

**TAX HAVENS: An Analysis of the OECD Work with Policy
Recommendations.**

Aloisio Almeida
Ford School of Public Policy
April 2004

Contents

Introduction

1. The OECD Work on Tax Havens

- 1.1 Overview
- 1.2 The OECD Arguments against Tax Havens
- 1.3 The OECD Criteria to Identify Tax Havens
- 1.4 Applying the Criteria

2. Analysis of the OECD Framework

- 2.1 Comments on OECD Arguments and Criteria
- 2.2 Are Tax Havens a Relevant Issue?
 - 2.2.1 Are Tax Havens Harmful or just Fair Competitors?
 - 2.2.2 How Much Harm Can Tax Havens Impose on OECD Countries?
- 2.3 Has the OECD Strategy Been Effective?

3. Policy Alternatives

- 3.1 Unilateral Defensive Measures
- 3.2 Bilateral Agreements
- 3.3 The OECD as the Negotiator

Conclusion and Recommendations

Introduction

According to the Organization for Economic Cooperation and Development (OECD)¹, international tax competition is lowering tax rates and making government expenditure more efficient worldwide. However, the OECD also reported that some countries have introduced harmful tax practices that encourage noncompliance with the tax laws of other countries. The OECD defines two types of harmful tax practices: preference regimes and tax havens. This paper focuses on the OECD work on tax havens. It introduces the OECD arguments and its criteria for the identification of tax havens and provides an evaluation of whether arguments, criteria are consistent. It argues if lack of transparency more than low tax rates is what makes the issue critical to OECD countries. It evaluates three policy alternatives that OECD member countries could adopt to avoid tax havens' unwillingness to exchange information: unilateral defensive measures, bilateral and multilateral approaches. In conclusion, it recommends a multilateral solution to a sustainable long-run cooperation.

1. The OECD Work on Tax Havens

1.1 Overview

Globalization is reducing trade barriers and increasing capital flows among countries. The availability of great amounts of mobile capital represents a distinguished opportunity for many countries to attract investors. The OECD asserts countries make adjustments in

¹ "The OECD 1998 Report on Harmful Tax Practices". Available at www.oecd.org/dataoecd/60/28/2664438.pdf. site visited on April 08, 2004.

their tax systems for this purpose². Whenever these adjustments were supposed to foster competition and economic efficiency, the OECD offers no opposition. However, when countries adopt aggressive tax policies that can certainly disrupt other countries, they should be seen as harmful. The *OECD 1998 Report on Harmful Tax Practices* described this situation as follows:

“...globalization has, however, also the negative effects of opening up new ways by which companies and individuals can minimize and avoid taxes and in which countries can exploit these new opportunities by developing tax policies aimed primarily at diverting financial and other geographically mobile capital.”

In the same report, the OECD set the principles and the strategy designed to guide a project to eliminate harmful tax practices worldwide. The initial report established the criteria for identification of tax havens, the agenda for future work and several recommendations to OECD members regarding defensive measures, dialogue policy, treaties and other issues. The project has been followed up by three other OECD progress reports in the years 2000, 2001 and 2004. In the year 2000, the OECD issued the first list of jurisdictions that were considered to be tax havens. This list has been updated ever since. In addition, the OECD has invited all those jurisdictions to commit on the elimination of their harmful tax practices. Today, 33 jurisdictions have signed commitments to cooperate while there are still five uncooperative jurisdictions. Table 1 (below) reproduces the current list of cooperative and non-cooperative jurisdictions.

Table 1A: The Five Non-cooperative Jurisdictions.

Andorra	Liberia	Principality of Liechtenstein	Principality of Monaco	Marshall Islands
---------	---------	-------------------------------	------------------------	------------------

² In “Are Corporate Taxes, or Countries, Converging?” Slemrod argues if tax rates convergence is a matter of international tax competition or a result of domestic pressures.

