

Tax Havens & The OECD Campaign Against them

By

Hakan Narci

Supervisors

Guttorm Schjelderup and Henrard Luc

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Executive Summary

There are two essential primary purposes for this thesis.

The first has been to highlight the phenomena Tax Havens with its economical impact on other countries outlined in chapter two. Firstly the concept of tax havens is presented based on the OECD definition. Secondly the secrecy legislation, regulation and the corporate structures which tax havens offer to foreign investors and firms are given with their significance for other states. Thirdly, the ways tax havens are used by foreign investors and firms are given. This chapter ends by looking into the effects tax havens have on other countries, in other words does the existence of havens matter to other countries? This chapter concludes that existence of tax havens has led to more intensive competition among countries for mobile capital, which seems to only benefit companies and investors and not other countries where they lose their tax base and thus threatening the welfare state, while the biggest damage seems to be the hindrance of the democratic process in developing countries. In addition, havens' tax system is discriminatory, since it favors only foreign investors and companies compared to other countries. With the combination of secrecy rules and regulations one could claim that tax havens do not compete on equal terms, this represent a kind of competition which harms other countries economy.

The second primary purpose is to present the Organisation for Economic Co-operation and Development (OECDs) campaign against Tax Havens. The main objective is to analyse the campaigns major historical developments. To improve our analysis political theories has been applied, to provide further explanation both for the existence of the OECDs campaign and major historical developments. The idea is to provide knowledge for better be able to understand the political power behind the developments and why. This part ends by reflecting on what this account may forecast for the prospect for tax information exchange. Multinational organizations such as the OECD are created to fundamentally promote the interests of their member countries and eventually change their purpose in accordance with changing collective interests. Jurisdictions such as tax havens that are forced to change their actions will most likely comply only with the extent necessary to evade sanctions. Finally, in the light of the new Global Forum on Transparency and Exchange of Information the future of tax information exchange is evaluated and the effectiveness of Tax Information Exchange Agreements is deliberated and the likelihood of mock compliance is assessed.

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1. Introduction

Tax evasion is a very popular topic for states worldwide. Due to high advancements in technology and enterprises in general, businesses have become global in nature. This has motivated states to compete over attracting businesses. A favourable tax rate may be a tool to achieve this objective. These developments have led to some states endorsing laws which entirely focus on providing low tax rates to foreign businesses and investors. They provide methods which are suitable for enterprises and investors to avoid tax in other countries, thus the term tax haven. Even though this represents international competition among countries, tax evasion in this sense does not seem fair when it does not display economic reality. A state imposes taxes on its residents and domiciled businesses to finance its public expenditures. Ethically, all parties who contribute with taxes should benefit from public goods. Tax havens incentivize residents of other countries to take advantage of their methods to avoid taxation in their home country. At the same time, these residents still receive benefits created by other taxpayers' contributions in their home country. Due to this, states have endorsed (and still endorsing) legislation to prevent this kind of abuse.

2. Tax Havens

This chapter firstly presents the concept of tax haven and its definition. Even though there are several definitions, I find it most naturally to focus on the OECD definition since it is the most internationally recognized one. The difference between tax havens and harmful preferential tax regimes is also accounted for. Common features that characterize tax havens as a group have also been presented.

Moreover, this chapter examines the attractiveness of tax havens, and some examples of different methods on the way they are used are given such as transfer pricing and debt arrangements. This chapter ends with the important discussion on the economic effects of tax havens to reach a conclusion about the desirability of tax havens.

2.1 The Concept of Tax Havens

Since the 1950s, the term Tax Haven has been widely used, but there is still no consensus on its meaning (Palan, 2009). The use of tax havens first became possible due to the creation of illusory tax domiciles – the rupture of legal residence from the physical location of enterprise operations or investments (Webb, 2004). Since the 20th century, 'virtual' residencies were possible because of the British courts, where they allowed companies to incorporate in Britain without paying tax and laid the foundation of the entire tax haven phenomenon. The Court decided that a firm's "home" country for tax obligations relied on the location of the "center" of management and control", rather than where the firm was incorporated. This new principle became common among most law jurisdictions, thus accepted standard for tax residence. The new principle is exploited by companies and firms to avoid tax obligations from the countries they actually operate in. For instance, firms can fly their directors to a tax haven for its annual meeting in order to claim that this is where the control is exercised. These sorts of peculiar techniques are elaborated later in this chapter.

Globalization and the enormous increase in international business in the last decades have led to a debate on tax havens' impact on global economy, policy makers around the world have shown their concern and measures have been taken to address the negative effects of tax havens. Even president Barack Obama addressed this issue 4th of May 2009, when he

submitted a proposal on new tax regulations and measures against tax havens because of their negative impact on the US economy¹. However, the US itself is sometimes called a tax haven, showing the level of uncertainty about what tax havens really are. Therefore, there is no standard definition of a “tax haven” and a lot of controversy exists around these jurisdictions. The concept is therefore not used in international law or national legal texts, but can be found in certain lawmaking proposals which seek to approve procedures to counteract harmful structures and the lack of information-exchange in tax cases (NOU 2009: 19).

Even so, the expression “tax haven” is common and often used in media; it is used vaguely to describe countries characterized by the implementation of abnormally low tax rates – both for their entire economy or for shell firms for foreign owners. Using only the tax rate as a criterion for identifying havens is too vague, since some high-tax countries also have implemented low taxes on some parts of their economy – permanently or for defined periods (NOU 2009: 19).

In the broadest sense, the term tax haven is used to denote offshore financial centers (OFCs) and secrecy jurisdictions. This makes the concept of tax haven even vaguer. No matter which definition used the principal objections remain the same, that the regulations and laws are engineered to accommodate foreign firms and investors to avoid private and public interests in other countries, meaning those countries where the firm owners and investors are domiciled or have their obligations.

As previously mentioned, there is high uncertainty about what tax havens really are, still there are some clear identifiable criteria which make it easier to distinguish pure tax havens from other countries. This is discussed in the next section.

2.1.1 The OECD Definition of a Tax Haven.

In this part, the OECD’s general definition of a tax haven will be outlined with its main identified characteristics, and then a discussion where the distinction from harmful

¹ <http://thecaucus.blogs.nytimes.com/2009/05/04/obama-takes-aim-at-offshore-tax-havens/>

preferential tax regimes will follow. The essential characteristic to identifying a tax haven is that its laws can be used to avoid or evade regulations or tax laws of other authorities. The important factor here is the minimisation or the escape of tax liability. Even though this factor gives a good indication, it is far from sufficient to judge only by this factor.

The OECD acknowledges that there are no specific grounds why two nations should have the same level and structure of taxes, and that these are vital political decisions for state governments and their domestic policy. States should be free to design their own tax system as long as they abide by internationally accepted standards in doing so (OECD, 1998). The challenge is to reach consensus on which international standards should be followed. In 1996, Ministers from G7 requested the OECD to “*develop measures to counter the distorting effects of harmful tax competition on investments and financing decisions and the consequences for national tax bases, and report back in 1998*” (OECD, 1998, p 3). The OECD constructed international standards for taxation which seems to be the most internationally accepted standards since 1996. The resulting report “Harmful Tax Competition” was published in 1998, which leads to the main characteristic elements at that time given by the OECD to identify Tax Havens (OECD, 1998 p 23): In the aftermath the OECD have made some changes the number of criterions, this is elaborated on in chapter 3.

- a) *no or only nominal taxes*
- b) *lack of effective exchange of information*
- c) *lack of transparency in the jurisdiction`s tax practices*
- d) *no substantial activities*

The first criteria “no or only nominal taxes” is crucial to identify a jurisdiction as a tax haven. If a jurisdiction offers itself as a place where non-residents can avoid tax in their home country, it may be reasonable to classify this jurisdiction as a tax haven. While the other factors work more or less as facilitators for the use of havens as a way to minimize tax expenses, in other words as explained below the classification of tax havens depends on the particular context.

The second factor, lack of effective exchange of information, involves the willingness or the ability to cooperate and share information with other states’ tax authorities. This is under a Tax Information Exchange Agreement (TIEA) or Double Taxation Agreement (DTA). The OECD demands each tax haven to sign minimum 12 TIEAs to be deleted from the blacklist

and in turn become a cooperative tax haven. A co-operative tax haven is expected to make yearly scheduled commitments to remain delisted from the blacklist, thus eligible for successive renewals of its status to move to the next stage of the plan of progressive changes. If a tax haven's regimes contains any harmful aspects after the deadline for their elimination and/or the milestones and timetable are not met and it is not acting in good faith in accordance with its commitments, the OECD will place the tax haven on the List of Uncooperative Tax Havens. A jurisdiction could be limited in exchanging information, due to the implementation of a tax treaty or of an application of a national legislation. These secrecy laws prohibit the tax authorities in other countries from collecting information on taxpayers benefiting from the laws of tax havens. Even if there are no secrecy laws, administrative policies or lack of cooperation in tax havens may hamper the exchange of information. Tax havens might be difficult in obtaining and providing information on behalf of high-tax countries, such regulations could imply that these jurisdictions constitute harmful tax competition. According to NOU (2009:19), most OECD countries have opted to implement the domiciliary principle for high net worth individuals and source state principle for firms to taxation. The first principle entails that private individual taxpayers are taxable in their country of residence, without regard for where the revenue has been earned, while the latter gives right to the country where the revenue is earned. It is also possible to combine these two principles. One could assume that these principles lay a good foundation for decisions regarding for which tax category and tax-rates states should impose on enterprises and individuals. If this was the case, and that all countries implemented information sharing systems where all information was available to other states tax authorities, the tax-rate calculated for companies and individuals should not be affected. Unfortunately, this is not always the case, since some jurisdictions refuse to share little if any sort of information regarding tax issues.

