Introduction: Globalisation, Tax Competition and Economic Development

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The Commonwealth Response to the OECD Initiative on Harmful Tax Competition

The publication of the OECD's 1998 Report on Harmful Tax Competition and the threat of sanctions against non-OECD jurisdictions classified as 'no or low-tax jurisdictions' crystallised a long smouldering acrimony by high-taxing social welfare states against many international business service exporting nations with low income tax structures. The primary concern of the OECD countries was that their tax revenue bases were being eroded by what they regarded as 'harmful' tax competition from low-taxing non-OECD countries. From the OECD perspective, the forces of globalisation and the integration of global financial markets has created concerns that the OECD revenue base is being eroded by cross-border tax competition by international financial centres outside the OECD.

Many Commonwealth jurisdictions were identified by the OECD as meeting its criteria of being potentially harmful, based on four key criteria, including no or low income taxes, ring-fencing regimes, lack of transparency and lack of exchange of information. The OECD sought letters of commitment from all targeted non-OECD governments in which they were to agree to comply with the new OECD guidelines, and future detailed standards and regulations to be formulated by the OECD as the project evolved.

Many of the affected Commonwealth jurisdictions reacted with considerable alarm at the highest levels of government to the OECD Initiative, which was seen as an attempt to infringe on national sovereignty in taxation matters. Fiscal sovereignty is a right which has been carefully guarded by sovereign states and protected in international law over hundreds of years; international fiscal disputes have provoked major international political upheavals, including being one of the triggers for the American Revolution against British colonial rule after the British Parliament imposed the Stamp Act (1765) and the Tea Act (1773). Indeed, the American settlers rallied to the cry of 'no taxation without representation' in their struggle for independence, forging a separate nation to establish their right to fiscal sovereignty. In India, Mahatma Gandhi's major campaign of non-violent protest began with the formation of the Non-Co-operation Movement in 1929, which eventually led India to independence. The defining moment of his campaign was the protest march against the British salt tax in March 1930. By the end of April 1930, the British had imprisoned 60,000 Indians for breaking the salt tax laws and mounting civil disobedience on a massive scale, including related charges against Gandhi himself.

If my letter makes no appeal to your heart, on the eleventh day of this month I shall proceed with such co-workers of the Ashram as I can take, to disregard the provisions of the Salt Laws. I regard this tax to be the most iniquitous of all from the poor man's standpoint. As the Independence movement is essentially for the poorest in the land, the beginning will be made with this evil.

Letter from Mahatma Gandhi to Lord Irwin, British Viceroy of India, 2 March 1930

In response to the OECD Initiative, many affected jurisdictions were also concerned that the standards sought from non-OECD jurisdictions were far more demanding than those that were being required of the OECD countries themselves, creating a double standard that would further enhance the competitive advantage of the OECD international business service exporting industries. A particular concern was also that the OECD sought to impose sanctions on other sovereign states without first undertaking the normal process of consultations and negotiations that would be necessary in forging a multilateral agrement of this nature, via the normal process of international treaty negotiations.

Since the launch of the OECD Report in 1998, many Commonwealth developing countries have expressed their concerns about the OECD Initiative in various Commonwealth ministerial meetings. Concerns about the OECD actions were initially raised at the Commonwealth Finance Ministers Meeting in 1999 as well as at the Global Conference on Development – Agenda for Small States Meeting in February 2000. The Meeting of Law Ministers and Attorneys-General of Small Commonwealth Jurisdictions on 15–17 May 2000 considered that the OECD Initiative was in breach of natural justice and impinged on the sovereignty of small jurisdictions. They also argued that the OECD Initiative eroded the rights of all jurisdictions to compete freely in the provision of international financial services, rights recognised by the Commonwealth Heads of Government Meeting held in Durban in 1999. The Meeting called for these deep concerns to be brought to the attention of Commonwealth Finance Ministers and Heads of Government.

