far less likely than the rich simply to be losing taxes on funds that make their way back to national markets; lower income states are typically also losing real investment to richer areas through the tax havens.

None of the states considering policy change can, of course, be treated as a unitary political actor. In general, established firms domiciled in states that are neither production nor headquarters havens can be expected to support restrictions on the use of such devices by competitors and potential competitors. On the other hand, current sham haven activity allows some firms greater profits than would otherwise be possible. And it is clear that the OECD states scarcely see eye to eye on the corporation income tax. Rates vary considerably, and a number of states exempt foreign corporate income from home corporate taxation altogether.⁴⁰ Much of the corporate sector in every country can be expected to pressure for maximum flexibility in the use of havens by national firms while favoring a tightening in other jurisdictions.

With respect to individual income tax evasion, however, the situation appears to be much clearer in two senses. Not only is national income much more unambiguously enhanced by a tightening up of the current regime, but the current escape of taxation is manifestly perverse by allowing persons of high income and wealth to pay lower rates than statutorily mandated and, given the low level that maximum income tax rates come into effect in many European countries, lower effective rates than those with much lower incomes. Therefore, although the rich may struggle to defend secrecy havens by appealing to financial privacy as an element of liberty, to the extent that the issue gains popular saliency, their position can be predicted to lack widespread acceptance. However much national views differ on the tradeoff between liberty and equality, it seems unlikely that the exploitation of the international economy to thwart national law, thus increasing the tax burden on lower and middle income groups, could generate much support in most countries.

⁴⁰ For a concise statement of the case that the U.S. corporate taxation of foreign income is far more competitively damaging to national welfare than has been thought since the 1960s, see *Effect of Tax Policy on U.S. Competitiveness: Hearing Before the Senate Finance Comm.*, 108th Cong. (2003) (statement of James R. Hines, Jr., University of Michigan Business School Office of Tax Policy Research).

Haven Types and Policy Options

We see political pressure for national action and the need and prospects for effective international cooperation differing dramatically by state and across categories of tax haven activity.

Figure 1 displays a matrix in which the various categories of haven are arrayed vertically, while policies aimed at eliminating haven practices are presented horizontally. A “C” in a cell indicates that the policy works on the corporate income tax, and an “I” indicates the direct relevance of the policy to the individual income tax.

Figure 1 goes about here

Production Havens

As noted earlier, production tax havens are sometimes seen as two types: low corporate tax areas and those with discriminatorily lower taxes aimed at attracting foreign activity. The OECD has declared no interest in the former category. We believe that it correctly regards non-discrimination as a widely acceptable regime characteristic. Some observers, however, find more harm in the current situation. Avi-Yonah, for example, has expressed great concern that the non-OECD countries have competed with each other and reduced their corporate tax bases alarmingly. Moreover, absent substantial collective action, he sees the problem as steadily worsening.⁴¹

The most straightforward solution to the erosion of corporate income taxes generally would be an agreement limiting tax competition.⁴² Such a proposal was made for the EU by the Ruding Commission in 1992, however, and was subsequently rejected as interfering with a member state’s ability to determine its own taxes.⁴³ While some still believe that increased integration, and especially the common currency, will hasten the adoption of intra-European corporate tax minima, there appears to be no such sentiment among the OECD countries more broadly. Corporate tax rates may have dropped, but they have not converged in recent years,⁴⁴ a fact that provides prima facie, but not conclusive, evidence that states are not consciously competing—or at least are doing so without much sense of urgency.⁴⁵ Perhaps most important, the major source of competitive corporate tax erosion supposedly comes from the developing countries, and nothing would prevent them from striking an agreement to limit corporate tax competition if they chose.⁴⁶

A radical policy innovation has been proposed by Avi-Yonah.⁴⁷ He considers the three major jurisdictions relevant to the corporate income tax: source, residence and demand. He sees present, and

⁴¹ See Avi-Yonah, *supra* note 4, at 1596.

⁴² See Joel Slemrod, *Tax Principles in an International Economy*, in *WORLD TAX REFORM: CASE STUDIES OF DEVELOPED AND DEVELOPING COUNTRIES* 21 (Michael J. Boskin & Charles E. McLure Jr., eds., 1990).

⁴³ It might also be noted that the agreed floor was higher than the level now prevailing. This could be adduced as evidence that cooperation would have been a good idea, except for the widespread view that the erosion resulted mainly from competition outside the EU that only a broader agreement could have prevented.

⁴⁴ Harry Grubert, *Tax Planning by Companies and Tax Competition by Governments: Is There Evidence of Changes in Behavior?*, in *INTERNATIONAL TAXATION AND MULTINATIONAL ACTIVITY* (James R. Hines Jr., ed., 2001)

⁴⁵ See Avi-Yonah, *supra* note 4, at 1592.

