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Offshore or 'Shorn Off'? The OECD's Harmful Tax Competition Initiative and Development in Small Island Economies

Richard Woodward[1]

The difficulties of developing and executing a sustainable development program in Small Island Economies (SIEs) are well documented. Comparatively small domestic markets, remote export markets, a dearth of natural and human resources, susceptibility to environmental change and natural disasters, plus limitations on the state's capacity to govern economic activity have narrowed the range of feasible development strategies resulting in a reliance on sectors vulnerable to the vicissitudes of the global economy (Demas 1965; Kakazu 1994; Briguglio 1995; Commonwealth Secretariat/World Bank Joint Task Force on Small States 2000: 5-19).[2] In this context 'offshore' strategies including the creation of offshore financial centres (OFCs) and Export Processing Zones (EPZs) (see Heron, this volume) were widely advocated as an effective addition to the development and diversification strategies available to SIEs. Though there are dissenting voices (see for example Maingot 1994; see also Heron, this volume, on the drawbacks of EPZs), most commentators consider that offshore financial services have 'lifted a host of small jurisdictions from the poverty of the developing world to levels of affluence few would have believed within their grasp' (Hampton & Abbott 1999b: 1). However, this benevolent attitude towards OFCs was gradually superseded by one of antagonism and hostility. Recently OFC jurisdictions have been vilified as 'parasites' (Palan & Abbott 1996) or 'pariahs' (Hampton & Christensen 2002) of the global financial community. These territories were castigated for the laxity of their regulatory and supervisory arrangements which

were held responsible for catalysing and exacerbating financial crises and facilitating criminal activity including money laundering and tax evasion. Of the 36 SIEs with OFCs, 31 have, at some point, appeared on one or more of the lists endorsed by the Financial Action Task Force (FATF), the Financial Stability Forum (FSF) or the Organisation for Economic Co-operation and Development's (OECD's) censuring them for substandard fiscal or regulatory arrangements (see Appendix 1).

The publication of these lists is indicative of efforts to develop a more intricate and inclusive international financial architecture, a central plank of which has been to ensure that OFCs comply with internationally accepted standards of regulation (FSF 2000a; IMF 2002a). Some analysts suggest this tightening of the regulatory regime has violated the conditions that made OFCs possible and profitable, leading them to temper their enthusiasm for using offshore finance as the backbone of development strategies in SIEs (Hampton & Christensen 1999, 2002; Hampton & Levi 1999; Christensen & Hampton 1999b). This chapter seeks to assess how one aspect of this tighter regulatory regime, the OECD's Harmful Tax Competition initiative, will affect development of SIEs hosting OFCs. Using a framework originally devised by Hampton (1996a) it will argue that the OECD initiative is constricting the political, fiscal, regulatory and secrecy 'spaces' needed for OFCs to prosper. Nevertheless, acknowledging that these spaces are *shrinking* is not the same as accepting they will be *closed*. Despite the understandable concerns of SIEs, the OECD project seems unlikely to lead to the collapse of offshore finance. Proponents and critics alike have overlooked the unresolved issues and tensions implicit in concluding a deal to tackle tax competition, not least wavering political support, the open hostility of corporate interests, and the inherent dynamism of financial markets.

Offshore finance - definition, development and growth

Hampton (1994: 237, 1996b: 4) defines an OFC as ‘a centre that hosts financial activities that are separated from major regulating units (states) by geography and/or by legislation’. The inducements offered by a typical OFC include no or low rates of taxation, special tax privileges for non-resident business, and a light and flexible supervisory regime. These incentives are usually complemented by labyrinthine and impenetrable secrecy laws designed to obfuscate the identity of the owners of offshore assets. Offshore financial activities are highly varied encompassing offshore banking (private banking for wealthy individuals and wholesale banking facilities for transnational corporations), offshore investment funds, offshore company formation and captive insurance (Hampton 1996b: 23-33).

Since the late 1960s offshore finance has grown rapidly. By 1998 some $5.1 trillion of assets resided offshore (Diamond and Diamond 1998 quoted in Palan 2002: 156). The likelihood is that this substantially underestimates the true extent of offshore financial activity. Existing data disregards activities taking place ‘off balance sheet’ and pays scant attention to the quantity of assets held by non-bank financial intermediaries. The overall growth in offshore finance is mirrored in SIEs. A 1975 survey listed just 11 SIEs hosting offshore financial services (Diamond & Diamond 1975). Today, 36 small island territories have a presence in the sector (see Appendix 1) with the Cayman Islands and the Bahamas now among the 15 largest international financial centres measured by the size of external banking assets (Dixon 2001).