As a result of these concerns, the OECD Harmful Tax Competition Initiative was a key focal point for ministerial discussion at the Commonwealth Finance Ministers Meeting held in Malta in September 2000, and was the special theme for discussion at the meeting of Senior Finance Officials held just before the Finance Ministers Meeting. Many developing countries expressed their concerns about the OECD Initiative. A number of Commonwealth countries were particularly concerned about the potential impact of the OECD Initiative on global economic competition and government efficiencies, and the Commonwealth Finance Ministers Communiqué reflected these concerns. Finance Ministers stated:

Ministers recognised that tax competition could in fact be helpful, and not harmful, because it can further spur governments to create fiscal environments conducive to generating growth and employment.

Commonwealth Finance Ministers Communiqué, September 2000

The importance of tax competition between governments has also been emphasised by Professor Milton Friedman, in order to ensure that government services are provided as efficiently as possible. Professor Friedman stated in May 2001:

Competition among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or enterprises in the goods and services they offer for sale and the prices at which they offer them. Both lead to variety and innovation; to improvement in the quality of the goods and services and a reduction in their cost. A governmental cartel is no less damaging than a private cartel.

Milton Friedman, Hoover Institution, Stanford University,
Professor Emeritus, University of Chicago and Nobel Laureate, May 2001

One of the underlying assumptions that appeared to be implicit in the OECD approach was that jurisdictions with low or no income taxes were viewed as being 'low or no tax' jurisdictions, which is something quite different altogether. The assumption that absence of income tax or having low income tax was synonymous with having 'no or low tax' is dismissive of the right of a jurisdiction to choose to raise revenues through indirect taxation, customs and excise taxes or other similar taxation instruments. Indeed, many OECD countries have been trying to shift their own tax structures away from direct taxation of incomes towards indirect taxation. At the same time, some of the largest EU and OECD members have done little to plug large revenue loopholes in their own domestic legislation prior to embarking on this overseas exercise. For example, France has a loophole that encourages Frenchmen to sell their businesses and shift their capital and residence abroad, while the UK allows these same

French nationals very attractive loopholes also, generating a thriving community of wealthy French emigrés in the UK. Most EU countries also pay massive fiscal subsidies to agriculture, sometimes even for farmers not to grow any crops on their land. The OECD Initiative also ignores major asset classes such as property. The London property market alone is a major tax loophole for foreign investors, including investors from other EU countries. The scale of this loophole far exceeds the total size of assets in any of the listed OFCs, but no steps have been proposed to exchange information on foreign property owners or tax these assets. Large segments of the London property market are foreign-owned and have bid up prices so high that ordinary British workers, such as nurses and teachers, are unable to afford to live in London, creating shortages of many essential public sector workers.

Many Commonwealth developing countries also expressed concerns about the economic development implications of the OECD Initiative, since the key targets were some of the very industries into which international economic advisers had been urging these countries to diversify in order to reduce dependence on primary commodity exports and subsistence farming.

Recognising the need for consensus building, Commonwealth Finance Ministers also mandated the Commonwealth Secretariat to facilitate multilateral dialogue on harmful tax competition. The Commonwealth Secretariat worked urgently with the OECD Secretariat to organise high-level consultations between the OECD and affected Commonwealth jurisdictions in St Michaels, Barbados on 8–9 January 2001. These consultations were made possible by the gracious invitation of the Prime Minister of Barbados, The Right Honourable Owen Arthur.

The Barbados consultations were the first multilateral discussions on the OECD Initiative held by affected non-OECD jurisdictions. The process of multilateral consultation improved the transparency of the OECD process and also assisted jurisdictions on both sides to achieve a better understanding of the concerns and perspectives of the other side. One of the main outcomes of the Barbados consultations was the creation of a Joint Working Group of OECD and non-OECD jurisdictions to try to find a mutually acceptable way forward. Importantly, agreement was also reached at the Barbados meeting by the non-OECD jurisdictions to commit to three broad principles of transparency, exchange of information and non-discrimination.

The newly created Joint Working Group, comprising six OECD and seven non-OECD jurisdictions, met twice in subsequent weeks in order to negotiate a suitable way forward. The meetings, for which the

Commonwealth and OECD Secretariats provided administrative support, resulted in detailed technical discussions of the OECD requirements. While there was significant progress towards greater agreement, there were still many aspects of the OECD Initiative which the non-OECD jurisdictions felt required greater transparency. As a result, the second meeting of the Joint Working Group held on 1–2 March 2001 included substantial discussion of a list of 17 technical questions which the non-OECD jurisdictions put to the OECD, and which were discussed verbally. However, at the conclusion of the meeting, the OECD undertook to respond to these 17 technical questions in writing, and provided technical responses in mid-July 2001.

