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Background to the 2006 Assessment

The 1996 Lyon Summit of the OECD member states launched an initiative aimed at limiting certain types of tax competition which were deemed contrary to the interests of the world's most developed countries. Although there was little, if any, published evidence that tax competition was in fact adversely affecting, or indeed was likely to adversely affect, the economies of the OECD member states,[4] the concluding communiqué of the Heads of State urged the OECD to develop pre-emptive measures to address any potential or perceived threats of tax competition to the interests of the member countries and to report back in 1998. The communiqué stated:

> Finally, globalisation is creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, carrying risks of distorting trade and investment and could lead to the erosion of national tax bases. We strongly urge the OECD to vigorously pursue its work in this field, aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices. We will follow closely the progress on work by the OECD, which is due to produce a report by 1998.[5]

In 1998, in response to this request, the OECD's Committee on Fiscal Affairs published a report entitled *Harmful Tax Competition: An Emerging Global Issue* wherein, among other points, four factors for the identification of 'Tax Havens' and 'Harmful Preferential Tax Regimes' were established.[6] It should be noted that Switzerland and Luxembourg, both OECD member states, did not endorse the report.[7] The OECD's Harmful Tax Competition Initiative, as it became known, was initially only concerned with the activities of OECD member states. In 1997, however, it was decided to include selected (small and developing) non-OECD countries, which the 1998 report labelled as 'tax havens', within the scope of the initiative.[8] Since then the OECD has published further reports on developments in this area, including the 2006 Assessment.

Much of the early history of the OECD's Harmful Tax Competition Initiative was undoubtedly acrimonious and marked by the absence of any meaningful dialogue between the initiators and the non-member target states.[9] There was also an apparent lack of understanding and mistrust on both sides. Tax officials from OECD member states no doubt felt justified in their efforts to secure the economic interests of the governments they represented. The non-OECD countries threatened by the Initiative felt aggrieved by the processes used, the arguably capricious manner in which they were targeted, and the lack of any 'level playing field' in terms of the development and application of any

standards for tax-related economic competition, and the threats to their economic development efforts.

The situation at the outset of the Harmful Tax Competition Initiative was exacerbated by the fact that virtually all of the then limited academic literature on the provision of cross-border financial services was written from the perspective of those in geopolitically dominant centres of financial services activities. This is perhaps understandable given that, according to some recent estimates, the member states of the OECD continue to account for approximately 80 per cent of the provision of financial services to non-residents.[10] While a considerable amount of material has since been written about the early phase of the Harmful Tax Competition Initiative and the designation of small and developing non-OECD countries as 'tax havens', the implications of the Initiative for the small and developing non-OECD countries targeted was not fully considered.[11]

The language which has developed in relation to the cross-border financial services sector tends to parallel this dominant country perspective. By way of example, concentrations of financial services activities within the dominant countries tend to be referred to by relatively precise designations such as 'Wall Street', in the case of the United States, and 'the City', in the case of the UK, while those not in dominant countries tend to be referred to generically as 'offshore financial centres'. This has led to an 'us versus them' dichotomy which belies the fact that the activities in these centres are closely linked, if not essentially the same, irrespective of their location. The 'offshore' frame of reference has no doubt been enhanced by the fact that in a number of cases the financial centres outside the dominant countries have also been geographically located close to, but off the geographic shores of, the dominant countries. There has also been a tendency in ill-informed circles to characterise all 'offshore financial centres' as 'tax havens', ignoring the actual economic bases of these centres.

In June 2000 the OECD published an initial 'blacklist' of 35 'tax haven' countries, a number greater than the number of OECD countries.[12] In November 2000 the OECD, under the OECD's multilateral framework of 'the Global Forum on Taxation' (Global Forum), commenced a dialogue with six non-OECD countries which had made what the OECD viewed as acceptable, political commitments to remove harmful tax practices and to implement transparency in taxation matters, as well as effective exchange of information in civil and criminal tax matters.[13] In January 2001, with the assistance of the Commonwealth Secretariat, the scope of the dialogue and the number of countries participating was greatly expanded. Subsequently during 2001, five additional countries made similar commitments, increasing the number of committed countries to 11.[14] This increase in committed countries may be linked to the OECD's revised criteria, which continued to include 'transparency' and 'effective exchange of information', but removed 'lack of substantial activities' and 'ring fencing'.[15] Following this revision in the OECD's criteria, a significant number of additional commitments from countries were received. In 2002 the evolving collaboration under the OECD's Global Forum produced a non-binding Model Agreement on Tax Information Exchange ('Model Agreement') setting out certain standards for the exchange of tax information and transparency.[16] In addition,

the Global Forum Joint Ad-hoc Group on Accounts developed guidance for accounting and record-keeping requirements to be used in association with the 2002 Model.[17] It should be noted that a number of countries whose commitments were not made until, or after, late 2001 do not accept the OECD Tax Information Exchange Agreement model as being an 'international standard', as they were not parties to the development of the model.