Table 1B: The 33 Jurisdictions Committed to Improving Transparency and Establishing Effective Exchange of Information in Tax Matters.³

Anguilla	Antigua and Barbuda	Aruba	Bahamas	Bahrain	Belize
Bermuda	British Virgin Islands	Cayman Islands	Cook Islands	Cyprus	Dominica
Gibraltar	Grenada	Guernsey	Isle of Man	Jersey	Malta
Mauritius	Montserrat	Nauru	Netherlands Antilles	Niue	Panama
Samoa	St. Christopher & Nevis	St. Lucia	San Marino	Seychelles	St. Vincent and the Grenadines
Turks & Caicos Islands	US Virgin Islands	Vanatu			

1.2. The OECD Arguments against Tax Havens

The OECD has put forth the following main arguments concerning tax haven' practices:

- a) They can erode national tax bases of other countries;
- b) They may alter the structure of taxation by shifting part of the tax burden from mobile to relatively immobile factors and from income to consumption;
- c) They can discourage compliance by taxpayers and increase the administrative costs of enforcement; and
- d) They may hamper the application of progressive tax rates and the achievement of redistributive goals.

The OECD considers that these pressures on tax systems apply to both business income in the corporate sector and to personal investment income. The logic underlying OECD's arguments may be summarized as follows: when a jurisdiction applies no or only nominal taxes on income (business or personal), residents of a non-haven country may divert their

³ Source: http://www.oecd.org/document/39/0,2340,en_2649_33745_30572135_1_1_1_37427.00.html.

“The OECD has determined that three other jurisdictions - Barbados, Maldives, and Tonga - identified in the 2000 Progress Report as tax havens should not be included in the List of Uncooperative Tax Havens. Barbados will not be included in the list because it has longstanding information exchange arrangements with other countries, which are found by its treaty partners to operate in an effective manner. Barbados is also willing to enter into tax information exchange arrangements with those OECD Member countries with which it currently does not have such arrangements. Barbados has in place established procedures with respect to transparency. Moreover, recent legislative changes made by Barbados have enhanced the transparency of its tax and regulatory rules. The OECD has determined after careful review of the current laws and practices of Tonga and the Maldives that these jurisdictions do not meet the tax haven criteria.”

investments and be free riders of the public goods available in their home countries.⁴ As a result, non-havens' base for taxation shrinks and, in order to keep up revenues, governments feel tempted to shift the tax burden from mobile to immobile factors such as labor, consumption and property. Consequently, progressivity and redistribution are both undermined.

The OECD also argues that tax havens can distort financial and, indirectly, real investment flows, and induce distortions in the pattern of trade and global welfare. Presumably, the rationale here is that tax havens may lack substance to drive up investment to higher output levels and net exports than a non-haven country with a numerous labor force and a strong business sector. They harbor great amounts of financial capital but it is arguable whether real capital flows accordingly, since they are usually small islands with limited resources. Truly, most people suspect that financial capital inflows in tax havens hide illegal transactions such as, for example, money-laundering and even terrorism.⁵ The recent news about the Parmalat financial scandal⁶ in its Cayman Island subsidiary gives some support to this idea. However, solid empirical evidence is hard to find since secrecy is one of the key strategies used by tax havens.

⁴ Tax havens residents are also seen as free riders of the public goods of neighbor countries since these are key factors to generate income.

⁵ See Cohen, Adam. "Banking on Secrecy". Time. New York. Oct 22, 2001. pp 73-75.

⁶ Cayman Net News in "Cayman Islands probe into Parmalat one of many around the world", February 10, 2004, available at www.caymannetnews.com/2004/02/589/probe.shtml.

