The OECD Harmful Tax Competition Policy: A Major Issue for Small States[1]

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Evolution of OECD Policy

On 26 June 2000, the OECD released its report, *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices*. The report listed 35 jurisdictions (nearly all small states) which are deemed to be 'tax havens' using criteria developed in the OECD's 1998 report, *Harmful Tax Competition: An Emerging Global Issue*. Following the 1998 Report, the OECD set up the Forum on Harmful Tax Practices. The June 2000 Report was the outcome of the work of the Forum, which was agreed by the OECD Council.

The term 'tax haven', recognised in the past as a neutral description for countries offering low-tax regimes to attract financial services and other economic activities, has been reinterpreted by these two reports to connote indulgence in harmful tax practices. This narrow and pejorative definition of the term by the influential OECD will restrict its future use.

The 1998 Report set out criteria for determining 'tax havens' and guidelines for dealing with harmful tax practices. The key factors used in identifying 'tax havens' were:

- ✍No taxes or only nominal ones;
- ✍Lack of effective exchange of information;
- ✍Lack of transparency;
- ✍No substantial activities – investment or transactions are mobile and purely tax driven.

It was on the basis of these criteria that 35 jurisdictions were identified in the June 2000 Report. They are all very small states with populations of

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less than half a million, with the exception of Bahrain, which is just over that level, and Liberia which has a population of just under three million.

The list excluded jurisdictions which are regarded as 'tax havens' but which gave written advance commitments that they will abolish tax policies that are deemed harmful. Six jurisdictions gave such commitments, just before the list was announced.

Listed jurisdictions were given a year – until July 2001 – to provide commitments, in the absence of which defensive actions against them will be taken by OECD members on a co-ordinated basis. They would at that time be deemed 'unco-operative tax havens'. Consultations with the 35 jurisdictions have continued and three of the 35 provided letters of commitment before the July deadline. The July deadline has now been postponed because of continuing opposition on the part of the Offshore Financial Centres (OFCs) but substantially also because the Bush Administration in the USA has reservations about some aspects of the OECD policy, especially as it relates to the issue of sovereignty over tax rates, the extent of the erosion of bank secrecy and ring-fencing.

A significant development has been the formation early in 2001 of the International Tax and Investment Organization (ITIO) comprising many of the affected OFCs, including some that have provided letters of commitment. The organisation, prompted by the perception of heavy-handed pressures against small OFCs by the OECD, addresses wider tax, trade and investment concerns of developing states. The forum provided by the ITIO has helped to articulate the case of the small OFCs and to develop a common approach, and thus to alleviate the pressure on individual states to sign up to OECD policy.

However the 11 September tragic incident in New York, which has changed the world in many ways, has had a major impact on OECD policy. The new heightened concern about the international financial activities of terrorist organisations is leading to a spate of legislation on money laundering requiring cross-border co-operation which has advanced considerably, already eroding the right to privacy in the bank/client relationship.

This international shift in policy, with the USA playing a leading role, will revive talk of sanctions for non-compliance with the newly expanded anti-money-laundering legislation that countries worldwide are introducing to combat terrorism. It should be noted that most Commonwealth countries have vigorously supported the new US, UN and Commonwealth initiatives to improve co-operation against terrorism. (The Commonwealth issued a Statement on Terrorism on 25 October

2001 strongly supporting UN Security Council Resolution 1373, with a range of other measures and actions to be undertaken to strengthen co-operation against terrorism.)

The OECD has recognised that even before such defensive actions are implemented, the 'naming and shaming' involved in such a list of 'unco-operative tax havens' would begin to have negative effects on the investment and trade of the jurisdictions concerned. It should be noted that this action will add to other listings and assessments being undertaken by the major countries. Standards regarding money laundering are being assessed by the Financial Action Task Force (FATF), an intergovernmental body linked to the OECD, and on bank supervision by the Financial Stability Forum (FSF) which was set up by the G7. The FATF has issued its own list of non-complying countries, which has confused and compounded the problem.