Competition Among Financial Centres

Financial centres, both 'onshore' and 'offshore', compete with each other to attract flows of money. One of the factors which influences these flows, and which in a sense therefore both defines and links so-called 'onshore' and 'offshore' jurisdictions, relates to regulatory regimes. As noted by Wise:

> … [i]n an age of instant telecommunications, insularity is not determined by geography. Today, offshore banking centers are not necessarily physical islands set off by the oceans; rather, they are islands surrounded by a sea of regulation.[18]

That is not to say that so-called offshore centres are unregulated. Rather, as Rawlings has noted,[19] they are indeed regulated, but often in a manner which differs from that of the 'onshore' regulators, offering more efficient and competitive alternatives to the users of international financial systems.

Regulatory regimes can both attract and repel international financial flows. By way of example, a contributing factor in the initial development of the so-called offshore financial centres (OFCs) in the Bahamas and the Cayman Islands can be linked to the early efforts of the USA to defend the Bretton Woods system, a dollar-centric global geopolitical economy within a bounded national financial regulatory framework. The Interest Equalisation Tax (IET) imposed by the USA in 1963 as a capital control measure similarly had the effect of stimulating the rapid growth of the eurocurrency system. Banks in London realised that they were able to lend US dollars globally at lower rates than banks in the USA; as a result they established branches in the Caribbean financial centres and elsewhere. This allowed them to operate free of exchange controls and interest rate ceilings, and meant that their infrastructural costs were lower than those of banks based in London. They also benefited from the convenience of being in the same time zone as many of their clients. US banks soon followed suit; the total number of overseas branches of US banks rose from 180 to 732 between 1965 and 1975, with the Caribbean financial centres' component increasing from five to 164 over the same period.[20] It may thus be argued that under the law of unintended consequences, the IET capital controls largely shaped the emergence of modern international finance and the so-called OFCs in the mid-1960s. As observed by Aliber:

> … [B]anks did not invent the euromarket, governments created it by seeking to control the natural flow of money.[21]

Edwards adds:

> … [T]he remarkable development of offshore dollar banking is at bottom a history of regulatory myopia, together with a good bit of regulatory mismanagement.[22]

Capital Mobility

The control of mobile financial services was a major focus of the OECD's 1998 report. The general global decrease in restrictions on cross-border capital movement stimulated by the relaxation of capital controls in the 1970s, coupled with improvements in telecommunications, produced a marked increase in the mobility of capital. The dynamic economic activity brought about by this increase in capital mobility, together with a perpetual search for profits, helped to develop new monies which were detached from national spaces – so called 'stateless monies' – the regulation of which was in tension with the existing state-centric geo-regulatory frameworks. Such 'stateless monies' challenged existing territorial regulation as the organising principle of the modern international political economy. As Leyshon has noted:

> … [T]here emerged for the first time an essentially de-territorialized economic phenomenon, which possessed a logic and a dynamic completely at odds with the national-centric order of the international regulatory system.[23]

The natural response of state-based regulators was to attempt to establish control over this economic phenomenon of new monies in order to force the genie back into the bottle and bring it under their control.

Market Efficiency

It may be argued, and indeed it has been accepted by the OECD, that one of the main historic benefits of the so-called OFCs is the way in which they facilitate commerce by creating market efficiency and liquidity.[24] It may further be argued that without the competitive pressures brought about by the non-OECD financial centres, the global markets would exhibit higher potential credit costs, other pricing inefficiencies and general illiquidity. Nonetheless, by the late 1990s the OECD member countries had come to view this set of market efficiency advantages provided to the global markets as being more than offset by a perceived threat to their existing positions.

> Tax havens generally rely on the existing global financial infrastructure and have traditionally facilitated capital flows and improved financial market liquidity. Now that the non-haven countries have liberalized and de-regulated their financial markets, any potential benefits brought about by tax havens in this connection are more than offset by their adverse tax effects.[25]

It should be noted, however, albeit in retrospect, that the available literature indicates that while tax rates and tax rate differentials may affect some investment decisions, there is little if any good evidence to support the conclusion that the activities of the small and developing nations targeted in the OECD exercise pose a threat to the tax bases of the OECD countries.[26]

Global Competition and Regulatory Response

It is useful at this juncture to recall that as a result of the 1959 treaty extensions to the 1945 treaty between UK and the USA, many of the small and developing countries in the Caribbean which were former UK colonies were included in the treaty network. However, these treaty extension agreements, which included provisions for the exchange of tax information, were terminated, in many instances unilaterally, by the USA around 1983.[27] In order to counteract the double taxation which resulted from the cancellation of the treaties, many small and developing countries in the Caribbean found it necessary to change their income tax systems to exempt non-resident income in order to prevent double taxation of such income, which would ultimately have stifled inward investment. It may thus be argued that the 'onshore' regulatory measure of unilaterally cancelling treaties was a root cause of the lack of tax information exchange which the OECD countries later complained of. It is arguable that had the 1980s approach been one of modifying treaties to prevent abuse, rather than cancelling them, then many of the problems later perceived by the OECD might never have arisen.[28]

By the late 1990s, the OFCs had grown to constitute a significant part of the new economic geography. This development of the OFCs corresponds to the global transition from a modern to a postmodern geopolitical economy in which the mobility of capital and its new geography challenges the state-territorial organisation of traditional regulatory space and power.

