Tax Havens: Renegade States in the International Tax Regime?*

LORRAINE EDEN and ROBERT T. KUDRLE

Taxing multinational enterprises (MNEs) is inherently conflictual because national tax systems are not well designed to handle their international activities. The OECD has been instrumental in developing an international tax regime to govern the conflicts and interdependencies induced by national taxation of MNEs. The strength of this regime depends on the extent to which states adhere to the regime's norms and practices. We examine the OECD's Harmful Tax Competition initiative, arguing that tax havens have been as renegade states in the international tax regime. We explore how the OECD initiative developed and evaluate its impact on regime effectiveness.

I. INTRODUCTION

International regimes are "sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations" (Krasner 1983: 2). Regimes are international governance structures established by nation states to manage their conflicts and interdependencies at the international level (Eden & Hampson 1997). International regimes can increase the predictability of behavior, provide generalized sets of rules, and improve the information available to participants.

Eden (1998) argues that an international tax regime exists to manage conflicts and interdependencies among nation states and multinational enterprises (MNEs) with respect to the taxation of MNEs' worldwide income. The results of government cooperation in the international tax area

* We would like to thank Jun Li and Dan Li for helpful research assistance on this paper. Earlier versions of this paper were presented at the July 2001 meetings of the International Studies Association in Hong Kong and at the March 2003 workshop on "Law, Technology, and Development" at the Baldy Center for Law & Social Policy, University of Buffalo Law School. We thank the session participants and two anonymous reviewers for helpful comments. Financial assistance was provided by the Center for International Business Studies at Texas A&M University and the Hubert Humphrey Center at the University of Minnesota.

Address correspondence to Lorraine Eden, Department of Management, Texas A&M University, College Station, Texas 77843-4221, USA. Telephone: (979) 862-4053; fax: 979-845-9641. E-mail leden@tamu.edu.

LAW & POLICY, Vol. 27, No. 1, January 2005 ISSN 0265–8240
© 2005 UB Foundation Activities Inc., for and on behalf of the Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

include a variety of national tax policies, double tax treaties (DTTs), and model tax treaties and guidelines. National tax authorities commit themselves, through double tax treaties, to international equity and neutrality principles, expressed in terms of avoiding double taxation and preventing tax evasion and abuse. The U.S. Treasury and the OECD's Committee on Fiscal Affairs have been the key actors behind the development, support, and extension of the international tax regime. The OECD explicitly recognizes its role in developing and deepening the international tax regime:

> Since 1956, the OECD has sought to build-up a set of internationally accepted "rules of the game" which govern the ways in which Member countries tax profits arising from international transactions. The main instrument . . . has been the development of an OECD Model Tax Convention . . . [Its] purpose is the avoidance of international double taxation and to assist tax authorities in counteracting tax evasion and avoidance. (OECD 1993: 1)

A renegade state is an outlier from the specified practices of an international regime; that is, a renegade state is "a state whose practices are salient to an international regime but whose behavior does not comply with the descriptive norms and practices of the regime" (Eden & Hermann 1996). Renegades weaken regime effectiveness. Applying this definition to the international tax regime, a nation state is a renegade if its tax practices are salient to the regime and its behavior does not comply with the regime's descriptive norms and practices.

We argue in this paper that tax havens are being treated by the OECD as renegade states in the international tax regime. Tax havens are countries that employ explicit policies designed to attract "international trade-oriented activities by minimization of taxes and the reduction or elimination of other restrictions on business operations" (Johns 1983: 20). Havens typically have low or zero tax rates on personal and/or corporate income, secrecy laws on banking and other financial transactions, and few or no restrictions on financial transactions. Havens can be separated into four groups (Palan 2002: 154): countries with no income tax where firms pay only license fees (e.g., Anguilla, Bermuda), countries with low taxation (e.g., Switzerland, the Channel Islands), countries that practice so-called "ring fencing" by taxing domestic but not foreign income (e.g., Liberia, Hong Kong), and countries that grant special tax privileges to certain types of firms or operations (e.g., Luxembourg, Monaco).

Tax havens can also be categorized by the types of activities that are given preferential treatment by the national tax authority (Avi-Yonah 2000; Kudrle & Eden 2003). Where the tax attraction induces a significant change in real haven value added, it can be called a production haven. The Republic of Ireland, until it recently changed its laws, was cited as the prime example. Headquarters havens lower corporate taxes by providing tax advantages to firms that incorporate in that jurisdiction, wherever their shareholders are located; principal examples are Belgium and Singapore. Sham havens host low corporate-tax financial intermediaries that may be

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

little more than an address for investment activity directed from elsewhere. Nearly all of the Caribbean and Pacific tax havens fall into this category. Many sham havens are also headquarters havens insofar as the low value-added activity is not a subsidiary of a foreign firm but is independent and legally based in the haven. Some Liberian and Panamanian shipping firms and some Bermudan insurance companies serve as examples. Nearly all sham havens are also secrecy havens. Havens that exist only because of secrecy can exist with any level of corporate taxation. They 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.

Countries become tax havens from some combination of opportunism, desperation and luck (Palan 1998, 2002). Small, poor states lacking natural resources or other obvious attractions to foreign direct investment may turn to tax haven status in order to induce inflows of foreign banking and commercial activities. Tight secrecy laws and unwillingness to exchange information were critical in the formation of some havens such as Switzerland (Palan 2002). Historical ties with rich countries that included preferential status for their investments in the poorer partners also encourage low tax rates, since the home country effectively engages in "tax sparing," making the applicable tax rate the host rate (e.g., Puerto Rico and the United States over most of the post-war period).

In the majority of instances, it is OECD companies and/or elites that carry out businesses and maintain their private savings in tax havens. Havens thrive precisely because of the existence of foreign banks and service companies, largely from non-tax haven countries. The so-called "high tax" countries are, therefore, under pressure from their own financial sectors to continue a certain regulatory laxity (Palan 1998: 637). This ambivalence is reflected in national tax policies such as tax deferral and tax-free treatment of interest earnings on foreign portfolio income which encourage investments in the havens.

In 1998, the OECD released a report on harmful tax competition (OECD 1998), arguing that tax haven countries were diverting substantial amounts of foreign direct investment (FDI) and taxable income away from its member countries. In 2000, the OECD published the names of thirty-five countries, most of them small island economies, on a black list of "non-cooperating tax havens." The OECD demanded that these countries change their policies or face punitive retaliation measures. Most of the noncompliant tax havens have responded by signing commitment letters agreeing to eliminate their harmful tax practices.

The purpose of this paper is to explain, using the lens of international regime theory, how tax havens came to be labeled by the OECD as renegade states in the international tax regime. We examine the history of early – and

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

unsuccessful – unilateral actions against the havens by the U.S. government in the 1980s, the development of an EU-wide regional approach by the European Commission during the 1990s, and the emergence of the OECD's multilateral attack on harmful tax competition at the end of the 1990s. We argue that the OECD's harmful tax competition initiative, in effect, "picked up the baton" from the U.S. Treasury and European Commission in order to protect and strengthen the international tax regime. Important in our analysis is the ambivalent treatment of tax havens by individual OECD member countries, caught between conflicting desires: wanting to stamp out harmful tax competition in order to protect their domestic tax base from erosion offshore, and wanting to maintain the competitive position of their businesses investing abroad.

The paper proceeds as follows. First, we explore the international tax regime and renegade state concepts. Using this theoretical lens, we then trace the history of unilateral attempts by the U.S. government to protect the U.S. tax base from erosion by tax havens; the development of a European consensus; and the emergence of the multilateral approach through OECD's harmful tax competition initiative. We conclude with an analysis of the likely success of the OECD's initiative.

II. THE INTERNATIONAL TAX REGIME

A. REGIME PURPOSE

One of the areas where international conflicts are inevitable between nation states is the taxation of multinational enterprises (MNEs), because domestic tax systems set up for domestic purposes are poorly designed to handle the international activities of MNEs. Tax authorities and MNEs are likely to disagree about the appropriate tax the enterprise should pay at the national level. Conflicts can also occur between tax authorities where units of the MNE are located, when governments compete for their "fair" share of an increasingly mobile tax base. Double taxation of MNE profits, relative to the taxes that would be paid by a purely domestic firm engaged in comparable activities in comparable circumstances, can occur. Differences in national tax systems also allow the possibility of tax arbitrage, shifting real and/or financial activities from high-taxed to low-taxed locations, pressuring high-tax states to reduce their taxes and/or to tighten their monitoring and enforcement mechanisms in order to avoid losing mobile firms and employment opportunities. Thus, national tax differentials can create inequities and non-neutralities at the international level. As a result, the principles of public finance – equity and neutrality – which should underpin a good tax system (Musgrave 1983) are unlikely to be satisfied at the international level. Domestic taxation of MNEs, without harmonization or coordination of national tax systems, in sum, is a recipe for conflict.