Hampton (1996a) insists that the phenomenal growth and continuing success of OFCs is contingent upon the prevalence of four interdependent 'spaces' (political, fiscal, regulatory and secrecy) supplying international financial capital with the latitude to operate. The availability of political space is dependent upon the main political actors adopting a broadly supportive or at least passive disposition toward the conduct of offshore activity. Political space has external and internal dimensions. Elsewhere in this volume a number of authors note how small, peripheral economies are vulnerable to external changes (see chapters by Lodge & Stirton, and Sutton) Therefore, OFCs require the approval of nearby onshore authorities and the international community more generally. The tolerant attitude of the British state, for example, facilitated the rise of OFCs among its dependencies (Hampton 1996a, 1996b). A compassionate international community is equally indispensable. A determined coalition of powerful states could, if it so wished, move to curb or close down offshore centres through the imposition and enforcement of rigorous international standards. In the past political expediency negated the emergence of such an alliance, not least in recognition of the roles OFCs played as sources of cheap funding for capital importing developed nations such as the United States and in assisting development in former colonies (Strange 1998). Internally, domestic political stability is a prerequisite of hosting an OFC. The peculiarities of small island polities often assure the triumph of domestic political stability. Consensus politics tends to prevail whereby the elites of both parties are drawn from the same pro-business cadre, ensuring a seamless transition from one pro-OFC administration to the next. The checks and balances found in developed polities including an independent civil service, academic institutions and a free press are absent or underdeveloped meaning there is no intellectual community capable of critiquing OFC friendly

policies (Hampton & Christensen 2002: 1664; Mitchell et.al. 2002). In short, unsophisticated government machinery allows financial capital 'to exert considerable political influence in sponsoring favourable tax and regulatory legislation' (Christensen & Hampton 1999b: 16).

The creation of fiscal, regulatory and secrecy space requires the existence of political space. Without political space the state is unable to enact the legislation needed to lay the foundations for an OFC. Fiscal space refers to the provision of low or no rates of taxation and/or tax exemptions for assets belonging to non-residents (Hampton 1996a: 107). Tax advantages are a common thread linking all major forms of offshore activity (Hampton 1996b: 24-33). Regulatory space is created in two main ways. Firstly, the divergence of supervisory requirements between onshore and offshore realms. A widely held view is that the growth of OFCs from late 1960s onwards is attributable to the emergence of onerous financial and fiscal regulations among OECD nations from which increasingly mobile financial capital sought avenues of escape (Johns 1983; Johns & LeMarchant 1993; FSF 2000a). Despite two decades of subservience to neo-liberal policy nostrums and the concomitant liberalisation of financial markets among advanced economies, OFCs still constitute less regulated spheres attractive to mobile international capital. Secondly, regulation is hampered by the scarcity of suitably qualified staff available to supervisory authorities in OFCs (Christensen & Hampton 1999a: 181, 1999b: 16; Riechel 2001; IMF 2002a: 16, 2002b). The problem is exacerbated by the complexity of contemporary financial instruments, the effective management of which has repeatedly proved beyond the mastery of even the most well resourced regulators. Furthermore, the task of regulation is habitually conflated with, and subordinate to,

the job of marketing and attracting business to the OFC (Maingot 1994; Christensen & Hampton 1999a, 1999b). The comparative leniency of regulation in conjunction with the shortcomings of regulatory structures, especially in SIEs, has created the regulatory space that gives international financial capital the room to manoeuvre. Lastly, secrecy space refers to the opacity conferred by strict confidentiality laws and the complex layering of financial activities which serve to conceal the genuine owners of assets (Hampton 1996a: 108). Confidentiality laws preclude the exchange of information with juridical or revenue authorities from overseas. This makes it difficult, if not impossible, for onshore authorities to apply fiscal or regulatory practices on the foreign activities of their residents. In the last decade the international regulatory authorities have elicited a grudging commitment from OFCs to co-operate with their counterparts on criminal matters, such as tax evasion and money laundering and the related maladies of drug trafficking and the financing of terrorist organisations, through the signing of Tax Information Exchange Agreements and Mutual Legal Assistance Treaties. Nevertheless those pursuing civil cases, for example those relating to tax avoidance, are still confronted by insurmountable hurdles to obtaining information.

