

THE INTERNATIONAL CRISIS OF INCOME TAXATION: COMBATING TAX HAVENS, CAPITAL FLIGHT AND CORRUPTION

Prof. Sol Picciotto
Lancaster University Law School¹

Summary

For over a century, the income tax has been the mainstay of the modern fiscal state, and has underpinned a massive growth in collective spending, especially after it became a mass tax in developed capitalist countries, although in poorer countries tax capacity has been restricted which has weakened their governance. However, the income tax has been damaged by the loss of social solidarity with the growth of income inequalities, and the increasing difficulty of taxing income from capital. The opportunities for evasion or avoidance of taxes on capital income have increased, especially due to financial liberalisation, fuelling an explosive growth of 'offshore' finance, which takes advantage of the weaknesses of the system of international tax coordination which developed historically. Data in the US and UK show that the vast majority of the largest companies, especially transnational corporations (TNCs) pay little or no tax on profits, and wealthy individuals pay a much lower proportion of their income in tax than do the poor. A radical reform of international tax cooperation is essential to end the abuses of tax havens and offshore finance, and restore tax capacity to national states.

TAXATION AND GOVERNANCE: A HISTORICAL AND COMPARATIVE OVERVIEW

Taxation is key to the character and functioning of the state, economy and society, and its effectiveness and the levels of compliance greatly depend on acceptance by citizens of its legitimacy. Fiscal sociologists suggest that the shift from earlier forms of tax state to a modern fiscal state based on public finance is both facilitated by and enables the separation of an apparently private sphere of economic activity from the public sphere of the state (Schumpeter 1918, Musgrave 1992), which is characteristic of capitalism. When Adam Smith suggested that the four 'canons' of a good tax system are equity, certainty, convenience and economy,² he was also expressing an Enlightenment critique of the tax systems of the absolutist monarchies which, although they had been a key element in the formation of centralised states, were experienced as capricious and oppressive. Britain's success in establishing a 'fiscal-military state' in the 18th century could be contrasted with the tax revolts and crises of France, where the fiscal crisis eventually sparked the French revolution (Daunton 2001: 7). Economic growth and the absence of major wars during the 19th century enabled Peel and Gladstone to fashion a strong 'fiscal constitution', developing a high

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² *Wealth of Nations*, Book IV, Ch.II, Part II.

degree of mutual trust between government and taxpayers, based on restraint and efficiency in public expenditure and a shift to direct taxation of income (ibid., 26-30).

During the 20th century taxation underpinned the development of the welfare-warfare state, following a similar pattern although with significant variations in the major capitalist countries (Steinmo 1993). In these countries, state expenditure rose from some 5-10% of gross domestic product (GDP) at the start of the century, to 30-50% by its close, rising as high as 60% in some countries (Tarschys 2001). This substantial level of collective spending has been sustained by the acceptance of the legitimacy of equally high levels of taxation. That legitimacy has greatly depended on the centrality of income tax as the key revenue source. However, this is now under threat.

The income tax began as a tax on the small section of society which was well-off, on individual income, and on the income or profits of legal persons such as companies from business or commercial activities.³ It enabled state finance to move away from reliance on a multiplicity of duties and charges, which fell disproportionately on the poor. Its legitimacy was based on the principle of proportionality, justified by the concept of ability to pay, which was reinforced by the shift to a progressive, graduated tax (higher tax rates on higher income).⁴ Its acceptance, and eventual spread to become a mass tax, was linked to wartime patriotism, as well as the need to finance a growth in welfare spending, with the first introductions of social security programmes early in the 20th century, and their major expansion in its second half. Since the 1970s tax revenue as a proportion of GDP has continued to rise in OECD countries, from around 23% in 1965 to a weighted average of 33% in 1999,⁵ and despite the impact of privatisations and the drive to 'roll back the state' state expenditures have remained in the 35-50% range.⁶ Taxes on personal and corporate income have continued to be an important component, at around a third of total tax revenue. However, the overall growth in state expenditure has required their supplementation by other taxes,

³ In some countries, such as France, the income tax originally covered only individuals, with separate taxes on various types of revenues from commerce, business and land; others, notably the UK, applied a single tax to all legal persons on income from all sources, although specific rules apply to different types of income identified in the 'schedules'; after 1945 there was a trend to integration, although corporate taxes were often treated as distinct, and most countries allowed some imputation of corporate taxes paid on dividends as a credit for the shareholders (see below)

⁴ Steinmo 1993, 22. Daunton (2001, 138-) gives a detailed account of the interplay between economic theories and tax policy, especially how marginalist economics eventually overthrew the classical liberal views for example of John Stuart Mill, who supported differentiation (between 'earned' and unearned' income) but not graduation (assuming the threshold was set above that needed for subsistence); in the event differentiation was not introduced in the UK until 1907, quickly followed in 1909 by a progressive, graduated income tax (ibid., 155).

⁵ OECD 2001, 10; OECD 2005, 68. The ratio of tax to GDP is generally accepted as the best measure of the level of taxation and the role of the state in the economy. However, it should be remembered that it only provides an approximation, as there are important differences both between countries and over time on matters such as the treatment of transfer payments and the effects of tax subsidies and tax expenditures (exemptions, allowances and credits): see OECD 2001, 9, Stewart & Webb 2006, 165-8.

⁶ In the UK the ratio of state spending to GDP peaked at nearly 50% in 1975, and was 46% in 1979 (when Mrs Thatcher came to power) rising to 48% in 1982-4, falling to 39% in 1989, but rising again to 44% in 1992-3 (OECD 2002, 94).

especially value-added tax (VAT) on sales, which has spread rapidly especially in the 1980s (Tanzi 1995, 46; Ebrill et al. 2002).

The evolution has been rather different in peripheral capitalist countries. In colonised territories and dependencies income taxation played a much less significant part, for both economic and political reasons. In the early empires, political domination and economic exploitation were closely linked: conquest meant looting. As industrial capitalism developed during the 19th century, the main aim of imperialism became the opening up of dependent territories for profitable trade and investment, especially for raw materials. Governments of imperial countries such as Great Britain considered that the colonies should at least pay their own costs through local taxation, and if possible contribute to the costs of empire.

However, it was no easy matter to devise and enforce taxes on subject peoples, due to the perceived link between taxation and political representation, as the revolt of the north American colonies had shown. To establish legitimacy and efficiency, the form of taxation needed to take account of both the economic structure and pre-existing patterns of surplus-extraction by rulers, while also aiming to change both of these in line with colonial policy. In India, the complex hierarchy of claims to land was converted to a system of land ownership, providing a basis for a land tax; this provided the fiscal mainstay, but it declined from 52% of government revenue in 1861-65 to 28% in 1920-25, and had to be supplemented by import duties, salt duties and an income tax (from 1860 to 1873, reintroduced in 1886). Elsewhere, revenues were mainly raised from taxing commodity transactions, especially by duties on imports. In territories where there was little trade, such as African colonies at least initially, there was resort to hut taxes or poll taxes. In addition to raising revenue, these created pressures for people to move into the money economy, and not surprisingly they often led to revolts.⁷

A shift to direct taxation was urged by Frederick Lugard, who in west Africa devised the system of 'indirect rule' through local elites. He saw direct taxation as essential to civilised states, and a means of providing legitimate revenue which could be shared by the imperial Government with local rulers 'not as a dole from Government, which would destroy their self-respect, but as their proper dues from their own people in return for their work as Rulers or Judges' (Lugard 1919/1970, 167). He argued that this form of tax would allow abolition of slavery and forced labour, and encourage economic development. However, direct taxes on income greatly relied on assessment and collection by local chiefs, meaning less revenue for the central administration and the imperial government; so they therefore preferred a poll tax, although this courted anti-tax revolts (Daunton 2001, 133-5). The gradual introduction of self-government did not necessarily make it easier to shift to direct taxation, as franchises were usually limited to the affluent such as colonists.