Information sharing systems are relatively easy to implement, but they do have some cost, and havens will most probably bear most of it. Since investors and multinationals companies use tax havens to reduce or avoid tax in their country of domicile where they operate from. Therefore, most of the information flow will go from havens to other high –tax countries. The most likely reason for these sorts of rules and practices which limit the access to information must be that both the jurisdiction and the taxpayer are concealing important information. This could be the lack of ability and desire to enforce the two principles. The gain in the event of such practices is that one has the potential to attract taxpayers who wish

to commit tax evasion. For example, for wealthy private individuals, the lack of effective exchange of information may be attractive if they want to put their savings outside the reach of the tax authorities of their own country.

The third factor, lack of transparency in the jurisdiction's tax regime, is about the possibility outsiders have to get an overview of the operations of a country's tax regime. Even though the jurisdictions have written laws where the tax rate and tax base are not negotiable, if the way administrative policies work and the enforcement does not conform to the written laws, this could be harmful towards other countries. When access to this type of information is obstructed, there is a lack of transparency. Human creativity is the only restriction to make those laws more convenient for taxpayers. By interpreting the laws in different ways to serve the temporary agenda one has or to adapt to the enforcement of the laws. According to the OECD tax havens can, for example, intentionally implement a lax audit policy as an implicit incentive to taxpayers to not act in accordance with the tax laws, while NOU (2009:19) claims tax havens often exempt foreign investors and firms from the obligation to audit, where it is up to the firms to decide if they want to make an audit. Furthermore, as mentioned earlier, havens can adopt unusual administrative practices contrary to the elementary procedures underlying statutory laws. These may motivate corruption and discriminatory treatment and make the enforcement of tax laws of other countries more problematic. This will most probably give these taxpayers a competitive advantage, hence more likely to increase harmful tax competition.

The last factor concerns the lack of the requirement that the business activity must be substantial. This factor implies that a jurisdiction could be attempting to attract investments or transactions which are solely tax driven. According to the OECD, many havens are constructed in a way that permits taxpayers to obtain remuneration from the regime, while at the same time engaging in activities which are entirely tax driven and engross no substantial activities. For instance, transactions related to holding activities may make jurisdictions attractive when there is no requirement for substantial activities. Therefore, a company which has chosen to locate in a jurisdiction where it has no substantial activity would be difficult to defend, and thus the most logical explanation for this kind of company decision seems to be tax evasion.

The OECD also makes a distinction between pure tax havens and harmful preferential regimes. This is viewed in the next section.

Harmful Preferential Tax Regimes

Some jurisdictions adopt a tax system favorable only to a selected group of taxpayers or parts of the economy. If so, this way of constructing the tax regime may serve as an attractive factor for foreign investors, without benefiting domestic taxpayers. In other words, the low tax rate and other possible benefits only apply to foreign investors. To clarify the distinction from tax havens, the OECD uses the term harmful preferential tax regime in its report. The main elements given by the OECD to identify Harmful preferential tax regimes (OECD, 1998 p 27):

- a) no or low effective tax rates
- b) “Ring fencing” of regimes
- c) lack of transparency in the jurisdiction’s tax practices
- d) lack of effective exchange of information

The purpose is to determine to what extent a jurisdiction functions as a tax haven. A harmful preferential tax regime has been given the same distinctive features as a tax haven, although is incorporated in a non-haven regime, and does not concern the “traditional” tax system of the jurisdiction. The only difference among the given criterions compared to tax havens is “ring fencing”.

Examples of “Ring fencing” (OECD, 1998 p 27).

- i. The regime may explicitly or implicitly exclude resident taxpayers from taking advantage of its benefits.*
- ii. Enterprises which benefit from the regime may be explicitly or implicitly prohibited from operating in the domestic market.*

On the basis of these elements, the primary goal of a harmful preferential tax regime is to be a magnet for highly mobile activities from foreign countries, and at the same time not influence the regime’s own economy. This often implies laws which prohibit foreigners from using the local currency, local labour, and the establishment of local enterprises in the jurisdiction (substantial activity). According to the OECD, the most likely reason for these types of laws is to protect their own economy from the favourable tax regime they are offering to certain taxpayers. It’s quite obvious that these jurisdictions are forming their tax-policy in a such way that the regime cannot be used domestically by the foreign investors, and at the same time does not prevent it from being used against other countries. Thus, the

jurisdictions do not care about the damaging effects their tax-system will have on other countries. The fact that a state actually needs to shield its own economy from the regime by “ring fencing” gives a strong sign that the jurisdiction has the potential to harm other countries’ tax bases.

As we can see the term “ring fencing”, is the only difference among criteria when harmful preferential tax regimes are compared to tax havens by the OECD in its report. Despite the prevailing definitions applied, the primary objections of tax havens and harmful preferential tax regimes remain the same. Their administrative regime is built in a way intended to bypass public and private interests in other countries. This means the countries where the proprietors of the firms have their permanent residence or have their obligations. The tax misuse in other countries is especially influenced, but structures in tax havens and harmful preferential tax regimes are in several cases as well convenient for harbouring a number of other forms of criminal activities (NOU, 2009:19). Since the difference between tax havens and harmful preferential tax regimes is very vague therefore it would be more expediently to combine the criteria provided by OECD of tax havens and harmful preferential tax regimes together. This gives us five key criteria:

- a) no or low effective tax rates
- b) “Ring fencing” of regimes
- c) lack of transparency in the jurisdiction’s tax practices
- d) lack of effective exchange of information
- e) no substantial activities

Through the part of this chapter the five key criteria given by the OECD report “harmful tax competition” have been thoroughly explained.

For the rest of this paper, tax havens shall include harmful preferential tax regime, so no distinction between those two concepts will be made from now on. The OECD itself makes a clear distinction between tax havens and harmful preferential tax regimes due to the logical reason that they serve governments in identifying tax havens and in distinguishing between acceptable and harmful preferential tax regimes. From OECD own institutional perspective this distinction is essential since tax havens have no concern in trying to curb the “race to the bottom” with respect to tax revenue and are contributing to the erosion of tax base in other countries. As a result, these jurisdictions are not likely to collaborate in curbing harmful tax

competition. While a harmful preferential tax regime may have a considerable sum of income that are at risk from the increasing harmful tax competition, for that reason it will be more likely to collaborate on a concerted agreement.

2.1.2 Features of Tax Havens

Dharmapala and Hines (2009) have researched to identify countries that are more likely to become tax havens. Their research on this topic starts from a different perspective compared to OECD. Their analysis uses lists of tax havens² where typical characteristics of havens can be depicted. However, this method does not give explanations for when a jurisdiction is classified as a tax haven.

Some of these factors are that tax havens are mostly small countries, commonly below one million in population, have English as the official language, poor in natural resources, and that their geographical distance from major capital exporters is smaller compared to non-tax havens.

Some essential findings from their research which seem to be important factors for jurisdictions to become tax havens are elements related to governance quality - governance quality is defined as the level of political stability, government efficiency, rules of law, voice and accountability and the control of corruption. This argument is justified by cross-country indices of governance quality in which tax havens score very high. Many of the common features they identify among tax havens lead these jurisdictions to transforming into open economies. According to the analysis, there is a positive and significant correlation between governance quality and the probability of being a tax haven, which becomes even more significant when applied only to small countries. Based on these results, Dharmapala and Hines argue that small countries would like to be tax havens. Institutional quality is an important trigger for economic development, the competition among havens for capital increases their chances for growth. Therefore, only better governed governments are capable

² Dharamapala & Hines use the lists from the studies of "Hines and Rice, 1994" and "Diamond & Diamond, 2002: The list do not include 9 jurisdictions identified by the OECD as tax havens (Aruba, Virgin Island, Nauru, Mauritius, Samoa, Niue San Marino, Seychelles and Tonga), but in addition includes Luxembourg, Macao, Switzerland, Singapore, Ireland, Hongkong, Lebanon and Jordan.

to grow into tax havens and consequently set low tax rates. Since higher institutional quality implies a safer place for investments.

2.2 Structures in Tax Havens

So far in this chapter, the concept of tax havens and their main characteristics have been outlined, along with common features among tax havens. In this part, the characteristics of the legislation in tax havens are described, and their practical use. The aim is to describe the factors which contribute to the tax havens as facilitators for evading taxes and commit offences in other countries. The main factors are *secrecy legislation*, *regulation* and *peculiar corporate structures*. This does not necessarily imply that all havens have implemented these policies, but they are still common among most tax havens.