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

Eden (1998) argues that an international tax regime has developed as a response to these conflicts and interdependencies. The goals of the international tax regime are the avoidance of double taxation of income and the prevention of tax avoidance and evasion. These goals are to be achieved through coordination and harmonization of national tax systems. The results of government cooperation in the tax area include a variety of national tax policies, the OECD's model tax conventions, and over 2,400 bilateral income tax treaties (DTTs) (UNCTAD 2000). [1]

The key international organization in this process has been Organization for Economic Co-operation and Development (OECD). The head of the OECD's Committee on Fiscal Affairs, Jeffrey Owens, explained its role in international taxation, as follows:

> To work effectively, a global economy needs some acceptable ground-rules to guide governments and business . . . Over a 30-year period, the OECD's Committee on Fiscal Affairs (CFA) has worked . . . to produce such globally accepted standards . . . its efforts . . . have all contributed to a fiscal climate which is more conducive to cross border business while promoting a fair sharing of the tax base between countries. (Hammer & Owens 2002: 1)

The international tax regime reduces transaction costs associated with international capital and trade flows; resolves conflicts between tax authorities and multinationals, and between home and host governments; and reduces the possibilities for opportunistic behavior by MNEs and by nation states. International regimes are typically analyzed in terms of their components: principles, norms, rules, and procedures:

> *Principles* are beliefs of fact, causation and rectitude. *Norms* are standards of behavior defined in terms of rights and obligations. *Rules* are specific prescriptions or proscriptions for action. *Decision-making procedures* are prevailing practices for making and implementing collective choice. (Krasner 1983: 2; emphasis added)

Table 1 outlines these components, which we discuss briefly below.[2]

B. REGIME PRINCIPLES AND NORMS

There are three principles underlying the international tax regime: the inter-nation equity principle, determining which jurisdiction has the right to tax; the international neutrality principle, ensuring that the international tax system does not distort private decisions; and the international taxpayer equity principle, ensuring that taxpayers are treated fairly by the tax authorities (Avi-Yonah 2000; Eden 1998; Musgrave 1983). Inter-nation equity (or, as it is sometimes called, jurisdictional allocation) requires that tax shares be allocated fairly among countries. International neutrality requires an international tax system that neither encourages nor discourages choices such as, whether to invest at home or abroad, work at home or abroad, or consume foreign or domestic goods. Lastly, international taxpayer equity

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

Table 1. Characteristics of the International Tax Regime

Regime characteristic	Application to the international tax regime
Purpose	• To reduce double or under taxation caused by overlapping tax jurisdictions, which generates distortions in capital markets and inequities among taxpayers
Principles	• Equity: inter-nation equity • International taxpayer equity • International neutrality
Norms	• Double tax treaties establish jurisdictional and allocational norms, such as which country has the right to tax, defining the tax bases
Rules	• Specific rules implementing the norms, such as rules defining nexus, corporate income, and withholding tax rates, when tax deferral applies
Procedures	• Auditing and dispute settlement procedures outlined in double tax treaties, including: mutual agreement procedures for settling interjurisdictional disputes, exchange of information among tax authorities, and simultaneous examination procedures
Scope	• Issue area: cross-border transactions that affect or are subject to national taxation • Geographic: OECD member countries and their double tax treaty partners

Source: abstracted from Eden (1998: 66–67).

requires that all taxpayers resident in the same jurisdiction should receive equal tax treatment regardless of the source of their income. This means that if the pre-tax returns from foreign source income and domestic income are the same, so should be the after-tax returns. Reconciling these three principles has been difficult since they lead to conflicting policies. As a result, actual tax practices differ from country to country.

The norms of the international tax regime represent standards of behavior, defined in terms of rights and obligations of the national tax authorities, which are designed to achieve the principles of the regime. The OECD has, since its 1963 Model Tax Convention, endorsed the concept of the separate entity as the underlying basis for allocating taxing rights between countries. Permanent establishments within a country are treated as separate entities. Each taxing authority has jurisdiction over the income and assets of this separate entity, earned or received within the country up to its water's edge. Where MNEs are involved, affiliates are treated as separate legal entities, and income is apportioned between them assuming intra-firm transactions take place at arm's-length prices (Eden 1998).

C. REGIME RULES AND PROCEDURES

The international tax regime has specific rules in double tax treaties that are designed:

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

> (a) to establish a generally acceptable entitlement rule which spells out the source country's right to tax, (b) out of that entitlement rule to establish the base which may be taxed, (c) to lay down common definitional rules to ensure that there are no overlaps or gaps in the tax base which is divided among the countries of source, and (c) to set mutually agreed rates of tax which may be applied to that base. (Musgrave 1983: 282)

The tax boundaries established in most developed countries are roughly the same: the fiscal authority taxes the worldwide income of its residents and the domestic source income of its nonresidents (Eden 1998). Many countries, for example the United States, tax worldwide income of their residents, but defer tax on foreign-source income until it is repatriated. In the host countries, withholding taxes are levied on income paid to nonresidents that arises from passive investments or casual, non-recurring activities in the source country, such as royalties and management. Withholding taxes can be as high as forty percent but are normally reduced through DTTs to less than ten percent. In calculating the home-country tax, a foreign tax credit is granted for the corporate income taxes and withholding taxes paid in the host country, up to the level of the home-country tax. In certain cases, the residence country exempts all foreign source income from tax, and taxes only on a territorial basis. In still others, certain categories of foreign-source income are exempt while others are taxable as earned.

Both domestic and international procedures are part of the international tax regime. For example, at the domestic level, national tax authorities publish regulations and have auditing and dispute settlement procedures. At the international level, a network of DTTs based on the OECD's Model Tax Convention is used to settle interjurisdictional disputes. The basic purpose of a tax treaty between two countries is to clarify their respective tax jurisdictions; that is, the nature of the transactions to be taxed and the percentage of the tax base each country has the right to tax. Where disagreements occur, tax treaties contain a mutual agreement procedure for cooperation where the representatives of each government (the "Competent Authorities") get together to resolve disputes. Where two countries do not have a tax treaty between them, there is no easy way to resolve interjurisdictional taxation disputes.

D. REGIME SCOPE

International regimes are typically evaluated in terms of their scope and effectiveness (Krasner 1983). The scope of a regime is a function of its issue coverage and geographic reach; the broader the scope the more salient the international regime. Since the purpose of the international tax regime is the avoidance of over/under taxation of MNE income, any income earned in or received from another location is potentially subject to taxation by two jurisdictions: where the income arose and where it was paid.[3] The types of taxes involved are also numerous: corporate and personal income taxes,

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

withholding taxes, value added taxes, and mining taxes, for example. The issue scope of the regime is therefore potentially very broad.

The regime's geographic scope can be thought of as three concentric circles. In the center are the twenty-nine OECD member countries, which are linked through DTTs based on the OECD's Model Tax Convention.[4] Their senior ministers of finance and taxation meet regularly at the OECD's Committee on Fiscal Affairs and its various working groups, functioning as an epistemic community involved in developing the rules and procedures that guide member countries. The second concentric circle consists of non-OECD member countries that explicitly or implicitly have adopted the characteristics of the international tax regime and have networks of DTTs with OECD members (e.g., Argentina, Brazil). While the OECD's Model Tax Convention was designed as a model tax treaty for use by all nation states, not just OECD members, in practice, this second group of non-OECD compliant nation states is small, since most DTTs are between OECD members. The outer circle consists of non-OECD countries that do not follow the international tax regime and have signed few or no DTTs; this list would include almost all tax haven countries.

Geographic scope of the international tax regime is not as straightforward as three unbroken concentric circles, however. At the heart of the regime, even among the twenty-nine member countries of the OECD there are a number of nation states with tax-haven aspects or direct links through double tax treaties to haven countries (frequently former colonies). We explore the nuances of the effectiveness of the international tax regime below.