In the post-colonial period, developing countries have achieved a much lower level of taxation than the OECD countries: government tax revenues have been in the range of 10-20% of GDP, the countries with higher per capita incomes generally being at the

⁷ See generally Daunton 2001, 124-135.

higher end of the range (Tanzi 1987, 216).⁸ Also, income taxes have accounted for a rather lower proportion of these revenues than in OECD countries (20-30%), and a higher share of this has come from corporate rather than personal income taxes.⁹ Import duties continued to be very important, averaging 25% of revenue (Tanzi 1987, 217). However, since the 1980s tariff reductions due to trade liberalisation have had a significant impact, both directly by reducing revenues from this source, and indirectly due to substitution effects and the adoption of other means of supporting domestic industries which involve tax expenditures (IADB 2004). Partly to plug this gap, bodies such as the International Monetary Fund (IMF) have urged the adoption of a VAT, and many have followed this advice. However, it has been criticised for being inappropriate and indiscriminate (Stewart & Jogarajan 2004), and overall the revenue loss from reduced trade taxes has been only partly recovered from other taxes (Baunsgaard & Keen 2005).

It is significant that 'the capacity to tax grows with the growth of income' (Tanzi 1987, 218), although a number of other factors, both structural and specific, also affect the ability to raise revenue.¹⁰ Poor countries are restricted by their relatively low tax revenues from stimulating their economic development from their own resources, leading to dependence on aid.¹¹ The view has gained ground that strengthening the tax systems of developing countries, through taxes accepted as legitimate, would make a major contribution both to their prospects for economic development, and to improving their governance, through greater political pressures for accountability of politicians and state officials to citizen-taxpayers (Bräutigam 2002, Moore 2007).¹² However, this is extremely difficult to achieve in countries where the vast majority of the population are very poor, and which often suffer from autocratic and corrupt governance. A shift in the sources of government revenue towards greater reliance on internal taxation would involve a major transformation of what have been described as the 'lame Leviathans', the post-colonial autocratic states in which local elites maintain the deceptions of sovereignty while using clientelist strategies to exploit external patronage and systematise internal patrimonial practices (Badie 2000).

⁸ Although the newly industrialised countries of south-east Asia have been an exception to this (Zee 1996).

⁹ The averages of course conceal considerable variations, especially in relation to oil-producing states; these obviously can obtain considerable revenues, which since the 1950s have taken the form of a combination of royalties and profits taxes (which the companies can claim as credits against home country tax liability).

¹⁰ A recent IMF study has examined a variety of factors, in addition to per capita GDP, that appear to affect 'revenue performance' (the effectiveness of taxation), including economic structure (e.g. the GDP share of sectors such as agriculture, which are hard to tax); it also suggests some significant variations between countries as to how well they actually perform in relation to predictions based on such factors (Gupta 2007).

¹¹ In a number of developing countries foreign aid receipts are close to or higher than tax revenues (Fjeldstad & Rakner 2003, 2).

¹² This echoes the views of Lugard, cited above.

The developed countries also face some fundamental challenges which go to the heart of the nature of the state and society. The decline of social solidarity, and the recent widening of income inequalities, is undermining direct taxation of income and profits, and hence the efficiency and legitimacy of the tax system. The personal income tax began as a tax on the rich, but became a mass tax from 1940, especially with the introduction of collection at source from employment income, and in advance, via pay-as-you-earn (PAYE). In the boom period of the welfare state, the growing tax burden fell increasingly on individuals, and personal income tax peaked at 30% of tax revenues in 1985, but has declined since then to some 25%. This has been compensated for by rising social security contributions, which became the largest component of tax revenues in 2003 at 26%, attributable to higher social spending, especially on pensions and health-care (OECD 2005, 23). Income tax now falls disproportionately on salary- and wage-earners, due to the greater opportunities for avoidance available for many types of income from capital, business or self-employment.¹³ High marginal rates have been reduced in an effort to curb such avoidance and improve the overall effectiveness of collection. However, with rising economic inequality the reduction of progressivity means that taxation impacts even more on the poorer,¹⁴ and hence reduces its legitimacy. Some countries, especially transitional economies facing difficulties with tax compliance by the rich, have introduced 'flat taxes' (essentially, a single rate of income tax); where a flat tax is set at a high rate but with substantial personal allowances it may succeed in maintaining both progressivity and revenue, but countries opting for a low rate generally see a decline in both, which suggests that this approach is not sustainable (Keen et al. 2006). Governments have also tried to supplement income taxes by resorting to a variety of special taxes, such as transaction taxes (e.g. on insurance premiums or air tickets), but these are often resented as 'stealth taxation'. They also create often substantial compliance costs for the tax administrations and taxpayers, both individuals and families as well as businesses.¹⁵ While specific taxes may be used for regulatory purposes such as encouraging energy saving or environmental protection measures, they are unlikely to raise significant net revenue.

¹³ The term avoidance is generally used to mean attempting to reduce tax liability by lawful means, although they might be disallowed; the use of unlawful means (usually requiring proof of deliberate or intentional deceit) is termed evasion, unlike in other languages, such as French, where direct unlawfulness is described as fiscal fraud, and everything else is *évasion fiscale*. Avoidance devices are of three main types: recharacterising a revenue flow (e.g. as a capital gain instead of income), altering the timing of a payment, or altering the recipient. These are often used in combination, in complex ways.

¹⁴ In the UK, 48% of total income tax receipts came from the top 10% of income tax payers in 1998, compared with 25% 20 years earlier; but in the same period the proportion of their gross income paid in tax by the richest 25% of households fell from 37% to 35%, while for the poorest 25% it rose from 31% to 38% (Fabian Society 2000, 74).

¹⁵ Attention has been drawn to the administrative costs for business of the plethora of taxes which firms are required to pay or collect, by a report done by the World Bank in conjunction with the accountancy firm Price Waterhouse Coopers (PWC & WB 2006). This is a valid point, although it ignores the burden on families of the growth of special taxes and charges; it is also mixed in this report with more sweeping and spurious claims about the 'total tax contribution' of firms, and arguments which generally encourage reducing taxes on business especially to attract foreign investment.

Not surprisingly, therefore, there has been political resistance to higher taxation, which is often stronger from lower earners, although there is support for higher income tax rates on top earners (Fabian Society 2000, 46, 52-3). Willingness to pay taxes is strongly linked to taxpayers' sense of the effectiveness of government in delivering key public services, especially education, health care, and infrastructure (ibid. 47-9). This has led to a variety of proposals for 'reconnection' of taxation and expenditure, including methods of making governments more accountable for public expenditures (ibid., ch. 7). More radically, there have been attempts to democratise decisions about tax expenditure, through various kinds of participatory budgeting initiatives (Bräutigam 2004). Especially debated has been the experience in Porto Alegre, Brazil (de Sousa Santos 1998), which has been both lauded as an empowering experiment in new public and democratic forms of local state (Novy & Leubolt 2005), and criticised as a partisan political strategy which disappointed the expectations it had raised (Goldfrank & Schneider 2006). A similar initiative in Africa is the Constituency Development Fund launched in Kenya in 2003, which is also aimed at involving communities to ensure that spending meets local needs, but is also vulnerable to political manipulation (Kimenyi 2005).

Another approach is to introduce a direct connection between a specific tax and a specific service. This may take two broad approaches, hypothecated taxes or user-charges. Hypothecated or 'earmarked' taxes are those which use the revenues they raise for specific, designated purposes benefiting the general public. Charges are levies on the users of specific services as a condition of access to that service, such as road tolls, or fees for education or health care services. Although both these forms establish a direct connection between taxation and expenditure, they have a number of disadvantages, such as inflexibility, and the possibility of political manipulation. In addition, charges are generally flat-rate and therefore regressive, and tend to exclude the poor from access to vital services. On the other hand some services, such as higher education, may benefit mainly the better-off, and it may be considered fairer for at least some of the costs to be borne by the beneficiaries (World Bank 1988, 21 & ch.6).