2.2.1 Secrecy Legislation

Secrecy legislation is different sorts of laws which prevent the flow of information from the public or private sector to third parties. According to NOU (2009:19), the objective of these laws is to ensure havens' foreign investors complete discretion. In other words, the use of secrecy rules averts admittance to information about the proprietorship of firms and trusts. Since secrecy rules are probably the most important "service" havens offer to attract investments. Contrary to what is usually expected of orderly rule-of-law states, tax havens offer secrecy rules about business activities that take place in other countries where the proprietor is domiciled and the company actually operates. Thus, the secrecy legislation will infringe severely on the sovereignty of other countries, since the aim of these rules has no objective other than concealing vital information on activities taking place in other countries.

This practice viewed from Dharampala and Hines (2009) article where they emphasize governance quality as a crucial factor for countries to become tax havens seems to make their definition of governance quality too narrow. Since when a state allows the private sector to practice activities which harm other countries economy represent itself clearly as bad governance. As governance quality is defined as the level of political stability, government efficiency, rules of law, voice and accountability and the control of corruption, logically, one

would assume that these qualities result in a traditional order rule of state. Therefore even if some tax havens are well governed as in having a high governance quality and still implementing such practices into their legislative framework this may strongly suggest that they don't respect other states laws and policies especially in tax matters.

The secrecy legislation gives the foreign investor the opportunity to conceal investments, ownerships, business activity and even criminal offences in other countries. The disturbing issue here is that this privacy can be abused. This could inflict harm or injury to public interest or even individuals. Therefore, it is important that information regarding business activities both legal and illegal is available to authorities concerned. While tax havens emphasize that their policy is constructed to give protection to the private sector, they fail to take into consideration the harm that may be caused to other parties. This policy leads to or very limited information available in public records on the activities pursued and who is behind them, making obtaining any information that may exist nearly impossible. In addition, havens tend to be less inclined to cooperate with other states. Moreover, there is a requirement of legal request under strict conditions for accessing information, which makes the process of obtaining information impeded.

From a practical point of view, by accomplishing several transactions through tax haven(s), the secrecy rules make the tracking of transactions from beginning to end nearly impossible, thus concealing the actual owner of capital and asset placements as previously mentioned. This makes it nearly impossible to collect information about where and how the funds or assets materialized, and whether the funds have an illegal origin. Secrecy is essential to tax havens because it allows people to take advantage of the benefits of tax havens with the assurance that their home jurisdictions will not be able to hold them accountable. In other words, secrecy legislation makes it easier and even gives incentives to evade tax and is as well a convenient apparatus for money laundering of illicit funds. This shows that secrecy covers the aspects lack of "effective exchange of information" and "transparency" of tax havens. They will together be referred to from now on simply as secrecy.

2.2.2 Regulation

In addition to secrecy laws, there are numerous other laws within the regulatory framework of tax havens which differ from corresponding rules in traditional rule-of-law states, and

experience shows that havens tend to be very creative to attract capital and foreign companies.

Information sharing among tax havens and other countries is only possible if international bilateral agreements have been entered into. Even if most havens have entered into such agreements with other states which have normal tax rates, especially after pressure from the OECD after GFC (see chapter 3), there is still uncertainty whether these agreements will be useful due to several factors. The possibility for investors and companies to swiftly move their documents to other tax havens may make the value of such access limited. Furthermore, a creative act by most havens where they have allowed the issuance of bear shares creates even more obstacles when information about ownership is sought. Bear shares are securities where the ownership is not registered anywhere except for the security itself. This implies that whatever firm or individual who physically is in possession of the shares is to be considered as owner. Changes of ownership can be accomplished without any formalities by the physical transfer of shares from one person to another. Another problem which emerges after this transfer is that afterwards no one has the right to claim the securities back. Tax havens have laws that entail that change of ownership is not recorded, and the securities may be kept anywhere in the world, and the only way to prove the ownership is by submitting the securities. Therefore, bear shares create difficulties and impede information gathering for third parties, thus making it easier for investors and companies to conceal taxable income.

Most tax authorities in tax havens deliberately implement lax audit and accounting policies. Often there is not statutory for foreign firms to prepare any kind of accounts. If there are statutory requirements to prepare accounts, they are often loosely worded. The ways accounting rules are enforced are uncertain, if they are enforced at all. The authorities in havens are usually not concerned with control and enforcement of broad and complex rules because local interests are not involved (no substantial activity). Additionally, if there are any prepared accounts, there is often no or limited requirement for keeping the documents and where they should be kept. Since foreign companies pay no or little taxes, tax havens exempt these firms from the obligation for preparing accounts. Since this requires a great deal of managerial and legislative work for the authorities responsible, it implies unnecessary costs, but it also means that havens do not take into consideration the effect exempted firms have on other states NOU (2009:19).

2.2.3 Peculiar Corporate Structures

Tax havens offer numerous unique corporate structures to foreign investors and companies, which also contribute to giving the outside world little or no chance of gaining information admittance to trustworthy information on firms and trusts registered in havens. In this section, some of the most common structures in tax havens have been accounted for.

Some of the most common corporate structures are either called “international business corporations” (IBC), personnel investment company (PIC) or “exempted companies”³. These terms go under the legislation as tax havens but are collectively referred to as offshore companies. The term “offshore” in this context implies that the companies are registered in the jurisdiction but do not have any substantial activity there (cf. With OECD substantial activity factor). In addition to some of the factors mentioned earlier in this chapter, such company structures in havens are attractive due to:

- The right to redomicile the company
- Exemption from the obligation to:
 - o prepare audit or accounts
 - o pay taxes and duties
 - o register and publish ownership
 - o preserve accounting documentation (if accounts required)
 - o hold board meetings locally

The consequence of establishing an “exempted company” in havens is that there is no or little activity there. This means that the firms are exempted from several obligations on the condition that all activity of any importance takes place in other states, where assets are actually located and owners domiciled. The only condition required by tax havens for establishing a company and taking advantage of the all the favourable conditions is often the prohibition of engaging in business activities in the jurisdiction, such as using local labour or the local currency.

³ The popularity of these kind of corporate structures is reflected for example in British Virgin Islands with 22.000 residents have registered over 830.000 IBCs (NOU, 2009:19, p 34), and Cayman Islands with 49.000 residents have registered approximately 45.000 such companies (Sikka, 2003, p 372)

Foreign Company is another collective term for corporate structures. For instance, under the legislation in Mauritius, they are referred to as Global Business Company 1 (GBC1) or Global Business Company 2 (GBC2). The general characteristic features on GBCs firms are similar to structures in other havens (NOU, 2009:19). Authorities in Mauritius permit the establishment of a foreign company as long as the business is not locally operated, conducted in foreign currency, and no locals are employed (cf. With OECD substantial activity factor). Both company types benefits from numerous exemptions, which differentiate them from local firms, such as (NOU 2009:19, p 86):

- *No obligation to publish any reduction in stated capital*
- *A subsidiary can own shares in a holding company which owns the subsidiary*
- *Exemption from the requirement to prepare an annual report and annual return*
- *Exemption from official inspection of the company and the duty of redemption, obligation to indemnify and so forth.*

Furthermore, there are exemptions which only apply to GBC2 due to the difference in essential areas of the regulation between GBC1 and GBC2, where GBC2s have additional exemptions than GBC1. The purpose of two different types of structures is that they are directed at different target groups. GBC1 is intended for investors and firms who want to benefit from the tax treaties⁴ with transactions out and into Mauritius. The requirements are that the firm must be considered as the beneficial owner of the income within the provisions of the tax treaty and regarded as resident in Mauritius. The degree these rules are fulfilled is often unclear, and due to secrecy rules and exemption from accounts, obtaining information is difficult. This implies that a firm`s contractual partners have no chance for getting information regarding the firm`s operations. Therefore, their contractors will not be in a position to report for example violations or to require clarification for unclear factors affecting the accounts. Companies registered as GBC2 cannot use the tax treaties mentioned above and corporation tax is zero. As we can see the elements discussed through this whole chapter also apply here, and therefore, these types of structures are suitable for tax evasion and economic crime.

⁴ Most tax havens have a relatively well-developed network of tax treaties to avoid double taxation (NOU, 2009:19)

Protected Cell Companies

A relatively new company structure called Protected Cell Companies (PCCs) was implemented by Guernsey in 1997. Since then, many other havens have followed the same path. This type of company structure is especially popular among funds such as pension- and investment funds. In basic terms, a PCC is a firm constructed with dissimilar patrimonies, all separated through “cells”. The total number of cells constitutes the entire company, which is an independent legal entity. In other words, the company itself may be considered as an outer shell which consists of numerous cells. This is possible since the company has the option to divide their assets and liabilities into different cells with their respective activities. The cells are separate and independent from each other and the outer shell. Consequently, this type of company structure gives great protection against creditors and third-country governments. Since the cells are autonomous, the financial commitment of a cell has no effect on other cells. Thus, in case of insolvency, creditors and third-parties will only be entitled to assets in this cell, and insolvency should not affect the business of the whole entity or the performance of other cells. According to NOU (2009:19) PCCs have no real activities in the additional domicile offered by havens while they are benefitting from a zero tax regime. This means that the source country where the firm operates is robbed of tax on capital income, therefore only favorable for investors. This represents a harmful structure. No public registry of PCCs exists, thus they are also sheltered by secrecy laws. As a result of this, and due to PCCs’ structure gaining information as an outsider will be time-consuming and resource intensive. To access any kind of information requires a legal request. Initially one has to obtain information about the firm (outer-shell) before obtaining information about the individual cells, and further information about the individual cells also requires legal requests, and an individual cell could consist of several protected cells as well. Therefore PCCs are very suitable for protection of assets and secrecy against third parties.