⁴⁶ In a regression attempting to explain the reported corporate income tax rates for eighty-five countries in 1999, purchasing power parity GDP per capita was not a significant variable (results available from the authors). Of course, the reported rate may not be the one typically facing foreign investors.

⁴⁷ See Avi-Yonah, *supra* note 4.

especially future, competitive erosion at both the source and residence levels, i.e. the places of production and ownership, and he stresses that technical change in communication and product delivery is making it more difficult to collect corporate taxes based on accepted standards of “permanent establishment” in the demand, i.e. final sales, jurisdiction as well. To avoid a corporate tax collapse, he proposes the introduction of refundable withholding taxes collected at the local corporate income tax rate but on the level of sales in the markets in which internationally-produced goods and services are sold. The taxation would be based in the first instance on the volume of those sales rather than on net income. Firms could then make claims for tax relief only if they could show an appropriate level of corporate tax payment to other jurisdictions. This scheme, aimed especially at production havens and “stateless” corporations, was first proposed several years ago and has generated heavy criticism on grounds of both equity and administrative feasibility.⁴⁸ It would essentially replace the current tax regime with something utterly different, and it strikes many as a very complex and constraining alteration of a system that either is not seriously broken or whose inadequately functioning elements could be more effectively improved in other ways.

In contrast with Avi-Yonah, most economists see the slow fall of corporate income tax receipts towards the level of user fees as a welcome development and not as one that should be thwarted by overturning the current regime—even if the latter were feasible.⁴⁹ This is not to say that some non-OECD states in the future may not attract the criticism that Ireland did until its recent removal of corporation income (and other) tax discrimination in favor of foreigners. But, just as in the Irish case, the threat of foreign retaliation is likely to generate reforms that create at least nominal equality in the corporate (and perhaps other) tax treatment of foreign and domestic business. In extreme cases the attraction of subsidiaries to such locations could be attacked by the abrogation of tax-sparing treaties and the immediate taxation of earnings from the offending jurisdiction at home country rates.

The current regime norm for production havens is widely accepted, and the problem is unlikely to generate important coordinated activity because no major threat is recognized and, even if some states were seen as egregious offenders, it is not obvious that cooperation among home countries would play an essential role in retaliation. Moreover, some tolerance in unilateral or cooperative policy could be offered to low income countries while discrimination could still be rejected for more advanced states. Such tolerance could rest on an understanding that a poorly functioning internal price system currently blocks many low-income countries from finding a niche in the global economy. Ultimately, the World Trade Organization might consider many production haven issues.

Headquarters Havens

Headquarters havens lower corporate tax earnings of what would otherwise be the “natural” home jurisdiction of a firm by enticing it to incorporate or re-incorporate in a low tax area. Issues of credit and deferral for the affected firms are rendered irrelevant because the only corporate income tax rate that counts is that of the headquarters haven. Avi-Yonah sees headquarters havens as the wave of the future.⁵⁰ Some developments tend to support his prediction. The principal OECD headquarters haven, Belgium, has dragged its feet on dropping discriminatory taxation, despite pressure from its EU partners,⁵¹ and the U.S. saw a spate of “corporate inversions” in 2002. The U.S. is particularly vulnerable to such behavior

⁴⁸ See, e.g., Stanley Katz, *International Taxation of Electronic Commerce: Evolution Not Revolution*, 52 TAX L. REV. 655 (1997).

⁴⁹ Much of the opposition to the corporate income tax comes from the inefficiency of taxing different parts of the domestic capital stock at different rates and uncertainty about the incidence of the tax.

⁵⁰ See Avi-Yonah, *supra* note 4, at 1595.

⁵¹ See Robert Goulder, *Worldwide Tax Overview*, 25 TAX NOTES INT’L 1261 (2002).

because U.S. firms face lower barriers to changing nationality than do the firms of some other states.⁵² Avi-Yonah's rationale for the previously explained "demand jurisdiction" withholding tax rests on the inability of states to maintain corporate tax revenues, not just as a result of competition for the relocation of real activity, but also from incorporation competition and the associated right to collect corporate taxes. He views with skepticism claims that such legerdemain can be avoided by assigning jurisdiction on the basis of stockholder location, as suggested as a possibility in *Harmful Tax Competition*,⁵³ noting that the stock of many firms is anonymously traded on a number of national exchanges.⁵⁴

Avi-Yonah's solution appears unnecessary to deal with the headquarters haven problem. More straightforward action could eliminate headquarters havens. First, states could maintain the same corporate tax rate for headquarters as for other activities, foreign and locally owned, under threat of a variety of unilateral or cooperative sanctions, including treaty abrogation and immediate accrual. Second, a claim to be the headquarters of a corporation could be denied by other states if the state claiming headquarters status could not demonstrate ownership of a certain minimum fraction of the firm's stock by its natural citizens. If the threshold were set at a low enough level, of course, this could affect some important existing firms, but that is unlikely. Even a modest local ownership requirement would reduce the number of candidate havens dramatically.⁵⁵