The OECD's Harmful Tax Competition Initiative

The perception of OFCs as weak links in the quest for global financial stability ushered in an era of aggressive international action to plug these regulatory lacunae. In 1996, as part of this drive to minimise abuses of the global financial system, the OECD Annual Ministerial Meeting called upon the organisation to 'develop measures to counter the distorting effects of harmful tax competition'

(OECD 1998: 7). The OECD's Committee on Fiscal Affairs picked up the baton and in April 1998 published its report entitled *Harmful Tax Competition An Emerging Global Issue* (hereafter the 1998 report). This argued certain tax practices were diminishing global welfare. The OECD was worried that the growing mobility of capital combined with the availability of low tax jurisdictions had weakened the ability of states to levy taxes, denying governments of much needed revenue. Firstly, it has become axiomatic that the presence of low tax jurisdictions prevents states from raising taxes on wealthy individuals or corporate profits because this would cause capital to relocate offshore. The second consideration was the direct price of tax avoidance and evasion. These practices are reckoned to cost the US Internal Revenue Service $70bn each year in lost revenue (Wechsler 2001: 45) while accountants Deloitte and Touche calculate that in the 20 years since 1976 the British Treasury has been robbed of £2000bn (at 1996 prices) (quoted in Guardian 1998). Tax dodging also afflicts developing nations with $50bn of tax revenue slipping from their grasp annually (Oxfam 2000). These leakages thwart attempts by governments to raise sufficient revenue to deliver public goods. To surmount these fiscal constraints the OECD feared that states would resort to shifting the burden of taxation onto immobile factors of production and consumption, moves which are highly regressive (OECD 1998: 14). This mix of more regressive tax structures and widespread tax avoidance would 'undermine the fairness, neutrality and broad social acceptance of tax systems' (OECD 1998: 8).

Broadly speaking the 1998 Report defines harmful tax competition as the combination of low or no rates of taxation on foreign owned assets with legal or administrative procedures that prevent overseas tax authorities from identifying the

owners of assets (Woodward, forthcoming). The report distinguishes two categories of harmful tax competition: tax havens and preferential tax regimes (PTRs). A tax haven is a jurisdiction that maintains no or nominal rates of taxation and promotes itself as a location where non-residents can elude tax in their country of residence (OECD 1998: 22). However, low or no taxation is a necessary but not sufficient condition for identifying a harmful tax haven. Low taxes in tax havens are only deemed harmful when combined any of the following features. Firstly, a lack of effective exchange of information. This refers to laws or administrative practices that prevent foreign tax authorities from obtaining the information required to apply their own tax laws upon their residents (OECD 1998: 22-3). Secondly, the absence of transparency in legal, administrative or legislative affairs. This hinders the ability of tax authorities to identify the beneficiaries of assets held overseas, preventing them from accurately auditing the foreign activities of their residents and hence their ability to levy taxes upon them. Finally, the absence of substantial business activities. This indicates that the jurisdiction seeks to entice investment motivated purely by tax considerations.

A similar methodology is used to identify harmful PTRs, with low rates of tax becoming harmful when the regime lacks transparency and effective mechanisms for the exchange of information about non-resident investors (OECD 1998: 26-30). The critical difference between a tax haven and a PTR is that in a tax haven low taxes normally apply across the entire jurisdiction whereas in a PTR only certain income streams from non-resident investors qualify for less onerous treatment. PTRs exist in countries which generate significant revenue from general taxation, but grant exemptions to certain sectors according to residential status. The practice of offering

tax immunity exclusively to non residents the OECD calls ‘ring fencing’ (OECD 1998: 26). This is considered harmful because while the domestic tax base of the country sponsoring the regime is insulated, it simultaneously poaches the tax base of other nations by attracting mobile capital seeking to avoid taxation in its country of residence.

