Chapter 6

Global Value Chains, Tax and Trade: Upgrading the Position of Small States

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Abstract

This chapter considers the role that some small states that host international financial centres (IFCs) have sought to play as part of the global value chain (GVC) structures of multinational enterprises (MNEs) seeking to maximise tax efficiency. It provides some history of the challenges faced by such jurisdictions in responding to the development of norms and standards by bodies such as the Organisation for Economic Co-operation and Development, establishing context for more recent changes that, still unfolding, will affect the role that some IFCs located in small states have within MNE structures. Small states developed IFCs as a means of economic diversification, given the inherent challenges of participation in traditional GVC structures; the chapter concludes by reflecting on the need for IFCs, and the small states that host them, to build on the physical and professional infrastructure developed to date to identify ways that they can continue to provide high-value financial services within the GVCs of MNEs in a global tax framework in which taxation outcomes are better aligned with underlying economic activity.

6.1 Introduction

The fragmentation of global production that has occurred in recent years has been underpinned by revolutions not only in technology, but also in finance. A complex web of transactions has arisen between networks of firms not necessarily bound by direct ownership structures, nor ostensibly tied to the location where most substantive activity takes place. The expansion of vertically fragmented global value chains (GVCs) has been motivated by efficiency-seeking foreign direct investment (FDI), underpinned by a highly fragmented investment regime with, essentially, no globally agreed rules on finance. One aspect of the efficiency sought by multinational enterprises (MNEs) in structuring their GVCs is tax efficiency.

While there is a range of means by which an MNE can pursue tax efficiency, one method has been for MNEs to include in their GVC structures affiliated entities located in small jurisdictions that host international financial centres (IFCs). The use of entities in no- or low-tax jurisdictions in turn takes advantage, among other things, of an international tax system, the development of which has been based on norms and principles that are ill suited to today's modern, globalised economy.

The onset of the global financial crisis (GFC), which saw dramatic declines in the budgetary positions of many developed countries, led to, among other things, an increased focus on the tax practices of MNEs by governments in search of revenue. These developments, unfolding alongside recent scandals such as the release of the 'Panama Papers', have led to a period of increased scrutiny regarding the absence of globally agreed rules. Concerns have arisen regarding a global 'race to the bottom', with jurisdictions increasingly competing by adapting their regulatory frameworks and attracting a broad range of efficiency-seeking investments as well as finance. Alongside an increased focus on the tax practices of MNEs, major public policy concerns have arisen relating to tax evasion and the effects of illicit financial flows. The international response, led by the Organisation for Economic Co-operation and Development (OECD) and with the political impetus of the G20, led to a significant and ongoing process of reform to the international tax system that has, as one of its broad goals, a better alignment of taxation outcomes with substance – that is, with the underlying economic activity.

This chapter reflects on these developments from the perspective of the small states that host IFCs, many of which have come to play significant roles in the global investment system. Such states, often remote and isolated, and facing large trading costs and other challenges to participating in GVCs, have sought to develop IFCs as a means of diversifying their narrow economic bases towards high-value services and away from limited commodity dependency.

Current processes under way will undoubtedly affect some IFCs, although the considerable diversity of small states that host IFCs means that the full implications are likely to vary significantly between countries. Yet, for many small states, identifying viable options for economic diversification and for ongoing participation in GVCs remains a very real and ongoing challenge. In adapting to the evolving international taxation and regulatory environment, building on the financial services infrastructure already in place to focus on new, value-added services may open up fresh opportunities.

This chapter is organised as follows. First, some of the terms used in the current debate on tax and trade are defined. Some of the reasons why some small jurisdictions have sought to develop IFCs as a means of economic diversification are described. An overview of the history of the regulatory and taxation landscape and issues as they have affected small states which host is also provided. Finally, this chapter outlines some of potential implications of the current regulatory clampdown, mitigation measures, and concludes with reflections on how small states can continue to effectively engage with the future GVC fragmentation mechanism.

6.2 What are international financial centres?

In an area where terminology assumes a particular importance, it is unfortunate that there is so little consensus or certainty around key concepts, despite efforts to develop clear definitions (Zorome 2007). Terms such as 'offshore financial centre' and 'international banking centre' are often used interchangeably, along with the pejorative 'tax haven', but all have slightly different meanings depending on the context.