According to the OECD stance, a state which provides an advance commitment would agree to a standstill, that is not to enhance such harmful practices. An advance commitment jurisdiction will develop an acceptable plan with the OECD, describing the manner in which it intends to achieve its commitment, the time-table for doing so and milestones to ensure steady progress, including the completion of a concrete and significant action during the first year of the commitment. All commitments must be fulfilled by December 2005.

Defensive measures against offending 'tax havens' are a polite usage for sanctions, and the list of possible measures is long. Severe measures include not entering into tax conventions and abrogating existing ones; imposing withholding taxes on payments to residents of the havens concerned; requiring comprehensive information and reporting rules on transactions involving these jurisdictions; enhancing audit and enforcement activities; disallowing deductions, exemptions, credits or other allowances; imposing charges and levies on transactions with the jurisdictions; adoption of controlled foreign corporation rules; and possible denial of non-essential economic assistance.

Beyond the threat of sanctions, member countries with particular political, economic and other links to 'tax havens' will ensure that these links do not contribute to harmful tax competition.They are also expected to use these links to put pressure on 'tax havens' to eliminate harmful tax policies.

Defensive actions against non-compliance will not be imposed by OECD members alone. Other countries have an interest in thwarting tax competition from low-tax regimes and the OECD has sought to use this converging interest to obtain wider support for pressures against 'tax havens' and for sanctions. Thus, soon after the release of the June 2000 Report, the French Minister of Finance launched a global dialogue on harmful tax practices by bringing together the 30 members of the OECD with 30 other countries to discuss how to develop a global response to harmful tax practices.

The OECD's plan to blacklist 35 OFCs is meeting stiff opposition, especially from within the Commonwealth, to which 26 of the jurisdictions named are connected, either as members or through other forms of association.

The ongoing debate came to a head at the Commonwealth Finance Ministers' Meeting in Malta on 19–21 September 2000, at which the affected Commonwealth OFCs and other developing countries mounted a concerted attack on OECD policy. Pressure was put on the OECD to relax the July 2001 deadline for declaring its list of 'unco-operative tax havens' and wider multilateral discussions of the issues were called for.

This stand, supported by continuing strong dissatisfaction expressed by non-Commonwealth OFCs, could not be ignored by the OECD. In response to the call for wider international discussions, and as a follow-up to the Malta Commonwealth Meeting, a High Level Consultation organised by the Commonwealth Secretariat in co-operation with the OECD was held on 8–9 January 2001 in Barbados, involving the OFCs, other Commonwealth members, the Caribbean Community, the Pacific Islands Forum, the Inter-American Development Bank, the World Bank and the IMF.

The Barbados Consultation set up a 13-member Working Group on Global Co-operation against Harmful Tax Practices, comprising six representatives from OECD countries and seven from developing countries, six of whom were from OFCs. The focus of the work was to be on the criteria for classifying countries as 'unco-operative tax havens'. Three principles embodied in the OECD criteria – transparency, non-discrimination and effective information exchange were to be given major attention.

However, the hope that the Barbados Consultation would lead to the adoption of a wider multilateral approach has been dashed. The OECD is maintaining bilateral pressure on the listed OFCs to secure their compliance. Many of them, although deeply dissatisfied with the whole process, are anxious to avoid the severe economic consequences of being classified as unco-operative. Already OECD action is having an adverse impact on the establishment of banks and other international companies in the OFCs.

A major challenge for the OFCs is the need for an agreed interpretation of these OECD principles before they are forced into making a commitment. As matters stand, the OECD has made a submission of what it means by these principles. These remain as uncompromising as when the whole process started. The OFCs have not been able to dilute this interpretation. This poses the great problem for the OFCs that the whole process is proceeding on the basis of the extreme OECD position.

There is still a long way to go in solving some of the more basic issues, such as the extra-territorial and unilateral threat of OECD rule-making and the OECD requirement for erosion of strongly held traditional principles of bank secrecy and bank/client confidentiality. Rule-making by the OECD for non-OECD states is of questionable international legality, especially when it involves co-ordinated sanctions, even though the sanctions regime is dressed up as a voluntary one.