III. TAX HAVENS: RENEGADES IN THE INTERNATIONAL TAX REGIME

A. RENEGADE STATES IN INTERNATIONAL REGIME THEORY

International regimes are generally assessed on their strength or effectiveness. Strong international regimes provide rules that define rights and responsibilities, allocate benefits and costs, provide mechanisms that safeguard against opportunism and monitor compliance, and prevent and mediate disputes among member states. A *renegade state* is an outlier from the specified practices of a regime; that is, a renegade state is "a state whose practices are salient to an international regime but whose behaviour does not comply with the descriptive norms and practices of the regime" (Eden & Hermann 1996).

What are the motives, internal and external, that lead a state to become a renegade in an international regime? Renegade behavior within an international regime is likely to emerge when states profit directly from renegade behavior (Eden & Hermann 1996; Nadelmann 1990). Crazy renegades, in the sense of irrational or crazy states, are possible, but most renegades base

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

their behavior on a realistic assessment of national benefits and costs. We briefly explore some rationales for renegade behavior below.

First, a state may believe that the regime's norms and prescribed or proscribed behaviors are unjust and unfair, and therefore should not be followed. The definition of unfair, of course, is in the eyes of the beholder and may be used to rationalize renegade behavior rather than characterize the true reasons for noncompliance. However, where the benefits and costs of a regime are seen to benefit one group of member states at the expense of another group, questions of fairness may lead to free riding and possibly renegade behavior.

Second, a state may have other interests that conflict with this regime's norm and practices, and these other interests take precedence over this regime. These interests may be domestic or foreign policy concerns. A state may become a renegade simply because it is weak and cannot enforce compliance with the regime's norms on domestic actors (e.g., producer and consumer groups, multinational corporations).

Third, a state may believe that the consequences of defying the regime's norms and practices are negligible or worth less than the advantages that accrue from weak or strong cheating. Renegade behavior is more likely to occur where the benefits from noncompliance are high, the prohibited activities require readily available resources and no particular expertise, noncompliance is easily concealed, and such activities are unlikely to be reported to the authorities. To get international cooperation, states must establish institutions that prevent noncooperative outcomes and deter defection.

Detection of violations of an international regime's norms may be difficult (Yarbrough & Yarbrough 2003). First, there is no international consensus as to whether a state's commitment under a regime automatically becomes domestic law; as a result, domestic actors can affect regime compliance. Second, signing treaties as part of a regime is like signing a contract. Contracts are not binding under all circumstances in that a signatory can break a contract, claiming unforeseen events make the contract inoperable. In such circumstances, it is difficult to distinguish between discarding and breaching a contract. Third, it may be difficult to define exactly which behaviors are permissible and which are not, and to prove that an existing behavior is proscribed by the regime. Fourth, a state may have historically practised habits or customs that deviate from the norms and practices of the regime. This is most likely where a global prohibition regime forms to outlaw existing practices (e.g., whaling, counterfeiting, and slavery). For example, Nadelmann (1990) argues that global prohibition regimes develop over time, and that practices that were acceptable to most states in the early period become renegade behavior in later periods.[5]

B. RENEGADE STATES IN THE INTERNATIONAL TAX REGIME

Following Eden and Hermann (1996), we argue that renegade states in the international tax regime are states whose tax practices are salient to the

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

regime, but their behaviors do not comply with the regime's descriptive norms and practices. Eden (1998: 96–97) argues that tax renegades must have some or all of the following characteristics:

(i) the state has a zero or very low tax rate on business income in general;
(ii) domestic secrecy laws are strong and the state refuses to exchange information with other tax authorities;
(iii) the state actively promotes itself as a tax haven where tax avoidance and evasion practices are allowed, e.g. money laundering and tax evasion are not illegal;
(iv) the state is known as a drug conduit state; and
(v) the state does not have a network of DTTs.

A key characteristic of a tax renegade is likely to be tight domestic secrecy laws, including the refusal to exchange information with other tax authorities, because this encourages the movement of illegal activities into these havens.

Most tax havens are true outsiders to the international tax regime; for example, Andorra, the Bahamas, Panama, and the United Arab Emirates. These are *outside renegades*, with no formal ties to regime member countries; they belong in the outermost concentric circle in terms of the regime's geographic scope.

While tax havens in developing countries, such as those in the Caribbean, are clear examples of renegade states in the international tax regime, they are not the only renegades. At the heart of the regime – the twenty-nine OECD states – are a number of important "pretend" compliers, including Switzerland, Luxembourg, and the Republic of Ireland, which are tax havens in their own right. We call these OECD tax havens *inside renegades* because they are part of the international tax regime but do not comply with its practices. These havens belong in the innermost concentric circle. Switzerland was the first major financial tax haven, with strong bank secrecy laws designed to encourage the banking and financial sectors (Palan 2002). Luxembourg also greatly expanded its financial sector with measures assuring confidentiality. Ireland's renegade status came from its decision in the 1980s to set minimal tax rates on manufacturing profits in export processing zones, in order to encourage industrialization and growth.

In addition, some OECD countries – apparent "compliers" with the regime – maintain special jurisdictional relationships with tax havens. About half of all tax havens have quasi-outsider status because they are linked to an OECD member country either as a former colony or dependency, possession, free association, or a double tax treaty; for example, Aruba and the Netherlands Antilles are linked to the Netherlands. Most Caribbean islands still have tax treaties with the United Kingdom. Some are islands off the coast of OECD member countries (e.g., the Channel Islands). Hampton (1996: 69) refers to these havens as offshore territories linked to onshore states that tolerate or encourage these activities; they are "within and yet without."

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

We call this group of tax havens the *quasi-outsiders* since they enjoy some of the benefits of the international regime through their linkages with OECD member countries. Of this third group, most have a preferential link with the United Kingdom either directly as an overseas territory or crown dependency or through a double tax treaty. The United States has links with only four: Barbados, Cyprus, Grenada, and the U.S. Virgin Islands. This differential treatment of tax havens between the United States and the United Kingdom, as we argue below, has been a primary reason why unilateral U.S. attempts to fight tax havens were unsuccessful and multilateral attempts such as the OECD harmful tax project were problematic.

The linkages between OECD member countries and non-OECD tax havens suggest that our analogy of the geographic scope of the international tax regime as three concentric, unbroken circles needs some revision. Within the first concentric circle, there are tax havens (inside renegades) in addition to regime "supporters" that encourage abusive tax activities through their linkages to tax havens. Thus, the "core" of the regime is not as strong as traditional international regime theory would suggest.

Table 2 provides a list of tax haven countries, together with their linkages to OECD member countries.[6] Several OECD countries have longstanding linkages to tax havens; in addition, the dominance of the United Kingdom is very clear. Table 2 suggests that any multilateral attempt to brand tax havens as renegade states in the international tax regime should face grave difficulties from inside renegades, and from renegade "helpers" such as the United Kingdom and the Netherlands because inside the OECD are tax and finance ministers with conflicting interests in terms of compliance with the principles and norms of the international tax regime. These "helping" activities allow tax havens to free ride on the international tax regime, enjoying its benefits without paying the costs, and weaken the overall regime effectiveness.

To understand how the OECD came to label tax havens as renegade states, it is important to look at historical treatment of havens. In the early 1980s, as private-sector assets and foreign investments began to increase rapidly in the tax havens, the U.S. government began to see tax havens as generating harmful tax competition that was eroding the U.S. tax base, encouraging abusive tax behavior, and attracting drug trafficking and other criminal activities (Barrett 1997; U.S. IRS 1981: chap. III). The United States initially took the policy lead in targeting the havens; however, its unilateral actions in the 1980s were unsuccessful, which provided the impetus for the OECD's multilateral policy initiatives in the 1990s.