At the most basic level, a financial centre is simply a concentration of financial intermediaries that provide services to individuals, businesses, governments and other groups. An 'international' financial centre is a financial centre of international significance, providing services to entities or individuals not resident in that jurisdiction. Some of the world's most significant IFCs include London, New York, Singapore and Hong Kong. A reference to an 'offshore' financial centre, as opposed to an 'onshore' financial centre, usually signifies services that are largely provided to non-residents. This is case for most IFCs hosted in small states, given the small size of their domestic markets.

6.3 Small state hosts

The Commonwealth considers a small state to be one that has a population of fewer than

Box 6.1
Small states

The Commonwealth defines small states as sovereign countries with a population of fewer than 1.5 million people. Some larger states are also considered to be small states, because they have many of the same characteristics (Commonwealth Secretariat 2016a). Similar concepts are used in different contexts. For example, the World Trade Organization (WTO) has a concept of small and vulnerable economies (SVEs) (WTO 2016), which are jurisdictions that account for only a small fraction of world trade and are particularly vulnerable to economic uncertainties and environmental shocks. A concept of small island developing states (SIDS) is also used by a number or organisations. There are clearly overlaps between these definitions.

1.5 million, though usage also encompasses a number of larger states that have similar characteristics (Box 6.1). There are 30 small states in the Commonwealth and a number of these have established IFCs. However, there are many more territories and dependencies of Commonwealth members (notably the United Kingdom and New Zealand) that host IFCs. The network, span and global reach of IFCs can therefore vary significantly.

In terms of the services provided by IFCs hosted by small state jurisdictions, these often include a range of intermediate financial services such as international banking, insurance, the facilitation of collective investment and asset management (Lane and Milesi-Ferretti 2010). While many IFCs in small states purport to offer a full range of such intermediate financial services, many often specialise in the provision of certain services and therefore develop specific regulatory regimes for these. For example, Bermuda has emerged as a centre for insurance services, while the Cayman Islands has emerged as a centre for fund management.

The significance of IFCs hosted by various small states and jurisdictions varies greatly. Vanuatu, for example, has a relatively modest IFC that in the International Monetary Fund's (IMF's) estimation contributes around 5 per cent to GDP, roughly 3 to 5 per cent to government revenue and less than 2 per cent to total formal sector employment (IMF 2015a). The contribution of IFCs to the Bahamian economy is around double this (IMF 2015b). Certain small jurisdictions also host some of the most globally significant financial centres. The Cayman Islands and the British Virgin Islands, for example, rank among the top 40 global financial centres (CDI and Z/Yen 2016).

While the extent to which an IFC contributes to a small jurisdiction may vary, the type of benefits a jurisdiction may receive include direct revenue arising from corporation registrations, local employment, the transfer of skills to the local population and other ancillary benefits such as those accruing to the tourism industry. The development of IFCs has therefore been pursued as an important economic diversification strategy among many small states.

6.4 High-value services and export diversification strategies

Small states and jurisdictions that have sought to develop IFCs have done so in response to inherent structural characteristics that necessarily limit the application of conventional trade and development strategies and require more heterodox policies. With small domestic markets and high trade costs as a result of long distances from export markets, many Commonwealth small states are also highly vulnerable to natural disasters such as earthquakes, volcanic eruptions, hurricanes and climate change. In response to such challenges, a number of these jurisdictions have sought to create a comparative advantage through the introduction of a regulatory regime that accommodates niche markets (Woodward 2011).

Two of the earliest examples of small jurisdictions adopting an IFC model include The Bahamas and the Cayman Islands. The IFCs in each of these jurisdictions were first developed during the 1960s, in response to US-imposed capital controls. The US government's decision to tax interest payments received from foreign securities, to reduce its balance of payments deficit, meant that British banks could lend at lower rates than US banks. To capitalise on this, establishments were created in the Caribbean, in a time zone that enabled them to compete with US banks, and with infrastructure costs lower than those found in London.[2] This example demonstrates how IFCs often develop in response to changes in the international financial architecture and the specific niches that may be created within particular jurisdictions.