Economic Development Perspectives

The issue of international tax competition and economic development strategies for industries are inextricably linked, since fiscal incentives and the tax environment are often critical ingredients in corporate decisions on where to locate investment. As a result of the favourable business environment that they have created in recent decades, international financial and business centres like the Cayman Islands, Bermuda and Barbados today offer many opportunities to their young people for careers in areas such as law, accountancy, banking, fund management, company administration or insurance.

Their island lifestyles seem idyllic, and are undoubtedly the envy of many in more inhospitable regimes, whether geographic, political or fiscal. However, their development into international business centres is relatively recent, taking place mainly in the 1960s and 1970s. Prior to that, most Caribbean islands, and many other islands of the Commonwealth, such as Mauritius, Seychelles, Vanuatu and Fiji, were predominantly colonial outposts, either serving as administration centres, ports or agricultural economies dominated by plantation crops such as sugar, coffee or cocoa. Indeed the British Virgin Islands was at risk of being turned into a bird sanctuary, with a proposal by colonial advisers for its population to be relocated elsewhere, as colonial administrators could think of no sustainable economic activity for long-term employment of the local population.

In seeing the recent economic achievements and the highly skilled professional workforce that exists today in many Caribbean countries, such as the Bahamas, Cayman Islands, Bermuda and Barbados, it is also easy to forget the region's history of African slavery. An estimated 12 million African men, women and children were enslaved and shipped to the Americas, the largest forced migration in world history, with 2 million dying in the slave ships. Of this total, an estimated 5 million enslaved

African people were imported into the Caribbean to work on European colonists' plantations, after the Spanish genocide of an estimated 3–5 million indigenous Taino people. Indentured Indian labour was also transported to Guyana, Jamaica and Trinidad between 1844 and 1917. Even in the 1950s, many islands remained essentially rooted in the plantation economies they had inherited. It is important to recognise this historical background in order to understand the very substantial human development and capacity-building task that was required to transform these jurisdictions into centres of excellence in new growth industries and formation of skilled human capital.

Against this historical background, the achievements of many of the small island states through diversification into international business services and tourism during the last few decades are remarkable. Economic diversification has occurred mainly since the 1960s, as governments sought to attract new industries such as financial services and tourism. Much of the development that has occurred in the Caribbean has reflected these strategies, and has led to the success of some of the island states that is evident today. These strategies were successful because they focused on several of the world's most rapidly growing industries in the late twentieth-century in international business services, where small island states could be internationally competitive.

The world offshore financial services industry has shown rapid growth in the last two decades. This reflects a number of global trends, including the deregulation of domestic financial markets in many countries, rapid growth in world trade and investment, and the globalisation of the financial services industry. The size of the offshore financial services industry is estimated to be US$5–6 trillion, reflecting rapid growth in global foreign investment and trade flows, and the resultant growth in demand for international financial services.

The rapid growth in this industry has resulted in efforts by many nations to compete in this industry sector, with around 70 offshore centres now established worldwide. The term 'offshore' refers to the nature of the client rather than the location of the service. Hence foreign clients using London, Frankfurt or Tokyo for their financial services are making use of an 'offshore' financial services provision in the same way as those who are using services in far-flung islands in the Caribbean or Pacific.

The global offshore financial services industry is in fact dominated by the major financial centres of OECD countries. Indeed, recent estimates by the IMF of global offshore financial services activity indicate that around 60 per cent of total global offshore centres activity is carried out in London, the USA and in the Japanese offshore market. Overall, an estimated 80 per cent of the total offshore financial services industry is located in OECD countries, excluding their colonies. The remaining 20 per cent is outside the OECD, with even this segment dominated by a few very large centres such as Hong Kong.