1.3 The OECD Criteria to Identify Tax Havens

The OECD has defined four factors for the identification of tax havens⁷: No or only nominal taxes, lack of effective exchange of information, lack of transparency and no substantial activities.

a) No or only nominal taxes – it means that there is no or nominal tax on the relevant income, usually capital. This is the first necessary condition to identify a tax haven but it is not sufficient because a country may be competing fairly or adopting a preferential regime.

b) 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.

c) Lack of transparency - e.g. the details of the regime and/or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure. Lack of transparency may be attractive for those who want to hide the origins of their income or keep them undeclared in their source countries; and

d) No substantial activities - the jurisdiction facilitates the establishment of foreign owned entities without the need for a local substantive presence. This is what makes doubtful how small islands can host billions of dollars in foreign direct investment if they apparently do not have the necessary resources to yield production

⁷ Extracted from “The OECD 1998 Report on Harmful Tax Practices”.

To be included in the OECD list of tax havens, a jurisdiction must present all these factors. Yet, as a principle, the OECD states that if a country offers itself as a place, or is perceived to be a place, to be used by non-residents to escape tax in their country of residence, it should be a tax haven.

1.4 Applying the Criteria

When applying these criteria, the OECD Forum based its conclusions on a factual review of jurisdictions that appeared to have the potential for satisfying them.⁸ This is what the Forum reported:

“...Starting from published sources, the Forum identified an initial grouping of 47 such jurisdictions. These jurisdictions were asked to submit information pertinent to the application of the tax haven criteria in the context of their facts and circumstances. The Forum examined, discussed, and reviewed this information, using a series of bilateral contacts (under the auspices of small Study Groups comprised of Forum members) and through multilateral consultations with the Forum itself. The Study Groups prepared factual jurisdiction reports with input from, and in many cases agreement by, the jurisdictions as to the factual accuracy of the reports. In these contacts and consultations, the full participation of each jurisdiction was invited and encouraged.”

Recently, the OECD has abandoned the “no substantial activities” factor. It has pointed out that it is very difficult to define whether a country lacks substantial activities.⁹ Thus, only the “no or only nominal taxes” and the information factors remained as important to identify tax havens.

⁸ The OECD 2000 Progress Report on Harmful Tax Practices. Available electronically at website www.oecd.org. consulted in April 08, 2004

⁹ The OECD 2001 Progress Report on Harmful Tax Practices. Available electronically at website www.oecd.org. consulted in April 08, 2004.

2. Analysis of the OECD Framework

Based on the OECD work on tax havens, this section investigates whether tax havens are (or not) a relevant issue, why one can see them as harmful and, if so, how much harm they can impose on OECD countries. Finally, it evaluates the OECD strategy concerning tax havens to conclude it is on the way to achieve its goal.

2.1 Comments on OECD arguments and Criteria

Contrasting the OECD criteria and its arguments, one can argue whether they are directly related. While the former are based on the nature of tax havens practices, the latter focuses on the consequences on other countries, which are hard to measure. It is remarkable, though, that the OECD has included lack of effective exchange of information and lack of transparency in its criteria and has asked tax havens to commit on the elimination of both. Interestingly, there is no requirement to commit on the ban of low tax rates. Does this suggest that the OECD sees more harm on the ability of tax havens to hide information than in any other practice? This discussion continues along the next sections.

2.2 Are Tax Havens a Relevant Issue?

The lack of empirical evidence specifically denoted to tax havens makes it difficult to answer to this question. Yet, most of the material available for analysis was found in the research dedicated to tax competition. This question is key to understand if the OECD has raised the issue appropriately since there is some criticism mainly from the claimants

of assets protection. In order to find the answer, first it is argued what is harmful on tax havens practices and, second, if any harm exists, it is asked what the length of it is.

2.2.1 Are Tax Havens Harmful or just Fair Competitors?

For some people, tax havens help keep tax rates down and, therefore, are legitimate tax competitors. They are seen as legal offshore instruments to provide assets protection from governments' abuses or even confiscation. According to Cohen,¹⁰ this was the argument that officials from the banking-industry-friendly Center for Freedom and Prosperity made to convince the early Bush administration to stay out of the OECD's campaign against tax havens. The events of September 11th, however, brought the anti-money laundering issue back to life.