Trusts

A trust is an assortment of assets where the original owners of the assets transfer their assets to managers or trustees with a legal obligation to administer for the benefit of designated beneficiaries (original owners) as stated in trust agreements. According to these agreements, the trustees are the formal and legal owners of the assets while the original owners are entitled to benefit from the assets. These agreements are structured so that the trustees

exercise ownership in accordance and on the behalf on trust in agreement with the trust contracts on behalf of the beneficiaries. The original owner decides if he/she wants to make himself or the trustee to be the beneficiary. In trust contracts usually trustee's benefits are fees for keeping the legal and formal ownership, additionally receiving compensation for work hours. The original owners could select an agent between the trustees and the beneficiary. These are very reliable individuals who either instruct or are charged with monitoring whether the trustees operate in agreement with the trust contract and in the interest of the beneficiaries. Practically, this implies that the original owner or the appointed agent has actual control and authority in respect of the trust funds and not the formal and legal trustee.

There are many advantages that come with trusts but the most important one is the distinction between the actual control and legal ownership. This gives the opportunity for "transferring" ones taxable wealth from a high-tax country to a trustee located in a tax-free haven. Even though those who are designated as beneficiaries of the trust will be exposed to taxation when distributions are received from the trust, the owners will easily manage to avoid taxation due to secrecy rules. There is no open registry of trusts in tax havens, this implies a huge challenge for tax authorities and third parties in other countries to collect information on trusts subsistence and become informed of assets placed in trusts. In case of legal claims against the beneficiaries, the plaintiff will meet several obstacles due to the lack of information regarding the existence of trusts and the real circumstances of control. In other words, this information is obstructed by the secrecy laws of havens NOU (2009:19).

Harmful Structures in other States

A number of countries who are not regarded as pure or classical havens permit harmful secrecy laws. Although they only have elements of harmful structures compared to full-fledged havens, they cause loss and damage to public interests in other countries. Some of these countries are Switzerland, USA (Delaware), Luxembourg, and Belgium. Only few states among these offer secrecy at the same level as havens, while others who do not usually make use of firms in tax havens. A highly popular structure which accounts for a significant amount of capital flow is pass-through arrangements of various sorts. In practice, often a holding company is used as an intermediate which usually has no activity in the pass-through country. On paper, the states where the pass-through firms operate in, have given the

firms the right to be regarded as domiciled under the tax treaties, and thus these firms will be the beneficial owner of the capital transferred from other states, which implies that it is the legal owner of the revenue that passes through. This means that the source country where the firm operates is robbed of tax on capital income, while favourable only for the investors. This represents a harmful structure. Most likely, the majority of these countries have adopted this rule since it is a necessity for the pass-through model to function.

The so-called shell-companies, for instance “Special Financial Institutions” (SFIs) in the Netherlands, are a good example that illustrates the extensive use of pass-through arrangements. By the end of 2008, their assets totaled approximately EUR 4 150 billion. While direct investments from the Netherlands accounted for EUR 2 200 billion, SFIs accounted for over EUR 1 600 billion of these (NOU, 2009:19). By allowing synthetic and commercially unneeded firms to be placed between the source and domiciliary country, the tax-base in states is most probably negatively affected. Furthermore, there are countries who have implemented regulations which allow foreigners who settle there to only pay tax in revenue locally earned, while income from other states is tax free due to tax treaties. While some states allow firms which are exempted from audit and tax requirements, these types of firms are often suitable for participating with states with great arrangement of tax treaties and company structures in havens.

2.3 The use of Tax Havens

The OECD says publicly that havens serve three key purposes (OECD 1998, p 27)

- *They provide a location for holding passive investments (“money boxes”)*
- *They provide a location where “paper” profits can be booked*
- *They enable the affairs of taxpayers, particularly their bank accounts, to be effectively shielded from scrutiny by tax authorities of other countries.*

Intuitively one might believe that tax havens may also be attractive for real businesses. Therefore, the OCED view of havens could seem too narrow. Then again, since most havens prevent foreign companies from substantial activity in their jurisdictions, havens’ attractiveness is mainly due to the peculiar techniques which havens use as a tool for tax

evasion or even economic crime. Below two main techniques used by enterprises are outlined.

2.3.1 Transfer Pricing

Transfer-pricing is price setting between affiliated enterprises (Bjerke, 1997). According to the OECD, enterprises are related when a company participates directly or indirectly in the management, control or ownership of another enterprise, or the same person is participating directly or indirectly in the management, control, or ownership in another company. For these companies, differences in tax-base and tax-rates between high-tax -and low-tax countries could give them, as foreign companies, significant additional profits. By shifting taxable revenue to low-tax countries and adjusting prices of intra-group transactions. Naturally it appeals to multinational companies to reduce their tax burden since it represents a cost, and tax havens play a big role in these transactions. Intra-group transactions are generally legitimate and necessary, but on the other hand, problems arise when companies drive illegal price-setting of intra-group transactions.

Nearly every country has implemented the arm's length prices method for intra company transactions. This method requires that prices that would be charged between unrelated parties shall be used. The problem is to determine the arm's length prices due to lack of comparable unrelated transactions, which leaves a considerable room for discretion (Hines, 2005). In practice, for instance, when it comes to intellectual property, nearly impossible to define arm's length prices for design, trademarks, know-how etc. (Desai, Foley & Hines 2006a). Furthermore, research shows that multinational companies in the US are more prone to have tax haven affiliates if there is a higher intensity of sales linked to parties abroad. This is consistent with the relocation of taxable revenue to tax havens by exploiting transfer pricing.

In practice, transfer pricing is when a company sets low transfer price on products or services from a high-tax to an affiliate in a low-tax country, the company then achieves low taxable net income in high-tax country and a high taxable net income in low-tax country. The lower the transfer price from the company in the high-tax country, the lower the net income, thus reduces total taxable income. Another way, or the opposite way, would be to inflate prices on products or services to an affiliated company in a country with high tariff

rates, thus reducing duties. According to Baker (2005), the same principle method is also used by independent companies which enter into contracts for price setting which is profitable for both parties. These kinds of contracts are made in advance in tax havens to avoid tax authorities in high-tax countries, thus in secrecy, where the company in the high-tax country receives some of the overpricing from the public transaction.

2.3.2 Debt Arrangements

Another strategy which multinational companies use is rearrangement of debt among their enterprises, which can be accomplished through intra-enterprise lending. In practice, an enterprise in a high tax-country lends capital from capital markets, where interest expenses are deductible to tax purposes. This new capital is then transferred to an affiliate enterprise in a low-tax country as equity. Then, the enterprise in the high-tax country lends the equity back, and the interest obtained by the affiliated enterprise in a low-tax country on this loan will be subject to a low tax rate, while the enterprise in the high-tax country gets additional interest expenses and gets further tax-deductible interest expenses. The enterprise in the high-tax country then makes a risk free investment. Since interest cost is generally deductible for tax purposes in high-tax countries, income subject to tax will decrease. This method is called earnings stripping or interest stripping (Dharmapala, 2008). According to Desai, Foley and Hines (2003) affiliates in high-tax states have higher debt/asset ratios than affiliates in low tax countries. They show that 10 % higher local tax levels are related with 2,5 % higher debt/asset ratio. Their research does not directly prove by any means of debt arrangements since havens are used for debt arrangements. Nonetheless, it does illustrate that debt is used to finance related enterprises in high-tax states, and resulting in lower total tax expenses. Since this will most probably threaten high-tax countries' tax bases, they shield their tax base by enacting thin-capitalization rules which limit interest deducibility after certain debt/asset ratio is exceeded.

2.4 Economic Effects of Tax Havens

The characteristics of tax havens have now been reviewed with their typical regulatory framework and corporate structures that are offered and methods of how companies take advantage of this in practice are given.

This section look into the effects this have on other countries, in other words does the existence of havens matter to high-tax countries? The first topic in this part examines the development in economic growth of havens in relation to their natural growth potential. In the second part the research on negative and positive effects of havens on high-tax countries are discussed.