Electronic commerce has exacerbated a growing problem that is closely related to that of headquarters havens. There are now few barriers preventing firms with unknown ownership—corporations or otherwise—from operating freely, i.e. untaxed, in the global economy. What prevents a firm providing software from operating with unknown owners—perhaps entirely residents of OECD countries—from an arbitrary tax haven location? Avi-Yonah's demand withholding solution, despite employment of a de minimis total sales volume threshold, would catch some "pirate" activity of this kind. But such a revolutionary change in the global tax system would not be necessary to track untaxed business. A straightforward innovation would greatly reduce the problem while also protecting the demand jurisdiction's consumption tax base. All international commerce—whether electronic or not—is subject to a state's international trade laws. It would appear entirely appropriate under international law to require that purchasing from foreign web sites be done (without elaborate red tape) only after the sites

⁵² The bi-partisan rage over expatriation still saw many Republicans going easy on the "inverters." The Homeland Security Bill passed in November 2002 rejected the banning of such firms from government contracts, although this was widely decried across the political spectrum. Nevertheless, House Republicans in late September 2003 continued to block such action in a homeland security funding bill. See Patti Mohr, *Corporate Inversion Language Stripped From Homeland Security Bill*, 31 TAX NOTES INT'L 1148 (2003). More generally, the right has attempted to use the inversion issue as a lever to force tax reform, a tactic that seemed to gain support from the Bush administration's investigation of the problem. See generally OFFICE OF TAX POLICY, UNITED STATES DEP'T OF THE TREASURY, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS (2002). The reform apparently favored is one that would eliminate the corporate tax on overseas earnings. One skeptical commentator has argued "territorial systems enhance and legitimize methods of tax avoidance and evasion that should be curtailed under any sensible policy rule," and such policy changes would increase U.S. corporate tax problems rather than reduce them. Stephen Gale, *Notes on Corporate Inversions, Export Subsidies, and the Taxation of Foreign Source Income*, 27 TAX NOTES INT'L 1495 (2002). Gale joins other commentators, see OFFICE OF TAX POLICY, *supra* note 52, in pointing out that inversion threatens not just the modest taxation of foreign earnings that remains after crediting and deferral, but also an unknown part of U.S. domestic tax liability. Inversion does not relieve U.S. operations from the U.S. corporate income tax, but "earnings stripping," from the excessive use of debt instead of equity, to the new "headquarters" by U.S. "subsidiaries" can substantially reduce that liability.

⁵³ ORG. FOR ECON. COOPERATION & DEV., *supra* note 23, at 60.

⁵⁴ See Avi-Yonah, *supra* note 4, at 1666.

⁵⁵ Avi-Yonah has also advocated a simpler fix based on the location of the day-to-day management of the corporation. Reuven Avi-Yonah, *For Haven's Sake: Reflections on Inversion Transactions*, 27 TAX NOTES INT'L 225-33 (2002).

have provided certain information, including national provenance of the value added of sales and the ultimate beneficial ownership identities of the seller.⁵⁶ It should also be noted that major initiatives in this area could come entirely from unilateral action without any substantial international cooperation, although the exchange of information by all importing countries would certainly improve effectiveness.

The suppression of headquarters havens has the character of a stag hunt for most OECD players. In game theory terminology, this implies that the preferred ordering of outcomes puts cooperation ahead of unilateral defection as the most desired outcome.⁵⁷ In other words, most states can be expected to see their national interest best served by an effective regime. They would not only avoid defection, but they might unilaterally pursue measures to attack headquarters havens as well as pirate firms. This is not to say that the attacking states would not also wish to headquarter more firms if it were possible to do so at the expense of other states, but simply that the policy instruments for being a headquarters haven have not been chosen by most members of the OECD.⁵⁸

Sham Havens

Sham havens typically serve both the corporate sector and individuals. This section focuses on the former function, leaving individual “secrecy” issues for later. Sham havens dealing mainly with financial allocation provided much of the focus for the initial OECD efforts.