IV. THE UNILATERAL APPROACH: THE U.S. ATTACK ON TAX HAVENS

Until the early 1960s, the U.S. government did little to discourage U.S. multinationals from shifting activities to tax havens. In fact, the firms were

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

Table 2. Tax Havens and their Linkages

Country	**State type and linkages**	**OECD link**	**On OECD (2000) list?**
Andorra	Co-principality between France and Spain	France, Spain	Yes
Anguilla	UK overseas territory	United Kingdom	Yes
Antigua & Barbuda	Independent, Commonwealth member		Yes
Aruba	Part of the Kingdom of the Netherlands	Netherlands	Yes
Bahamas	Independent, Commonwealth member		Yes
Bahrain	Independent		Yes
Barbados	Independent, Commonwealth member		Yes
Belize	Independent, Commonwealth member		Yes
Bermuda	UK overseas territory	United Kingdom	Coop*
British Virgin Is.	UK overseas territory	United Kingdom	Yes
Canary Is.	Autonomous community within Spain	Spain	No
Cayman Is.	UK overseas territory	United Kingdom	Coop
Cook Is.	Free association with New Zealand	New Zealand	Yes
Costa Rica	Independent		No
Cyprus	Independent, Commonwealth member		Coop
Djibouti	Independent		No
Dominica	Independent, Commonwealth member		Yes
Gibraltar	UK overseas territory	United Kingdom	Yes
Grenada	Independent, Commonwealth member		Yes
Guernsey	British crown dependency	United Kingdom	Yes
Hong Kong	Special administrative region of China		No
Ireland	OECD member	Ireland	No
Isle of Man	British crown dependency	United Kingdom	Yes
Jersey	British crown dependency	United Kingdom	Yes
Jordan	Independent		No
Labuan	Federal territory of Malaysia		No
Lebanon	Independent		No
Liberia	Independent		Yes
Liechtenstein	Independent		Yes
Luxembourg	OECD member	Luxembourg	No

Table 2 *Continued*

Country	State type and linkages	OECD link	On OECD (2000) list?
Macau	Special administrative region of China		No
Madeira	Autonomous region of Portugal	Portugal	No
Maldives	Independent, Commonwealth member		Yes
Malta	Independent, Commonwealth member		Coop
Marshall Is.	Independent, free association with United States	United States	Yes
Mauritius	Independent, Commonwealth member		Coop
Monaco	Independent		Yes
Montserrat	UK overseas territory	United Kingdom	Yes
Nauru	Independent, Commonwealth member		Yes
Netherland Antilles	Part of the Kingdom of the Netherlands	Netherlands	Yes
Niue	Free association with New Zealand	New Zealand	Yes
Panama	Independent		Yes
Puerto Rico	US possession	United States	No
Samoa (Western)	Independent, Commonwealth member		Yes
San Marino	Independent city state in free association with Italy	Italy	Coop
Seychelles	Independent, Commonwealth member		Yes
Singapore	Independent, Commonwealth member		No
Solomon Islands	Independent, Commonwealth member		No
St. Kitts & Nevis	Independent, Commonwealth member		Yes
St. Lucia	Independent, Commonwealth member		Yes
St.Vincent & Grenadines	Independent, Commonwealth member		Yes
Switzerland	OECD member	Switzerland	No
Tonga Islands	Independent, Commonwealth member		Yes
Tunisia	Independent		No
Turks & Caicos Islands	UK overseas territory	United Kingdom	Yes
United Arab Emirates	Independent		No
Uruguay	Independent		No
US Virgin Islands	US overseas territory	United States	Yes
Vanuatu	Independent, Commonwealth member		Yes

*Coop means that this jurisdiction agreed to eliminate its harmful tax practices and therefore was not included in the OECD's 2000 list of abusive tax havens.

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

encouraged to transfer the ownership of intangible assets offshore to U.S. possessions such as Puerto Rico and Guam in order to stimulate employment and growth in these developing countries.

However, in the early 1960s, the situation began to change. In 1962, the U.S. government introduced the so-called Subpart F provisions, under which U.S. shareholders of CFCs are taxed as earned on a pro rata basis on certain types of income. These situations primarily involve passive income earned in tax haven countries and not distributed to the United States. For example, dividends, interest, rents, and royalties received by a U.S. citizen from a closely held company in Bermuda or the Cayman Islands would be taxable as accrued. Foreign trusts were exempt from this legislation until the 1976 Tax Reform Act eliminated income splitting, tax deferral, capital gains tax breaks, and tax-free accumulations for foreign trusts (Doggart 1997: 115).

Many tax havens have historically had a special relationship with an onshore economy, often as remnants of the colonial period. The Netherlands Antilles, for example, has taken advantage of its privileged relations with the Netherlands; as a Dutch protectorate, the 1948 U.S.–Netherlands tax treaty was applicable to its territory. A similar arrangement existed between Britain and numerous Caribbean islands. When many British colonies achieved nation status in the 1960s, the 1945 U.S.–British tax treaty was simply extended to these new nations (U.S. IRS 1981: 149). Until the 1960s, the United States allowed treaty shopping, whereby residents of a third country that did not have a U.S. tax treaty could triangulate and take advantage of treaty benefits to reduce overall tax payments. This meant that U.S. firms could engage in treaty shopping, using tax havens like the Netherlands Antilles and the Caribbean islands to avoid paying U.S. withholding and corporate income taxes. In 1962, the U.S. Treasury began to outlaw this practice; first denying the benefits of the U.S.–Swiss treaty to non-residents of Switzerland, and then to the U.S.–Dutch treaty in 1987 (which also applied to the Netherlands Antilles, a Dutch protectorate). This meant that firms could not use the Netherlands Antilles to shelter income from tax.

In 1981, the IRS issued a massive report on tax havens, written by Richard Gordon, IRS Special Counsel (U.S. IRS 1981). The report noted that tax havens often had a disproportionately large banking and finance sector measured as a percent of gross domestic product, or measured in terms of the size of foreign assets of deposit banks relative to foreign trade.[7] The report made several recommendations (U.S. IRS 1981: 10–13; 128–235), which are outlined in Table 3.

The Gordon report was followed by a 1984 U.S. Treasury report on U.S. citizens moving assets to tax havens in the Caribbean (Beard 1986; U.S. Department of Treasury 1984). In 1985, the U.S. Senate Permanent Subcommittee on Investigations concluded that between $150 million and $600 million in unreported taxable income was linked to tax havens and that "criminal exploitation of offshore havens was flourishing" (Barrett 1997: 14).

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

Table 3. Key Recommendations of the Gordon Report (1981)

- *Access to information*: The IRS and Federal prosecutors needed access to relevant information on international transactions of U.S. residents. This could be accomplished by requiring U.S. taxpayers to produce the books and records of their foreign subsidiaries and either maintain them in the United States or produce them on demand. Increase the penalties for failure to file or to produce books and records.
- *Burden of proof on taxpayer*: Taxpayers must substantiate deductions, valuations and transfer pricing for tax purposes. Section 482 (transfer pricing regulations) should be clarified and tightened.
- *Broadening U.S. jurisdiction*: Consider adding a management and control test for determining the head office of a firm for tax purposes so that foreign corporations that are effectively managed in the United States could be taxed on their worldwide income.
- *Refund or certify withholding taxes at the statutory rate*: Where tax treaties exist, a firm can apply to have the lower treaty rate levied at source. This could be changed such that the statutory rate applied and the investor would need to apply formally for a full refund, including certification that the investor is eligible for the treaty benefits.
- *Subpart F*: Expand the Subpart F provisions to tax U.S. shareholders of a CFC formed in a tax haven on all of its income. Merge the Foreign Personal Holding Company provisions into the Subpart F rules.
- *Tax treaties*: Terminate the existing tax treaties with the Netherlands Antilles and the UK extensions, and consider terminating all double tax treaties with tax haven countries. Do not enter into tax treaties with tax havens unless they include a non-discrimination provision, a competent authority mechanism (for settling tax disputes) and an exchange of information provision.
- *Exchange of information*: All U.S. tax treaties, with haven and non-haven countries, should include a strong exchange of information provision that overrides bank secrecy laws and practices in the tax haven. Consider adopting measures that would discourage U.S. firms from investing in abusive tax havens that do not exchange information as a way to encourage these havens to enter into exchange of information agreements with the United States. Possible examples include raising the withholding tax on U.S. source income paid to these havens and/or levying a no-fault penalty set at 50 percent of any income that is reallocated through a tax—haven transaction.
- *Treaty shopping*: Limit the benefits of a tax treaty to residents of a treaty country.

Source: authors' summary of U.S. Department of Treasury report (1981).

As a result of these reports and the widespread perception that unreported income in tax havens would continue to grow, the U.S. government made several changes in its policies towards tax havens. First, the government terminated its tax treaties with the Caribbean havens. New treaties were to be negotiated only if a strong exchange of information clause was attached to the treaty, overriding foreign bank secrecy laws in the tax havens. U.S. bilateral treaties were also to be restricted to residents of a treaty country, so that "treaty shopping" could not be used by non-residents to gain the benefits of the tax treaty (U.S. IRS 1981: 12–13). So far, Barbados is the only country in the Caribbean Basin that has established a U.S. tax treaty along these lines.