2.4.1 Economic Developemnt in Tax Havens

In the last decades, the world has experienced immense expansion of global business activity. The rapid development of more liberal capital markets has increased the economic significance of foreign direct investments (FDIs) since the 1980s. The high growth in international business seems to have been and probably still is beneficial to havens. They attract disproportionate shares of aggregate FDI because of their low tax rates and efforts to facilitate tax evasion (Hines, 2005). Between 1982-1999, havens achieved greater growth rates of Gross Domestic Product (GDP) within their country's borders than the world as a whole. Even though this may be due to correlating similar characteristics compared to other countries, such as government quality, wealth, and their size, the analysis still shows higher growth rates when controlled for these observations. In other words, havens grew faster than would be assumed on the basis of their size and wealth (Hines, 2005). There is high uncertainty whether all or most of the difference in growth rates can be explained by FDI. Hines (2005) exemplifies with figures from multinational companies domiciled in US that their influence has increased on havens' economies. This can be considered as an indication that FDI highly contributed to the abnormal economical growth in havens. This explosive growth raises several questions. Havens probably achieve higher growth at the expense of high-tax countries. The important issue is whether the kind of structures which characterizes havens is competing on equal terms with other high-tax countries, and are they harmful to other countries?

2.4.2 Negative Effects of Tax Havens

In this section the negative aspects inflicted on modern rule-of-law states by havens are highlighted and discussed.

Harmful Tax Competition

Economic integration since world war two has led to higher capital mobility, giving states the opportunity to give favorable tax terms to attract capital from abroad, thus increasing tax competition among countries. Countries may tend to set to low taxes without knowing that they are harming other countries' tax bases, and this is reinforced by havens' use of secrecy rules and fictitious residencies, thus exploiting the domiciliary principle. Most OECD country members have implemented this principle to taxation, but due to secrecy rules the domiciliary principle has often proven to be difficult to enforce. The effect of higher tax competition has led to lower taxes on mobile tax objects and higher on immobile tax objects (NOU, 2009:19)

Among many other unfortunate effects, this change leads to more skewed distribution in tax burden. For instance, owners of capital will pay a smaller portion of total taxes while wage earners pay a higher share. Research shows that change in tax composition from what is socially optimal where reduced capital taxes are offset by higher taxes on other parts of the economy increases the social costs. For example, increased taxes on wage earners reduce the incentives for working more, which leads to higher loss of efficiency (NOU, 2009:19).

Generally, the loss of efficiency in tax financing is smaller the broader the tax base and the lower the tax rates are. Since havens offer low tax levels mainly for mobile factors, this leads to a reduced tax base for other states, forcing them to implement high taxes for the residual tax base, resulting in higher loss of efficiency. Another important aspect on this issue is that secrecy rules make tax competition even more damaging to high-tax countries, since it prevents them from obtaining essential information which causes further harm. One could therefore rather argue that havens do not increase tax competition, but exploit lawful structures which intrude on the sovereignty of other states.

Tax Revenue in other States

The discussion above leads to an important question to examine about whether other countries have less taxable income because of the existence of legal harmful structures in havens. According to Dyreng and Lindsey (2009) this inspection has proven to be a challenge. First of all, it is nearly impossible to survey the amount of domestic revenue which has been relocated to havens for tax avoidance. Since this will have a great impact on tax income, the research will therefore be significantly limited. The analysis is therefore constrained to the loss of tax income under the condition where revenue has already been relocated to havens. Furthermore, the income effect of the relocation itself is not considered, so this might alter any research findings. The analysis that is possible in this case compares existing companies with operations in tax havens and existing companies without tax haven operations. If a company with business operations in havens has a lower effective tax rate in home state one could argue that the home state is losing tax income because of operations in havens. The foreign tax rate could influence the domestic effective tax rate but not the tax revenue directly. Dyreng and Lindsey (2009) examine the effect of havens and other foreign countries on the tax rates of multinational companies in the USA. Their study uses financial accounting data from a large sample of US multinationals with and without tax haven operations in a regression analysis.

The US tax-system only permits residents to benefit from operations in havens when profit repatriation is deferred. The US taxes repatriated foreign profits at its own statutory tax rate, providing only a credit for any foreign tax paid up to the US tax rate. A lower effective tax rate in the US for a firm with tax haven operations can therefore only be reached through deferral. According to this study, US companies which have operations in at least one haven achieve an average worldwide effective tax rate on worldwide revenue that is 1,5 % points lower than enterprises without any affiliate firm in a haven. The calculated “worldwide tax rate” is a combination of national and foreign tax rates on domestic and foreign income. If all the returns would be repatriated to the US companies, the worldwide tax rate would roughly equal to the national tax rate because the US taxes the difference amid the US tax rate and the foreign tax rate when returns are repatriated. The worldwide tax rate will be higher than the US national tax rate when the foreign tax rate is higher than the US national tax rate, since no US taxes are due. Dyreng and Lindsey`s (2009) regression model, shows that foreign tax rates are lower for companies with operations in havens than for their counterparts without operations located in tax havens. On average, US companies show

\$0.26 in present tax costs for each \$1.00 in pre-tax foreign revenue. This rate reduces to \$0.25 per \$1.00 for companies with operations in havens. Presuming a US tax rate of 35 %, the estimations give 9 percent national tax rate on repatriated foreign earnings for companies without operations in havens and 10 percent for companies with operations in havens. However the actual estimated tax rate for both “type” of companies is 4.4 percent. This rate implies a large deferral of foreign revenue, with the amount of deferral by firms with haven operations being somewhat higher. Translated into dollar amounts, these rates suggest that the US treasury could have collected an additional \$91.6 billion from the period 1995-2007 if firms were not able to defer the federal tax on foreign earnings. This analysis indicates that states have lower tax income because of the deferral of revenue repatriation by foreign operations. This applies for both companies with operations in havens and other foreign operations. Dyreng and Lindsey (2009) do not present a distinction in this effect for companies with operations located in havens, but it is quite obvious that low tax rates in havens suggest a greater amount of deferral.

As previously explained, the characteristic of the US tax-system is such that the US taxes repatriated foreign returns always at its own statutory tax rate. Due to this, havens may only generate a benefit through deferral. If a country uses another system, for instance, exempting all repatriated foreign revenue from its tax base, havens may as well generate a benefit without deferral. Thus, the use of havens will be more beneficial from those countries, and as a result, the corresponding loss of tax income will be greater. This study, one suggests that the existence of havens have a negative effect on tax income in high-tax states.

Tax Havens Impact on Institutional Quality in other Countries

Politicians in countries with well-built institutions and well-functioning political systems face problems related to tax havens – where they harm the economy and diminish public income. These negative effects can be reduced by policy or institutional changes. Therefore well-functioning states will be able to put in countermeasures against tax havens to decrease their damaging effects. This aspect viewed from a developing country’s perspective results in disturbing findings, their response to tax havens is more likely to be completely different.

According to NOU (2009:19) the most serious consequence posed by tax havens is their potential negative effect of weakening the developing countries’ institutions and their

political systems. The main reason for this is tax havens creation of a self-interest for politicians to weaken the public institutions. The lack of strong public institutions and enforcement bodies in developing countries gives an incentive to their politicians to exploit the opportunities given by tax havens to hide the gains from economic crime. Therefore for some politicians in states with weak public institutions and political system tax havens represent an opportunity - rather than a problem. Since they make it easier to conceal revenue which has been obtained illegally from for example the exploitation of natural resources, government budgets or development aid. Thus tax havens provide strong incentives to politicians in developing countries to make the political system weaker and rather tear down than building public institutions, therefore slowing down the democratic process.

NOU (2009:19) uses the Indonesian and Malaysian players' exploitations of the rainforest reserves as an example where they made a fortune. To achieve this, public institutions which were established to avoid such exploitation of natural resources were undermined by these players. Hence politicians were heavily incentivized by tax havens to make those institutions weaker to extract as much income as possible. This is also true for developing countries with huge oil reserves, where the democratic process is prevented by the politicians since it presents an obstacle for them to dishonestly obtain revenue and spend it as they please.

According to NOU (200:19) Acemoglu, Johnson and Robinson (2001) have produced the best-known study of the impact of institutions on state revenue. The authors' estimate that if a state is in the 25 percentile in institutional quality could develop their institutions into the 75 percentile, their national revenue would grow seven-fold. There are few factors that have such immense impact on economical growth and democratic development as institutions. Therefore the damaging impact of tax havens can be huge for developing countries. Not only do tax havens maintain institutions weak but they also heavily contribute to make them even weaker and at the same time slowing down economic growth which is much needed for the population in developing countries.

Inefficient Allocation of Investments

NOU (2009:19) explains that tax havens can change private investors' behavior, where some of the most profitable projects are rejected by investors in favor of less profitable projects.

The creation of society's wealth rests on investing in where the gains before tax are maximum in other words investing in where the economic gains are highest. But for investors and companies the return after tax is most important since this is the revenue they earn on their investments. For the whole society as one there should be constructed a model where the added value would be highest, therefore preferably the tax system should be constructed to make sure that the relationship between socio-economic and private investment decisions naturally corresponds.