A worrying question is the technical justification and legitimacy of the whole notion of tax competition as harmful, which was the original prompt for OECD action against OFCs. Even though there have been subsequent endeavours by the OECD to shift the emphasis from tax competition to harmful tax practices, assisted recently by the Bush Administration's concerns about the notion of tax competition as harmful, low or no taxes remain the first of the four classifying criteria of harmfulness in the tax regimes of the OFCs.

The main motivation for OECD action against small OFCs is the competition provided by these low-tax regimes in attracting international savings and investment. Seiichi Kondo, the Deputy Secretary-General of the OECD, in his article supporting the OECD initiative in the *Guardian*, 8 January 2001, left no doubt that tax-driven flows, seen by him wholly as tax evasion, were the main concern. Of great significance is the tendency in his article to end the long accepted distinction between evasion and avoidance.

There are other troubling features in the OECD action, not least of which is the element of dictation, coercion and excessive demands on a group of small and powerless states. The OECD action is discriminatory in that although tax regimes in OECD states themselves fall within the OECD criteria of harmfulness, these have been categorised less pejoratively as 'preferential tax regimes' and deemed only 'potentially' harmful.

Harmful Practices in OECD Countries

Concerned as the two reports were with harmful tax practices, their remit was wider than identifying 'tax havens'. They sought to take on harmful practices when they are carried out by member countries and non-member states other than OFCs. The OECD, in other words, is developing a global approach and a global framework of rules and sanctions. Through its influence the UN is now considering the adoption of a global model tax regime. However, any initiative that encourages the harmonisation of tax rates internationally is economically unjustified and will be inimical to economic growth and development in developing countries.

The preferential tax regimes of OECD countries generally have the same features as those of the 'tax havens', although they tend not to feature so importantly in overall fiscal and investment policies. Thus while the term 'tax haven' describes whole jurisdictions, in the case of OECD members and other countries, parts of the fiscal system deemed potentially harmful are identified as preferential tax regimes and targeted for remedy.

The June 2000 Report listed 47 preferential tax regimes in member countries. Members have committed themselves to removing practices which are practically harmful by April 2003, although four OECD countries have now abstained from the OECD 2001 Progress Report on the latest version of the OECD Initiative. In practice, the administrative process for dealing with preferential tax regimes, in terms of determining harmfulness and adopting sanctions, is much less stringent and much more consultative. Unlike the 'tax havens', the regimes listed are regarded as potentially harmful rather than actually harmful.

The process will involve the development of a 'generic basis of guidance' on applying the preferential regime criteria, i.e. the generic nature of harmful practices rather than the specific practice. The OECD will develop guidelines which will assist member countries in determining which potentially harmful regimes are actually harmful and how to remove the undesirable features.

Unlike 'tax havens', member countries with preferential tax regimes will have a larger involvement in determining whether a practice is actually harmful and in developing the guidelines for such determination and for the timetable of removal.

Of great significance is the fact that the whole question of defensive measures is given softer application. The June 2000 Report merely states that 'if harmful features are not eliminated by the prescribed deadlines, other countries may wish to take defensive measures'. And according to the 1998 Report, 'counteracting measures will focus both on nullifying the benefits of such regimes for tax-payers and encouraging the countries which operate such regimes, particularly those in the OECD area, to modify or eliminate them'.

In the case of preferential tax regimes in non-member countries, the June

2000 Report recognises their existence. Action envisaged, however, emphasises encouragement and assistance to remove harmful practices.

The report states that it is important to take forward the work of the Forum with regard to eliminating harmful tax practices on a global basis. To this end, the OECD's Committee on Fiscal Affairs will encourage non-member states to associate themselves with the 1998 Report and to agree to its principles. It will hold regional seminars that will encourage and assist these economies to remove harmful features of their preferential regimes. The work programme will endeavour to facilitate the removal of harmful tax practices in non-member economies by 31 December 2005.

For the future, the Forum will continue to explore ways in which non-member countries that share the concerns of the OECD and that are prepared to accept the same obligations, can be more closely associated with its work.

The OECD as an Appropriate Institution

A basic issue is whether the OECD is the appropriate institution for developing an international regime for dealing with harmful tax practices. The OECD recognises that its own members are engaged in such harmful practices, but the differential ways in which these practices are regarded, in which the consultative process takes place, and in which sanctions are emphasised and imposed demonstrate a basic weakness and inequity in the approach which justifies serious concerns. Many of the 'tax havens' have complained bitterly, not only of the nature of the process, but also of inadequate consultation and inequality of treatment.