Political obstacles to substantive tax reform have led to a focus on reform of tax administration, generally involving new managerial techniques and professionalisation, and a shift to a culture of service delivery and customer orientation, aiming to improve tax compliance (Hamilton 2003, Aberbach & Christensen 2007). Tax authorities have been given greater autonomy from government, within a defined remit, with corporate plans and performance targets. Although this has led to some improvements in collection rates, they have tended to be short-term, and accompanied by taxpayer complaints of over-zealous enforcement, especially in developing countries; while pressures to do more with fewer resources (to achieve 'efficiency gains') have led to talk of a crisis in tax administration (Aaron & Slemrod 2004). Others have argued for a more holistic approach, which should combine simplification of the tax code (based on broad principles supplemented by more specific regulations, rather than a complex mass of detailed rules), with a more responsive form of administration aiming to build trust and hence improve compliance (Braithwaite 2003, Picciotto 2007). Clearly however, purely technocratic changes to administration are no substitute for a tax system which itself is generally accepted as fair and democratic.

TAXING CAPITAL AND BUSINESS INCOME

The difficulties of matching the needs and demands for collective spending with adequate tax revenues are now greatly exacerbated by the pressures on governments to relax taxation of both wealthy individuals and corporations. This makes it harder to maintain the principle of equal taxation of all persons on income from all sources, on which the legitimacy of the income tax rests. This principle has two pillars.

First, freedom of incorporation entails the corollary that not only individual income should be taxed but also the income or profits of legal persons such as companies, otherwise incorporation provides a simple avenue for avoidance. To encourage business investment and entrepreneurship, various start-up incentives and capital allowances can be provided. Also, the corporate and personal income taxes are often integrated by providing a credit either to the corporation or to its shareholders, to mitigate what may be regarded as double taxation of business profits at the corporate level and dividends paid to shareholders from those profits.¹⁶ Some argue for ending taxation of companies, on the grounds that for them it is 'merely a cost' passed on to customers; but to do so would greatly increase the burden on income from wages and salaries, and create inequity.

Secondly, equity also demands that earned or active income should be taxed at similar rates to unearned, passive income. Of course, there are usually incentives in the form of tax exemptions for savings to provide for personal and family needs such as housing and old-age. Beyond that, wealth is usually treated as capital and income derived from it is taxable.¹⁷

The Impact of Capital Mobility and Tax Competition

These principles of equal taxation have become increasingly difficult to maintain, mainly due to the increased mobility of capital. Some have challenged the so-called 'globalisation thesis', that the tax burden is shifting away from capital, which is mobile, and towards labour, which is not (Hobson 2003, Stewart & Webb 2006). They rely on data which show that overall tax revenues in OECD countries have increased in relation to GDP even since the 1980s, and that revenues from taxes on corporate income or profit have remained steady, as a proportion both of GDP and of government tax revenues (OECD 2001, 2005). However, it has also been pointed out that overall tax revenues have not kept pace with the demands on public expenditure, especially for social programmes, leading to higher levels of public debt even in the wealthy OECD countries, which have only been alleviated in periods of economic

16 Howard Zee (2002) discusses the range of possibilities, as well as other approaches, such as dual income tax systems which distinguish sharply between capital and labour income; he also argues pessimistically that lowering or even ending taxation of capital income may be inevitable, both for practical reasons due to the 'ever-increasing opportunities for capital income to escape the tax net, through either clever tax engineering or outright evasion' (1185) and because high capital mobility is equivalent to supply-elasticity, which undermines the comprehensive income concept underpinning economists' views of equity based on taxable capacity (1187); this seems to entirely overlook political considerations.

¹⁷ Equity and prevention of avoidance also require equivalent taxation of capital gains; further discussion of this is beyond the scope of this chapter.

growth. Thus, resistance by both capital and labour to tax increases has restricted the ability of governments to reform welfare programmes to meet new challenges from structural shifts in employment and the impact of demographic trends (especially ageing populations), and even to renew basic infrastructure (Genschel 2002, Swank & Steinmo 2002). Some regard this 'tax competition' as a necessary discipline on the wasteful tendencies of 'big government', but others argue that there is no evidence that it has this effect, and governments should be accountable through democratic politics.

More fundamentally, the data on aggregate revenues from corporate tax take no account of the proportion of profits in the overall tax base. Corporate tax rates have certainly been cut, and this is clearly linked to economic liberalisation (Swank & Steinmo 2002, 643; Ganghof 2006). Top marginal rates of personal income tax have also fallen, but the reduction of corporate tax rates to below the top personal rate has increased the incentive for the self-employed and small business to incorporate (Ganghof 2006). This, as well as other factors, tends to increase corporate profit as against individual income, so that the steady level of revenue from corporate taxes as a proportion of GDP is likely to conceal a decline due to the increased share of corporate profits in the total tax base. This has been confirmed by one study, which found that the corporate surplus as a proportion of GDP averaged across a sample of 14 OECD countries rose by almost 20% between 1980 and 1996, and that measuring the average effective corporate tax rate (taking account of the increased share of corporate profits in GDP) has declined, confirming a significant negative impact of liberalisation on corporate taxation (Bretschger & Hettich 2002, 706, 708ff).

To evaluate the impact of capital mobility, a distinction needs to be made between financial or money-capital and business or production-capital. Financial capital is inherently highly mobile, and the ending of most exchange controls since the 1980s has greatly increased the opportunities for money-capital to be held 'offshore' in jurisdictions which facilitate avoidance or evasion of taxation especially of 'passive' investment income. Capital invested in production is generally less mobile, indeed it is sometimes referred to as fixed capital. However, increased global inter-connectedness and changes in the nature of production have made it easier for firms to pick and choose production locations. This has increased the competition among countries to attract such mobile investments, often by offering tax incentives. This will be discussed in the next section, and the following section will discuss taxation of financial capital and the 'offshore' problem.

Business Taxation and the Competition to Attract Productive Investments

During most of the 20th century the bulk of international investment was foreign direct investment (FDI), by transnational corporations (TNCs). This was restricted by stringent controls on capital movements in the 1930s, but some, especially US-owned TNCs were able to resume their international expansion from the early 1950s mainly using retained earnings, and then benefited from the relaxation of currency controls on non-residents by OECD countries after 1959. FDI is generally relatively long-term, and while tax is a consideration in the location decisions of such firms, other factors are also as important, or even more so, such as good infrastructure, and a skilled workforce available at relatively lower wage-rates. Nevertheless, there has undoubtedly been considerable competition to attract FDI, especially since the 1980s, which often includes offering tax incentives, usually aimed at (active) business

income. At the same time, improved communications have increased the flexibility of choice for location of production regardless of the ultimate market for the products, and many TNCs have shifted to contracting out of specific functions through production chains, which has made it easier also to relocate such activities by shifting between suppliers.

Many countries use a variety of tax incentives to attract investment from abroad. A global survey carried out at the turn of this century found as follows:

While the efficacy of incentives as a determinant for attracting FDI is often questioned, countries have increasingly resorted to such measures in recent years. In particular, they have been offering tax incentives, to influence the location decisions of investors. This study contains a survey of tax incentive regimes in over 45 countries from all regions of the world. Nearly all countries surveyed offer incentives that target specific sectors. Regional incentives aimed at assisting the economic development of rural or underdeveloped areas are also prevalent in nearly 70 per cent of the countries surveyed.