Having delineated the nature of harmful tax practices the Report goes on to make 19 Recommendations to counteract the problem. Fourteen of these measures were unilateral or bilateral (see OECD 1998: 40-52). However, the OECD was sensitive to the fact that unilateral or bilateral responses alone would merely displace rather than extinguish harmful tax practices (OECD 1998: 37, 52). Therefore the lynchpin of the OECD’s approach was the intensification of multilateral co-operation. It proposed the creation of a new body, the Global Forum on Harmful Tax Practices, to oversee the adoption of the recommendations and to co-ordinate international work on tax competition. OECD countries were automatically eligible for membership of the Forum, non-member countries would be admitted only after they had publicly committed to the elimination of harmful tax practices. By signing up to the 1998 Report, OECD members committed to eliminate harmful elements of their tax system by April 2003. The Forum’s first task was to initiate a process for OECD countries to identify and eliminate their harmful PTRs. OECD members were asked to review their PTRs and to report aspects which might be harmful. The tax practices submitted by member states were then peer reviewed. The outcomes of these reviews were discussed by three specially convened Working Groups of the Forum. The OECD’s 2000 Report *Towards Global Tax Co-operation* (hereafter the 2000 Report) listed 61 potentially harmful PTRs occurring in 21 OECD states (OECD 2000: 12-4).

The OECD also requested the Forum to pursue work in non-member countries and to draw up a list of tax havens. The methods used to identify and assess tax haven jurisdiction differed markedly from those used to identify PTRs. Instead of self-evaluation followed by peer review the Forum conducted external reviews of tax haven arrangements. Following these reviews 41 jurisdictions were found to meet the tax haven criteria and were invited to appear before the Forum. Between July 1999 and April 2000 tax haven territories came before the Forum where 'in an inquisition-type setting, representatives of these small jurisdictions were arrayed before senior Treasury officials of the OECD countries and presented with an OECD-researched report describing their territory as "tax havens"' (Sanders 2002: 328). A handful of jurisdictions (Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino) quickly capitulated and provided commitments to the harmful tax competition initiative. The 35 remaining jurisdictions were listed in the OECD's 2000 Report (OECD 2000: 17) as meeting the tax haven criteria and were given until the end of July 2001 to make a commitment to eliminate harmful tax practices by 2005. Failure to do so would result in those territories being placed on a List of Uncooperative Tax Havens, rendering them liable to official countermeasures from OECD countries. Possible countermeasures include disallowing deductions, exemptions and credits on transactions, the imposition of withholding taxes, charging levies on transactions and the termination of tax conventions (OECD 2000: 25).

Over the next year progress was made toward the preparation of a list of uncooperative tax havens. However, in May 2001 the OECD proposals were thrown into disarray when US Treasury Secretary Paul O'Neill said the US had 'serious

concerns….about the direction of the OECD initiative’. While reiterating US support for the ‘core elements’ of the project, namely greater transparency and information exchange, he inveighed against the unequal treatment of OECD and non-OECD members and the premise that low rates of tax were inherently dubious (US Treasury Department 2001). The OECD’s pointed out that its objective was not the abolition of low tax regimes but to make low tax regimes more transparent (see Owens 2000). The OECD’s protestations, while entirely accurate, could not disguise faltering political support for the project. Indeed O’Neill’s announcement was a public acknowledgement of behind the scenes negotiations that were already taking place between US Treasury officials and their counterparts from other OECD countries aimed at securing substantial modifications to the original plans. The other OECD countries, realising that the project could not succeed without the backing of the world’s largest economy, had little option but to acquiesce.

The alterations to the initiative with regard to tax havens were unveiled following the meeting of the G7 Finance Ministers in July 2001 (G7 Finance Ministers 2001) and confirmed in the OECD’s 2001 Harmful Tax Competition Progress Report. Firstly, the deadline for tax havens to make commitments and avoid inclusion on the forthcoming OECD blacklist was extended to 28 February 2002. Secondly, the no substantial activities criterion was dropped and commitments would now only be sought with regard to transparency and information exchange. Finally, there was a guarantee that co-ordinated defensive measures would not be applied to non-OECD tax havens any earlier that they would be applied to OECD members hosting PTRs (OECD 2001).

The initial phase of the OECD project came to fruition on the 18 April 2002 with the publication of the inaugural list of uncooperative tax havens (OECD 2002b). Feverish negotiation in the months immediately before the list's disclosure saw all but eight of the 35 jurisdictions listed in the 2000 Report make a commitment. Seven of these jurisdictions (Andorra, Liberia, Liechtenstein, the Marshall Islands, Monaco, Nauru and Vanuatu) were designated uncooperative. The eighth, Barbados, reached a separate agreement with the OECD in January 2002. In detailed discussions between the two parties Barbados was able to convince the OECD that its mechanisms for information exchange and transparency were adequate. In return the OECD agreed that Barbados would not appear on list of uncooperative tax havens.