While more consultation has now taken place, the 'naming and shaming' involved in listing jurisdictions, and the background threats of co-ordinated sanctions against small and weak states with limited economic opportunities, must raise worrying international legal and ethical questions. Issues arise not only about the consultation and the determination process, but also about the fact that the international regime being developed is driven and controlled by a group of countries which are themselves major perpetrators of the 'offending' actions.

It is clear that the global issue of tax competition and harmful tax practices require a more inclusive international approach. Relevant representative international institutions are already engaged. Hence the OECD's aggressive involvement seems unwarranted. Directly related issues of fiscal policy, and bank regulation and supervision, are already covered by institutions such as the IMF and the Bank for International Settlements (BIS). The IMF has developed a Special Data Transmission Standard, a

Code of Good Practices on Fiscal Transparency and a Code of Good Practices on Transparency in Monetary and Fiscal Policies. The Basle Committee on Banking Supervision has agreed Core Principles for Effective Banking Supervision and the International Organisation of Securities Commissions (IOSC) has developed a set of Objectives and Principles of Securities Regulation. The assessment methodology of the latter, which is to be used for self-assessments, has been proposed in co-operation with the World Bank, the IMF and regional development banks.

The WTO is concerned in a major way, through the establishment of the General Agreement on Trade in Services (GATS) which is developing an international regime for regulating trade in services. Although issues such as taxes, transparency and bank secrecy have only featured in a marginal way in its discussions, there is no doubt that they will become more substantial with time. The GATS is new in the WTO but its coverage is deepening and becoming more comprehensive.

These related international developments in representative and relevant international organisations raise the question of whether the issue of harmful practices, originated by the OECD, should not now be pursued more substantially and practically in these other institutions. They also raise the question of effective international co-ordination. However, some of the states classified as 'tax havens' are not members of international organisations such as the IMF and the WTO. This provides scope for an organisation like the Commonwealth, comprising many of the small states affected, to be given a more substantial role in the discussion of harmful tax practices. Some of the Commonwealth small states concerned are closely linked to major Commonwealth members such as the UK, Australia and New Zealand, which have encouraged and facilitated the development of financial services in these states. Their finance companies, including those from Canada, are often major players. They therefore have a strong interest in the outcome of these discussions.

Conceptual Problems and Other Issues

The many complex conceptual issues involved in notions such as harmful tax competition, harmful tax practices, the dilution of bank secrecy and client confidentiality, and 'tax havens' support the case for further analysis and a more cautious, evolutionary and consultative approach to action.

The provenance of the issue and the early OECD stress on 'competition' and on targeting low-tax regimes, raise the issue of the extent to which competition offered by low taxes and the revenue loss involved were not a major motivation for action. But such action implies interference in the sovereign right of nations to determine their own tax regimes. It is a right normally strictly guarded by states and even in regional economic arrangements it is usually conceded only reluctantly and in the advanced stages of integration.

While sovereignty is becoming diluted in a globalised world, it is important that this is not carried too far, especially as it affects the capacity for free action by small and powerless states. It must remain the case that when tax evasion by residents is involved through offshore investments, the first line of action must be the many ways open to a home country to close loopholes and adopt policies which discourage evasion.

Similarly, tax avoidance must be reduced through closing tax loopholes at home rather than by harassing nationals who find scope for avoidance abroad or by abolishing the distinction between evasion and avoidance. Co-operation is essential in cases of serious crime and terrorism. In the light of the events of 11 September, efforts must be stepped up to improve information exchange and transparency without abuse of the continuing justifiable case for bank secrecy, bank/client confidentiality and human rights. There is scope also for improving transparency in offshore business by restricting or abolishing the use of bearer shares and requiring fuller financial reporting. Great advances are being made in these areas and these efforts must continue in a determined way. However, dangers of overkill in some aspects are emerging and such overstepping could be particularly harmful to OFCs.