It is the smallest, non-OECD providers of offshore financial services that are currently facing considerable pressures for change by a number of initiatives coming from the OECD countries, including the Harmful Tax Competition Initiative. This Initiative is focused on eliminating what the OECD determines to be harmful practices in all geographically mobile services. This includes not just to financial services, but all geographically mobile services, including, but not limited to, shipping, distribution services, service industries, and the provision of company headquarters. The OECD is already taking steps to extend its work to e-commerce in developing countries, and its 1998 Report flagged that it would later turn its attention to manufacturing industries in developing countries. Hence the OECD moves to eliminate harmful tax competition in financial services in non-OECD countries is part of a broader initiative to remove harmful competition in a wide range of industry sectors, including e-commerce and manufacturing.

The OECD has indicated that some form of sanctions might be used against those financial services centres which are regarded by the OECD as 'non-co-operating'. Consequently, considerable uncertainties are being created in the near term in relation to the future role of the offshore centres.

With many of the small, developing members of the Commonwealth having concentrated on an economic development strategy focused on exports of international services, the implications of recent initiatives are potentially very adverse for many of the countries most dependent on exports of services. This, in turn, could have far-reaching implications for the political, economic and social stability of many Commonwealth jurisdictions.

The World Trade Organisation (WTO) has observed that 'protectionism is not the first best choice to deal with fiscal challenges arising from trade liberalisation and globalisation'. In fact, governments are already responding to these challenges in more appropriate ways. High marginal income tax rates and corporate tax rates are falling, while consumption taxes rise. The WTO's Annual Report for 1998 observed that tax harmonisation was being discussed in the European Union (EU) and the OECD to deal with harmful tax competition, but noted: 'This option, however, should be treated with considerable caution, as the fight against a "race to the bottom" in tax rates may be used as a pretext for introducing a tax cartel.'

The Future Outlook

The OECD Initiative against non-OECD jurisdictions which it deemed to be 'harmful' commenced as an aggressive co-ordinated action by 28 of the largest developed economies against a wide range of jurisdictions, predominantly small, developing countries. Since late 2000, there have been signs of a more constructive approach, with Commonwealth ministers having played an important role in encouraging greater multilateral dialogue between OECD and non-OECD jurisdictions. However, the most significant step was the US announcement in May 2001 that it did not wish to support elements of the OECD Initiative that were viewed as anti-competitive. In particular, the USA withdrew its support for the OECD Initiative's objective of removing ring-fencing regimes.

However, the 15 EU members, who make up half of the OECD's 30 members, have an ambitious programme of reforms that parallels the OECD Initiative. The EU has been implementing removal of ring-fencing regimes and has already achieved political agreement on removal of harmful tax competition, not only in business services, but also in manufacturing. Importantly, all new EU aspirant countries will need to be compliant with the EU codes and laws prior to entry, creating a strong momentum for these countries to adopt taxation regimes that will be regarded by the EU as acceptable for regional integration.

The EU Directive on Savings Taxation has also pressed ahead with a tight timetable for exchange of information amongst EU member countries of savings interest for residents of other EU countries. As the success of this initiative is dependent on the EU's ability to secure commitments from the USA and Switzerland to undertake similar measures, the EU has now entered into negotiations with these other key financial centres in order to try to achieve its objectives.

This convergence between the EU and OECD Initiatives implies that even if the OECD membership cannot advance as ambitiously with the OECD Harmful Tax Competition Initiative, the EU will continue to press for similar outcomes via its own Directive on Savings Taxation. For non-OECD countries, this therefore poses considerable risks that they will be further driven towards greater regulation by a handful of powerful countries.

The broader context within which the OECD Initiative and the EU actions have taken place includes a number of other initiatives by the rich countries of the OECD to try to set the rules for the world economic system in a manner that is not inclusive of developing countries. These included the failed OECD Multilateral Investment Initiative (MAI), which was close to being finalised by OECD governments until it became publicly known, and provoked massive protests from civil society within the OECD as well as in developing countries.

Even within the WTO, IMF and World Bank, developing countries express considerable concerns about being excluded from the decision-making structures, with the IMF and World Bank voting rights and constituency systems dominated by OECD member countries. Within the WTO, OECD nationals exercise a large and disproportionate influence within the Secretariat, with the French grossly exceeding any fair staffing level, while the Seattle negotiations for a new round of trade talks were destroyed by the Green Room negotiating tactics of the OECD countries, whereby a group of the largest nations attempted to control the detailed negotiations, but eventually provoked a massive wave of resentment amongst developing countries, leading to the collapse of the Seattle talks.