It is very hard to draw the line between fair and unfair competition. Looking back at the OECD's arguments against tax havens, most of them are addressed extensively in the literature regarding tax competition, which the OECD admits can be also fair. Moreover, if a country has had its tax base eroded, how is it possible to know if this is a result of fair international tax competition, domestic pressures or tax havens practices? Slemrod (2000) assures that no empirical evidence on it was found. Also, if we consider that tax havens are sovereign jurisdictions, why cannot they fix their own tax regimes? Even the OECD recognizes that every country has the right to set its own tax policy. If tax havens apply no tax on foreign investment and this makes non-havens worse off, there is still no reason to assert this is unfair because it can also benefit investors and reduce the inefficiencies associated to taxes that, in most cases, occur.

¹⁰ See Cohen, Adam. "Banking on Secrecy". Time. New York. Oct 22, 2001. pp 73-75.

Following this reasoning, the Switzerland government has stated the following about the

OECD 1998 Report:

“The Report recognizes that each State has sovereignty over its tax system and that levels of taxation can differ from one State to another. However, that same Report presents the fact that tax rates are lower in one country than in another as a criterion to identifying harmful preferential tax regimes. This results in unacceptable protection of countries with high levels of taxation, which is, moreover, contrary to the economic philosophy of the OECD.”

However, there is one issue that deserves attention. Tax havens deny information that is important to other countries to unveil criminals. Anonymity is an essential condition on their practices. The Cayman Islands’ rules, for example, explicitly state that any requirement for information about tax evasion from another country shall be denied. This is an ideal situation for terrorists and drug criminals to park money out of sight. Even if without concrete proofs on it, lack of transparency is potentially bad for the majority of the world population. In other words, if for the sake of a few ones who keep assets in tax havens a big part of the world population has to pay the price for terrorism, money laundering and crime, then jurisdictions that hide information that could be used to track the origins of dirty money shall be seen as harmful. In this sense, the campaign against tax havens should be extended to involve all lack of transparency in the world banking system.

In sum, if the OECD arguments are controversial and provide no shelter to fight against low-tax rates regimes, countries should have at least one strong reason to deter tax havens’ lack of transparency: because they can hide information that could be useful to prevent crime and by doing it they impose a cost on the rest of the world.

2.2.2 How Much Harm Can Tax Havens Impose on OECD Countries?

Accepting the idea that tax havens are potentially harmful the question is how to evaluate the extension of this harm? The OECD reports say tax havens can have a large impact on the tax bases of other countries but those reports never show this in numbers. The literature is also vague in respect to tax havens. Thus, if tax havens are harmful it is necessary to investigate if their effects in foreign tax systems are large or small.

According to OECD arguments, tax havens are harmful because they can erode other countries' tax bases and move the tax burden to immobile factors such as labor and property. If tax havens' harmful practices were supposed to degrade other countries' tax systems, this is not happening on a global scale. Genschel,¹¹ based on OECD data, concluded that tax revenues, on average and in many countries, are not declining but still increasing. He also concluded that the capital income tax base has not been eroded and the effective tax rates on corporate income have increased slightly since 1970. A recent study by the OECD shows that taxes on labor are falling in most of the OECD countries, though in some countries such as Turkey and Iceland, tax wedges have increased over the last seven years.

Genschel shows that there is neither sharp fall in effective tax rates nor total revenues in the period of 1970-1999. This means that at least in OECD countries as a whole, tax havens practices impact on the total tax base, if any, could not undermine the ability of governments to collect taxes. What is still unknown, and need more research, is if this

¹¹ Genschel, P. "Globalization, Tax Competition, and the Fiscal Viability of the Welfare State". Max Planck Institute. May, 2001.

pattern happened because OECD countries' domestic tax policies were effective or if tax havens effects were insignificant. It is also unknown if tax havens could affect the tax systems of only particular OECD member countries and their effects in non-members states.