Many of the Gordon Report's other proposals were instituted over the next few years, including formal document requests, information reporting requirements, and deemed royalty payments, new transfer pricing regulations

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

for intangibles. By the early 1990s, it had become clear to the U.S. Treasury that reducing tax evasion and avoidance on a global basis could not be accomplished by individual nation states. Tax havens continued to proliferate. At that point in time, it became clear to the United States that a multilateral approach was necessary. The Gordon Report was prescient in this regard, stating:

> The United States alone cannot deal with tax havens. The policy must be an international one . . . to isolate the abusive tax havens. The United States should take the lead in encouraging tax havens to provide information . . . However, such steps taken unilaterally would place United States businesses at a competitive disadvantage as against businesses based in other OECD countries. Accordingly, a multilateral approach to deal with tax havens is needed. (U.S. IRS 1981: 10)

V. INTERNATIONALIZING THE ATTACK ON TAX HAVENS

A. EARLY OECD EFFORTS

Many OECD countries have individually enacted domestic tax rules designed to lessen the attractiveness of tax avoidance and evasion through tax havens. Eliminating tax deferral for foreign branches and subsidiaries in "black listed" countries, or for certain types of passive income earned in these locations, is a common approach. Transfer pricing regulations that ensure intrafirm prices must be based on the arm's-length standard are another method of reducing the possibility of tax avoidance. Doctrines of sham (artificial transactions designed so as to unduly reduce taxes) and general anti-avoidance legislation are also used, together with tax regulations that shift the burden of proof to the taxpayer and/or require substantial amounts of information about the transactions from the taxpayer.

The OECD's Committee on Fiscal Affairs (CFA) has exercised leadership by internationally coordinating the approaches of its member countries in several areas relevant to tax havens. As Eden (1998) and Overbeek (2001) argue, the CFA has played an effective role as an epistemic community by bringing together senior civil servants and financial, tax, and economic experts to develop guidelines for its member countries.

In 1977, the OECD mandated the CFA to "facilitate the anti-avoidance and evasion procedures of Member countries and improve the means available for international co-operation and exchanges of information and experiences" (OECD 1987: 11). In the 1970s, the two key anti-avoidance measures adopted by the OECD were the 1977 Model Income Tax Treaty (updating the 1973 convention) and the 1979 Transfer Pricing Guidelines, which recommended that the OECD member countries adopt the arm's-length standard for intra-firm transactions in goods, services, and intangibles.

In 1987, the OECD published *International Tax Avoidance and Evasion*, which consisted of four studies: tax havens, double tax treaties and the use

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

Table 4. The OECD's (1987) Recommended Anti-Haven Tax System

An anti-haven tax system should have:

- General provisions against international tax avoidance:
  - Transfer pricing legislation based on the arm's length principle.
  - General provisions discouraging tax avoidance.
  - Substance over form: the prevalence of economic or social reality over the literal wording of legal provisions.
  - Maintaining high withholding taxes on income paid to non-residents.
- Specific legislation directed against tax havens:
  - Shifting the burden of proof from the tax authority to the taxpayer.
  - Subpart F-type provisions that effectively tax the income, particularly passive income, of the foreign affiliate in the hands of the shareholders in the home country on an accrual basis.
  - Other provisions such as requiring emigrants to pay tax for a specified number of years after emigration, "rent-a-star" company legislation, requiring the arm's-length principle be applied to the transfer of assets abroad, taxing the income from offshore investment funds on an annual basis, and using foreign exchange controls to screen taxes.

Source: authors' summary of recommendations in OECD (1987).

of base companies, DTTs and the use of conduit companies, taxation and the abuse of bank secrecy. The report noted that national tax authorities had attempted to use both general and targeted measures against tax havens, and that targeted measures were more successful. The most sophisticated anti-haven systems were deemed those in Canada, France, Germany, Japan, the United Kingdom, and the United States. These measures consisted of two sets of provisions, general and specific (OECD 1987: 29–36); see Table 4 for details.

The report argues that international cooperation should be extended to support national anti-haven efforts. In particular, the OECD should facilitate exchange of information agreements among member countries, and encourage limited tax treaties with haven countries focussing on administrative assistance, non-discrimination, and "comprehensive exchange of information provisions possibly overriding secrecy laws in the tax haven" (OECD 1987: 46).

However, little was done at the OECD level. Tax avoidance and tax havens were hardly discussed at the 1990 symposium between OECD and non-OECD countries on taxation and international capital flows (OECD 1990). This was most probably because the Committee on Fiscal Affairs was focussed on the transfer pricing regulatory changes in the United States, which were finalized in 1994 (Eden 1998); see, for example, OECD (1993).

B. THE EUROPEAN UNION AND HARMFUL TAX COMPETITION

The focus on tax havens by the European Union came about as a by-product of the attempts by the European Commission to harmonize corporate

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

income taxes within the Union. Early attempts by the European Commission, as far back as the 1960s, to muster support among national tax authorities for the harmonization of intra-EU corporate income tax rates attracted no interest (Radaelli 1999: 667).

The first successful policy changes were related to the "EC 1992" single common market initiative. As cross-border barriers were removed within the Union, other barriers became more pronounced, in particular, differentials in national tax rates. A key issue for high-tax jurisdictions such as Germany was the fear that some EU member countries (for example, Ireland) were using low tax rates to lure business.

In 1996, the European Commission surveyed the national tax systems of its member countries and discussed ways to increase cooperation (the so-called "Verona paper", see Commission of the European Communities (1996)). The Verona paper argued that,

> Fair competition in a key component of the Single Market, but unfair competition in the tax area is a cause of concern because of its potential negative effects, particularly on tax revenues of Member States, on the efficient allocation of economic resources within the EU, and on competitiveness and employment. (Commission of the European Communities 1996: 2)

After the Verona paper, the German Minister of Finance, Oskar Lafontaine, raised the issue of intra-EU harmful tax competition (Overbeek 2001; Radaelli 1999). In October 1997, the Commission proposed a minimum 20 percent withholding tax on interest, the elimination of withholding taxes on intracorporate payments within the EU, and a voluntary code of conduct designed to eliminate unfair tax competition among the EU member states (the "Monti package"). A 1999 survey showed that the Netherlands and the United Kingdom had over half of all reported infringements of the code, mostly by their offshore dependencies.

The proposed withholding tax was hotly disputed (Overbeek 2001). The final decision in June 2000 was to allow countries to choose either to impose a 15 percent withholding tax (to be shared between residence and source countries) or adopt a general exchange of information system accompanied by the abolition of bank secrecy laws among EU member states. In late 2002, the European Union concluded an agreement obliging Belgium, Luxembourg, and Austria to introduce withholding taxes of 15–20 percent, while the other EU members would exchange information on intra-EU portfolio investments. Luxembourg and Austria agreed on the condition that Switzerland and the United States cooperate, but Switzerland refused. The Savings Directive took effect in January 2004.

C. LAUNCHING THE OECD'S HARMFUL TAX COMPETITION PROJECT

We argue that the OECD's decision to focus its resources, starting a major initiative against harmful tax competition particularly by tax havens, can be

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

traced to two key actors within the OECD – the United States and the European Union – simultaneously realizing that they needed to address the problem, for different reasons.

First, the initial rapid growth of cross-border financial transactions conducted over the Internet raised the issue of taxation of e-commerce. Globalization of business and finance raised the specter of a "race to the bottom" that could "sap the fiscal power of the state" (Kudrle 2000). Many argued, "the current model of international taxation is no longer viable for use in a truly global marketplace" (Gaskin 1999: 191). The Internet created legal loopholes, exacerbated tax evasion problems, encouraged money laundering, and made regulation more difficult.[8]

The U.S. government became concerned that "fiscal termites busily gnawing away at the foundations of the tax systems" were proliferating (Tanzi 2000: 4). Some of these rapidly growing termites identified by Tanzi included electronic commerce and transactions, electronic money, intra-firm trade within MNEs, offshore financial centers and tax havens, derivatives and hedge funds, foreign shopping. The United States, home to one third of the world's multinationals, the largest stock of inward foreign direct investment, and the largest number of Internet firms, was understandably concerned about globalization and e-commerce. The U.S. Treasury, recognizing that this was an international problem that could not be solved by any one tax authority, even the largest and most influential, began to see the need for international cooperation (Webb 2001).