If principles of democracy and good governance are to have any credibility, it will be crucial for OECD nations to move away from their efforts to establish a cabal or cartel arrangement for global economic decision-making. A world order governed by a handful of the richest nations may have worked in the seventeenth, eighteenth and nineteenth centuries, but the end of raw colonialism in the latter half of the twentieth century is unlikely to be able to be converted during the twenty-first century into an adapted form of neo-colonialism where the USA, EU and Japan try to run the world economy. The emergence of new industrial giants such as China, India and Brazil requires a new form of global governance architecture to be created that will be more inclusive of developing countries, and hence the broader aspirations and concerns of the world's population.

As the President of the World Bank, James Wolfensohn, said in November 2001, the developed countries must co-operate with developing countries to create new global governance structures and to redesign the global architecture to create a more inclusive global order.

The notion of two worlds of rich and poor or developed and developing collapsed at the time of the World Trade Center.

As we enter a world that is becoming more integrated, and where all the growth is going to come in the developing countries, we better have a better balance in the world.

James Wolfensohn, November 2001, in *IMF Survey*,
26 November 2001

Structure and Outline

This book comprises a collection of papers written by experts who have, for the most part, been closely involved during the period since the publication of the 1998 OECD Report in the matter of international tax competition, particularly from the small states and developing country perspective.

The papers are organised under five main headings, which consider the broad themes of globalisation, international tax competition, WTO issues, regulatory issues, and legal and constitutional issues.

The first section, on ***globalisation and international taxation***, contains several papers by the political leaders of small Commonwealth jurisdictions affected by the OECD Initiative, as well as papers by academic experts on related international economic and legal issues. The papers consider the broad issues of globalisation, with the leaders of some of the affected jurisdictions providing varying perspectives on the issue.

The first paper, by Professor B. Persaud, Director of the Commonwealth Partnership for Technology Management, provides an overview of the OECD Initiative on Harmful Tax Competition and its implications for small states. It provides constructive advice on building a more co-operative framework for international co-operation on tax matters, while respecting the sovereignty of developing countries. Professor Persaud questions whether the OECD, as a narrow grouping of the most powerful rich countries, is the suitable institution to take forward such a global initiative, which might be more properly handled by a globally inclusive international institution such as the IMF or World Bank where developing countries are more widely represented (albeit still with only a fraction of the voting rights).

This is followed by a paper by the Financial Secretary of the Cayman Islands, George McCarthy, based on his speech at the High Level Consultations between the OECD and affected jurisdictions held in January 2001 in Barbados. The Cayman Islands was one of the six jurisdictions which gave the OECD advance commitment letters prior to the release of the OECD indicative list of potentially 'non-co-operative' jurisdictions in June 2000. George McCarthy's paper, on 'Promoting A More Inclusive Dialogue', is therefore particularly insightful, as it is based on the Cayman Islands' experience of working with the OECD after the letter of commitment was entered into.

In contrast, the perspective of the Governor of the Central Bank of Samoa, Papali'i T. Scanlan, expresses the concerns of a small island nation that has been targeted by the OECD. He considers the economic and legal concerns of Samoa in regard to the OECD Initiative, calling on the OECD to respect the sovereign rights of the Pacific island nations, which have already been buffeted by a wide range of international initiatives with only limited opportunities for consultation.

The paper by Sir Ronald Sanders, the Chief Foreign Affairs Representative of Antigua and Barbuda, is based on a speech to the PriceWaterhouseCoopers Conference on Financial Services Investment Practice in Nassau, Bahamas in September 2001. It provides a summary of recent developments in the process of negotiations with the OECD, as well as views on potential future steps to build co-operation.

Sir Neville Nicholls, as President of the Caribbean Development Bank, addressed the Barbados High Level Consultations on the subject of the 'Administrative and Resource Implications for Small States' of the requirements from the OECD. His paper, based on his speech at the Consultations, discusses the detailed resource implications and capacity development issues.