In terms of the types of fiscal incentives granted, there is clearly an increasing trend towards offering full or partial tax holidays or tax rate reductions for specific types of activities. Nearly 85 per cent of the countries surveyed offer such incentives. (UNCTAD 2000, 3).

It is widely accepted that the competition to offer such incentives is highly undesirable, and that many of them create harmful distortions in capital allocation decisions. Incentives are generally aimed at foreign investors, which are mainly TNCs, and hence may give them a competitive advantage against domestic firms. The ability to locate production facilities in low-tax locations is a competitive advantage for TNCs in a number of industries. For example, it has been pointed out that Intel, the US semiconductor chip designer and manufacturer, has major production facilities in Puerto Rico, China, Malaysia, The Philippines, Ireland and Israel, all of which grant tax holidays (Avi-Yonah 2001, 4).

The only internationally-agreed restraints on fiscal incentives are those established within the framework of the World Trade Organisation (WTO): the Agreement on Trade Related Investment Measures (TRIMS), and the Agreement on Subsidies and Countervailing Measures (SCM). Far from aiming to control incentives offered to foreign investors as such, the provisions in these agreements prohibit measures designed to boost the domestic economy, for example linking advantages offered to investors to the use of local rather than imported inputs, or to export performance. This would cover for example the tax exemptions often given in Export Processing Zones (EPZs), which are linked to production for export, although developing countries have asked for longer transitional periods for TRIMS, to help preserve such incentives. However, the effect of the WTO restrictions is to move governments away from specific incentives targeted at stimulating local production, and towards general tax holidays (with no trade linkages) which tend to benefit large TNCs against local firms.

International investment agreements similarly do nothing to prevent foreign investors from being offered special incentives. Although they are based on principles of non-discrimination (national treatment and most-favoured-nation treatment), they are

worded so as to provide *guarantees* to foreign investors. Such treaties bind the host state to give foreign investors treatment *at least as good as* it gives to both domestic investors or those from any other third state. They therefore provide TNCs with a legal basis to complain if they consider they have suffered *negative* discrimination, but are silent about any special advantages they might receive, such as fiscal incentives.¹⁸ Not only is this the case for bilateral investment agreements,¹⁹ even the proposal for a multilateral agreement on investment (MAI) entirely failed to build on the already weak attempts by the OECD to discipline the competition to offer incentives (Picciotto 1998, 750-751, Picciotto & Mayne esp. 92-3).

A better alternative to tax holidays for investors from abroad is to provide investment allowances, for example generous provisions on depreciation of capital, to all businesses. However, this runs counter to the trend to reduce tax rates, which depends on a broadening of the tax base in order to maintain revenue. Nevertheless some states, especially developing countries, have moved in this direction, since it is preferable to offering general tax holidays. However, such allowances can still be geared towards foreign investors, by privileging specific sectors. For example mining, which is dominated by TNCs, often benefits from a special regime, with generous investment allowances and exemptions of imported equipment from duties or VAT, which can greatly reduce the tax liabilities of mining firms. This has been matter of controversy in a number of developing countries for example in Africa, for whom mining is often economically very important. The response of governments to public concerns about the low tax revenues in relation to the size of mining sectors has been to stress the need to offer an internationally competitive tax framework to attract mining investments, to boost employment and GDP. It is regrettable that developing countries generally offer few tax incentives to small and medium enterprises (SMEs), which could do much to encourage local entrepreneurship. Such incentives could also help to formalise informal economic activities, which are generally a major component of developing country economies.

Despite the obvious benefits, cooperation to restrict the competition over incentives has been difficult to achieve. This may be attributable to successful collaborative efforts by special interest groups, combining lobbying at national levels and influence on decision-makers at the international level (Nov 2006, 849). Nevertheless, the view has gained ground that a new approach is needed, based on international cooperation.

Taxing Passive Investment Income and the Problem of 'Offshore'

The main impact of the relaxation of controls on currency transactions since the 1980s has been to widen the opportunities for avoidance or evasion of tax on passive

¹⁸ Fiscal measures are in any case normally excluded from international investment agreements (UNCTAD 2003, 20).

¹⁹ The main type are Bilateral Investment Treaties (BITs), which have been used since 1959, but have developed into a much more widespread network since the 1990s (UNCTAD 2000). The North American Free Trade Agreement (NAFTA), a multilateral agreement between Canada, Mexico and the USA, includes a strong version of such a treaty as its Chapter XI. The attempt to negotiate an ambitious Multilateral Agreement on Investment (MAI) through the OECD collapsed in 1998 (Picciotto & Mayne, 1999).

investment income. Countries generally assert the right to tax all their residents on such income, and this is most effectively enforced by deduction at source from interest or other payments by the borrower, usually a bank or other financial institution. In the case of foreign portfolio investors this takes the form of a withholding tax on interest or dividend payments. However, this may be waived by the host country, in order to attract financial investments, especially if it has concluded a bilateral tax treaty with the investor's country of residence.

Financial liberalisation has made it much easier for both wealthy individuals and companies to receive income from financial investments free of tax. Facilities to do so are offered by international financial service providers, especially those based in tax havens and offshore finance centres (OFCs). For individuals, the most straightforward method is a bank account which pays interest gross (i.e. with no tax deduction), coupled with a credit card allowing access to the funds anywhere in the world. The recipient may legally be liable to tax on such income under the tax rules of his or her country of residence, but if it is not declared to the tax authorities they will have great difficulty discovering its existence. OFCs have generally enacted secrecy laws to strengthen the usual obligations of bank confidentiality, and generally cannot or will not override these to help other countries assess or collect taxes which may be due to them. An array of more complex arrangements are also available which make it even more difficult to obtain information for tax purposes, such as assets in the name of nominees, or held by trusts, or by companies formed in a third jurisdiction where company ownership details can be kept secret.

Havens enable outright tax evasion by exploiting the possibilities for tax avoidance. These have grown, as many more taxpayers have become able to exploit the grey areas of the concepts of residence of the taxpayer and source of the income, on which the international tax system is based. Since many countries claim to tax their residents or citizens on their world-wide income as it arises, these devices often entail outright evasion or tax fraud. Some, however, are able to exploit legal ambiguities or special provisions which may allow them to consider that such income is not taxable, which amounts to avoidance. For example, some professionals, especially in service industries, may undertake work in various countries, and may be able to establish residence for tax purposes in a low-tax country, even if they frequently visit and have extensive connections with a high-tax country. Rules on residence are increasingly hard to apply, and indeed states may be tempted to relax them. Thus, the UK has allowed its exception to the normal residence rule for individuals who may be regarded as non-domiciled to be used by an increasing number of wealthy persons. This allows some foreigners (those who can claim a continuing link with another country) to be resident in the UK, but exempt from tax on non-UK source income unless it is actually remitted to the UK.²⁰ This has been defended as a means of attracting wealthy persons to the UK, although there is no evidence that they would not choose to live there anyway. It also encourages such persons to invest outside the UK, since only their foreign-source income is exempt. However, there are a number

²⁰ In the Pre-Budget Review of October 2007 the Chancellor announced a partial closure of this loophole: this would require those 'non-doms' who have been UK-resident for over 7 years and who wish to retain these advantages to pay a flat amount of £30,000; this would clearly still greatly benefit the very wealthy, those with foreign incomes of over about £100,000 p.a.

of ways in which they can benefit from such income without actually remitting it to the UK, for example buying expensive items such as houses, yachts or even football clubs, which could be in the name of a foreign-resident company.