The Implications of the OECD Initiative for SIEs

The OECD initiative has been the subject of excoriating attacks from several quarters and, in particular, officials, politicians and business leaders in the Caribbean. Here the investigation into harmful tax practices is denounced as nothing short of an act of economic warfare motivated by a desire to bolster the position of OFCs in OECD countries and to re-assert colonial and imperialist modes of control in the region (Sanders 2001, 2002). This final section evaluates the potential impact of the OECD's initiative on SIEs. Initially it will examine the contention, propounded by SIEs, that the OECD's initiative is imperilling their development because it will inevitably result in the shrinkage or closure of the spaces needed to ensure the survival of OFCs. The second part will go on to suggest that these fears, while understandable, may prove unfounded.

The dangers to development

Previously it was shown that political goodwill is essential to offshore finance, for it enables the relevant authorities to devise the fiscal, regulatory and secrecy arrangements needed to entice capital to offshore locations. In the 1990s political tolerance among advanced industrialised nations towards OFCs began to evaporate. The consequence has been a series of international initiatives seeking to clampdown on OFCs. SIEs hosting OFCs are now expected to conform to the panoply of rules, codes and standards or incur the wrath of international financial institutions. OFCs have been offered a stark choice: conformity or closure. Those searching for a competitive advantage by flouting international norms have been promised a ‘bleak future’ by leading regulatory authorities (Financial Services Authority (UK) 2001). This has imposed a regulatory straitjacket which severely retards the freedom SIEs once enjoyed to develop their own regulatory framework, a feature lying at the very heart of their competitive advantage.

From the perspective of SIEs the harmful tax competition initiative presents a number of dangers. OFCs in SIEs seem destined to lose business whether they commit to eliminating harmful tax practices or not. The choice between conformity and closure offered to SIEs by the OECD omits the problem that conformity *will lead to the closure* of their offshore sector. If, on the one hand, the SIE makes a commitment to avoid being the subject of countermeasures economic sanctions they would be required to submit themselves to the principles of transparency and information exchange. This would involve the creation or extension of tax information exchange agreements, to include civil as well as criminal tax matters, and

allowing access to locally maintained information about the ownership of assets and financial statements of registered companies. In so doing the veil of secrecy that forms one of the principal attractions of offshore finance would be lifted resulting in a significant loss of business. In other words, compliance with the OECD's initiative would necessitate closing the secrecy space needed to survive. Alternatively SIEs may elect not to make a commitment. Under these circumstances SIEs would be placed on a list of uncooperative jurisdictions and the OECD would be empowered to ask its member states to invoke countermeasures against them. These countermeasures would prevent or increase the cost of conducting transactions in these centres causing business to flee. Jurisdictions are in the unenviable position of 'either committing to the initiative (so suffering possible and immediate to long-term loss of economic activity through the loss of offshore sector clients) or not providing a commitment (and suffering loss of economic activity through the imposition of defensive measures by OECD members)'. Whichever route is selected 'the elements which make offshore financial tools attractive will be removed and so cause the shrinkage or closure of this sector in listed nations' (Pacific Islands Forum 2001 quoted in Woodward 2004).

Worries about the migration of business out of SIEs are reinforced by the absence of a level playing field between OECD and non-OECD jurisdictions. From the outset Switzerland and Luxembourg have abstained from the initiative, citing their desire to protect client confidentiality and disagreements with the criteria used to identify harmful tax practices (OECD 1998: 73-8). By not consenting to these reports Luxembourg and Switzerland have yet to make a commitment equivalent to those made both by other OECD members or committed tax havens. Furthermore, the OECD has been somewhat ambiguous about whether or not it is developing

countermeasures to deal with its own members with PTRs as well as un-cooperative tax havens (ITIO 2002b). 'When asked directly whether "the defensive measures will apply to uncooperative OECD countries" Jeffrey Owens, the Head of the OECD's Centre for Tax Policy and Administration, trotted out the well established mantra that "there is only going to be one distinction: co-operative or uncooperative"' (Owens 2002: 6 quoted in Woodward, forthcoming). This assertion is demonstrably false. Despite their persistent failure to make a commitment, Switzerland and Luxembourg have never been referred to by the OECD as uncooperative jurisdictions and they were conspicuous absentees from the list of uncooperative jurisdictions. These flagrant double standards threaten to undermine the viability of OFCs in SIEs. While the regulatory and secrecy spaces of SIEs are slammed shut they remain open in Switzerland and Luxembourg, two of their principal competitors. If they are not obliged to make the same reforms as tax havens funds will be drained from SIEs and relocated in jurisdictions which are not quaking in the shadow of OECD sanctions. The International Tax and Investment Organisation (ITIO) suggests that there is already clear evidence of business flowing away from SIEs towards Switzerland as a result of the offensive on tax havens (ITIO 2002a).