Dale Pinto, Senior Lecturer in Business Law at Curtin University in Western Australia, provides a detailed discussion of the implications of globalisation for fiscal sovereignty and considers the future role of the nation state faced by the forces of globalisation. He considers the impact of the internet and e-commerce on international tax revenues.

Section Two considers the role of ***international tax competition in business services***. The paper on the OECD Harmful Tax Competition Initiative by Professor Michael Deveraux, Professor of Economics and Finance at Warwick University, was originally written for the Commonwealth Finance Ministers Meeting held in Malta in 2000. The paper discusses some of the international tax policy issues based on the OECD Initiative as specified by mid-2000. A key finding is that corporate revenues in OECD countries have remained steady as a share of GDP over the last two to three decades, despite significant declines in corporate tax rates, suggesting that governments have been effective in sustaining their revenue inflows despite their fears that globalisation is eroding their revenue base.

My contribution, 'International Trade in Offshore Business Services: Can Developing Countries Compete?', looks at international business services exports, finding that the OECD controls around 80 per cent of exports of these services. With developing countries increasingly turning to exports of finance, e-commerce and other IT services to build their knowledge industries, they are increasingly challenging the OECD countries for market share in key global growth industries. This has the potential to be one of the key economic battlegrounds between the OECD and developing countries over the next two decades, as developing countries try to expand their market share in these industries.

Dr Trevor Carmichael, QC, Chancery Chambers, provides a valuable contribution on the captive insurance industry and its emergence as a significant financial sector product during the last 50 years, with a number of small jurisdictions such as Bermuda and the Cayman Islands having become major international providers of captive insurance services.

Section 3 focuses on the ***World Trade Organisation and fiscal competition***. A paper by Dr Roman Grynberg and Bridget Chilala of the Commonwealth Secretariat considers the WTO compatibility of the OECD proposals to take defensive measures. Their paper is complemented by a paper by Steve Orava of the Baker & McKenzie Global WTO Practice which provides another viewpoint on this issue.

The WTO has also undertaken far-reaching negotiations on investment incentives and under WTO agreements that have already been reached significant changes to international use of fiscal incentives are being made. An article by David Robertson, of Baker & McKenzie, looks at 'Export Processing Zones and the WTO Agreement on Subsidies and Countervailing Measures', discussing the impact on developing countries of the WTO Subsidies and Countervailing Measures (SCM) Agreement.

Section 4 considers ***regulatory issues for financial centres***. The paper by Winston Cox, Deputy Secretary-General of the Commonwealth Secretariat discusses the crucial importance of 'getting the domestic financial architecture right'. The attention given to the financial architecture is intended to make the system more robust and less prone to crisis and to ensure that financial intermediation supports steady growth and development. The initial concern with financial architecture has been with the international financial system, but since the international system includes a linked network of domestic financial systems, it was inevitable that the architecture of domestic financial systems would also come under scrutiny. In his paper Winston Cox examines the reforms of the domestic financial system in developing countries. He argues that developing countries must continue to strengthen their prudential regulation and supervision of the financial system or face endemic crises that will wipe out gains in poverty reduction.

The paper by Colin Powell, Chairman of the Jersey Financial Services Commission, provides a practical view of the key challenges facing offshore financial centres from one of the leading experts in financial supervision and regulation. The article is based on a speech he gave to a financial services conference in 2001.

Richard Hay, a lawyer from Stikeman Elliott, discusses the implications of the OECD Initiative for international financial centres. At the least, this means that standards should be set by bodies with universal membership, so that offshore centres know that the same rules will apply to all. Importantly, he calls for offshore centres to be given a genuine and substantial part to play in the design of future regulatory changes.

The book's fifth and final section considers the ***international legal and constitutional issues*** arising from the OECD Initiative. A paper by David Simmons, QC is based on his speech to the Barbados High Level Consultations as the Attorney-General of Barbados.

Finally, a paper by Professor William Gilmore of the Edinburgh Law School, Edinburgh University provides a detailed technical assessment of the OECD Initiative from an international legal perspective. His longstanding reputation in international law and in strengthening Commonwealth legislation to combat serious crime make his article an important contribution to the international legal perspective on this issue.