As well as offering a generally stable and predictable legal environment, jurisdictions may offer a legal system that enables the ready creation of financial-sector entities such as banks, or structures such as unit trusts, corporate entities or limited partnerships used for asset management. They also often offer a skilled workforce and an accommodating regulatory environment (Lane and Milesi-Ferretti 2010). While taxation outcomes are not the sole driver of the use of an IFC, the level of taxation and how this compares to the 'parent' country can often be an important 'pull' driver of capital flows. Usually in the context either of no corporate tax system, or of a system that specifically provides for either no or very low levels of taxation for certain defined, 'offshore' financial-sector entities, MNEs can utilise such entities to lower their global effective tax rate through, for example, allocating income-producing assets to those entities.

Other motivations for the incorporation of IFCs based in small states into the transactional networks of globally operating firms include the presence of attractive tax treaty networks, with investment destinations that may have the effect of lowering withholding taxes on returning income streams or producing capital gains tax benefits. The presence of strong tax secrecy laws and non-disclosure provisions has also traditionally been a driver, though often more so as a driver of the tax planning practices of high-wealth individuals. However, as noted below, this has become less of a driver as the tax transparency agenda has gathered momentum.

6.5 Responding to regulatory change

Having often been established in response to the tax or regulatory framework of other, larger jurisdictions, it is perhaps not surprising that small states which host IFCs continue to be affected by, and need to adapt to, the broader international regulatory environment. Although there are major trade policy dimensions to the regulation of investment and capital flows (with clauses and references increasingly included in bilateral deals), it is fair to say that a soft-law approach continues to dominate at the international level. Increasingly, a 'name and shame' approach towards regulatory reform has been taken by international bodies.

An example of this, and also an example of where the role of IFCs in the structuring of GVCs by MNEs has been challenged, was the OECD's Project on Harmful Tax Practices, which began in the early 2000s. At that time, the OECD, an international economic organisation consisting predominantly of high-income countries and whose membership now numbers 35, listed a number of jurisdictions as 'tax havens' based on an assessment of their tax regimes against criteria designed to identify harmful regimes. The four key factors used as the criteria are identified in Box 6.2.

Of the 35 jurisdictions identified at that time by the OECD, using its defined criteria, 26 were Commonwealth member countries or jurisdictions otherwise affiliated with a Commonwealth member. This identification process led to a number of outcomes. The 'naming and shaming' process affected not only the host country but also, in some cases, the reputations of lead firms and investors using IFCs in those countries; this led to some changes in the host countries' domestic tax and regulatory regimes. Moreover, it also led to increased international efforts to promote greater collaboration between revenue authorities. One tangible outcome of these efforts and the exchange of information generated has been the creation of the world's largest multilateral taxation platform. The *Global Forum on Transparency and Exchange of Information for Tax Purposes* was mandated by the G20 to monitor the implementation of these standards (Box 6.3).

Although the outcomes now embodied in the Global Forum are laudable, the process that led to its development raised many concerns for small states affected at the time. For instance, there had been limited engagement with the jurisdictions affected by the process, while concerns were raised in relation to the nature of the identification process and the extent to which this was based on criteria applied objectively and in a transparent way, and also about the manner in which non-OECD jurisdictions were treated relative to OECD members. It was in this context that the Commonwealth Secretariat took on a role with a number of its small state members, advocating a fairer process. The issue was the subject of discussions at Commonwealth Finance Ministers Meetings held in 1999 and 2000.

Box 6.2

OECD criteria for identifying tax havens (OECD 1998)

i) No or only nominal taxes

No or only nominal taxation on relevant income is the starting point to classify a jurisdiction as a tax haven.

ii) Lack of effective exchange of information

Tax havens typically have in place laws or administrative practices under which businesses and individuals can benefit from strict secrecy rules and other protections against scrutiny by tax authorities, thereby preventing the effective exchange of information on taxpayers benefiting from the low-tax jurisdiction.

iii) Lack of transparency

A lack of transparency in the operation of the relevant legislative, legal and administrative provisions is another factor in identifying tax havens.

iv) No substantial activities

The absence of a requirement that the activity be substantial is important, since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven.