Beyond the sensitive issue of the impairment of sovereignty, OECD arguments and demands involve a substantial distortion of the very nature of low-tax regimes in OFCs.

Firstly, in many of these states the option of a low-tax regime is only possible because of their low public expenditure as a percentage of GDP – in some cases 20 per cent instead of the 40 per cent or so usual in the OECD countries.

The factor of size also encourages the possibility of using low taxes as a means of facilitating economic enterprises and attracting foreign investment. All states use tax policies for revenue as well as a means of creating a climate conducive to investors in a global competitive market. The wider scope allowed to small states for making effective use of tax policies as an economic investment inducement should not be seen as harmful tax competition, especially when account is taken of the dearth of economic opportunities available to such states arising from size constraints.

A misperception of low-tax regimes is that they thrive on tax evasion. Often, however, what they encourage is tax avoidance or postponed tax payments – these are legitimate activities. They may allow tax-free payments of dividends and interest, but when such earnings are repatriated, the investors are liable for taxes in home countries.

What is also not sufficiently recognised is that low-tax regimes encourage genuine economic activities, for example in manufacturing as well as in financial services. By allowing a more footloose location of service activities, the internet and the spread of e-commerce make for a greater mobility in international business. This is adding to the opportunities available to OFCs. Perhaps it is the increase in the genuine location attractiveness of OFCs that is worrying the OECD and is spurring action at this time.

Examples of genuine economic activities located in OFCs are the pharmaceutical and chemical industries as well as container port facilities in the Bahamas. A variety of financial services, such as insurance and re-insurance, captive insurance, fund management and trust services are offered in the Bermudas, Malta, Mauritius, Barbados and the Bahamas.

By focusing on tax evasion, the OECD is attempting to denigrate the economic structure of the OFCs in order to facilitate its application of pressure on them, so bringing about a change in their economies that would be to their detriment.

To curb the savings and investment activities of their nationals in the OFCs, the OECD is demanding through the criterion of information exchange that OFCs abolish traditional and revered principles of bank secrecy and client confidentiality. Banks operating in OFCs would be required to provide information on the investment and banking activities of their clients to the tax authorities of their home countries. This would be carried out routinely by an administrative order rather than through the judicial process now in use, or when criminal investigations are clearly being pursued.

Such a demand represents a revolutionary change in banking principles. It requires OFCs to comply with a requirement that would benefit the tax authorities in OECD countries at the expense of the financial service sector of the OFCs. It would be administratively costly for all concerned, and especially for small economies. It goes beyond anything the OECD countries have so far been able to achieve among themselves in tax co-operation and in fact they may never be able to achieve it. Powerful constraints are the human rights implications and their citizens' right to privacy in their personal financial affairs.

The consequences for the OFCs of compliance could be severe. Legitimate activities of tax avoidance and the investors' incentive to locate in low-tax regimes would be greatly compromised.

It took years of discussion within the EU to agree on information exchange among members for tax purposes. This was only achieved in June 2000 in Feira. There was widespread concern about this at the time and countries with offshore financial regimes, such as Luxembourg and Austria, were unhappy about the change of policy. In the final result, Austria agreed that it would comply only when countries outside Europe also co-operate. This will remain a difficult issue for a country such as Switzerland. It will be recalled that Switzerland and Luxembourg did not endorse the 1998 OECD report. In the EU, in lieu of information exchange, a few countries have been allowed the option of adopting withholding taxes on non-resident investment earnings. The OFCs believe that exchange of bank information and its extent must remain a matter for bilateral tax treaties, and should not be part of an international regime, which should only provide a framework for bilateral co-operation.

It is pertinent to note that liberal low-tax regimes were encouraged by high levels of economic, financial and monetary regulation and high taxes in other countries, and the competition provided by these regimes helped to spur international liberalisation which has generally been beneficial. They also encouraged the lowering of taxes, which may have been good for enterprise and growth, although tax competition carried too far can result in excessive income inequality. It is worth noting that countries like Ireland and Hong Kong, and some states in the USA have deliberately used very low taxes as an investment incentive.