U.S. firms argue that their use of havens partially compensates for the failure of the U.S. to exempt rather than merely credit foreign corporate earnings as done by some other states. Firms can be expected to take a narrow view of sham haven activity, but a case can be made for the complementarity of such activity with the national welfare, along the lines of recent defenses of overall tax deferral.⁵⁹ Effective action has important prisoner’s dilemma elements. The “abusive” use of sham havens by subsidiaries of OECD firms may provide competitive advantages that are more than just special pleading. The Canadian treatment of haven income differs considerably from U.S. practice, yet Canadian analysts have also expressed concern about the impact of tightening on competitiveness.⁶⁰ Nonetheless, most states, whether they exempt foreign corporate earnings or credit foreign taxes with deferral, already employ restrictions on the passive corporate reinvestment of funds in tax havens. The OECD has suggested that they increase their efforts, ideally duplicating or exceeding the restrictiveness of the American “Subpart F”

⁵⁶ The requirements placed on foreign sellers should not be seen as a trade barrier. Complying foreign suppliers would experience no extra provision cost. Moreover, national security, respected by the GATT and the WTO, provides a sufficient reason for the intrusion. The U.S. government, for example, wants to know that import payments are not benefiting Iraq or North Korea. A failure to cooperate by not providing the information required for electronic commerce could ultimately result in loss of domain name. See Mike France, *Behave – Or Lose Your Domain Name*, BUS. WK. ONLINE (Aug. 23, 1999), at <http://www.businessweek.com/ebiz/9908/ep0823.htm>. This last step would, of course, need to be considered seriously and would necessitate international cooperation. For a variety of approaches to protect the domestic consumption tax base as electronic commerce grows, see ORG. FOR ECON. COOPERATION AND DEV., *TAXATION AND ELECTRONIC COMMERCE: IMPLEMENTING THE OTTAWA TAXATION FRAMEWORK CONDITIONS* (2001).

⁵⁷ The term comes from a parable told by Jean-Jacques Rousseau in *Discours sur l'origine et les fondements de l'inégalité parmi les hommes* (1755). A group of hunters understand that all must cooperate to catch a deer. Although all prefer deer to rabbit, they also know that, absent a binding agreement, each will stray critically from the task to pursue a rabbit that crosses his path. If cooperation is C and defection is D, a prisoner’s dilemma game can be written as DC>CC>DD>CD, while a stag hunt is CC>DC>DD>CD.

⁵⁸ Among other problems, the practice creates equity issues among firms and could lead to threats of expatriation of “home” firms absent special tax breaks.

⁵⁹ See Hines & Rice, *supra* note 1, at 149.

⁶⁰ See Conklin & Robertson, *supra* note 1, at 342.

provisions.⁶¹ Similarly, the countries signing the 1998 Report—all but Switzerland and Luxembourg—agreed to shore up transfer pricing practices that allow profits to be declared in the havens when more defensible accounting would find them assigned to higher tax rate jurisdictions. In general, while all states would benefit from the increased vigilance of other home countries in making certain that their subsidiaries do not use havens to avoid paying the full taxes due, both special interest politics and perhaps the national economic interest suggest there is less incentive to assiduously police their own firms.

Transfer pricing disputes arise not just with tax havens but also among OECD countries, and, in addition to restrictions on the variation in corporate tax rates mentioned in the previous section, a solution based on the American sub-national experience has been suggested. The assignment of profit shares among states for taxation purposes could be done with a formula based on real assets, employment, and sales in various nation-states. This would immediately end all transfer price disputes both with havens and within the OECD.⁶² As with Avi-Yonah's withholding scheme, however, such an innovation would revolutionize the current tax regime, and even some who see it as a policy improvement do not regard it as remotely feasible.⁶³ Transfer price monitoring will remain a relatively unsatisfactory element of the current regime, but its importance will likely decline with the general importance of the corporate income tax.

The various self-studies and the continuous dialogue of the Forum suggest that the general level of sham haven monitoring has improved. Even in these early days, it appears that increased specificity of desired action and greater mutual attention within the OECD have produced a higher level of overall control. An increased flow of high quality information from the havens will contribute to that control. Nevertheless, the accepted focal points for regime tightening are not without ambiguity, and real, if limited, prisoner's dilemma motives will persist. Current U.S. policy certainly reflects both national and special interest concerns.

Secrecy Havens

Secrecy havens exist both within the OECD and outside, where secrecy is usually embedded in a sham haven. As noted earlier, although useful, the category covers a substantial variety of practices. Even those European countries with the strongest bank secrecy laws, Switzerland, Austria and Luxembourg, cooperate with other states when confronted with a sufficiently specific and compelling request. Indeed, Switzerland long ago lost its usefulness for some investors for exactly this reason. But this is quite different from a routine information exchange that would substantially increase personal income tax compliance by the greatest share of contemporary evaders. To meet that latter objective, the EU has pressed for automatic exchange of information on interest earnings and initially tried to gain acceptance of this approach with key players outside of Europe, notably the U.S. and Switzerland. Neither state would accept the approach, so an agreement reached in January 2003 is based instead on U.S. collection of interest information on European investors to be shared upon request and a withholding tax on similar payments by Belgium, Luxembourg and Austria rising from fifteen percent to thirty-five percent by 2010. Switzerland has expressed a willingness to match the withholding of these latter states, while the rest of the EU automatically exchanges the earnings information. Switzerland has also agreed to exchange