Also, there is no empirical evidence of a race to the bottom in effective capital tax rates. Hays (2003) evaluates the hypothesis of capital taxes rates converging to the middle but he also states that some countries might be able to compete for mobile capital despite high rates of taxation. Garret(1998) concludes that international capital flows are unrelated to total revenues or personal income, consumption or corporate taxes as shares of GDP in developed capitalist democracies. Garret explains that public infrastructure and other public goods are attractive to international capital. Slemrod (2001) found a strong tendency for both statutory and corporate rates to regress toward the mean. Yet, he was unable to find direct evidence that international competitive pressures exert a large influence on them.

Grubert and Mutti (2000) have different opinions. They say tax systems exert a highly significant effect on the choice of US corporations for locations. They argue that FDI is an inappropriate measure of real investment because they may simply represent financing or repatriation behavior. Instead, they suggest the use of the stock of capital and cost of capital as key variables in their model. About tax havens, they suggest that tax havens' investors likely use real capital in branches somewhere else.

Hence, the literature does not clarify the question of how much harm tax havens impose on the tax bases of other countries. Nevertheless, it is possible to check an indicator of their prominence. For example, the OECD has argued that FDI in low-tax jurisdictions in the Caribbean and the Pacific more than five-fold from 1985 to 1994. Yet, it is also true that globalization has made FDI flows increase in other parts of the world. In order to give an idea of how much investment was driven to in tax havens and compare this to the levels of investment in the rest of the world, the table below condensed relevant FDI data collected from the United Nations Conference on Trade and Development (UNCTAD) website¹².

Table 2: FDI inflows in millions of dollars.

YEAR	Avg. (A)	Avg. (B)	% (B-A)/A
COUNTRY/GROUP	85-89	90-94	
World	128,048	203,172	59%
Developed countries	105,064	134,636	28%
Tax Havens *	1,232	2,898	135%
China	2,487	16,062	546%
United States	48,759	37,240	-24%

* These are Panama, Gibraltar, Malta, Netherlands Antilles, Cayman Islands, British Virgin Islands, Bermuda, Belize, Bahamas, Aruba, Antigua and Barbuda.

Source: UNCTAD *World Investment Report 2000*

The numbers show that the rate of FDI inflows to tax havens increased more than the world and the developed countries' average, but less than the rate in China. In relative terms, FDI inflows to tax havens are only 2.1% of the level in developed countries and only 1.4% of the world. These numbers suggest that Garret and Hayes conclusions that there may be other factors that influence decisions on capital investment is true since

¹² Available at <http://www.unctad.org/Templates/StartPage.asp?intItemID=2068>. Site visited on April 22,2004.

China and developed countries were able to attract large amounts of capital despite their tax regimes. However, the increase in the FDI to tax havens also suggests that Grubert and Mutti may be true. Given the small percent of the world investment in tax havens and the increase in the levels of FDI inflows to developed countries, it is arguable if tax havens can exert a large influence on tax systems of OECD members.

Another important aspect of this question appears if we look at to what extent are tax havens connected with money laundering, crime and terror. This time, there could be a large cost to the rest of the world, given the losses in terrorist attacks and criminal activities. There are costs in terms of loss of lives as, for example, the Victim Compensation Fund that was created to compensate the families of people who were killed in the September 11th tragedy is about to cost between \$3 to \$5 billion dollars to American taxpayers. There are costs to business as, for instance, in the Parmalat scandal, a loss of more than 10 billion dollars is supposed to be impinged on creditors.¹³ However, none of these costs are related to the OECD arguments against harmful tax practices. Still, these are potentially huge costs though further research is needed to estimate them.