Second, as we have argued above, the European Union had become more interested in harmful tax competition due to the EC 1992 initiative (Radaelli 1999). Some of its members, such as Ireland, were seen as poaching other states' tax bases. Lower taxes on highly mobile capital meant that immobile labor would have to bear the burden of paying for public services. The March 1996 Verona paper made several proposals designed to limit harmful tax competition among EU member states, including

1. a minimum level of effective taxation of capital income that would "not risk driving business or wealth out of the EU";
2. greater transparency of tax measures;
3. clarification of State Aids to business;
4. more consultations among national tax authorities where "a co-ordinated approach by Member States within the OECD would be highly beneficial" (Commission of the European Communities 1996: 13).

As a result of these concerns, in May 1996, the OECD Ministers of Finance (and subsequently the G-7) asked the OECD to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases" (OECD 1998: 7). The Committee on Fiscal Affairs was tasked to report back in 1998. The impetus for this request was the perception that:

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

> Globalization has . . . the negative effects of opening up new ways by which companies and individuals can minimize and avoid taxes and in which countries can exploit these new opportunities by developing tax policies aimed primarily at diverting financial and other geographically mobile capital . . . [G]overnments must take measures, including intensifying their international co-operation, to protect their tax bases and to avoid the world-wide reduction in welfare caused by tax-induced distortions in capital and financial flows. (OECD 1998: 14, 18)

The harmful tax competition project had three purposes (Hammer & Owens 2002), to (1) assist the OECD's general goal of providing a level playing field for cross-border activities in the taxation area; (2) facilitate fair and transparent competition; and (3) ensure that all taxpayers meet their tax obligations. The Committee on Fiscal Affairs' 1998 Report focused on the tax treatment of "geographically mobile activities such as financial and other service activities." (OECD CFA 1998: 19). The report distinguished two types of renegade behavior: preferential tax regimes, and abusive tax havens; see Table 5 for details.

The report suggested that virtually all OECD states employ some offending activity in their attempt to maintain policy competitiveness. The report made nineteen recommendations in three categories, most of which were similar to those in the 1983 Gordon Report. The OECD thrust was the exchange of information, transparency, and nondiscrimination between domestic and foreign activities – all proposals made in the Gordon Report and implemented by the U.S. Treasury in the 1980s (without success).

Table 5. OECD's (1998) Definitions of Renegade States

A *preferential tax regime (PTR)* exists if:

- There is no or low effective taxation on the relevant income.
- The regime is restricted to nonresidents or is otherwise isolated from the domestic economy (this is known as *ring fencing*).
- The regime is nontransparent.
- There is a lack of access to information on the taxpayers benefiting from the regime.

An *abusive tax haven* exists if the jurisdiction:

- Imposes no or nominal income taxes,
- Offers itself as a place to be used by nonresidents to escape tax in their country of residence, and
- Possesses confirming criteria:
    - Lack of effective exchange of information: Strict secrecy rules prevent the effective exchange of relevant information with other governments on the benefits businesses and individuals receive in these jurisdictions.
    - Lack of transparency: There is a lack of transparency in the operation of the legislative, legal, or administrative provisions.
- Attracts business with no substantial activities: There is no requirement that activity qualifying for the tax exemption or incentive be substantial; that is, the jurisdiction is attempting to attract investment or transactions that are purely tax driven.

Source: authors' summary of definitions in OECD (1998).

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

OECD (1998) urged its member states to move unilaterally to make abuse of their own tax codes more difficult. A specific suggestion was to tax the haven income of a state's own controlled foreign corporations (CFCs) immediately at the full home-country rate. Strict attention to transfer price manipulation is also suggested. The OECD Report urges that all bilateral agreements included the maximum possible exchange of tax relevant information. Third, and most innovatively, the report sets up a new institution, the Forum on Harmful Tax Competition, which 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 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.

D. PARALLEL INTERNATIONAL EFFORTS

Spurred by the OECD (1998) report, other international organizations began to study and develop regulations for tax havens and offshore financial activities. (See Table 6.)

The Financial Stability Forum (FSF), 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. Its first report (FSF 2000) ranks thirty-seven countries according to their supervision of offshore activities into three categories (highest quality, average, and worse than average). Another symbol of the growing importance of the campaign against tax havens was *The Economist's* special report on "Globalisation and Tax" (*The Economist* 2000).

Information sharing on tax matters caused a related initiative at the 1998 Birmingham G-7 Summit to act more forcefully against money laundering (Ault & Weiner 1998: 608). The OECD's Financial Action Task Force on Money Laundering (FATF), established in 1989 to monitor OECD members' anti-money laundering systems, released its report on trends for 2000–2001 (FATF 2001). The FATF reported on the progress in improving the anti-money laundering regulations of fifteen jurisdictions that had been identified as "noncooperative" in the FATF's 2000 report. The International Monetary Fund (IMF) also released a report examining the role it could play in monitoring and improving enforcement mechanisms of offshore financial centers (IMF 2000).

E. ENFORCING REGIME COMPLIANCE

1. *Naming and Shaming*

In June 2000, the OECD released a follow-up report (OECD 2000) outlining a variety of harmful tax practices, which are separated into two categories:

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

Table 6. International Policy Initiatives Dealing with Tax Havens

Organization	International Policy Initiatives
Committee on Fiscal Affairs, OECD	Tax Competition group issues 1998 report *Harmful Tax Competition.* Report leads to establishment of the Forum on Harmful Tax Competition, which was responsible for evaluating preferential tax regimes and determining which countries were tax havens. Started with list of 49 possible havens and published list of 41 non-cooperative tax havens (35 non-cooperative and 6 cooperative) and several preferential regimes in June 2000. Sets up dialogue and process for eliminating harmful tax practices by 2005.
Financial Action Task Force (FATF)	FATF Secretariat located at OECD. Set up to protect financial systems from criminal use for money-laundering purposes. Identifying detrimental practices and non-cooperative jurisdictions. Recommends 40 "best practices" to combat money laundering. Subgroups: (1) Ad Hoc Group on Non-Cooperative Jurisdictions established in 1998 to develop common processes to evaluate jurisdictions in terms of their anti-money laundering initiatives. Published list of 15 non-cooperative jurisdictions (June 2000). (2) Regional sub-groups such as CFATF (Caribbean jurisdictions). Published 19 recommendations, many dealing with offshore financial centers. Mutual evaluation process in the Caribbean.
Financial Stability Forum (FSF)	FSF has a Working Group on Offshore Financial Centers (OFCs) set up to review uses and activities of 42 OFCs and their potential effects on global financial stability. Recommends addressing problems of OFCs through compliance with international regulatory standards, notably cross-border cooperation. Had identified the standards, considered mechanisms for compliance and looking at incentives to encourage compliance. Asked IMF to assess havens. Report adopted March 2000. Publishes groupings of OFCs May 2000.
European Union	European Commission focuses on removing unfair tax competition (1998). Development of minimum withholding tax, exchange of information, and code of conduct rules. In addition, an organized crime multidisciplinary group within the EU focuses on cross-border investigation and cooperation.
G-7	G-7 has two working groups related to tax havens: (1) Finance Ministers' Working Group on Financial Crimes. Cross-border cooperation between law enforcement and regulators. Ten key principles. (2) Financial Experts Group. Transparency and regulatory cooperation.
Basel Committee	One of main tasks is supervision of cross-border banking (Basel Concordat 1975, 1983). Encourages cooperation between home and host central banks. Failure of BCCI in 1991 causes Committee to set up minimum standards for supervision of international banking groups (1992). Set up Working Group on Cross-Border Banking consisting of Basel Committee and Offshore Group of Banking Supervisors (1996). Working group issues first report *Supervision of Cross-Border Banking* (1996) and published *Core Principles for Effective Bank Supervision* (1997) with recommendations for all banks including OFCs. Designed to prevent bank failure from having worldwide repercussions. Survey on implementation of 1996 report.
Offshore Group of Supervisors	(1) Offshore Group of Banking Supervisors: Consists of 19 OFCs. Working closely with the Basel Committee to evaluate OGBS members' compliance with Basel's Core Principles. (2) Offshore Group of Insurance Supervisors: Develops standards and self-assessments for cross-border insurance regulation.