⁶¹ For a detailed discussion of U.S. tax haven policy towards corporations, see Hines & Rice, *supra* note 1. **THERE IS NO 1996 SOURCE BY THESE AUTHORS REFERENCED ELSEWHERE IN THE ARTICLE. PERHAPS THEY INTENDED THE 1994 SOURCE IDENTIFIED IN NOTE 1.**

⁶² See generally Oxfam, *supra* note 21; Ernest Zedillo et al., U.N., Recommendations of the High-level Panel on Financing for Development (2001), at http://www.un.org/reports/financing/full_report.pdf. For an evaluative commentary that compares this report with the work of the OECD, see Frances M. Horner, *Do We Need An International Tax Organization?*, 24 TAX NOTES INT'L 179 (2001).

⁶³ Charles E. McLure, Jr. *Tax Policies for the XXIst Century*, in VISIONS OF THE TAX SYSTEMS OF THE XXIst CENTURY 9 (1997).

information on request for both civil and criminal tax matters, regardless of the legality of the activity in Switzerland.⁶⁴

U.S. misgivings about information sharing are not based on sympathy for bank secrecy; in fact, the U.S. has quite consistently opposed it. For example, the U.S. forced Luxembourg to relent on such secrecy in 2000.⁶⁵ The range of instruments about which earnings information should be collected, the exact mechanism and occasion for exchange, and the kinds of privacy protections afforded remain open for further considerations. The U.S. has shared portfolio earnings information with Canada automatically since 1997.⁶⁶ Moreover, the recent 6049 bank deposit information reporting requirements (which the Europeans have apparently decided are sufficient for their purposes) make it possible for the U.S. to share information on bank deposit interest earnings of non-resident aliens with treaty partners. At least some in the government regard automatic exchange as more efficient than responding to individual requests. But other officials fear the impact of cooperation on the flow of capital into the U.S., and many private financial institutions have complained that 6049 is bad for business. More generally, Europe's concerns about leakage to the U.S. and Switzerland and the fears of the latter two about greater cooperation reflect concern about diversion of funds to other jurisdictions.⁶⁷

The OECD attack on "harmful tax competition" based on ease of evasion clearly reflects recent European concerns and policy directions. Moreover, prior European agreement on a problem may dramatically decrease the complexity of OECD agreement by reducing the effective number of players. Nonetheless, even if other industrial countries can be brought into agreement on information sharing, further extension appears thwarted by two complications: the lack of accurate and timely information and the absence of easily calibrated sanctions and side-payments.

Two barriers will impede full incorporation of the secrecy havens into an information exchange regime. First, they have every incentive to resist a truly transparent system, i.e. one that involves automatic earnings reporting, because secrecy is their only substantial advantage for portfolio investment.⁶⁸ Moreover, absent a global set of reasonably accurate and consistent taxpayer identification numbers, it is difficult to see how information exchange could be universalized. Therefore, the direct sharing of information appears unpromising to combat secrecy havens as tax-evading conduits for portfolio investment from citizens of rich and poor countries alike. Other approaches must be considered.

Slemrod⁶⁹ made a suggestion more than a decade ago that has recently been reintroduced with refinements by Avi-Yonah. Borrowing countries would levy a high withholding rate relative to the actual

⁶⁴ For a thorough discussion of the agreement, see David E. Spencer, *EU Agrees At Last on Taxation of Savings*, 14 J. INT'L TAX'N 4 (2003).

⁶⁵ THE FIN. TIMES, 2000, p. 2. [title and date of the publication?]

⁶⁶ *Id.* at 33. See ORG. FOR ECON. COOPERATION & DEV., *supra* note 13, for a more complete discussion.

⁶⁷ Avi-Yonah seems to err in arguing that one region alone could introduce withholding without raising local finance costs. In particular, he argues that the U.S. is such a desirable market that new taxes would be absorbed entirely by the lender. See Avi-Yonah, *supra* note 4, at 1580-81, 1667. This implies that the supply function of portfolio funds to the U.S. is completely inelastic, which it almost certainly is not.

⁶⁸ Rates of return can also be higher due to higher risk from weaker regulation, but this may be no better than a wash for most investors.

⁶⁹ See Slemrod, *supra* note 42.

liability rate in residents' countries with full refund, so long as resident authorities have been notified.⁷⁰ Avi-Yonah suggests a rate of "at least 40 percent,"⁷¹ higher than what has been agreed within Europe.