Such losses of tax revenues are far from limited to rich OECD countries. Indeed, developing countries suffer far more due to capital flight which is facilitated and encouraged by the offshore system. Raymond Baker has analysed cross-border flows of 'dirty money', and suggests that two-thirds is due to commercial motives including tax evasion, and the remainder to criminal money-laundering (Baker 2005); he estimates the total of such flows annually at between US\$1.06 trillion and US\$1.6 trillion, about half of which may come from developing and transitional economies. Studies of individual countries have estimated annual capital flight as high as an average of 9.2% of GDP for South Africa, 10.2% from China, 6.1% from Chile and 6.7% from Indonesia (Epstein et al 2005). Although some of this may be reinvested through 'round-tripping', it entails a massive volume of capital outflows, outstripping in aggregate the inflows of foreign aid, as well as considerable losses of public revenues. Indeed, the total losses to developing countries of leakages due to tax evasion and avoidance have been estimated by one commentator at \$385b annually, more than double the level of any potential official aid flows (Cobham 2005).

The 'offshore' system is not based only in small island states, as the name suggests. Indeed, it began with the acquiescence and even encouragement of authorities in the major developed countries. It originated in the era of exchange controls, when only non-residents were permitted to hold foreign-currency accounts; since these were generally dollars held outside the US they were termed 'Eurodollars'. The fixed exchange rate system gave an additional incentive to TNCs to exploit their corporate network structures not only to minimise taxation of retained earnings, but to reduce their cost of capital and exposure to currency devaluations. While controls on capital movements were still in force, they could exploit the hazy distinction between current and capital account payments, and use the flexibility of intra-firm international transfers by 'leading and lagging' payments, and adjusting transfer prices. These devices contributed to short-term capital flows which eventually broke the fixed-rate system.

The system of offshore finance was in effect created by the monetary policies of the main developed countries, especially the USA and the UK, acting symbiotically. The US bank regulator, the Federal Reserve, encouraged US banks to set up branches abroad to service the growth of US TNCs, by applying its interest rate ceiling only to domestic bank balances; while the Bank of England, keen to boost the rebirth of the City as a global financial centre, exempted foreign-owned banks from all credit and interest rate requirements, except on sterling transactions with residents. London also benefited from exploiting the facilities of related 'offshore' centres, many of which were Crown territories or British dependencies, such as the Isle of Man, the Channel Islands, and the Cayman Islands. Membership of the sterling area or another hard-currency link provided them with a stable currency, while deposits by non-residents could benefit from freedom from exchange controls and bank reserve requirements. As a result, international bank deposits attributed to tax haven areas grew to \$10.6 bn by 1968, half held by banks and half by non-banks; by a decade later, non-bank deposits had further grown 17 times and bank-owned international deposits nearly 30 times (US Treasury 1981). Although the British revenue authorities were concerned

with the potential tax losses, it proved impossible to formulate an official policy except to try to limit the damage to British interests.²¹

The system of globalised finance exploiting offshore centres has essentially functioned as a means of low-cost financial intermediation for those fortunate enough to have access to it. In the early period,²² exemption from reserve requirements enabled banks to offer low-cost loans while paying good rates to depositors. The tax avoidance facilities of the offshore system were further developed, so that Eurobonds and other financial instruments offer advantages to both borrowers and lenders. A bond issued in the name of a specially-formed company offshore can pay interest free of withholding tax to investors, and the funds raised can be on-lent via a stepping-stone conduit company in a jurisdiction benefiting from a tax treaty with the country of the ultimate borrower, to ensure deductibility of the interest and a minimum withholding tax liability for the borrower. More complex devices can secure additional tax reductions, such as the use of dual resident companies to allow 'double dip' deduction of the same interest against the tax liability in two countries, or sale-and-leaseback of assets to a captive offshore company to reduce operating profits. The tax authorities of the developed countries have done their best to combat each device as it became known (Picciotto, 1992: ch. 7), but working in the dark and with only rudimentary forms of international cooperation, they have hardly challenged the fertile minds and flexibility of the 'tax planning' industry.

The features which made OFCs tax havens were also convenient for a broader role as financial centres, and could be further developed. Chief amongst these is secrecy. Banker-client confidentiality is widely accepted in all legal systems, although it can usually be overridden by other legal obligations, especially when information is required for law-enforcement purposes, which may include tax. However, many countries have been reluctant to accept an obligation to assist with inquiries from

²¹ An attempt was made in 1970-71 to establish a policy through a civil service working group of officials from Treasury (including Inland Revenue) and the Foreign and Commonwealth Office (FCO). This resulted in a briefing paper for Ministers 'British Dependent Territories and Tax Havens Business', which barely papered over the cracks of the deep disagreements (Public Record Office File T/295/892, 'Balance of Payments and tax problems resulting from the setting up of overseas "tax havens"'). The concerns of the Revenue about large-scale tax losses, which far outweighed the benefits to the territories, as well as Treasury worries about the impact on the UK foreign exchange reserve, were counter-balanced by FCO emphasis on the developmental benefits, but especially on the limited powers of the UK government: the territories generally had been given a considerable degree of internal self-government, and even where the UK had retained control over financial matters the FCO considered it would be unfair to prevent one jurisdiction from doing something which another had the powers to do.

²² Although the Basel Committee was established in 1974, its Capital Adequacy standard was not agreed until 1988; its Concordat on bank supervision initially divided responsibility between home and host country authorities, and although the principle of consolidated supervision was accepted in 1983 and somewhat strengthened in 1990, the 'college' of supervisors did not prevent the debacle of the failure of BCCI, which although run from London and Abu Dhabi was chartered in Luxembourg and the Cayman Islands, and was later found to have been involved in extensive money-laundering. The problem of cross-border banking supervision was again addressed, following a series of further bank failures, in 1996 (BCBS 1996, Wood 2005, 52-67).

foreign authorities, in particular for tax assessment.²³ Indeed, some took active steps to augment bank secrecy obligations, including prescribing criminal penalties for disclosure of confidential information.²⁴ Confidentiality obligations often operate in a similar way to protect information held by professionals, such as lawyers and accountants. Artificial legal entities such as corporations and partnerships can be used to conceal ownership of assets and income, since obligations to register or disclose details of participants may be minimal or laxly enforced. Thus, even countries which require companies to establish a shares register may permit shares issued to bearer, or fail to require notification of this information to the authorities, especially for non-quoted companies. The old common law device of the trust, long used for estate planning, also offers significant secrecy advantages, and has equivalents in some civil law countries allowing entities which can be described as foundations, notably Liechtenstein's *Anstalt*.

Thus, the offshore industry was created as tax avoidance became allied with other types of regulatory avoidance, especially of controls over financial services. A wide range of financial services could make use of the fictions of offshore intermediation. Some, such as real-estate investment and insurance, are essentially avoiding taxes. Others, notably investment funds, were initially set up offshore to benefit also from bypassing exchange controls, and then to avoid restrictions on authorised investments (Hampton 1996, 26-27). The continuing boom in offshore collective investment funds is now largely due to their tax advantages, derived from 'rolling up' tax-free income and deferring tax liability (OECD 1999). Today, the Cayman Islands is nominally the world's fifth largest banking centre and a major location for hedge funds, while the British Virgin Islands is the place of incorporation of several hundred thousand 'shell' companies. At the same time, the facilities offered offshore, especially secrecy, facilitate concealment of a wide range of nefarious activities, from organised crime to covert political operations (Naylor 1994). These advantages have long been known to the cognoscenti, but especially since the 1980s they became more generally available for the price of a plane ticket, a phone call, or an internet connection.

Due to the interrelated nature of the international financial system, the main financial centres have been obliged to introduce some of the same features as offshore centres, in order not to lose business, on the principle 'If you can't beat them, join them'. A major change occurred when the US and UK in 1984 ended withholding tax on payments to non-residents, to try to regain some of the Eurobond flotation business lost to jurisdictions such as the Netherlands Antilles. In conjunction with an

²³ Even countries which accepted an obligation to exchange information for tax purposes often took the position that this only applied where they also had a 'tax interest', and did not extend to obtaining information to enforce another country's taxes. This was the position in the UK until statutory changes (Finance Act 2000, s.146), which allowed the UK to comply with the more specific information exchange provision adopted in the OECD model tax treaty in 2005.