The OECD is now de-emphasising competition as a motivation for its policy and is stating that the issue is not the level of taxes. However the starting point in delineating 'tax havens' has been low taxes, and even now low or no taxes is a presumption of harmful practice, regardless of the overall performance of low-tax regimes in terms of regulation, transparency, determination to make improvements and the extent of their international co-operation in tax and legal matters. If it is the case that the level of taxes is not now an issue, and since issues of information exchange and bank secrecy remain very controversial, then the main remaining concerns become prudential financial regulation and co-operation in handling cases of criminality.

Adequate regulation and transparency are requirements for a competitive financial centre and the need for them is not controversial. In fact many offshore financial centres are taking action to improve regulation and transparency and to prevent money laundering. Defensive action, including 'naming and shaming' for infractions in these areas, cannot be disputed if handled responsibly. But current problems in tax policies do not justify the extensive action proposed by the OECD, which can destroy the very rationale for offshore financial centres. Such action can also set back progress in co-operation in handling issues of regulation, transparency, accounting standards and criminal behaviour.

Some of the other characteristics used in defining harmful practices are also controversial. Discriminatory behaviour or 'ring-fencing' as between resident and non-resident investors has been cited. But this is not practised by some 'tax havens'. In states such as the Bahamas and Bermuda, income taxes are waived for both residents and non-residents, and local and foreign corporations. On the other hand, discrimination and incentives are used on a wide scale in OECD member countries and others, not only through their own offshore regimes in finance and shipping, but also in policies regarding withholding taxes and in tax and subsidy policies to assist deprived regions and agriculture. Singapore, for instance, has provided special incentives to attract the headquarters of multinational corporations and mutual funds. IMF figures show that the non-OECD share of the total offshore financial services industry is less than 20 per cent.

Other conceptual difficulties arise from the emphasis given to the encouragement of 'geographically mobile' activities in defining undesirability, and in consequence the large size of the offshore sectors concerned, relative to other economic activities.

It is claimed that by deflecting income from capital to offshore centres, tax burdens are being shifted to labour and consumption activities in OECD countries, and that an indication of the distortion is the size of financial sectors in 'tax havens' relative to other activities. Activities in offshore centres are seen as tax-driven and therefore undesirable.

However, tax considerations are important globally in all investment decisions. And the small tax variations among states not regarded as 'tax havens' may be more important in international investment decisions than the wider variation between 'tax havens' and other states. Capital is not easily attracted to very small states and a resort to low taxes should be seen as an attempt to overcome this problem.

Tax competition to attract savings and investments would not go away if these 'havens' are disbanded. As already pointed out, many OFCs encourage not only 'mobile' but also production activities. It should be noted, however, that most mobile activities are genuine production or service activities. In fact a weakness of the OECD reports is that it fails to recognise the substantial production and service industries that are also being attracted to OFCs.

In relation to distortions in tax structures, there is no evidence of any significant loss of revenue in home states from companies incorporating in 'tax havens.' In fact, the present situation in many major countries is revenue buoyancy leading to lower taxes, thus reducing competitiveness and harm from 'tax havens'.

A further factor is that while small offshore centres attract capital inflows, the ultimate destination of these investments is actually the major countries, thus nullifying or reducing the real effects on economic activities in industrial countries and in their revenue collection.

With development of the internet and virtual companies, and e-trading and e-commerce, and with easier sale of products and sale and transfer of services electronically, this criterion is being rendered problematic. It will, therefore, need to be reconsidered. An implication of imposing constraints on the movement of capital to 'tax havens' is that people themselves may relocate to 'tax havens', so involving a loss of the activity, and of citizens and residents with scarce skills.

Pressure on Small States

The fact that a large proportion of small states has turned to offshore financial services is an indication not only of the opportunity provided to them by higher taxes and restrictive financial and monetary policies in larger countries, but also of their needs arising from the limited range of economic opportunities available to them. The difficulties posed in attempting to diversify these economies and provide a more stable economic environment are indicated by their low levels of diversification and resulting higher levels of income volatility, even when per capita incomes reach middle and higher middle-income levels.

Another pertinent development feature of these small states is their inevitably high level of dependence on their external sectors for development. Service exports are proving particularly attractive. Tourism is a major industry in many of these economies and offshore financial activities have proved a welcome addition in order to achieve much-needed diversification.