Avi-Yonah asserts that the reintroduction of withholding on portfolio earnings is an "assurance game,"⁷² i.e. a stag hunt, without really explaining why. There are at least two elements for each state to consider in deciding whether full cooperation is superior to unilateral defection, i.e. "everybody else plays by the rules but me."⁷³ One test would be purely financial: does the country get lower cost finance that overbalances its tax losses from the provision of at least one borrowing market that will not penalize haven finance? This may not be an easy calculation to make. A second consideration, however, probably clinches the stag hunt strategy for many states' national interest. Modern states are concerned about costs beyond tax avoidance—particularly the increased ease of operation that havens give to organized crime and terrorism. Haven defenders have pointed out that most money is laundered in the rich countries and that these havens have been very cooperative in quests to track money laundering.⁷⁴ Yet the potential for abuse that routine secrecy provides cannot be ignored, and September 11, 2001 must certainly have pushed all OECD national calculations in the direction of cooperation.

Reform through withholding presents two major alternatives for the OECD states as a group. A return to the general practice that prevailed before the U.S. shifted its policy in 1984 to assure and encourage maximum foreign participation in funding its budget deficit, essentially forcing other rich states to follow, involves the collection of substantial *non-refundable* withholding taxes.⁷⁵ Avi-Yonah, however, favors refundable withholding to advantage low-income states. Would this be feasible? The OECD countries could probably persuade their taxpayers that refundable withholding means something other than a gratuitous donation to other states. First, no revenue is being sacrificed by comparison with the current situation. Second, the lion's share of the revenue collected would simply be redistributed within the OECD and would accord with the prevailing residence taxation norm. Third, while some of the funds returned would go to states outside the OECD, this still accords with the norm and would also bolster the OECD states' important collective goal of assisting poorer countries to develop effective fiscal systems. Such development would, other things being equal, greatly assist their economic and social advance⁷⁶, an important element of which would likely be increased domestic law enforcement relevant to global crime and terrorism. This evolution would, in turn, reduce the law enforcement challenge now faced by the OECD states. Fourth, the return of withholding taxes would also prevent any, probably very minor, increase in gross borrowing costs for the OECD countries as a group. Finally, refund ineligibility to the residents of non-cooperating states could serve to shore up the overall regime. A dyadic comparison of the present system with either a standard withholding regime or a refundable regime suggests that both changes are probably stag-hunts for most players because better control of dirty money with all of its negative spillovers would trump the slight competitive loss from unilateral defection. In addition to Europe and North America, Japan also has a strong interest in lowering its revenue losses from tax evasion and has been a leader in the OECD on relevant reforms.

⁷⁰ This is probably an improvement over Slemrod's suggestion that tax payment needs to be verified. Avi-Yonah also suggests that agreements might be struck whereby revenues assigned to some states could be transferred directly to their treasuries for a collection fee.

⁷¹ See Avi-Yonah, *supra* note 4, at 1669.

⁷² See *id.* at 1668.

⁷³ See Dooley, *supra* note 16.

⁷⁴ Daniel Mitchell, *OECD Nations Want Caribbean Tax Havens to Tell All*, WALL ST. J., Jan. 19, 2001, at A15.

⁷⁵ This is the way Avi-Yonah summarizes the situation. See Avi-Yonah, *supra* note 4, at 1580-1581. Some see the U.S. policy change, if not its quantitative result, as less dramatic than he presents it. See e.g., Sheppard, *supra* note 26, at 2022.

⁷⁶ See ORG. FOR ECON. COOPERATION & DEV., *supra* note 35.

Attacking the secrecy havens poses the twin challenges of establishing a clear need for well-coordinated action and molding agreed content. Opponents of effective action seek to portray agreement as threatening capital markets, preserving bloated public sectors, or both. The latter argument will constantly plague international cooperative efforts on taxation. The irreducible underlying idea of cooperation is maximum national sovereignty about taxes and the denial of their escape by recalcitrant citizens. Part of the right in America and elsewhere will continue to portray resistance to cooperation as rejection of membership in a high tax cartel and the evasion of taxes on investment earnings (“double taxation”)⁷⁷ as akin to righteous tax protest. As the former argument is exposed as almost wholly bogus and the latter is seen as an outrage by honest taxpayers, we predict that American cooperation will increase.

The capital market threat has substance, and withholding faces strong opposition from financial interests, especially in the U.S. and Britain.⁷⁸ A well-coordinated introduction of policy change appears essential. One apparently workable plan would need decisions about 1) which subset of states would employ information exchange rather than default withholding; 2) refundability; 3) the sphere of coverage (the scope of financial flows be covered);⁷⁹ and 4) rate. As noted, while withholding now appears a policy focal point because satisfactory information change could not work with the havens, the range of states and information for which an exchange regime might be feasible remains largely unexplored. Refundability should be treated similarly across states for the reform to work without skewing investment flows, but some variation in the tax rate and coverage on portfolio investment has been a characteristic of state policy to the present and does not threaten the scheme.