In conclusion, it is arguable if tax havens degrade or could degrade the tax systems of OECD countries. Yet, it is quite clear that hidden information on tax havens is potentially used for criminal activities and this is where the big cost is. If the OECD based its decision to campaign against tax havens on the idea of potential harm of lack of transparency and prevention of unfortunate consequences, then it makes sense to have the

¹³ Cayman Net News in “Cayman Islands probe into Parmalat one of many around the world”, February 10, 2004, available at www.caymannetnews.com/2004/02/589/probe.shtml .

issue included in its agenda with high priority. Remember that the IRS has estimated a 70 billion loss in taxes due to undeclared income hidden in tax havens; that the Cayman islands, with population of 35,000, holds more than \$800 billion in deposits; that according to the US State Department tax havens harbor more than \$ 5 trillion and their connections to illegal activities is at least probable;¹⁴ that terrorism is threaten people now more than ever. Clearly, OECD decision-makers could not look apathetically at these facts. Thus, even if research is inconclusive about tax havens harmful practices, the strategy adopted by the OECD that focuses on dialogue and transparency makes sense.

2.3 Has the OECD Strategy Been Effective?

The OECD has listed 38 jurisdictions as tax havens (see Appendix A). As mentioned, 33 jurisdictions have made public commitments to eliminate their harmful tax practices by 31 December 2005 and there are only five non-cooperative jurisdictions. By now, with 87% adherence, this process is on the way to achieve its goal, and probably the committed countries would not change behavior if the OECD has not pressured them to do it. Interestingly, the OECD is neither bargaining not threatening, which is remarkable. In other words, 33 jurisdictions agreed to change the behavior that was according to their domestic priorities in face of an external stimulus. However, 13% of jurisdictions remain non-cooperative and the OECD has not signaled with any sanctions yet.

The OECD strategy deserves closer attention. By simply including a jurisdiction on list of non-cooperative tax haven, the OECD may have imposed a high cost for business in most

¹⁴ These data come from Owens, J. "The OECD work on Tax Havens". The Friedrich Ebert Foundation Conference on "Money Laundering and Tax Havens - The Hidden Billions for Development". July 8 - 9, 2002.

jurisdictions, probably due to the risk of retaliation by any OECD member. Another issue is that the exclusion of the fourth factor (substantial activities) from the criteria for identification of tax havens was not as critical. Our analysis of the potential harm from tax havens suggests that the key issue is information, that is, it is important to the OECD members to have access to information hidden in tax havens whenever necessary to counteract illicit practices. In fact, the focus of the OECD work now is to develop an instrument that will provide a legal framework for effective exchange of information and at the same time preserve the confidentiality of taxpayers, preventing the use of information for unauthorized purposes. On the other hand, there is no mention in any of the OECD reports of proposals to make tax havens adopt different tax rates.

If all countries commit and behave accordingly, the issue might be solved. However, some points should be considered:

- Whether the criteria and the subsequent list really included all tax havens in the world is a good question. Indeed, not every country agrees with the OECD list and criteria. Brazil, though not an OECD member, adopts its own list of 54 jurisdictions;
- Only after December 2005 it will be possible to reevaluate tax havens' compliance; For now, the issue is following its course;
- The OECD is negotiating with the five uncommitted jurisdictions and there is still room to do it till December 2005. Yet, if these jurisdictions keep their status without any sanctions, the credibility of the whole project can be undermined.

Thus, even if the OECD arguments against tax havens seem not convincing and even if the criteria are subject to some criticism, the strategy has performed well because most jurisdictions have committed and the path for more transparency and cooperation in the international capital market is being paved. Yet, we should wait till 2006 to start watching the results. The key point is whether the OECD will have the autonomy to impose sanctions whenever it is necessary.