The feeling that SIEs are being unfairly victimised is heightened by the absence of a level playing field *between non-OECD members*. Places including Hong Kong, Singapore, Dubai and Costa Rica offer offshore facilities, but have neither appeared on the list of uncooperative tax havens or been forced to make a commitment equivalent to those made by SIEs. Again SIEs are confronted with the danger of an exodus of capital to jurisdictions unencumbered by the threat of countermeasures. The OECD has accepted the likelihood that SIEs will be afflicted by

some degree of economic dislocation as a result of implementing its commitment. To placate them the OECD has promised to 'work with other interested international and national organisations to examine how best to assist co-operative jurisdictions in restructuring their economies' (OECD 2000: 21). As yet, precise details of this assistance have not been forthcoming and critics complain that nothing has been offered in the way of practical compensation (Persuad 2002).

As Sutton (this volume) demonstrates small states must strengthen public regulation in order to obtain the maximum benefits from globalisation. However, the wholesale reforms necessitated by globalisation are often precluded by the resource constraints afflicting SIEs. Nowhere is this better illustrated than in the financial sphere, and in the problems confronting SIEs as they attempt to conform to the OECD's harmful tax competition initiative. Already the chapter has alluded to the difficulties facing regulators in SIEs in recruiting and retaining sufficient numbers of qualified staff. Though many SIEs have mechanisms in place to exchange information as a result of pressure to comply with the exigencies of FATF money laundering rules, the complexity of the OECD's proposals will 'place exceptional demands on already scarce and limited human and other resources available to small economies' (Scanlon 2002: 44). The OECD has promised technical assistance but 'technical assistance, however generous and ongoing, does not address the infrastructure and human resource limitations inherent in all micro and most small jurisdictions' (Commonwealth Secretariat 2000: 7). SIEs will be forced out of the offshore financial sector because of the prohibitive costs of erecting an institutional edifice capable of meeting the OECD's demands on fiscal transparency.

The OECD project – overstating the danger

From the above it would be easy to infer that SIEs face an uncertain future. The compression of political space and the concomitant pressure to close the fiscal, regulatory and secrecy spaces that gave them their competitive advantage, especially when these spaces remain open in their major OECD competitors, appear to sound the death knell of OFC's located in SIEs. Nevertheless there are signs that the threats posed by the OECD's proposed regime are beginning to recede and may always have been overstated.

The first factor is the strength and determination of the coalition driving the harmful tax agenda. The diverging interests of OECD members have fractured support for the project. This is exemplified by the fading political support from the US. In contrast to the Clinton government, which enthusiastically embraced the initiative, the demeanour of George Bush's administration has been decidedly lukewarm. The Republican government, with its inveterate sympathy for individual liberty and unfettered markets, provided a receptive audience for the intense lobbying from an unholy alliance of libertarian think tanks, big business and those campaigning on developmental issues. These various groups were adamant that cracking down on tax competition was not in the US' interests. The think tanks, amassed beneath the banner of the Coalition for Tax Competition and headed by the Centre for Freedom and Prosperity, were instrumental in sensitising the Bush administration to the philosophical and economic drawbacks of adhering to the OECD plan. They argued that financial secrecy is a crucial component of individual freedom. Committing to the OECD's principles of information exchange and transparency would necessitate

unwarranted intrusion by the state into private affairs. They also pointed out that the sort of tax competition being prosecuted by the OECD is one of the cornerstones of US economic policy. Low taxation combined with strict privacy laws for non-residents has assisted in attracting $9 trillion of foreign investment to the US (Mitchell 2002: 41) making it 'the world's biggest beneficiary of tax competition' (Mitchell 2001b: 6). As well as stimulating growth and employment these flows have been a cheap and readily available source of funds with which the US has been able to finance chronic trade and government deficits since the 1970s. The US trade deficit is now so severe that the US must attract $1.3bn a day simply to prevent the dollar's depreciation (Financial Times 2002b). This, in conjunction with the perpetually expanding war on terror and the tax cutting instincts of the Bush administration, suggests that the US would be 'unable to afford the cost of lost investment that would inevitably follow any international crackdown (on tax havens)' (Palan & Abbott 1996: 174).