The secrecy havens have little option but maximum cooperation because of their vulnerability to action by the OECD. One obvious response to non-cooperation would see the high income countries disallow the cost of debt financing from non-cooperating jurisdictions as a business expense for tax purposes. Unless well-monitored or very widely adopted by borrowing countries, however, such action would drive haven funds through “layers of laundry” before lending. Even more drastic measures are clearly available including the denial of access to the banking systems of the G-7 countries and the severing of transportation links.

No fundamentally opposed national interests underlie positions on these issues within the OECD. But agreement may not come quickly. It will likely be hastened by an increase in public awareness of the issue. Tax haven policy has not been an important political issue in any major state so far, but it appears that the new campaigns against terrorism and corporate inversions have substantially raised its profile in the U.S..

The Rest of the World

The argument so far has treated all non-OECD states as either vulnerable haven miscreants or victims of the havens. As a first approximation, this may not be inappropriate. The non-European sham and secrecy havens are ultimately defenseless. They have attempted to slow down the OECD process by raising a

⁷⁷ If two persons start with no legacies and have identical lifetime earnings, the taxation of investment income puts a higher total tax burden on the saver, which may seem unfair. But we live in a world with very large legacies and strong pressure from the right to reduce already ineffective taxation (the so-called “death tax”).

⁷⁸ *Chasing Capital Flight*, WALL ST. J., Nov. 28, 2000, at A26; Sal Picciotto, *The End of Offshore? Regaining Public Control of Finance and Taxation in the Era of Globalization* (1999) (unpublished manuscript, on file with the authors).

⁷⁹ The taxation of hybrid financial innovations has recently attracted considerable attention. See Victor Thuronyi, *Taxation of New Financial Instruments*, 24 TAX NOTES INT’L 261 (2001).

host of procedural and substantive objections and by portraying the new demands as violations of sovereignty and a new manifestation of neo-colonial exploitation.⁸⁰ This strategy may be the only one available. The formidable public relations problems of these havens become clear when the sharp difference in interest between the havens and the rest of the non-OECD world is considered. By any relative measure, most low-income countries are hurt more by capital flight and untaxed foreign earnings than are OECD states. Moreover, there is nothing they can effectively do individually or as a group to stanch the outflow. Because most of the capital flow from poorer countries is invested in OECD states, the rich hold the key to taxation reform. Finally, the gains to the havens themselves, particularly the secrecy havens, while not negligible, tend to be exaggerated. Intra-haven competition for business has kept the earnings from site exploitation to a modest level, apparently leaving the gains overwhelmingly with the tax evaders.⁸¹ The discussion of such havens and what should be done about them in the 2001 Zedillo Report for the United Nations follows the approach taken by the OECD quite closely except in one respect: the poorer countries would like to consider an International Tax Organization in which corporate income tax sharing on a formula basis would at least be considered⁸² alongside pressuring the havens into greater cooperation. At this juncture it would seem highly unlikely that the OECD states would support such an organization because they do not wish to consider formula tax base apportionment, and the new organization appears to offer nothing to combat sham and secrecy havens that the OECD states—if they agreed—could not accomplish by themselves. Moreover, it appears that individual OECD states can attack production and headquarters havens in various ways if they choose.

The present U.S. administration has expressed the view that discriminatory taxation between foreign and domestic investors is an inappropriate concern; this may reflect both special interest pressure and a genuine conviction about sovereignty. It almost certainly also reflects a view that these issues have been regarded as minor challenges to the U.S. fiscal system so far and a more urgent concern about the loss of portfolio investment.⁸³ More generally, the skepticism of the Bush Treasury Department has retarded the pace of attack on the havens, and it may well take a different administration to go beyond current measures somewhat reluctantly embraced, except possibly on matters connected with corporate inversion. There is little indication that the posture toward havens of most of the Democratic Party has changed, however, and many Republicans regularly attack not just inversion, but also haven-abetted personal tax evasion.⁸⁴ We forecast a growing political appeal for further action as the public gains greater awareness of the threats the havens pose to both prosperity and security.

Concluding Observations

The entire range of tax haven challenges divides rather sharply between corporate and individual income tax issues. This is true for two major reasons. First, every output market is different, and business competition is innately uneven. This gives policymakers considerable latitude in setting tax rates on success. Publicly interested officials in each OECD state must attempt to aim corporate taxation practices

⁸⁰ See Mitchell, *supra* note 74.

⁸¹ The development fillip from haven status remained under-researched. For discussion, see PALEN, *supra* note 3. Some estimates of revenue, employment, and income generation from haven activity are presented in SUSS ET AL., *supra* note 11.

⁸² See Horner, *supra* note 62, at 179.

⁸³ For other possible motives, see Spencer, *supra* note 64, at 9.