3. Policy Alternatives

In respect to tax havens, we can think about three policy alternatives that OECD members can adopt. Imagine the following scenario: after December 2005, all tax havens are committed to exchange information with OECD countries but some of them may feel a great incentive to cheat. If a tax haven does not comply, what are the alternatives for OECD member countries? First, each country can act unilaterally with defensive measures. Second, they can try a bilateral agreement with the rebel tax haven. Third, they can allow the OECD to speak for them with only one voice. In order to compare these alternatives it is useful to assume that tax havens are initially better off with non-transparency and the rule for cooperation is as suggested by Rodrik:

“Hence, for cooperation to be sustainable, the short-term benefits of defection must be small, the discount rate low, and the future benefits from cooperation high”

3.1 – Unilateral Defensive Measures

A bunch of defensive measures can be used to counteract harmful tax practices and the OECD has recommended their use under certain circumstances. The most relevant are Controlled Foreign Corporations (CFC) rules. The use of CFC means that a country

assumes that corporation income is in the hands of its resident shareholders who are taxed accordingly to this country's rules.

If a tax haven is non-transparent and if an OECD member makes use of CFC to avoid loss in tax revenues, the following should be considered:

- Assuming this measure is effective, it might have some influence on the evader's behavior but, unless under very particular conditions (for example, the country is the major and most significant supplier of investors to the tax haven), it will neither make short-term benefits of defection small (or costs high) nor the future benefits from cooperation high. The tax haven is still better off with defection because one country alone cannot change the tax haven's level of foreign investment;
- Because the issue is lack of transparency, it is very hard for the source country to figure out what the effective income really is. The tax base cannot be determined precisely without the tax haven's cooperation. Of course, the country can use presumptive higher tax rates but this may lead to a high efficiency cost to its economy;
- By taxing its residents, the non-haven country may be in competitive disadvantage if other countries do not do the same;
- This measure can both raise compliance and administrative costs, making the tax system more complex.

The obvious advantage of this policy is that it is easier to adopt since it is unilateral and does not require other OECD members to agree on it.

For similar reasons, other defensive measures¹⁵ included in the OECD 1998 report would fail. In order to impose a high short-term cost on tax havens so that it would be inclined to cooperate, a country would have to further defensive measures to do more harm. Some examples are a threat on trade sanction, a real trade sanction, and a military action.

These measures would follow sequentially till cooperation is achieved. Of course, the last one is extreme and would require a lot of conditions that are rarely achieved. As previously evaluated, since tax havens harm to OECD countries is unclear, it is arguable whether countries would be willing to adopt radical measures. Also, depending on the volume of trade between the tax haven and the harmed country, defensive measures related to trade sanctions could be more or less effective.

3.2 Bilateral Agreement

Since a tax haven is better off with non-cooperation, a bilateral agreement would work if the source country can offer a benefit greater than the incentive tax havens may have to cheat. For example, if the agreement is between the jurisdiction and its main country (for example, the British Virgin Islands and Britain), the cost of non-cooperation for a tax haven may be high. It might be the case that Britain provides some public goods for its colonies as, for instance, safety against a foreign invasion, that a tax haven would not be willing to dispense.

¹⁵ These are foreign investment fund rules, restrictions in foreign income participation, reporting of international transactions by taxpayers, and transfer pricing rules.

However, for most OECD countries, this policy would not work. Not every country can offer a tax haven benefits greater than their incentives to remain non-transparent regarding their tax records.

3.3 The OECD as the Negotiator

In this case, countries would give to the OECD the power to negotiate. One disadvantage is that sovereign states would resign their particular interests and obey the conditions of an agreement. Another disadvantage is that countries would have to wait until other OECD members decide on their prior questions and be subject to the distribution of power within that organization. Powerful countries would have more weight on decisions. If, for example, the US or the EU opposes the clauses that tax havens would obey, then an agreement will likely fail.

Despite these cons, this policy would extend the experience reported in this paper, which is on the way to effectiveness. Moreover, where the other alternatives fail, it can succeed. In dealing with tax havens, the OECD, more than isolated countries, can impose on them a high cost for non-compliance if its key members (the US, the EU and Japan) act with only one voice. It can discourage tax havens cheating by making all members adopt the same defensive measure and thus isolating the rebel tax haven from the international community. For example, if all OECD members impose an extra tax in all transactions with a certain tax haven, this might divert key investors to other choices. Consequently, investment on the defective tax haven may shrink till the point it disrupts its economy, and the tax haven would face a cost higher than the benefit of compliance would be. The use of other measures such as CFC and ultimately trade sanctions tend to be more

effective if adopted in a coordinated and massive way. However, till now, the OECD has not been coercive. To change this, member countries' leaders must support a change in the organization behavior based on certain conditions.