Because of small size and special need for openness, success in these areas usually means relatively large sectors in relation to the total size of the economy. It is not helpful, therefore, to view a large offshore financial sector as a sign of artificial and distorted development.

There is little recognition of the major economic disruption that could be caused in some small states by the extent and speed of a change in OECD policies.

Offshore financial services have become a significant part of the economies of many small states. These activities generate a substantial amount of licence fees which belie the notion of a no tax situation. They also generate employment involving secretarial, administrative, accounting, information technology and professional skills. They encourage business and leisure visits. The skills developed have wider favourable economic impact. Much rental income is also generated by the sector.

In the Bahamas in 1998, employment in financing, insurance, real estate and other business services was 11 per cent of total employment. This figure relates only to direct employment and a large part – more than half – was in offshore financial services. Considering the higher average income earned in the sector, the direct GDP contribution is higher still – about 15 per cent. Similarly large percentage contributions to employment and income occur in other major offshore financial centres in the Caribbean, for example the Cayman Islands, Bermuda, the British Virgin Islands and the Turks and Caicos.

While offshore activities would not be eliminated by OECD action, there could be a considerable decline. The OECD report offers little in the way of practical relief or adjustment assistance to 'tax havens'. The June 2000 Report recognises that removal of harmful tax practices 'may adversely affect the economies of some of these jurisdictions'. It states that the OECD 'will work with other interested international and national organisations to examine how best to assist co-operative jurisdictions in restructuring their economies'.

Of particular concern is the extent to which these states are being isolated and pressured to adopt the OECD recommendations. Isolation is also caused by the fact that these low-tax jurisdictions are largely confined to small states and other states have an interest in action along the lines pursued by the OECD regardless of the technical and policy merits of the small states' case. In this matter, small states cannot even look for support from development NGOs, since the use of low-tax regimes by investors and the rich is not an issue with which NGOs tend to sympathise. Further isolation is caused by the fact that the OECD members to which the OFCs are linked, for example as dependencies and Crown Dependencies, have agreed to use their influence to secure compliance by 'tax havens' with OECD demands. This situation has even been secured by a trade-off of interests between the member countries, and a sacrifice of the interests of their own dependencies and Crown Dependencies. As part of the compromise, EU member states, and primarily the UK, have committed themselves to promoting the EU's tax information exchange system in the Channel Islands, the Isle of Man and the dependent and associated territories in the Caribbean. The ITIO would be very important in helping to co-ordinate the position of small states in international tax and investment matters.

Summary

Small states with offshore financial centres are under considerable pressure from the OECD. They have been deemed 'tax havens', i.e. undesirable tax jurisdictions which make extensive use of harmful tax practices. Unless these 'tax havens' commit themselves to removing these practices, they will be listed as 'unco-operative tax havens' and subject to co-ordinated sanctions which could also involve OECD non-member states.

The OECD is endeavouring to develop a global approach and framework for dealing with harmful tax practices and it is bringing to bear wide international pressure against OFCs. The 'tax havens' concerned are further isolated by lack of support from the OECD members with whom they are closely linked and by the lack of sympathy shown by development NGOs. The OECD represents the interests of a relatively small number of nations, and its attempts to prescribe international rules in matters which are already the concern of more broadly representative international organisations and to advocate sanctions is a policy of doubtful international legality.

The OECD recognises that its members and other states also indulge in harmful tax practices. It is endeavouring to remove these, but its whole administrative approach towards its own members, involving assessment and the use of sanctions, is softer and more consultative.

The OECD does not have a strong technical or moral case against 'tax havens'. Many conceptual problems are involved in the classification criteria used and the demands being made. Several of the basic OECD approaches are controversial, for example the notion of tax competition as harmful. Efforts to abolish bank secrecy and client confidentiality, which have advanced after the September event, pose very serious problems in relation to deeply respected principles involving the traditional right to privacy in personal finance – foundation stones of stability, progress and bank development. Curtailment of such rights and traditional practices has already been put in place by recent anti-money-laundering legislation. OFCs and those concerned with protecting liberal values must guard against the imminent danger that this can go too far. The OFC countries recognise the importance of the non-controversial areas, for example regulation, transparency and mutual legal assistance, and are co-operating to improve their regimes.