Tax havens could change investor actions since some investments may be more lucrative after tax since it is possible to implement it through tax havens, therefore increasing the separation between private and socio-economic returns as a result lower value creation. The greater the difference between private and economic returns, the more the tax system in havens will cause the economy a loss of efficiency. In addition tax havens contribute to moving capital from industries with high returns before tax to industries with high returns after taxes. Tax havens low or zero tax regimes could imply that investments which would have not been made if they were taxed by the common laws are nonetheless conducted. This change eventually tears down the socio-economic gains on investments that have been carried out, thus tax havens reduce overall value creation for society in high tax countries.

2.4.3 Positive Effects of Tax Havens

Modern economic literature suggests a number of positive aspects related to tax havens.

Mobile and Immobile Factors

In economic literature, a distinction is made between taxation of mobile factors and taxation of immobile factors (Slemrod and Wilson, 2009). Immobile factors are linked to specific geographical location, for instance, machines, land and labour, while mobile factors in contrast are highly mobile such as capital. In other words, immobile factors are bound to a specific location, while mobile factors can easily be relocated to other jurisdictions, and are thus more suitable for tax evasion. Further on we will see that among many other academicians the difference between mobile and immobile factors in companies is often a starting point of a positive view on havens in economic literature.

Due to the high mobility of mobile Foreign Direct Investments (FDI), states compete over it. Regardless of the existence of havens, high-tax countries will compete for mobile FDI and eventually ease their taxes on mobile factors. Consequently, immobile factors will bear a greater part of the total tax burden, which would have a negative effect on total investments within the state. Due to the possibility of distorting effects of tax rate differentiation, this could lead to a “race to the bottom” for all different types of taxes.

According to Desai, Foley and Hines (2006a), high-tax countries wish to avoid this aggressive type of competition to maintain FDI. Thus havens serve up a positive point in limiting the scope of tax competition. Since havens facilitate harmful structures that offer a way to reduce the tax burden on mobile factors, they give an opportunity to high-tax countries to maintain high tax rates on the remaining tax base and at the same time to overcome their inability to set lower taxes on mobile factors. As a result, high-tax countries are able to draw investments, whereas havens attract mobile factors, such as FDI without severe rivalry. One important aspect which is not mentioned in this paper is the type of competition in combination with secrecy rules that tax havens represent. Havens heavily utilise authorized structures that encroach on the sovereignty of other states to attract capital – therefore one could claim that they don’t compete on equal terms and in this sense tax havens do not compete over tax.

Brennan and Buchanan (1980) have another view, they advocate that politicians tend to set the level of taxation to high, in such cases havens with low or non-existent taxes will lead those countries to decrease the general level of taxation, otherwise, they will lose parts of their tax base to havens. In other words, havens are for the benefit of voters since they discipline politicians so that they set more moderate tax levels. Brennan and Buchanan (1980) justify this statement by saying that politicians are usually not only attentive to fulfil voters’ desires, but they may have private benefits associated with high levels of taxes such as the wish for more power, strengthened by a larger public sector.

As explained earlier in this chapter, the presence of havens leads to a stronger change in tax composition from what is socially optimal in high-tax countries since havens’ secrecy rules and regulations enhance competition. Therefore, capital taxes are offset by higher taxes on other parts of the economy, which increases the social costs. Therefore, the loss of efficiency increases, since generally, the loss of efficiency in tax financing is smaller the broader the tax base and the lower the tax rates are (NOU, 2009:19). For that reason one could presume

that the assumptions underlying this analysis are based on ignorance of well-known economical literature on this respective issue.

Elevate Investments in Nearby High-Tax Countries.

Desai, Foley and Hines (2004) have undertaken an empirical study on the consequence of havens on high-tax countries in the same region. They argue that there is a positive correlation between economic activity in havens and economic activity in high-tax countries. Their regression analysis suggests that a 1.00 % increased probability of establishing a haven affiliate is related with 0.5 % to 0.7 % investments and sales growth of high-tax nation affiliates within the same region. This finding is linked to the positive view on havens as explained in the preceding part, where it was stated that the existence of havens made high-tax countries in a stronger position to attract investments, while mobile factors which accompany these investments are taxed lightly in havens. This means that havens contribute to increased activity in high-tax states, and therefore do not crowd out investment there. This will increase the effective return on investments and so make them more attractive for further investments. There are three possible explanations for this (Desai, Foley and Hines, 2004), which can be brought down to two:

- *The ability to relocate profits to tax havens improves the desirability of investing in high tax countries.*
- *Affiliates in tax havens offer valuable intermediate goods and services to companies in high-tax countries*

Since low tax rates can be considered to be the main factor which makes havens attractive, the first factor is most likely the most relevant one. It appears that tax havens facilitate investors and companies in escaping parts of the tax burden enforced by high-tax states. As results this leads to higher investment levels in these high-tax states than in the nonexistence of tax havens. This reallocation of capital which leads to higher investments levels don't necessarily imply that high-tax countries are better off, overall since investors and companies are able to make further investments this must indicate that capital which were supposed to be collected by the high-tax country as tax are in the hands of private sector therefore this can be perceived as a loss. Even if it results in increased investment activity and realization of more projects and jobs it also results in higher loss for the government, since companies are avoiding some of the compulsory tax. The paper does not discuss if less

tax levels which leads to higher investment leads to higher tax income for the governments. In addition higher investments could create more volatile markets and uncertainty especially with the combination of secrecy rules.

The second factor entails the sale of low-priced goods and services (lower priced since they are not taxed) to high-tax countries. These kinds of activities would probably also boost the return on investments in high-tax states. Tax havens mostly functions as facilitators for investors for avoiding some of the tax burden which is obligatory in high-tax states, and that the outcome is higher investment levels in those high-tax states than in the absence of havens. On basis of this analysis, one may conclude that the presence of havens stimulates overall investments, but this study is based on the presumption that investors are able to make real investments accompanied by real level of activity in a haven. Previously, in the part where the OECD definition of havens was presented, this discussion clearly showed that foreign investors who have operations in havens are not allowed to invest locally, use the local currency or use local employees. Therefore, seems like the assumption underlying the analysis is based on ignorance of investor regulations in havens.

Dharmapala (2008) explains that even if US FDI in havens increased over the period 1996-2006, overall US federal tax income from enterprises increased as well over the same period. Dharmapala argues that this shows that havens do not have negative effect on tax income in high-tax states. However, he does not take into consideration the effect other elements have on tax revenue, such as GDP. His analysis do not control for other significant factors when comparing for those two factors. US tax revenues may have increased because of the US economy, and this growth could have even been greater without the existence of tax havens.

2.5 Conclusion

Several aspects of economic effects of havens have been presented throughout this chapter. The question is now whether havens are advantageous for high-tax states. On basis of the discussed research, most of the aspects covered suggest that high-tax countries are better off without the existence of tax havens.

When it comes to high-tax countries, it is quite obvious that tax havens have a negative effect on their tax base. One could speculate if this effect can be outdone by other positive effects of havens, such as increased investment in high-tax countries, but as previously stated, the Desai, Foley and Hines (2006b) study is based on the presumption that investors are able to make real investments accompanied by real level of activity in a haven, which is prohibited by tax havens. Therefore, this study does not take into account those kinds of laws, thus losing much of its credibility. Based on the discussed research, high-tax countries overall loose tax revenue due to the existence of havens, and in addition motivate illegal transfer pricing and debt arrangements. Tax havens seem to only serve as a suitable facilitator for pass-through arrangements for capital, where there is no value creation since havens do not permit local investments in their jurisdiction. One of the most important aspect is tax havens impact on institutional quality in developing countries. An important potential negative effect posed by tax havens is weakening the developing countries' institutions and their political systems. Thus tax havens provide strong incentives to politicians in developing countries to make the political system weaker and rather tear down then building public institutions, therefore slowing down the democratic process.

Tax havens' use of secrecy and regulation to attract foreign companies and investors seems to impinge severely on the sovereignty of other countries, since the aim of these rules has no objective other than concealing vital information on activities taking place in other countries. This can lead both to tax evasion and economic crime in other countries. Furthermore, the company structures offered in tax havens for foreign companies tend to serve no other purpose than robbing the source country where the firm operates for tax on capital income.

The existence of tax havens has led to more intensive competition among countries for mobile factors, which seems to only benefit companies and investors and not high-tax countries. In addition, havens' tax system is discriminatory, since it favors only foreign investors and companies compared to other countries. With the combination of secrecy rules

and regulations one could claim that tax havens do not compete on equal terms, this represent a kind of competition which harms other countries economy.

The introduction of this chapter started with the questions “what is a tax haven”?, and “what do they represent”?. These questions have now been answered and thoroughly elaborated. Overall, there is a strong indication that tax havens do have a negative effect on high-tax countries.

Next chapter is about the OECD campaign against tax havens, where explanations for the existence of the OECD and its campaign are presented with the major developments on tax haven issue.

3. The OECD Campaign Against Tax Havens

In previous chapter tax haven's effects on other countries were outlined, which gave an economic explanation for OECD campaigns against havens. Additionally, it occurs to me naturally to give explanations for the existence of the OECD and its campaign developments on tax havens, also with political explanations. After all, these types of important decisions are taken by both highly ranked OECD officials and top-politicians from several OECD member-countries.