Discussions about the OECD harmful tax competition initiative have focussed principally on the interstate dimension and, in particular the ability of larger, more powerful states to bully smaller, weaker states into submission. However big business has been equally vociferous in its opposition to the OECD's plans and it is important not to underestimate the power of organised capital to resist tax reform through manipulating the agenda and influencing government. Webb (2002: 3) has shown how 'lobbying by TNCs and the transnational tax services industry also helped to move the OECD away from its original goals'. US corporations quickly recognised that they would lose out if the OECD's initiative were to proceed unaltered. American transnational corporations earn a third of their profits in low tax jurisdictions

(Mitchell 2001b). They professed that further layers of bureaucracy and administrative costs combined with higher effective rates of taxation would undermine the continuing vitality of the US economy. Finally, development agencies pointed to the threat to the economies of the Caribbean Basin in the US 'backyard'. The closure of financial services industries would undermine a number of SIE economies in the Caribbean, possibly sponsoring emigration to the US or forcing SIEs to turn to more damaging means of generating income, particularly the production of narcotics (Mitchell 2001c).

The antipathy of the Bush administration has forced the OECD to 'substantially curtail' (Mitchell 2001a: 9) the harmful tax competition initiative. The project now has an altogether narrower focus, with non-core elements being jettisoned and talk of harmful tax competition being replaced by less caustic references to 'fiscal transparency' (see for example Financial Times 2002a). The OECD has made these concessions as US withdrawal would almost certainly precipitate the collapse of the project. The OECD can only request that its members implement countermeasures. They have no authority to force them to do so. However, their effectiveness is critically dependent on all countries enforcing countermeasures. Presently the interests of the US seem diametrically opposed to the aims of the OECD's project and it is unlikely that the US would enforce punitive measures against offshore tax havens.

The renegade OECD members who have failed to sign up to the initiative are further evidence of disagreement amongst the OECD about the basic premise of tackling harmful tax competition. Moreover, they are now conspicuous barriers to

further progress because the pledges made by non-OECD members were conditional on a level playing field between OECD and non-OECD jurisdictions. Typically commitments were couched in the following terms

> 'The commitment is offered on the basis that………Those jurisdictions, including OECD Member countries and other countries and jurisdictions yet to be identified, that fail either to make equivalent commitments or to satisfy the standards of the 1998 Tax Competition Report, will be the subject of a framework of co-ordinated defensive measures…..' (OECD 2002a).[3]

The commitments entered into by tax havens will not be binding until either all OECD members make commitments or the OECD agrees to apply countermeasures to its own members. It is unlikely that Switzerland or Luxembourg will accede to the OECD's demands in the near future, nor does the OECD appear to have any stomach for adding its own members to the list of uncooperative jurisdictions. Until these matters are resolved the commitment letters of non-members are 'virtually meaningless' (Mitchell quoted by Centre for Freedom and Prosperity 2002). The OECD juggernaut has for the moment ground to a halt. Reports of the death of political space have been greatly exaggerated and, at least for the time being, the scope for SIEs to prop open their regulatory, secrecy and fiscal spaces remains.

Even if the OECD is able to resolve the current political impasse there are a number of further obstacles to be negotiated. The imposition of countermeasures will not be straightforward because 'virtually all' (Orava 2002: 181) of the countermeasures envisaged by the 2000 Report (OECD 2000: 25) will fall within the purview of the World Trade Organisation's (WTO) General Agreement on Trade in Services (GATS) (Simmons 2002; though see Grynberg & Chilala 2001). OECD

countermeasures are liable to be struck down by the WTO for impeding fair trade in financial services, particularly given that OFCs are not violating any of the WTO's rules pertaining to free trade. Nevertheless, the problem for SIEs is that recourse to the WTO is only possible *after* countermeasures are applied, by which time the damage to an SIE may be irreversible. Other prevailing international legal norms also need to be taken into consideration. The notion of 'dual criminality' asserts that states are only required to assist each other in investigating and prosecuting offences that are a crime in *both* countries. In many tax havens, including a number of OECD countries, tax avoidance is not a criminal offence. Countries could therefore refuse to comply with the exigencies of the OECD initiative citing the need to protect the confidentiality of their clients. The way round this would be for the OECD to insist as part of the commitment package that tax avoidance be criminalised. However, at present, support for such a move is muted, even among OECD member states (Gilmore 2002).