There is also another reason for a multilateral approach. If the issue is lack of transparency and lack of effective exchange of information, then the benefits for OECD member countries if they join a multilateral agreement are greater than if they try to act by themselves. First, there would be only one framework for exchanging information, reducing the administrative costs of all countries. Second, the other alternatives perform poorly. Unilateral measures would not improve transparency, as already discussed. Bilateral agreements would sponsor many frameworks and it would be hard for a member country to access the information that other member has. Thus, in the hypothesis of only one framework, access to information can be easier, less expensive, and member countries could also exchange information among themselves.

In conclusion, the multilateral solution using the OECD is the one that will bring the biggest benefit to member states. It would, however, cost to them the resignation to the decisions adopted in the external forum. Powerful economies such as the US, the EU and Japan must agree in order to make this policy successful. They must weigh the costs they face with that lack of transparency (and consequently its potential links with crime and terrorism) against the cost of their resignation to OECD decisions (which may include the political cost of domestic resistance) in order to take a decision.

Conclusion and Recommendations

The OECD has collected the commitment of most of the listed jurisdictions to eliminate tax havens practices. Though it is difficult to distinguish between tax competition and harmful practices, the OECD strategy to deal with tax havens enabled officials to set up a list of jurisdictions that were perceived as tax havens. Until now, most jurisdictions are committed to exchange information, which is key to prevent criminal practices and terrorism worldwide. Tax havens are not committed to raise their tax rates but no general degradation of OECD countries' tax systems could be observed.

In terms of policies, it is recommended that after December 2005, the OECD extends its power to negotiate an agreement with all tax havens. While unilateral defensive measures seem ineffective in most cases and bilateral agreements unfeasible in many situations, the multilateral approach offers the real possibility of effectiveness in achieving more transparency on transactions involving tax havens. It should be noted, however, that the OECD role could be undermined if key powerful members oppose cooperation. It is recommended that more research address the benefits that more transparency in the international capital market can bring to the fight against terrorism and crime. If this is emphasized then opposition shall be minimized. With regard to those current non-cooperative jurisdictions, it is recommended that the OECD carry on attempts to obtain their commitment till December 2005 and that powerful states support the adoption of proposed sanctions after that.

References

Cohen, Adam. "Banking on Secrecy". Time, N.York, Oct 22, 2001.

Garrett J. and Mitchell D. "Globalization, Government Spending and Taxation in the OECD," European Journal of Political Research. 39. 2001.

Genschel, P. "Globalization, Tax Competition, and the Fiscal Viability of the Welfare State". Max Planck Institute. May, 2001.

Hayes, Jude. "Globalization and Capital Taxation in Consensus and Majoritarian Democracies". World Politics. December, 2003.

Mutti, J. and Grubert, H. "Do Taxes Influence Where U.S. Corporations Invest?" National Tax Journal Vol LIII, No. 4, Part 1. December, 2000. pp 825-840.

Rodrik, Dani., "Governance of Economic Globalization," in Joseph S. Nye and John D. Donahue (eds.), Governance in a Globalizing World.

Slemrod, Joel. "Are Corporate Tax Rates, or Countries, Converging?" in Conference on World Tax Competition. July, 2001.

The OECD 1998, 2000, and 2001 reports on Harmful Tax Practices. Available electronically at website www.oecd.org. consulted in April 08, 2004.

Tanzi, V. – "Globalization and the Work of Fiscal Termites". IMF Working Paper number 00/181.

Wilson, John D. 1999. "Theories of Tax Competition," National Tax Journal 52. June 1999.