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

preferential tax regimes and tax havens. The report called for the full removal of the harmful effects of preferential tax regimes in OECD member countries to be removed within five years (April 2005), a limited "grandfathering" clause, and a "standstill" clause whereby OECD members would refrain from introducing or expanding their existing tax preferences. The report acknowledged that the cooperation of non-OECD members would be required to control harmful tax competition.

The novel action in the report was a blacklist, "naming and shaming" thirty-five countries as noncooperative tax havens and demanding that these countries change their policies, in particular by signing transparency and exchange of information agreements with OECD members (see Table 2, above, for the list). The report stated that individual havens could make bilateral commitments through a press release or adopt the new Collective Memorandum of Understanding issued by the OECD.[9] The Business and Industry Advisory Council (BIAC) Taxation Committee created a liaison group to work with the OECD Forum on Harmful Tax Practices, to ensure that business views were part of this process (Hammer & Owens 2002: 3–4).

In response to pressure from the OECD, six tax havens were "early adopters": Bermuda, Cayman Islands, Cyprus, Malta, Mauritius, and San Marino (i.e., they signed before the June 2000 report was released and so were never on the original list of non-cooperative havens). Of the thirty-five countries listed as harmful tax havens (see Table 2 for the list), by September 2003, thirty-one countries had made commitments to transparency and exchange of information, according to the OECD's harmful tax competition website. The current list of non-cooperative havens is quite short; only five countries remain: Andorra, Liechtenstein, Liberia, Monaco, and the Marshall Islands, as of September 2004.

2. *Evaluating Long-run Success*

A successful outcome to the 1998 harmful tax competition project was not guaranteed. Since many of the policies in the OECD harmful tax initiative were the same policies instituted by the U.S. government in the 1980s, one might have expected the prospects for the OECD's harmful tax competition project to be slim. The key problems were two-fold, one general, and one specific.

The first problem was the general ambivalence among OECD member countries about tax havens. Pressures for national competitiveness, the belief that competition is efficient, and the desire to respect national sovereignty were all reasons why governments preferred to not intervene in the domestic policies of tax havens. On the other hand, the growth in the number of tax havens over the 1990s and the widespread perception that globalization and the Internet were facilitating "fiscal termites" by bringing them "only a mouse click away" (*The Economist* 2000) were strong motivations to multilateral action against the havens.

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

The second, more specific problem was that a few OECD member countries were themselves tax havens (Ireland, Luxembourg, and Switzerland).[10] In addition, there were several OECD member countries that indirectly engaged in harmful practices by privileging certain tax havens through double tax treaties and other preferential tax treatments, thus creating quasi-insiders to the tax regime. In particular, the United Kingdom stood out because of its generous tax treatment of multiple dependencies and former colonies.

The commitment of the United States to the OECD tax haven project also waivered after the 2000 report was issued. Newspaper statements by the Secretary of the U.S. Treasury in early 2001, suggesting that the U.S. government was no longer committed to fighting the tax havens, were disconcerting for other OECD members. If the United States was no longer interested in punishing tax havens, the fight would be left primarily to the Europeans (Johnson 2001a, 2001b). September 11th was clearly important in terms of strengthening the resolve of the Bush Administration. The widely held perception of terrorist groups funneling money through tax havens also brought new anti-haven demands from the U.S. Congress.

In the end, the success of the OECD's initiative depends on compliance of the tax havens. While almost all the blacklisted tax havens have signed the OECD's Memorandum of Understanding agreeing to transparency and exchange of information, they have also signaled that their long-run commitment to these terms depends on compliance with the international tax regime's norms and practices from all OECD members, including the insider renegades. The OECD's willingness and ability to ensure such compliance is therefore critical. One positive signal is the January 2004 agreement between the OECD and Switzerland to exchange information on Swiss holding companies (Lomas 2004c).

The European Commission's role in encouraging intra-EU tax harmonization may be an important part of this process of regime compliance. Ireland, for example, recently agreed to end its ring-fencing by adopting a uniform low corporate income tax rate of 16.5 percent applicable to domestic and foreign firms. On the other hand, the European Savings Tax Directive, which is due to be implemented on 1 July 2005, still needs the cooperation of non-OECD European countries including Andorra, Lichtenstein, Monaco, and San Marino (Lomas 2004a, 2004b). In addition, the Swiss government has refused to sign the Savings Directive on the grounds that it might erode bank confidentiality.

VII. CONCLUSIONS

In 1998, the OECD released a report on harmful tax competition, arguing that tax haven countries had diverted substantial amounts of foreign direct investment (FDI) and taxable income away from OECD member countries.

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

In its 2000 report, the OECD put thirty-five countries, most of them small island economies, on a blacklist as non-cooperating tax havens.

We have argued in this paper that tax havens have been labeled by the OECD as renegade states in the international tax regime. Unilateral actions by the U.S. Treasury to eliminate tax havens were unsuccessful in the 1980s, as were intra-EU regional efforts in the early 1990s. With globalization and the growth of the Internet, both the U.S. Treasury and the European Commission became more concerned about tax poaching. The OECD's harmful tax competition initiative, in effect, "picked up the baton" in order to protect and strengthen the tax regime.

The literature on effectiveness of international regimes is still in its infancy. In addition, the jury is still out on whether the OECD's attempt to define and neutralize harmful tax practices by "naming and shaming" tax havens as renegade states in the international tax regime will be successful. Studying tax havens is therefore likely to prove a fertile ground for theory development for international political economy scholars over the next few years. We have focused in this paper on the policy actions of national governments and international organizations vis-à-vis tax havens. However, our analysis clearly points to the roles played by actors within these countries, in particular, to multinational enterprises, international tax and accounting firms, and other elites that are their primary beneficiaries – an area to which future research attention should be directed.

LORRAINE EDEN *is Professor of Management and an adjunct faculty member in the George Bush School of Government and Public Service at Texas A&M University. Eden holds a doctorate in economics from Dalhousie University. Her research interests are transfer pricing, international taxation and regional integration.*

ROBERT T. KUDRLE *is Professor of Public Affairs and Law at the Hubert Humphrey Institute, University of Minnesota, and an adjunct faculty member of the Minnesota Law School and the Department of Political Science. He holds a doctorate in economics from Harvard University and Master of Philosophy degree in economics from Oxford University.*

NOTES

1. For a concise review that stresses exchange of information, see Tanzi and Zee (1998).
2. For more details, see Eden (1998 chap. 2).
3. In fact, many income streams involve three or even more jurisdictions. In particular, there is often a "source" (production), a "demand" (sales), and a "residence" (ownership) jurisdiction, whose claims must be reconciled (Avi-Yonah 2000).
4. The OECD members are Austria, Australia, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, New Zealand, Netherlands, Norway,

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

Poland, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States.

5. Nadelmann (1990) outlines five stages in the formation of a prohibition regime. In the first period, the targeted activity is legitimate. Then, the activity is redefined as a problem, often by international legal scholars, religious groups, or other moral entrepreneurs. In the third period, regime proponents agitate for suppression and criminalization of the activity and the formation of international conventions. In the fourth period, the activity becomes subject to criminal laws and police action, and international institutions emerge to play a coordinating role. At this stage an international regime has emerged. Deviant states will refuse to conform to its mandate, weak states may formally accede but are unwilling or unable to crack down on violators within their territory, and dissident individuals and criminal organizations are a problem. In the fifth stage, a strong regime emerges and the proscribed activity is greatly reduced.
6. This table does not document double tax treaty linkages between OECD countries and tax havens. Adding the DTTs would strengthen the argument made here about the ambivalent treatment of the havens by OECD member countries.
7. A "smell" or reputation test is also a method for identifying a tax haven: if it looks like a haven and taxpayers treat it as a haven, it probably is a haven.
8. Forecasts for the growth of Internet commerce were greatly excessive in the 1990s, but the alarm that they stimulated was real and important (for the U.S. case, see Kudrle 2002: 82–83).
9. See the attachment to Owens (2002) for the memorandum.
10. We must also acknowledge that the U.S. practice of allowing foreigners anonymous tax-free earnings on certain financial investments, notably bank interest, while not attacked by the OECD, was widely seen as a "haven policy." The Clinton administration took action to direct that earnings information be collected so that it could be shared with treaty parties.

REFERENCES

Ault, Hugh H., and Joann M. Weiner (1998) "The OECD's Report on Harmful Tax Competition," *National Tax Journal*, 51: 601–8.