OFCs recognise their own interests in regulatory reform and are making efforts to achieve this. There is recognition that improved practices could help to make OFCs more reputable and durable. In the case of money laundering, numerous international organisations are involved – BIS, the UN, the G7's Financial Stability Forum and the OECD's own Financial Action Task Force. Model legislation and other forms of co-operation, such as mutual legal assistance to curb criminal activities, are increasingly being adopted. The Caribbean Community, for instance, has set up its own financial action task force with requirements that exceed those of the OECD's.

The OECD, prompted largely by worries over tax competition and the emerging difficulties for high tax states from the increasing mobility of economic activities through the use of the internet, is setting a dangerous precedent by usurping roles appropriate to more widely representative international organisations. The EU and OECD have themselves adopted plans for greater access to bank information, but progress in implementation is slow because of the continuing unhappiness of countries such as Austria, Luxembourg and Switzerland. Thus the demands the OECD is making on the OFCs are in excess of what it is able to achieve internally. This is clearly discriminatory.

Small states need to work together closely to resist the unwarranted pressures being put upon them. The setting up of the ITIO is a major step in this direction but it needs wider support from OFCs and wide recognition internationally of its crucial role in filling the gap in the international system. Even though some OFCs have already succumbed to the pressures and have agreed to comply, they remain unhappy and could co-operate with others through the ITIO to ameliorate pressure and achieve a more balanced and responsible approach. Small states also need to work closely with others who share their interests in low-tax regimes, such as the finance and business corporations which operate in 'tax havens' as well as with other commercial and political organisations with an interest in lowering taxes globally. They also need to maintain pressure on organisations in which they are strongly represented, such as the Commonwealth, to be more substantially involved in the international discussions and to assist them in articulating their case. Importantly, they also need to take a cue from the more developed OFCs such as the Channel Islands and Bermuda to secure greater diversification of their financial services sector and to thus become more economically resilient.

OFCs offer a useful means of extending the very limited range of opportunities available to very small states to promote diversified, durable and skill-intensive development. Tax competition is one of the few areas in which small size confers an economic advantage. Where OFCs are well established, their GDP contributions often range between 20 and 30 per cent and employment contributions, although lower, tend to be of a high-income and skill-intensive type. Removing the legitimate attractions of the OFCs could greatly set back the economic development of the countries in which they are based.

Greater consideration needs to be given to the economic impact on the affected jurisdictions of the change required by the OECD and to the requirement for appropriate adjustment assistance where mutually agreed changes are to be made. The Commonwealth Secretariat, the OECD and the World Bank should co-operate to undertake studies on the economic implications for OFCs of OECD policy.

What the OFCs should endeavour to secure is not only less stringent criteria for being classified as 'tax havens' but more radical changes in the criteria especially in such areas as 'low or no taxes' and the exchange of bank information. They must continue to resist any prescription on the level of taxes or the form of taxes. Exchange of bank information must not go beyond what is necessary to assist criminal proceedings and investigations and must discourage the use of 'fishing expeditions'.

The Working Group set up in Barbados should now be followed by a more permanent joint forum that would deal with issues involving OFCs on an equal decision-making basis rather than just having an advisory role to the OECD. The whole thrust towards OECD imposition and the threat of sanctions must be changed, and any rules developed must be jointly agreed.

In areas such as non-discrimination in tax policy and the exchange of information, OECD demands on OFCs exceed those on its own members, and one gets the clear impression that the OECD is using the OFCs as a soft target to leverage their own internal and wider objectives.

The OFCs will have the challenging task of avoiding an interpretation of the three principles of transparency, effective information exchange and non-discrimination and a political commitment on them, which in detail will strike at the very heart of their economic structure which they have carefully built up, in creative attempts to exploit their very limited economic opportunities. They are presently being lured to sign up on principles without a careful negotiation of their interpretation, and are being encouraged to do so with the promise of their involvement in a new multilateral arrangement. However their influence in such a widely inclusive arrangement would be negligible, and to wait on such a forum to interpret the principles after signing up, would mean their sure defeat.

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