⁸⁴ Senator Carl Levin's dismay at Treasury Secretary O'Neill's determination to narrow the OECD haven attack is very typical of that party. See Levin, *supra* note 19. Secretary O'Neill defended his narrowed focus on "illegal evasion of the tax laws by the dishonest few" as the core objective that the Administration fully supported. U.S. Senate Hearing, Exhibit 2, U.S. Treasury Secretary O'Neill, Statement on OECD Tax Havens, U.S. Department of the Treasury News Release. From the other side, libertarians and some other conservatives strongly attacked any Administration compromise with the OECD haven project or with the EU on interest reporting. For example, see Dan R. Mastromarco & Lawrence A. Hunter, *The U.S. Anti-Savings Directive*, 29 TAX NOTES INT'1 159 (2003).

at enhanced national welfare subject to the varying constraints of domestic political forces. The OECD today presents a range of corporate tax rates and practices that imitation and cooperation will modify but not homogenize. Reactions to the discrimination practiced by production havens are likely to continue to vary with little dire consequence. The locational viscosity of real activity contrasts sharply with the powerful and immediate tax saving temptations presented by sham and headquarters havens; the challenges of these havens will continue to generate both unilateral and cooperative policy initiatives.

Real investment mobility contrasts equally with the mobility of individually held non-ownership capital claims. The cross elasticity among jurisdictions of portfolio investment gives non-havens a strong incentive to keep practices in line and greatly increases the incentive for international cooperation. Another distinction between the corporate and individual levels of analysis is more fundamental. Corporate taxation is likely to decline in worldwide importance. From a purely accounting point of view, all else being equal, and assuming that the impact of tax is mainly on profits, this increases shareholder earnings and tax liability. The operation of secrecy havens threatens the ability of the state to collect the taxes assigned to those earnings. This problem, far from declining, can only become more important in the coming years. The national interests of most states dictate the forecast that the secrecy havens will eventually be destroyed. This prediction could have been made with some confidence even before September 11, 2001 and the increased scrutiny of haven activity that followed; it looks even more likely today.⁸⁵ But meeting the secrecy haven challenge will require cooperation well beyond anything yet actively considered.

⁸⁵ This prediction is based on the contribution of the crisis to a general understanding of the significance of the havens. The so-called “Patriot Bill” of October 2001 bowled over opposition from the right to greater selective attention to haven activity that would facilitate money laundering, although it did not direct directly with tax evasion and tax fraud. See Daniel Mitchell, *The Smoking Gun*, 24 TAX NOTES INT’L 259 (2001); David E. Spencer, *OECD Project on Tax Havens and Harmful Tax Practices: An Update (Part II)*, 13 J. INT’L TAX’N 312, 340 (2002).

Figure 1: Policies to Thwart Tax Haven Activity

POLICIES

HAVEN TYPES		Information exchange	Treaty denial	Transfer price monitoring	Immediate accrual	Denial of deductibility	Coordinated corporate tax rates	Formula corporate assignment	Corporate withholding	Portfolio withholding	Refundable portfolio withholding
	Production	C	C		C		C		C		
	Headquarters	C	C		C						
	Sham	C	C	C	C	C		C	C		
	Secrecy	I	I		I	I				I	I

Table 1: Alternative Tax Haven Classifications

	OECD Tax Haven List (2000) *	Hines & Rice Tax Haven List (1994)	Gvt of Brazil List of Tax Havens (2000)
Andorra	P	x	x

Anguilla	P	x	x
Antigua & Barbuda	P	x	x
Aruba	P		
Bahamas	P	x	x
Bahrain	P	x	x
Barbados	P	x	x
Belize	P	x	x
Bermuda	C	x	x
British Virgin Islands	P	x	x
Cayman Islands	C	x	x
Cook Islands	P	x	x
Costa Rica			x
Cyprus	C	x	x
Djibouti			x
Dominica	P	x	x
Gibraltar	P	x	x
Grenada	P	x	x
Guernsey (Channel Is.)	P	x	x
Hong Kong		x	
Ireland		x	
Isle of Man	P	x	x
Jersey (Channel Is.)	P	x	x
Jordan		x	
Labuan (Malaysia)			x
Lebanon		x	
Liberia	P	x	x
Liechtenstein	P	x	x
Luxembourg		x	
Macau		x	
Madeira (Portugal)			x
Maldives	P	x	
Malta	C	x	x
Marshall Islands	P	x	x
Mauritius	C		x
Monaco	P	x	x
Montserrat	P	x	x
Nauru	P		x
Netherland Antilles	P	x	x
Nevis			x
Niue	P		x

Panama	P	x	x
Samoa	P		x
San Marino	C		x
Seychelles	P		x
St. Kitts & Nevis	P	x	x
St. Lucia	P	x	x
St. Martin		x	
St. Vincent & Grenadines	P	x	x
Switzerland		x	
Tonga	P		x
Turks & Caicos	P	x	x
US Virgin Islands	P		x
Vanuatu	P	x	x
Total	41	40	44

*P = potentially harmful, C = cooperative

Sources:

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