The final factor is the ingenuity of financial markets in outflanking regulatory constraints. Strange (1998: 132) asserts that

> 'If the Group of Seven were to announce that they would be publishing a blacklist of the known tax havens and another blacklist of firms and individuals actively making use of tax havens, and would impose fines or other sanctions on them unless the accounts were closed within a specified time, there can be little doubt that most could not survive for very long. The reasons why this does not happen are, once again, political rather than technical'.

This implies that concerted political action alone will be sufficient to reign in offshore financial markets. However, this contradicts much of Strange's other work in which argues that markets are now beyond the political control of states acting alone or in

concert (see for example Strange 1986, 1996). The inherent dynamism of contemporary financial markets with their rapid rates of innovation enables them to outmanoeuvre attempts by regulators to control them. Indeed the Financial Times (2002c) reports that Wall Street is already devising new products in response to the OECD initiative. While political will is essential it cannot on its own overcome the huge technical difficulties associated with governing contemporary financial markets. International regulation has challenged the fertile minds of financial practitioners. However, instead of conceding defeat it is prompting a ceaseless stream of new products designed to take advantage of the new frictions introduced by changing regulatory structures. Reregulation will redirect the flow of funds but it will not prevent them entirely. Indeed OFCs have flourished despite the avalanche of international initiatives setting stricter parameters for their operation.

Conclusion

Critics of OFC led development in SIEs argue that one of its principal drawbacks is that it compounds rather than lessens dependency. Given the notoriously fickle nature of global capital markets and the vulnerability of OFCs to external policy change, the development of SIEs which rest on offshore finance is extremely precarious. The OECD's Harmful Tax Competition initiative brought this issue into sharp relief. If the plan had proceeded as intended it would have been a serious threat to the viability of the OFC strategy in SIEs, endangering the development of those with an existing offshore presence and narrowing the field of options available for other SIEs. The OECD project would have narrowed or forced shut the regulatory, fiscal and secrecy spaces that once made them profitable. Worse still, the absence of a

level playing field, which would have allowed certain OECD and non-OECD countries to prop their regulatory spaces open, would have provoked the transfer of capital out of SIEs. Thankfully from the perspective of SIEs these threats seem to be receding. The OECD project has been watered down with key elements of the 1998 report including the demand that tax havens force institutions to maintain a physical presence have been cast aside. Moreover, the project has now reached a political impasse. Without US support or the creation of a level playing field the OECD project is stalled. Finally, the creativity of financial entrepreneurs in developing products to circumvent or to derive profit from new regulations suggests that the imposition of countermeasures will not be as straightforward as the OECD has assumed.

Nonetheless there is no cause for complacency among SIEs. While the battle over the OECD's harmful tax competition initiative seems to have been won, the wider war on financial opacity in OFCs still rages. Following the terrorist attacks of 11 September 2001 and the corporate scandals which engulfed Enron and WorldCom, the US suddenly rediscovered its interest in financial transparency. It has passed a raft of legislation allowing it to peer into the offshore activities of its citizens and has wrung tax information exchange agreements out of a number of Caribbean tax havens. Furthermore the FATF has now revised its 40 recommendations on the countering of money laundering which include several provisions which could hurt SIEs, including the elimination of 'shell' banks (FATF 2003b). The European Union (EU) continues to seek its own settlement on the exchange of information for tax purposes. If the negotiations are successfully completed the dependent territories of EU countries, which include a number of SIEs, would be forced to adopt similar measures to those being proposed by the OECD. Finally, there are concerns that with many SIEs

committing to the initiative a certain legitimacy has been accorded to the OECD 'opening the floodgates to a raft of other demands from an organisation with no authority except the coercive power of its member states' (Sanders 2002: 339). The manner in which the OECD has dealt with SIE over the issue of tax competition has done nothing to assuage the view held amongst many in the developing world that the governance of globalisation remains an exclusionary and dictatorial project.

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[2] There is no precise definition of a 'small' state. This chapter subscribes to the threshold used by the Commonwealth Secretariat and the World Bank which designates small states as those with a population of less than 1.5 million.

[3] The letters of commitment by non-OECD members are available from the OECD's website at http://www.oecd.org/document/19/0,2340,en_2649_33745_1903251_1_1_1_37427,00.html