²⁴ Swiss bank secrecy dates back to the Federal Banking Law of 1934 (s.47), and was strengthened by commercial confidentiality laws which provided criminal penalties for an employee disclosing confidential information without authorisation. Countries developing their OFCs enacting such laws included Panama (Law on Coded Bank Accounts 1959), Cayman Islands (Banks and Trust Companies Laws of 1966 and 1989, and Confidential Relationships (Preservation) Law 1976), Bahamas (Bank and Trust Companies Regulation Act 1965), and Montserrat (Confidential Information Act 1985): see Effros 1982, Gallagher 1990.

announcement that they would end the tax treaty exemption from withholding tax of payments made to service Eurobonds to Netherlands Antilles entities, they also began to allow interest on Eurobonds to be paid gross by UK and US borrowers, subject to certification by the paying agent that the recipient is non-resident. This has meant that both the US and the UK have been unable to provide information about non-resident recipients of interest even to countries to which they have information exchange obligations.²⁵ Although in 2001 the US Treasury issued proposed regulations to require reporting of interest paid to residents of 'designated' countries, these have not entered into force, apparently due to fears that this would lead to an outflow of some of the \$1 trillion in US bank deposits held by non-nationals (Spencer and Sharman 2006, 28-9). Another well-known example is the use of 'Dutch mixer' holding companies as mailbox conduits for international investment, taking advantage of The Netherlands' extensive network of tax treaties and its favourable tax treatment of foreign investment returns (van Dik, Weyzig & Murphy 2006).

The availability of these 'offshore' facilities has made it extremely difficult for states to establish effective means to tax the passive investment income of their own residents. This was clearly shown by the attempts by Germany to apply a source deduction on bank interest payments. When this was introduced in January 1989, at the low rate of 10%, it resulted in an outflow of bank deposits estimated at DM60b, mainly to Luxembourg banks, and was hastily ended after six months (Picciotto 1992, 75; Avi_Yonah 2001, 9).

Thus, it is hardly surprising that new initiatives were launched in the mid-1990s to try to counter the problem of tax evasion and avoidance, in conjunction with other harmful effects of the offshore system. These will be outlined and discussed in the next section.

REFORMING THE INTERNATIONAL TAX SYSTEM

It has become evident since at least the mid-1990s that the international tax system is in drastic need of reform. It is clear that the pressures of globalisation have created continuing challenges for states in protecting their tax base, especially taxes on capital and business income. The time is right to adopt a new approach, which would provide a much sounder basis to face these challenges in the medium and long term. Such an approach would entail closer international cooperation and coordination, on a global basis. Far from posing a threat to fiscal sovereignty, as some might suggest, such closer cooperation is in fact the key to a reassertion of the rights and powers of states to establish effective taxation in the face of the extensive liberalisation of capital flows brought about in the past two decades.

The system of offshore finance now offers extensive opportunities for both wealthy individuals and TNCs to minimise their tax liabilities, as outlined in the previous section, which the present arrangements for international tax cooperation are inadequate to prevent. These opportunities are systematically exploited by many firms

²⁵ The UK has recently begun to collect some information, to comply with the EU Savings Directive, but only for individuals (not companies) who are resident in EU or other 'fully reportable' countries: see the Reporting of Savings Income Information Regulations 2003 (Statutory Instrument 2003/3297, as amended) which came into force on 1 July 2005.

and individuals. Data show that in the US between 1996-2000, some two-thirds of TNCs paid no tax at all, and over 90% paid below 5% of their total income (US GAO 2004). Similarly, in the UK, an official study has revealed that in 2005-6, 220 of the 700 largest firms paid no UK tax at all and a further 210 paid under £10m; these 700 firms account for only a little over half of the total corporation tax receipts, and 67% of this revenue came from only 50 firms in 3 main sectors (National Audit Office 2007, 10). Extremely wealthy persons involved in global financial operations, such as hedge funds, venture capital and private equity, can easily avoid taxation of their gains from such activities by carrying them out through vehicles formed in offshore centres. So it is hardly surprising that the Cayman Islands, which has no tax on either income or capital gains, boasts that it is the world's leading jurisdiction for registration of hedge funds.

The outline of a new approach will be sketched out below, based on two main initiatives which would help establish a sounder basis of international tax cooperation. One is a new approach towards the taxation of international corporate groups or transnational corporations, on a unitary or consolidated basis, with an allocation of the tax base based on formula apportionment. The other is a comprehensive system for obtaining and exchanging information for tax purposes. First, the next section will give a brief account of the international tax system, followed by a discussion of the limited reform initiatives attempted in the past decade, mainly by the EU and OECD countries.

The International Tax Patchwork

The application of income or profits taxes to international economic activities inevitably requires some international cooperation between states. Under international law, states are free to tax their own nationals and/or residents on their income from all sources, as well as taxing foreigners on income from sources or activities within the territory. States are also free to adopt their own definition of nationality and residence, although other states are under no obligation to accept such a grant of nationality.

These features create a dual problem, the resolution of which requires international cooperation. One aspect is the possibility of double taxation. Territorially based taxation can be applied on nationals or residents within the territory on their income from all sources, as well as on income from sources within the territory paid to recipients wherever they are located. Thus, a resident of country A with a source of income in country B may be taxed on it by both countries.²⁶ National variations on the residence and source principles result in many possible permutations of double taxation. The reverse side of this coin is the possibility of double non-taxation, if a flow of income escapes taxation in the source country because it is paid to a non-resident, while being untaxed in the country of residence, since it is foreign-source income. Exploitation of differences and interactions between source and residence rules provides many means of legal reduction of tax liability, or tax avoidance.

²⁶ For a concise explanation and analysis of source and residence taxation see the Briefing on the website of the Tax Justice Network, at <http://www.taxjustice.net/cms/upload/pdf/Sourceresidence.pdf>.

Not surprisingly, individuals and firms involved in international business were quick to complain of double taxation, especially when a number of states introduced taxation of income and/or profits and rates were increased at the time of the First World War. This led some states to introduce measures to prevent such double taxation: some agreed to exempt foreign-source income, while others decided on allowing a credit for foreign taxes paid on the same income.²⁷ However, the UK, which was at that time by far the largest source of international investment, was reluctant to take such unilateral measures, since they could create an incentive for UK residents to invest abroad in low-tax countries rather than in the UK.

These concerns led to moves to negotiate international arrangements to coordinate income and profits taxation. Since the issue was seen to be closely tied in with that of international capital flows and capital flight, it was taken up through the Financial Committee of the League of Nations. Following two expert studies, the Committee organised a multilateral conference in 1928, which resulted in agreement on the first Model tax treaties. After the demise of the League of Nations the newly-born United Nations established a Tax Commission to take over the work, but this fell into abeyance in 1954 due to Cold War and North-South conflicts. Since then the main work on tax treaty models has been done by the OECD's Committee on Fiscal Affairs (OECD-CFA). The UN established a Group of Experts on Tax Treaties between Developed and Developing Countries in 1968, which was upgraded to a Committee of Experts in 2004, although this fell short of the proposal to establish an International Tax Organisation put forward in the Zedillo report for the UN conference on Finance for Development, which has been widely supported (Tanzi 1999, Horner 2001).