Box 6.3

The Global Forum on Transparency and Exchange of Information for Tax Purposes

The Global Forum as it now exists is the continuation of a forum that was created in the early 2000s in the context of the OECD's work to address the risks to tax compliance posed by non-co-operative jurisdictions. The original members of the Global Forum consisted of OECD countries and jurisdictions that had agreed to implement transparency and exchange of information for tax purposes. The Global Forum was restructured in September 2009, in response to the G20's call to strengthen implementation of these standards.

The Global Forum now has 137 members on equal footing. Through an in-depth peer-review process, the restructured Global Forum ensures that its members fully implement the standards of transparency and exchange of information they have committed to.

The need to respond and adapt to a reform agenda driven largely by other groupings remains a challenge for small states. As outlined below, a number of recent and ongoing developments in international taxation regimes are likely to exert a significant influence on the business models of IFCs, and to redefine their place in GVCs.

6.6 The G20-led international tax agenda

The GFC saw the revenue base and overall budgetary situation of many of the world's developed countries sharply decline. The enhanced understanding of global production networks and aggressive tax planning by multinational enterprises subsequently became a central issues on domestic political agendas. Invariably, these discussions have been raised to the international level. The OECD, under the stewardship of the G20 – an enlargement of the G8 group, and reinvigorated in response to the GFC – has henceforth suggested a number of reforms to international financial architecture.

The first of these, of most relevance in the context of a discussion on GVCs and the role of small state IFCs, are the efforts being taken to curb tax avoidance practices among MNEs. Although there is no international tax law as such, the aspects of domestic taxation law that evolved to deal with cross-border investment focused, among other things, on seeking to clearly identify jurisdictional taxing rights and avoid the negative investment effects that might arise from so-called double taxation – that is, two jurisdictions seeking to tax the same income. These domestic provisions were supplemented by bilateral agreements in the form of double-taxation agreements. However, these provisions and treaties, and the underlying principles and norms that inform them, are ill suited to the modern global economy. They were developed at a time in which cross-border investment was less focused around the role of MNEs, involved clear, more direct forms of investment such as investment in bricks and mortar factories, and did not cater for the rise of the digital economy or the increasing importance of intangible and highly mobile assets such as intellectual property. As such, they were open to manipulation by MNEs, including through the use of affiliated entities located in IFCs, which could lead to significant decreases on global effective tax rates for the MNE and often double non-taxation for particular streams of income.

To address this legal tax avoidance, G20 leaders endorsed an ambitious OECD action plan to address so-called base erosion and profit shifting (BEPS), at their 2013 summit in St Petersburg (G20 2013). Under the 15-point BEPS Action Plan, a range of work was undertaken by both OECD and G20 members with the broad goal of limiting the abilities of MNEs to artificially shift profits to low- or no-tax jurisdictions by better aligning taxation outcomes with underlying economic activity.

The work under the Action Plan was broad and ultimately culminated in the delivery of 15 reports to the G20 at the end of Turkey's presidency in 2015. In a number of areas the reports flagged a need to undertake further work, but the BEPS project has since moved on to an implementation phase, focused around four so-called 'minimum standards', the implementation of which will be overseen and monitored by a group now numbering around 100 jurisdictions.

The first minimum standard will involve the introduction of provisions into bilateral tax treaties to prevent treaty abuse – that is, the setting up of companies in jurisdictions simply for the purpose of taking advantage of favourable tax treaty arrangements in investment destinations. To avoid the need to renegotiate more than 3,000 bilateral tax treaties, a multilateral instrument that will update the treaties of all signatory countries has been developed.

The second minimum standard is the implementation of so-called country-by-country reporting – a requirement for certain large MNEs to provide reports to tax administrations on a global breakdown of profits, tax paid and economic activities reported. The reports are intended to provide tax authorities with a better opportunity to assess the risk of MNEs mispricing the transfer of assets and services between related entities in the group as a means of shifting profits to lower-tax jurisdictions.