An introduction of the OECD with its functions is provided to better understand how decisions are taken. Throughout chapter 3, the political theoretical perspectives from constructivism and neoliberal institutionalism in the field of international relations have been presented, to give a better understanding of the OECD existence as an institution and its campaign with its major developments. Further on, weather the OECD supports norms or national interests emerge. This leads us to collective interests among countries and how it led to a campaign against tax havens.

The early major developments of the campaign in 2001 and 2002 are illustrated with main focus on reputation and interests as a result of OECD blacklisting. The new path, in terms of the reasons for why the OECD needed to make major changes to its campaign has been outlined, and how this affected secrecy.

The ways Global Financial Crisis affected national interests and in turn the campaign against tax havens is discussed. Further on why tax havens complied with the OECD terms, and the chapter ends by reflect on what this account may forecast for the prospect for tax information exchange to deal with the tax haven issue, followed by a conclusion.

3.1 The OECD

In this section a short introduction of the OECD is given to provide necessary general information and insight into the OECD's structure, function and by whom essential decisions are taken. This will provide a better understanding of the organization and more importantly how it's linked to its owners (members-states) and how strongly they affect each other is

also discussed later. This is important to better understand the decisions and the reasons behind the major developments in 2001 and 2008.

The OECD which is the key institution in this case study has 34⁵ member-countries, mainly from Europe but also from North America and the Asia-Pacific region. Including many of the world's most advanced countries as well as emerging countries. The common characteristic of these countries is that they are relatively wealthy and thus capital exporters.

The organisational structure of the OECD is built so that it consists of three main divisions, the Council, Committees and the Secretariat. The council vests the decision-making power. It consists of one representative from each member-country, in addition a delegate from the European Commission. There are about 250 committees, it contains the expert groups and working groups, in total there are 40,000 senior officials from different countries who attend OECD meetings annually to review and contribute to the work done by the OECD secretariat.

The secretariat consists of approximately 2,500 independent professionals who support the operations of committees and carry out work as directed by the Council. The staff is composed of lawyers, economists, scientists and other professionals and based predominantly in Paris.

3.2 Committee on Fiscal Affaires- The OECD locomotive

The work programme in the tax area is set by the OECD Committee on Fiscal Affairs (CFA), and also gives a forum for interchanging perspectives on tax policy and managerial issues. The detailed work carried out by this committee is provided by a number of subsidiary groups of experts in particular areas. CFA and their group-members containing senior tax experts are taken in from member-countries. Tax experts from non-member

⁵ http://www.oecd.org/document/58/0,3343,en_2649_201185_1889402_1_1_1_1,00.html

countries do occasionally take part in discussion meetings. Their results and conclusions generally require the approval from the OECD Council⁶.

CFA and working group seniors who are brought in from member-countries contribute their expertise in working groups, since they represent a member-country and also consult with their governments regarding tax policies according to the state's individual context and laws. This may suggest that these seniors ultimately serve their own governments.

Furthermore, one could also assume that the resulting reports from the CFA's working group meetings reflect OECD perspectives or approach to certain issues. During their work, draft reports are produced, they are frequently commented by representatives of business, trade unions and NGOs to contribute with further information to the reports⁷. These reports will commonly reflect the different views among states. Since the reports are produced by an institution which serve several states it would be extremely difficult to satisfy all states. Even though officials are cautious to ensure that the wording of the reports does not go against their state's policies, the reports won't be binding for member-countries and only serve as recommendations.

A natural result of CFAs work, will sometimes lead to changes in the OECD Model Taxation Convention text, which will, among other cases, serve as a starting point for bilateral tax treaty negotiations. If the change conflicts with a country's regulations, it must be possible to raise objections against the new changes, which will be perceived that the country will most likely depart from the model by other states, since the Model Taxation Convention cannot be binding as previously concluded.

The Exchange of Information (EOI) article in the OECD Model serve as an instrument for sharing information in tax matters between states tax authorities, states usually require information from their treaty partner(s) when it is necessary to carry out their national tax laws. Several OECD countries, such as Switzerland, Luxembourg and Belgium opposed to article 26 (EOI) until the Global Financial Crisis occurred. These countries accepted only bilateral treaties with very little versions⁸. Such international tax agreements which emerge

⁶ http://www.oecd.org/about/0,3347,en_2649_34897_1_1_1_1_1,00.html

⁷ <http://www.oecd.org/dataoecd/38/17/1909369.pdf>

⁸ http://www.oecd.org/document/40/0,3343,en_2649_33767_43582376_1_1_1_37427,00.html

in OECD Model Convention are also used among non-member countries for bilateral negotiations. But since these countries are not OECD members and not able to contribute to the Model construction, it has much less significance when it comes to influencing the interpretation of these treaties than it does between OECD member states.

The content and changes in the OECD Model Taxation Convention and changes in tax issues are decided by the CFA, but it must be approved by the OECD Council. The CFA is the division which has over the years overlooked the OECD's campaign against tax havens⁹.

As previously mentioned, the CFA consists of senior representatives from member countries who travel frequently to Paris from their respective capitals. Therefore the discussions in its working parties are strongly influenced by the policies and laws of the member-states, thus CFA is primarily representative of national interests. And since the OECD campaign against tax havens is heavily influenced by the CFA, it is essential to know the functions of the CFA to understand the campaigns major developments outlined later in this chapter.

3.3 The OECDs role - supporter of norms or national interests?

In 1960 the first OECD-members decided that the organizations shall promote policies aimed to achieve¹⁰:

- *The highest sustainable economic growth.*
- *The sustenance of financial stability.*
- *Sound economic expansion in member countries.*
- *Contribute to economic development in non-member countries; and*
- *non-discriminatory expansion of world trade.*

Logically, the first impression of these goals could easily be considered rational relative to the collective interests of all OECD countries. But it can also be argued that they are

⁹ http://www.oecd.org/department/0,3355,en_2649_34897_1_1_1_1_1,00.html

¹⁰ http://www.oecd.org/document/7/0,3343,en_2649_201185_1915847_1_1_1_1,00.html

normative objectives in accordance to liberal economic theory. The OECD as an institution is regarded as a missionary for liberal values (Webb, 2004). While constructivists argue that the norms that the OECD promotes are due to inherent normative values, the neoliberals argue that the norms are a driving-force for the promotion of member countries interest nonetheless this seems to be a moot point between the constructivist and neoliberals.

According to constructivists the OECD is a norm promoter, the institution enjoys a certain degree of freedom and has the capability to integrate countries and redefine their interests. Moreover, that the Secretariat is independent and technocratic which promotes norms that are consistent with the OECD's normative goals, and that this will eventually lead to officials in Committees and the Council to integrate so that the country's own interests are revised to match the OECD normative goals.

In the OECD, the final decision-making process requires a majority of officials voting for the proposal for it to be implemented, and it is based on willingly cooperation. As decision-making is based on consensus, constructivists regard this as an important factor in the way countries are integrated, which results in an agreement for the norms to be followed. The fact that all countries have the opportunity to participate in the decision-making creates international standards for appropriate behaviour. Countries' actions are then controlled by monitoring and joint assessments to further socialise countries and to the OECD's norms (Webb, 2004)

Constructivists point out that the OECD has an overall promotional identity that represents the liberal economic norms. This identity forces the OECD to act in accordance with the norms that it promotes (Webb, 2004). But Sharman (2006a), a supporter of constructivism, argues that to maintain its influential role as a developer of international standards, the institution must continue maintain its reputation for objectivity and its legitimacy as a technocratic authority.

According to neoliberals the OECD is formed by countries that have a basic desire to emphasize their common interests to increase the absolute economic gains. Furthermore, the member countries' interests are advanced by promoting economic liberal norms. On this basis it is argued further that the standards do not have intrinsic value beyond their ability to convince others in such a way that results in the states or groups promoting their individual or collective interests.

OECD Committee and the Council are important elements for neo-liberals as they are made up of officials from member-countries and are responsible for their country's actions. In the OECD the Council has the main power, which means that final-decisions can be taken only if member states approve it. Although the OECD Secretariat may have relatively large influence on the council and committees by counseling, they are funded by member-countries and therefore to a large degree accountable to the member-states.

Intuitive reasoning over the presented political theories from a practical perspective suggests mutual integration, where the OECD and its member-states to a certain level adapt to each other depending on the issue and situation. This view may be the most democratically optimal one, while in reality the most powerful member states influence the OECD more than other members. This in turn influences less powerful members. At the same time the persuasive and convincing power of a member states plays a strong role in influencing as well.

Later on the developments of the campaign will show that state interests especially during and after crisis are the main factors for significant actions among states. This important aspect illustrates how powerful-member of the OECD uses their position to influence the campaign to promote their national interests.

3.4 Collective Interests and the resulting OECD Campaign against Tax Havens

The OECD was often referred to as a “country club” as most member countries are wealthy. Politically, the members are homogeneous democratic, and culturally they are western. Member states have a large public sector that involves high government spending. Because of this there is a necessity for these countries to set high tax rates, in this way creating a large customer base for tax havens.