Since the formulation of the first tax treaty models in 1928, they have allocated the primary right to tax business income or profits to the host country, and the primary right to tax investment returns (dividends and interest) to the country of residence of the investor. The network of bilateral tax treaties based on these models was slow to develop in the 1930s, and only gained momentum in the second half of the 20th century, and mainly among the OECD countries, between which substantial reciprocal investment flows developed. However, already in the 1920s and 1930s international investors had begun to devise their own means of avoiding what they regarded as unfair international double taxation. These generally entailed using the fictions of legal personality by forming companies or trusts in convenient jurisdictions, and using these as conduits for international investment. Such devices might be legitimate, if the income received by these entities was properly exempted from (or had paid) source taxes, and if the country of residence considered it liable to tax only when actually remitted there, and not immediately the payment was made. This entailed a deferral of the tax liability. These techniques were used by TNCs, especially those owned by US parents, which financed their international expansion largely through retained earnings which benefited from deferral of US tax liability.

²⁷ This was introduced by the USA in 1918, a year after the first federal income tax on corporations. A foreign tax can in any case be deducted as an expense, but allowing it as a credit entailed an acceptance (urged by Prof. Adams of Yale, the Treasury's economic adviser) of the prior right of the source country to tax profits originating there. To prevent such credits from being used to offset US tax liability various limitations have been applied since 1921 (Picciotto 1992, 12-14).

At the same time, such techniques also began to be exploited by wealthy families and others who wished to evade the very high rates of tax applied in some countries on high incomes. They chose jurisdictions which gave them the benefits of a high level of secrecy, and had no or low taxation, either of all income or income from abroad. Home countries which attempted to tax such income were greatly hampered by the difficulty of obtaining information, and legal complexities. The further transformation of tax havens into offshore finance centres, as outlined above, greatly widened the extent of the problem of tax avoidance and evasion. Concerns about the role of OFCs in contributing to financial crises both of states and firms in the 1990s were taken up mainly through the G7, and led to the establishment of the Financial Stability Forum. This has coordinated attempts to improve the regulation of such centres from the point of view of financial soundness and combating money laundering and terrorist financing. However, the G7 referred the issue of tax havens to the OECD-CFA. This separation is unfortunate, since the strengthening of the prudential supervision of the financial services provision in OFCs has the effect of giving them a seal of approval, further encouraging their use for tax evasion.

Attempts to Combat Tax Havens and Preferential Tax Regimes

In 1998 the OECD-CFA issued a report on *Harmful Tax Competition - An Emerging Global Issue*, which had a major impact (Sharman 2006). This was supplemented by a parallel initiative by the EU member states, also aimed at 'harmful tax competition'.

The two main elements of the EU work have been the establishment of an intergovernmental Tax Policy Group, which has developed and applied a Code of Conduct for Business Taxation, and the negotiation of a Directive on the taxation of Savings Income. The EU's Code of Conduct aimed at identifying and pressuring EU states to phase out tax incentives for productive investments. In this it has been relatively successful, even though it has used a 'soft' method of coordination, largely because it has also been backed by legal powers under EU law prohibiting state aids, which have been applied by the European Commission to force member states to phase out a number of such incentive schemes.²⁸ The Savings Directive was aimed at dealing with taxation of individuals' interest income, through a scheme for comprehensive information exchange. However, this was resisted by some EU states with financial sectors, who argued that they would lose business to non-EU financial centres and OFCs. The Directive was finally agreed on the basis that almost all the member states would adopt automatic exchange of information on interest income from 2004, while three (Austria, Belgium and Luxembourg) and Switzerland would apply a withholding tax on such income,²⁹ 75% of this revenue to be paid to the residence state. The states which have rejected information exchange can therefore continue to protect fiscal secrecy, at least until the arrangements are reviewed in 2011. In any case, the Directive applies only to income of individuals, and does not apply to companies or other legal persons, so it can be evaded relatively easily by creation of a company or trust to hold such interest-bearing assets (European Parliament 2003, 70). The compromise also decoupled the EU negotiations from the broader assault on

²⁸ For more detail see Picciotto 2003.

²⁹ 15%, rising to 20% from 2007 and 35% from 2010.

international tax avoidance pursued under the OECD's 'harmful tax competition' initiative.

Despite its initial impact, the OECD initiative had major flaws, which have quickly become apparent (Sharman 2006, Sullivan 2007). First, its focus has been on trying to protect the tax base of the rich OECD countries, and the main target was seen as the small tax haven and OFC jurisdictions, rather than attempting to deal more comprehensively with the systemic aspects of the offshore system as a whole. Understandably, small countries have argued that they should not be subject to discriminatory treatment, and the Global Forum on Taxation which was set up as a result of the initiative has become engaged in a lengthy process of establishing ground rules for a 'level playing field' (OECD 2006, STEP 2006).

Both these initiatives have been fatally damaged by starting from the flawed concept of 'harmful tax competition'. This is due to what are regarded as the political difficulties of accepting that international tax cooperation entails a degree of harmonisation, especially of definitions of the business tax base. Such measures do not need universal acceptance, but coordination among a significant number of leading countries, such as the OECD. Due to the political difficulties, the approach has been the rather negative one of trying to identify features which could be agreed to be 'harmful' to others, or around the general concept of 'preferential tax regimes'.

The difficulties of the negative approach have become clear from the problems which the 'harmful tax' perspective has encountered. The OECD 1998 report identified as the necessary starting point for defining a tax haven that it

- (a) imposes no or only nominal taxes (generally or in special circumstances) and offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape tax in their country of residence.

This was linked with three subsidiary criteria:

- (b) laws or administrative practices which prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction;
- (c) lack of transparency and
- (d) the absence of a requirement that the activity be substantial, since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven (transactions may be booked there without the requirement of adding value so that there is little real activity, *i.e.* these jurisdictions are essentially "booking centres"). (OECD 1998, 22).

However, the 'no substantial activities' criterion was torpedoed in the *volte-face* by the USA announced by then Treasury Secretary O'Neill in July 2001, and it was formally withdrawn in the OECD's 2001 Progress report (OECD 2001, 10).

What amounts to a 'substantial activity', especially as concerns financial services, can certainly be difficult to define, as was acknowledged already in the 1998 report, and this difficulty was again cited as a reason for dropping the test in 2001. The problem

is well-known to the OECD tax specialists, since it is central to the operation of their rules for taxation of Controlled Foreign Corporations (CFCs), which are a major weapon against tax avoidance by residents, and which have been coming under increased strain, and consequently becoming inordinately complex. The substantive question, which the 'no substantial activity' test avoids, is where *should* financial service businesses, such as hedge funds, reinsurance, or futures trading, be regarded as taking place, and therefore be taxable? In an era of globalised finance this is increasingly hard to answer, which suggests it is the wrong question.

With the dropping of the 'no substantial activities' test, the OECD initiative has become focused on transparency, especially exchange of information. As Jeffrey Owens of the OECD stated in testimony to the US Senate Finance Committee, 'it is about all countries that lack transparency and are not prepared to cooperate to counter tax abuse' (Owens 2007). However, the effect of this is further to strengthen the arguments for a 'level playing field' made by the OFCs, or on their behalf by practitioners (STEP 2006). It has turned the spotlight on the extent to which even the leading OECD states themselves lack transparency and provide facilities for both tax avoidance and illicit transactions. Thus, even while a US Senate committee presented a fully-documented denunciations of the use of 'shell companies' in tax havens for tax evasion (US Senate 2006), other agencies documented the facilities for 'shell companies' offered in the US itself (Spencer 2007).

The effort to attain tax transparency has itself been greatly weakened, first by being limited to information on request, and secondly by the abandonment of the initial idea of a multilateral treaty. Information on request may help target egregious tax evaders, and may help discourage the fearful (Sullivan 2007). However, only arrangements for automatic provision of information on payments to non-residents, such as provided for in the EU's Savings Directive (although limited to individual interest income), would establish a realistic basis for ending evasion of tax on passive investment income. But, as we have seen, even major OECD financial centres, notably the US, are not in a position to provide such information. Limitations on the commitments which OECD countries are themselves able to make may also explain the dropping of the idea of a multilateral tax cooperation treaty. As a result, each OECD country has had to embark on the lengthy process of negotiating bilateral tax information exchange agreements (TIEAs) based on the OECD model. So far only some 15 have been concluded, and another 40 or so under negotiation (Sullivan 2007, 332); although the OECD is now stepping up this drive, there is clearly some way to go, and at best all that could be achieved is another patchwork quilt of bilateral treaties, with many holes.