The third minimum standard is the rejuvenation of the OECD's work on addressing harmful tax practices. The work undertaken during the two-year BEPS Action Plan focused generally on reviewing tax regimes, and specifically on attracting intellectual property (so-called 'patent boxes') and, in that context, providing further guidance on the 'substantive activity' requirement used to assess harmful tax regimes (see above). Going forward, in the context of the BEPS implementation framework, a peer-review process is being developed to consider the harmful tax practices of jurisdictions beyond the OECD and G20 that have otherwise been the focus of the work to date. The focus on processes that would appear to mirror those adopted by the Global Forum, emphasising a review by peers and the participation of jurisdictions on an equal footing, may go some way to allay the concerns of jurisdictions, including many small states, recalling the early stages of the OECD's work on harmful taxation.

The final minimum standard is not so much a minimum standard, but rather an agreement by members of the framework to progress the work on developing effective mechanisms to resolve disputes in international taxation matters.

While the above developments, particularly those relating to the first three minimum standards, will reshape the role that small states hosting IFCs play in MNE GVCs, it is worth highlighting another aspect of the G20 international tax agenda that is having an impact on small states. This is the development of a new standard for the automatic exchange of tax information between revenue authorities as a further means of combating global tax evasion. The 'Common Reporting Standard' (CRS) (OECD 2014) closely mirrors the key elements of the US Foreign Account Tax Compliance Act (FATCA)[3] in requiring financial institutions to report to tax authorities information regarding non-resident account holders. As well as endorsing and committing to the standard themselves at the end of the Australian G20 presidency in 2014, G20 leaders made it clear that jurisdictions hosting IFCs would also be expected to comply by 2018 (G20 2014).[4] All Commonwealth members hosting IFCs have committed to this timeframe, the implementation of which will again be overseen by the Global Forum.

6.7 The re-emergence of 'blacklists'

As an example of the soft-law approach to the enforcement of emerging global norms, two processes evolved in 2016 to promote compliance with these new international tax developments, both involving the listing of jurisdictions that fail to meet or commit to relevant standards. The first of these, developed by the OECD and agreed by G20 leaders at their summit in Hangzhou, will focus on jurisdictions that fail to meet international tax transparency standards (G20 2016). These criteria include:

- compliance with the existing tax transparency standard focused on the exchange of tax information on request;
- a commitment to implement the new transparency standard for the automatic exchange of information (the CRS identified above); and
- having in place the legal basis for the exchange of tax information.

A list of jurisdictions that fail to meet the criteria will be finalised by the G20 summit in Hamburg in July 2017. In addition to the listing of jurisdictions, G20 countries also indicated a preparedness to apply so-called 'defensive measures' against jurisdictions so listed. A paper outlining possible 'defensive measures', or actions that one country might take against a listed jurisdiction, has already been prepared under the auspices of the G20 (OECD 2015)[5].

This G20 process sits alongside the work being undertaken by the European Union (EU) as part of its work on good tax governance. EU ministers have committed to the development of a list of 'uncooperative jurisdictions' that will be finalised at the end of 2017 (European Council 2016). The development of the list also includes three criteria that, notably, extend beyond the G20/OECD list's focus on the implementation of tax transparency standards, to consider aspects of a jurisdiction's tax regime that are thought to facilitate aggressive tax planning and tax avoidance. The criteria are that jurisdictions must have:

- met/committed to international tax transparency standards (largely aligned with the G20/OECD criteria identified above);
- met the EU's 'fair taxation' criteria, meaning that the jurisdiction does not have harmful tax measures as defined by the EU, nor facilitate the creation of an offshore structure that can be used for profit shifting; and
- committed to the BEPS implementation framework, including the four minimum standards (see above).

Initial indications suggest that a number of Commonwealth small states that host IFCs will be a part of the screening process that will take place throughout 2017 (BNA 2016). The last criteria may involve a number of small-state IFCs being asked to engage and sign up to the BEPS implementation framework. Similar to the G20 process, the EU process may see certain 'counter-measures' applied against listed jurisdictions (European Commission 2016).