Avi-Yonah, Reuven (2000) "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State," *Harvard Law Review* 113: 1573–1676.

Barrett, Richard W. (1997) "Confronting Tax Havens, the Offshore Phenomenon, and Money Laundering," *International Tax Journal* 23(Spring): 12–42.

Beard, Peter (1986) "Offshore Financial Centers in Caribbean Basin Secrecy Jurisdictions: Current Trends and Developments in United States Anti-Tax Haven Policy," *Syracuse Journal of International Law and Commerce* 12: 520–51.

Commission of the European Communities (1996) *Taxation in the European Union: Discussion Paper for the Informal Meeting of ECOFIN Ministers*. Brussels: Commission of the European Communities.

Doggart, Caroline (1997) *Tax Havens and their Uses*. London: The Economist Intelligence Unit.

Eden, Lorraine (1998) *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America*. Toronto: Univ. of Toronto Press.

Eden, Lorraine, and Fen Osler Hampson (1997). "Clubs Are Trump: The Formation of International Regimes." In *Contemporary Capitalism: The Embeddedness of Institutions*, edited by R. Boyer & R. Hollingsworth. Cambridge: Cambridge Univ. Press.

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

Eden, Lorraine, and Charles Hermann (1996) "Renegade States in International Affairs: A Conceptual Exploration." Paper presented at the annual meetings of the International Studies Association Southwest Region, 20–23 March, Houston.
Financial Action Task Force on Money Laundering (FATF) (2001) *FATF Report on Money Laundering Trends for 2000–2001*. Paris: FATF Secretariat, OECD.
Financial Stability Forum (FSF) (2000) *Report of the Working Group on Offshore Centers*. Paris: Financial Stability Forum.
Gaskin, Jonathan (1999) "Policing the Global Marketplace: Wielding a Knife in a Gunfight," *Columbia Journal of Transnational Law* 38: 191–210.
Hammer, Richard, and Jeffrey Owens (2002) *Promoting Tax Competition*. Paris: OECD.
Hampton, Mark (1996) *The Offshore Interface: Tax Havens in the Global Economy*. London: Macmillan.
International Monetary Fund (IMF) (2000) *Offshore Financial Centers: The Role of the IMF*. New York: IMF.
Johns, Richard A. (1983) *Tax Havens and Offshore Finance: A Study of Transnational Economic Development*. New York: St. Martin's Press.
Johnson, David Cay (2001a) "Tax Enforcer Says Cheating Is on the Rise," *New York Times.* 19 July.
Johnson, David Cay (2001b) "Feds Plan to Pursue Tax Cheats," *New York Times*. 18 July.
Krasner, Stephen (1983) "Structural Causes and Regime Consequences: Regimes as Intervening Variables." In *International Regimes*, edited by Stephen Krasner. Ithaca N.Y.: Cornell Univ. Press.
Kudrle, Robert T. (2000) "Does Globalization Sap the Fiscal Power of the State?" In *Coping with Globalization*, edited by A. Prakash and J. Hart. New York: Routledge.
Kudrle, Robert T. (2002) "The Nation State Is Not Losing Its Power to Tax," *Challenge*, 45(4): 71–87.
Kudrle, Robert Thomas, and Lorraine Eden (2003) "The Campaign against Tax Havens: Will It Last? Will it Work?" *Stanford Journal of Law, Business, and Finance* 9: 37–68.
Langbein, Stanley (1986) "The Unitary Method and the Myth of Arm's Length," *Tax Notes: Tax Analysts Special Report*, 17 February: 625–81.
Lomas, Ulrika (2004a) "Swiss Insist Banking Confidentiality Is Non-Negotiable," *Tax-News.com* April 6. Available at http://www.tax-news.com.
Lomas, Ulrika (2004b) "Swiss Unlikely to Implement Savings Tax Directive in 2005," *Tax-News.com* April 21. Available at http://www.tax-news.com.
Lomas, Ulrika (2004c) "Switzerland Reaches Agreement with OECD Over Tax Questions," January 30. Available at http://www.tax-news.com.
Nadelmann, Ethan (1990) "Global Prohibition Regimes: The Evolution of Norms in International Society," *International Organization* 44:4: 479–526.
Musgrave, Peggy (1983) "The Treatment of International Capital Income." In *Taxation Issues of the 1980s*, edited by J. G. Head. Sydney: Australian Tax Research Foundation.
Organization for Economic Cooperation and Development (OECD) (1977) *Model Double Taxation Convention on Income and Capital*. Paris: OECD.
Organization for Economic Cooperation and Development (OECD) (1979) *Transfer Pricing and Multinational Enterprises. Report of the OECD Committee on Fiscal Affairs*. Paris: OECD.
Organization for Economic Cooperation and Development (OECD) (1987) *International Tax Avoidance and Evasion: Four Related Studies*. Paris: OECD.
Organization for Economic Cooperation and Development (OECD) (1990) *Taxation and International Capital Flows: A Symposium of OECD and non-OECD Countries*. Paris: OECD.

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.

Organization for Economic Cooperation and Development (OECD) (1998) *Harmful Tax Competition: An Emerging Global Issue*. Paris: OECD.

Organization for Economic Cooperation and Development (OECD) (2000) *Towards Global Tax Co-Operation: Progress in Identifying and Eliminating Harmful Tax Practices. Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs*. Paris: OECD.

Organization for Economic Cooperation and Development (OECD) (2003) *Tax Haven Update*, February. Paris: OECD.

Organization for Economic Cooperation and Development (OECD) Committee on Fiscal Affairs. (1993) *The United States Proposed Regulations Dealing with Tax Aspects of Transfer Pricing Within Multinational Enterprises*, January 10. Paris: OECD.

Overbeek, Henk (2001) "Taxing Capital: Globalization, Neo-Liberal Tax Competition and European Tax Harmonization." Paper presented at the annual meetings of the International Studies Association, 20–24 February, Chicago.

Owens, Jeffrey (2002) "The OECD Work on Tax Havens". Paper presented at the Friedrich Ebert Foundation Conference, "Money Laundering and Tax Havens – The Hidden Billions for Development". July 8–9, New York.

Palan, Ronen (2002) "Tax Havens and the Commercialization of State Sovereignty," *International Organization* 56: 151–76.

Palan, Ronen (1998) "Trying to Have Your Cake and Eating It: How and Why the State System Has Created Offshore," *International Studies Quarterly*, 42: 625–43.

Radaelli, Claudio M. (1999) "Harmful Tax Competition in the EU: Policy Narratives and Advocacy Coalitions," *Journal of Common Market Studies* 37: 661–82.

Tanzi, Vito (2000) *Globalization, Technological Developments and the Work of Fiscal Termites*. IMF Working Paper WP/00/181. Presented at the annual meetings of the Inter-American Center of Tax Administrations (CIAT), July, Washington, D.C.

Tanzi, Vito, and Howell H. Zee (1998) "Taxation in a Borderless World: The Role of Information Exchange." In *International Studies in Taxation*, edited by B. Wiman. Amsterdam: Kluwer Law International.

The Economist (2001) "Globalisation and Tax. Special Report," *The Economist*, 29 January.

U.S. Department of State (1999) *Money Laundering and Financial Crimes. International Narcotics Control Strategy Report 1999*. Bureau for International Narcotics and Law Enforcement Affairs. Washington, D.C.: U.S. Department of State.

U.S. Department of Treasury (1984) *Tax Havens in the Caribbean Basin*. Washington: U.S. Department of Treasury.

U.S. Internal Revenue Service (IRS) (1981) *Tax Haven and Their Use by United States Taxpayers (The Gordon Report)*. Washington, D.C.: Special Council for International Taxation, Internal Revenue Service.

United Nations Conference on Trade and Development (UNCTAD). 2000. *Taxation. UNCTAD Series on Issues in International Investment Agreements*. Geneva: United Nations.

Webb, Michael C. (forthcoming) "Defining the Boundaries of Legitimate Practice: Norms, Transnational Actors and the OECD's Project on Harmful Tax Competition." *Review of International Political Economy*.

Yarbrough, Beth V. and Robert M. Yarbrough (2003) *The World Economy: Trade and Finance, Sixth Edition*. Mason, Ohio: Thomson South-Western.

© 2005 Baldy Center for Law and Social Policy and Blackwell Publishing Ltd.