The resulting global competition to control this new geography – involving so-called 'stateless monies' – has led to the emergence of new regulatory regimes. Established economies, threatened by the potential loss of existing business and/or potential future business growth, may feel compelled to modify their regulatory requirements to secure their own interests. They may also respond by influencing or collaborating with other established economies to coordinate regulation or to form cartels in order to modify the regulatory regimes of others.[29] Wise has noted that in their attempts to regain control when regulations were undermined, the policy-makers are faced with two choices:

> … [E]ither they must seek to mitigate regulations in the direction of conditions existing in the external market, or, conversely, they must seek to gain control over the external market.[30]

By way of example, the USA's regulatory response to the burgeoning eurodollar market resulting from its IET may be viewed as consistent with the strategies suggested by Wise. It first sought to mitigate regulation to attract the dollars back onshore by enhancing the

competitiveness of US onshore banking; second, it sought to regulate offshore jurisdictions by applying US legal power extraterritorially in the offshore jurisdictions.[31]

As has been further noted by O'Brien:

> Financial market regulators no longer hold full sway over their regulatory territory: that is rules no longer apply to specific geographic frameworks, such as nation-states or other typical regulatory jurisdictional territories.[32]

Seen in this context, it should come as no surprise that in response to perceived or anticipated competitive threats coming from OFCs, 'onshore' authorities have sought to coordinate their efforts to assert extraterritorial control. As noted by the OECD's Jeffrey Owens in relation to the Harmful Tax Competition Initiative:

> We needed to encourage jurisdictions to come to the table. Our Member countries thought long and hard on what would be the most effective approach and concluded, as did the FATF, that we needed deadlines and a distinction to be made between cooperative and uncooperative jurisdictions.[33]

It was also arguably important to encourage those approaching 'the table' to do so with a certain posture of supplication. The result was the adoption of threats of 'blacklists' and other economic 'defensive measures' as a means of expanding control over regulatory territory.

Democratic Deficit

The action of effecting changes in the legal and regulatory framework of individual nation states without the input of the citizens of that nation state, or with a lack of representation from the democratic base of the nation state itself, arguably creates a 'democratic deficit' which taints the outcome and is likely to render it inherently unstable.

William Wechsler, a former senior US official writing in 2002 about the US strategic approach to extra-territorial regulatory control in the late 1990s, stated:

> The strategy also had to recognize the limits of traditional law-enforcement and regulatory channels as well as the relative ineffectiveness of previous diplomatic efforts. Furthermore, any strategy had to be global and multilateral, since unilateral actions would only drive dirty money to the world's other major financial centers. Yet Washington could not afford to take the 'bottom-up' approach of seeking a global consensus before taking action; if the debate were brought to the UN General Assembly, for example, nations with under-regulated financial regimes would easily outvote those with a commitment to strong international standards. Finally, the strategy had to be politically tenable, given the varied U.S. interests in many nations with underregulated financial sectors.[34]

It is perhaps worthy of note in this context that a subsequent objective assessment by the OECD's sister organisation, the FATF, has cast some doubt on claims of strong regula-

tory standards on the parts of those at the 'top'.[35] In addition the IMF Financial Centre Assessment Report noted that the so-called 'off-shore' financial centres were 'more favourably' regulated.[36]

This approach, described by Wechsler, of 'top-down' implementation, rather than seeking to achieve global consensus, and of only targeting countries which have relatively little geo-political influence, is consistent with what Keohane and Nye have referred to as the 'club model' of global governance.[37] In the club model, agencies of dominant governments (to the exclusion of other governments) work in a coordinated fashion to establish and promulgate rules, standards of practice and intended norms.

In the early phases of the Harmful Tax Competition Initiative, the small and developing non-member countries which were selected for potential 'blacklisting' were arguably not allowed any meaningful input into the process which resulted in them being placed on the blacklist. Indeed, the countries which were threatened with 'listing' were identified prior to the formal listing by the OECD, in effect creating a separate blacklist which anticipated the subsequent list.[38] It is arguable that a foreseeable consequence of this type of 'top-down' strategy would be to disrupt the economies of the small and developing countries which were targeted and force them to concentrate their limited resources on taking steps to have their countries removed from the blacklist rather than on maintaining any competitive advantage. In addition, the spawning of derivative individual country blacklists by adherents of the strategy arguably created further disadvantages for the targeted countries.[39]

The damage done to the economies of countries targeted by both the OECD's list and individual countries' lists remains a concern for many of the countries listed.[40] The economies of these small nations have suffered immense consequences as a result of being blacklisted by the OECD.[41] The constructive dialogue which has developed in the Initiative in the last few years has, however, offered the possibility of some relief for the countries originally listed. Indeed, it has now been acknowledged by the OECD that the information on which its 2000 list was based has been superseded by information set out in the 2006 Assessment.[42]