Towards a New Approach

The time seems right now to rethink some of the basic principles of international tax cooperation, focusing on a more positive approach to coordination of taxation of both international business (TNCs) and passive investment income.

An important first step should be a shift towards taxation of TNCs on a unitary basis. This idea is far from new. Indeed, when the problem of applying income taxes to international business was first identified early in the last century, even the early entrepreneurs suggested that this called for a global approach to business taxation. Thus, Sir William Vestey, whose grocers' firm had grown by importing eggs from

China and beef from Argentina, argued strongly in his evidence to the British Royal Commission on Taxation which reported in 1920:

‘In a business of this nature you cannot say how much is made in one country and how much is made in another. You kill an animal and the product of that animal is sold in 50 different countries. You cannot say how much is made in England and how much is made abroad. That is why I suggest that you should pay a turnover tax on what is brought into this country. ... It is not my object to escape payment of tax. My object is to get equality of taxation with the foreigner, and nothing else.’

As already outlined above, the tax treaty system which was laboriously constructed was based on the allocation of tax rights between home and host states, based on artificial concepts of residence and source. However, the technical experts who considered the matter acknowledged, as early as the 1930s, that applying these principles to internationally-organised businesses would be highly problematic. They understood that transnational corporations (TNCs), which had already emerged in the period 1890-1924 and developed further in the 1920s, operated on an integrated basis, as Vestey had explained to the Royal Commission in 1920. This suggested that such firms should be taxed on a unitary basis, using consolidated accounts, with an allocation of the tax base according to an internationally agreed formula. Indeed, an extensive international study conducted for the League of Nations in 1930-32 identified the difficulties of attempting to tax the local affiliates forming part of such an integrated group, both for the national tax authorities and the firms themselves. It also showed that in practice tax authorities in many cases did apply a unitary approach, basing tax assessments on an estimated proportion of group profits (Picciotto 1992, 27-31). However, they considered it impossible to establish an international framework for such an approach, since it would entail agreement on the allocation formula, as well as on some degree of harmonisation of the business tax base. This was hardly surprising in the political climate of the early 1930s.

Today the problem is much starker, but the response is not much different. A major reason for this has been the technicisation of these initiatives. Tax specialists, both revenue officials and professional advisers and tax planners, are very aware that in practice the present system leads to often arbitrary allocations of the tax base, and thus creates incentives for aggressive tax planning and avoidance. After several decades of attempting other approaches, the European Commission finally decided that the elimination of ‘tax obstacles’ to a single market should mean moving away from tax treaty principles of jurisdictional allocation, towards a system based on consolidated accounts (European Commission 2001). Although this could be done in a way which would retain national taxation and even national tax rates, the Commission anticipated the inevitable negative response from those national state political representatives who have stridently opposed any move to tax harmonisation in Europe. Yet state corporate taxation in the USA is already on a unitary basis, and proposals have been made by some specialists for this approach to be adopted internationally (Avi-Yonah & Clausing 2007). Nevertheless, the Commission has continued to approach the matter cautiously, in a highly technical way, setting up specialist working parties to work through the arcane details of company accounts and their tax treatment.

The unitary approach would provide a much more effective basis for dealing with the key problems posed by taxation of international business profits, such as transfer

pricing and tax deferral. It also would dispense with the need to obtain cooperation from tax havens for these purposes. The thorny problem of distinguishing between active and passive income would be avoided, by basing the allocation of the tax base on 'real' criteria (employees, external sales, physical assets). Perhaps most importantly, it would provide a much better basis for taxation of TNCs by developing countries. The present approach, based on treating affiliates of integrated corporate groups as separate entities can only be made effective by deploying a variety of anti-avoidance measures, for example against thin capitalisation and transfer pricing. Such measures require substantial staff with a high level of expertise, which are not generally available even in the middle-income countries.

Secondly, there is a clear need for a more comprehensive system for obtaining and exchanging information for the purposes of tax enforcement. It should be on the basis of multilateral obligations, rather than a network of bilateral agreements. The bilateral approach is not only time-consuming, its fatal flaw is that it leaves many gaps and creates new variations, and so creates new tax avoidance opportunities based on exploiting such gaps and differences. There is a precedent, in the 1988 Convention on Mutual Administrative Assistance in Tax Matters, agreed by the OECD and the Council of Europe, which is currently in force among 12 states.³⁰ This convention provides a greatly improved basis for tax cooperation, but it still establishes only a framework which requires development. First, it is important to be more specific about the information which should be provided. This should extend to information needed to penetrate behind the secrecy offered by entities such as shell companies and trusts, such as the names of shareholders, directors, trustees and beneficiaries. Secondly, the provision in article 6 of the 1988 Convention for automatic exchange of information must be activated, by establishing computerised systems, which can inter-communicate, especially for information on cross-border interest and other similar payments. The 1988 Convention contains extensive protections to ensure confidentiality of such information, which should allay reasonable concerns. Some states have gone further and given taxpayers the right to be notified and appeal against requests for information.

This multilateral framework should extend globally, beyond Europe and the OECD countries. Its provisions could become a global standard, if tax authorities treated with suspicion transactions with jurisdictions which refused to accept it, and subjected firms and individuals involved in such transactions to detailed tax audits. Combined with the application of unitary taxation to TNCs, this would greatly reduce the flow of funds to financial centres in jurisdictions lacking transparency for tax enforcement. Reputation is all-important for financial markets, and the establishment of a high standard of fiscal transparency should be made a key element for any reputable financial centre.

CONCLUSION

The two proposals made in the previous section would go a long way towards an effective reform of international tax cooperation. They would also be greatly

³⁰ CETS no. 127, available from <http://conventions.coe.int/>. The UK finally signed this treaty in May 2007, and is likely to ratify it soon.

facilitated by institutional reforms, which could both establish such cooperation on a sounder basis, and lay the foundation for other initiatives.

The establishment of an International Tax Organisation now seems essential. The only truly global tax body, the UN Committee of Tax Experts, has virtually no resources, and an extremely limited mandate, essentially confined to working on the model tax treaty and its commentary. Although it is supposed to be concerned especially with the problems of developing countries, much of its activity consists of adapting the work already done by the OECD-CFA to the relations between developed and developing countries. Other international institutions, notably the World Bank and the IMF, have taken relatively little interest in tax. Although this is now changing, they adopt an individual country rather than a system-wide perspective. A loose network for discussion mainly among officials and specialists has been established in the International Tax Dialogue, but it is little more than a website. An ITO would establish a much more effective forum to develop the kind of more positive coordination of taxation outlined above, restoring the powers of national states.

It has often been argued in recent years that globalisation is undermining the nation state. If this is so, it should be felt as sharply as anywhere in relation to taxation. The survey provided in this paper I hope paints a more complex picture. The national state is far from dead, or even moribund. However, economic globalisation, especially due to international liberalisation, has created some significant pressures which do threaten tax powers, and therefore pose a challenge for the future of effective and legitimate governance. As shown in the analysis presented here, the approach to international taxation developed in the last century has some serious limitations in the current context. Although some attempts have been made to overcome these, a more radical approach is needed.

The answer to these challenges is the development of more effective forms of international cooperation and coordination. This paper has suggested a number of ways in which this could be done in the field of taxation. Far from posing a threat to fiscal sovereignty, as some might suggest, such closer cooperation is in fact the key to a reassertion of the rights and powers of states to establish effective taxation in the face of the extensive liberalisation, especially of capital flows, brought about in the past two decades.

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