6.8 Other recent developments

6.8.1 Effectively tracing company ownership structures

As an example of the fluid regulatory environment in which small states hosting IFCs operate, 2016 also saw the emergence of new transparency initiatives. While not representing 'international standards' in the sense that they have been endorsed by the G20, emerging initiatives related to identifying the beneficial (or ultimate) owners of entities have nonetheless received significant attention, in large part because of the domestic political context in a number of G20 countries in the wake of the 'Panama Papers' and the increasing influence of non-governmental organisations in the international narrative. While the push to create publicly searchable registers of beneficial owners, which received attention at the time of the UK-hosted anti-corruption summit in London in May 2016, appears unlikely at this stage to receive broad international support, a related initiative for the automatic exchange of beneficial ownership information between jurisdictions has already been supported by more than 50 jurisdictions.

6.8.2 Withdrawal of correspondent banking relationships

A concerning development that has emerged over the last few years, and is receiving increasing international attention, is the withdrawal of correspondent banking relationships (CBRs). These relationships with global banks allow businesses and financial institutions in other jurisdictions to access the global financial system, facilitating for example wire transfers and other cross-border business transactions. The well-reported closing of these relationships by global banks has affected many small jurisdictions, particularly in the Caribbean (Commonwealth Secretariat 2016b), posing challenges for all such jurisdictions but representing a significant challenge for the operation of IFCs dependent on the smooth flow of capital. While the drivers of this withdrawal are multiple and complex, the increasing international dialogue focused on solutions has emphasised the need for affected jurisdictions to continue to strive to implement global regulatory standards. Reflecting in part the role that jurisdictional reputation may have as a contributor to the withdrawal of these relationships, a recent IMF staff report called on states hosting offshore financial centres to reconsider the sustainability of business models that rely on opaque or offshore structures (Erbenová *et al.* 2016).

6.9 Concluding remarks

The above discussion highlights that small states that host IFCs operate in a quickly evolving and complex regulatory environment, one that continues to see soft-law 'listing exercises' used as a means of enforcing evolving global norms.

This has a number of implications for states. The first is simply the immediate challenge it poses to jurisdictions needing to allocate scarce resources to understand and then effectively implement new standards. This will require not only technical resources, but also political will – will that the impending development of blacklists linked to the meeting of such standards is intended to support.

The second, of more significance in the context of this chapter, is the challenge faced by small states seeking to understand and respond to the broader implications of the international tax and regulatory agenda in terms of the role they have sought to play in GVCs, particularly in the structuring of MNEs. While the international tax transparency agenda is already and will continue to have an impact on the role played by small state IFCs, the broader tax avoidance agenda, which has focused on curbing the ability of MNEs to artificially shift profits to low- or no-tax jurisdictions, will clearly affect the role that some IFCs have played in GVCs. The BEPS process, both in its policy scope and possibly its implementation, is of course not perfect, with the overall stated goal of the project tempered by a reluctance of major economies to act too boldly, such that national firms are placed at a competitive disadvantage or inward capital flows currently facilitated through IFCs are placed at risk. Nonetheless, the BEPS project, and the fact that the public discourse around multinational anti-avoidance is likely to remain strong (and likely to provide the basis for further unilateral or multilateral action), seems likely to reduce the role of some IFCs in corporate finance.

This of course is not the end of the story for small states that have sought to develop IFCs as a means of economic diversification and indeed, depending on the business model employed, aspects of any one IFC may be largely unaffected by the unfolding international agenda. Nonetheless, for those that are affected, the need remains for these economies to identify viable ways to support their growth and development, including through their ongoing participation in GVCs despite challenges posed by their size and geography. For many of the more successful IFCs, having now established both the infrastructure and professional base to provide high-value financial services, this will involve identifying further opportunities to consolidate and build on the substantive activities already taking place in those jurisdictions – drawing on other non-tax advantages offered by the jurisdiction, including proximity to key investment destinations, physical infrastructure and a strong reputation in terms of meeting international standards and regulations.

Notes

1 Economic Adviser, Commonwealth Secretariat. The views expressed in this paper are the authors and do not reflect those of the Secretariat.
2 See Stoll-Davey (2007) for further information.
3 A unilateral measure of the US Congress designed to ensure that non-US financial institutions report accounts held by US citizens abroad.
4 With first exchanges to occur by 2018.
5 See in particular Annex 1, 'Report on tougher incentives for failure to respect the international exchange of information standard'.

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