The economical effects of tax havens were outlined in chapter two, where they takes advantage of the high tax levels of other states by developing tax strategy designed for diverting mobile capital. This would make taxation less equitable, decreasing the capability of welfare countries to reallocate wealth, and eventually have a negative impact on their

whole economy. Even though some perceive the existence of tax havens as healthy competition, the 'race to the bottom' in taxation is tremendously perceived as lose-lose game for high-tax countries.

At a time when most OECD countries were struggling to minimize state budget deficits, the tax havens extensive negative impacts on the global economy were known. Governments in high-tax countries wanted to avoid unpopular cuts in public spending or increase the tax rates, so they aimed to enforce existing tax laws against those avoiding them by the use of tax havens (Webb, 2004).

Tax competition between tax havens and high-tax countries is increasing and have put the later in a lose-lose situation. It would be possible for all countries to achieve high tax revenues if all maintained high tax rates, since it would not be any tax-related motivation for companies and investors to move capital from one country to another. But as long as it does not exist an agreement on tax- collaboration between countries, all are at risk of having their high tax rates undercut by other countries, hence they lose tax revenues and potential economic growth. Therefore high-tax countries find themselves in a tax-competition resulting in tax cuts, everyone loses tax revenue and no one will gain new capital (Sharman, 2006a).

A U.S. special adviser, who was formerly employed by the U.S. Treasury Secretary, discovered that the G7 has intentionally chosen to avoid working through the United Nations (UN) or World Trade Organization (WTO), and all organizations that have an open membership. The purpose was to avoid lengthy bureaucratic decision-making procedure and the risk of being outvoted in other forums. From the world's most powerful countries' perspective this was considered as a more efficient way to construct new laws and regulations which could be imposed in a "top-down" approach (Sharman, 2007a).

According to neo-liberals, this means that the campaign against tax havens is not in the interests of less economic powerful countries. Assuming that governments are rational and enters only in collaboration if it serves their interests, logically, states will not vote for a multilateral frame that is not in their interests. Therefore it is rational for the G7 countries to cooperate among themselves through an institution that served their collective interests. As a result, they expect greater benefits from the campaign, rather than establishing an organization that worked with a wider range of interests. Since tax havens are a threat to the

OECD countries, cooperation among these countries through an institution would be more economically profitable.

The neo-liberal view may not necessarily be true since tax havens may even be a greater threat to developing countries (part of less economic powerful countries). Their weak public institutions will most likely make it easier for individuals and corporations to escape tax, and as a result increase the level of corruption to make those institutions even weaker to illegally extract more capital (NOU, 2009:19). From this perspective the campaign against tax havens seems even more important for less economic powerful states than those powerful.

In recent decades, the integration of national economies has increased substantially, partly due to major advances in communication technology and international law. These changes have led to increased activity in international banking, as a result capital could easily be moved across borders, thus higher capital mobility (Nicodeme, 2009). According to neo-liberals this economic globalization¹¹ resulted in a fundamental structural change. From their point of view the OECD campaign was a collective response to this change (Scholte, 2001).

Several crises in mid 1990s, such as "Black Wednesday" in the United Kingdom in 1992, and the Peso-Crisis in Mexico in 1994 heightened the realization of the OECD campaign. Although, there were several clear reasons for the crises, the swift actions of investors and firms injecting and / or withdrawing assets, was evident proof that free-market forces alone did not provide financial stability. Therefore, a higher regulation and control of financial markets was seen as a necessity (Thirkell-White 2007). A free-market allowed market participants to easily and rapidly transfer capital across borders, which could often lead to highly destructive capital flights that would be very harmful to those economies affected (Hampton and Abbott, 1999). The crises changed focus on regulation by states and international financial institutions. Monetary crises had to be controlled in order that they might be prevented (Thirkell-White 2007).

This rationalization of globalization is confronted by the constructivists as the structural cause of coordinated nationals' interests. The structural explanation of globalization is in this case elaborated as an uncontrollable force that results in reducing the states' economic and

¹¹ Economic globalization refers two increasing economic interdependence of states economies across the globe through a permanent increase item in cross-border movement of products, service, technology and capital.

political independence. According to Sharman (2006a) this explanation is a result of normative debate, and not objective facts. Furthermore, the author argues that this interpretation of globalization was held and advanced by the OECD Secretariat, which also coincided with national decision-makers opinions. This meant that the normative framework enlightened the country's interests in such a way that governments were convinced of a collective action against tax competition.

It is true that states have provided increased development and implementation of international laws and trade liberalization which appear to have launched globalization, but the contribution from the private sector seems not be taken into account and therefore is underestimated among constructivists. Because the private sectors technological advancements that have been developed over time has led globalization into new heights in recent decades. Also, the extremely rapid changes indicate that even if countries accountable for the launch of globalization, the private sector are in charge, and governments have lost control over the consequences. Therefore, the OECD campaign against tax havens could be perceived as an initiative in itself to deal with threats.

The tax havens issue first gained prominence at a multilateral level at the G7 Ministerial Summit in May 1996, where Ministers from G7 requested the OECD to develop a report to be issued in 1998 on tax havens effects and develop potential counter measures. The 1998 report: *Harmful Tax Competition: an Emerging Global Issue*, includes the main characteristic elements given by the OECD to identify a Tax Haven (OECD, 1998 p 23).

1. *No or nominal taxation;*
2. *No substantial activities;*
3. *Lack of effective information exchange*
4. *Lack of legal transparency: and*
5. *The regime is “ring-fenced”*

These factors have already been discussed in chapter two and therefore require no further explanation here. On the basis of these criteria, 47 states were labeled as potentially harmful regimes (Nicodeme, 2009), including several OECD member countries. In addition the report gave several possible directives to those states for managing them. Member countries which were identified as preferential harmful regimes, was encouraged to evaluate their

existing laws and regulations for removing the damaging measures from their national tax-system within 5 years (OECD, 1998).

The OECD report went further on to propose that a list of the countries which were labeled as tax havens based on the criteria should be published within a year. In next phase, these states could be met with coordinated sanctions from all OECD member countries. The report presented a number of possible sanctions; for instance, prohibit tax deduction for operations in tax havens, canceling double taxation contracts and new and increased charges on transactions with tax havens.

The OECD was evident in the formulation of the report that all tax havens should commit to the same international tax laws and standards on the same timetable, those who choose to abstain would be met with sanctions. This principle is known as a "level playing field". The purpose of this strategy is to prevent countries that commit from being undermined and lose potential revenue because of dissenters. Since those tax havens who implemented OECD standards risked losing existing clients and potential income to havens that abstained from the standards (Sharman and Mistry, 2008).

At the same time as the report was published the Forum on Harmful Tax Practices was established by the OECD. The forum's main task was to carry on the war against regimes with harmful tax regimes. The Forum was tasked to make member-countries to evaluate their own tax system, each other and report back, in addition conduct external reviews of tax havens (Payne, 2005)

The report's proposals were implemented by the OECD Council in 1998, only Switzerland and Luxembourg abstained (OECD, 1998). According to Sharman (2006a) both Switzerland and Luxembourg have strong bank secrecy rules and quite low taxes, for that reason they rejected to be bound by the report or any work of the Forum on Harmful Tax Practices.

As shown globalization had similar effect on OECD member countries, this situation created a collective interest in protecting their tax base from tax havens that exploited the effects of globalization, where new laws and regulations and technological developments facilitate ease of capital transactions across borders. Despite that this international tax trend argued in this section and chapter 2 is even more damaging for developing countries the powerful G7 countries decided to launch a war against tax havens on their own. The G7 initiated the

OECD campaign against tax havens to hinder illegal capital transactions from high-tax countries.

In the next section the early developments of the campaign against tax havens which emphasize on the effects of the OECD's blacklisting of tax havens is presented. These actions led to some changes in numerous tax havens tax regime, but the OECD did not manage to achieve a real breakthrough in their fight against tax evasion.

3.5 Early Developments of the Campaign

Blacklisting - Reputation and Interests

In mid-2000 the OECD published the progress report on the *Harmful Tax Competition* project. Totally 35 countries were labelled as tax havens, most of them non-OECD member countries.

The report concluded that the 35 identified tax havens would be met with a new continuing blacklisting as long as they did not comply with OECD standards by 31 July 2001. The jurisdictions that did not commit by the end of the deadline would be met with sanctions, such as additional taxation, denial of non-essential economic aid, and targeting for audit. Such measures would be coordinated throughout the OECD-member countries. Most of the listed jurisdictions made commitments before the deadline for the removal of their name from the blacklist (Nicodeme, 2009). So why was it that tax havens complied even though they would face loss of administrative income and economic capital by committing with the OECD terms and stop operating as tax havens?

According to Sharman (2009) the OECD blacklisting of tax havens was a "speech act" where their reputation were severely harmed among multinationals companies and private investors, tax havens was pressed to accept the terms given by the OECD to prevent actual or anticipated capital flight. The way blacklisting was constructed gave an objective decision on the categorization of tax havens. Therefore the list created a new reality, where those listed were objectively tax havens and if not listed was not a tax haven. The OECD list

named and shamed those jurisdictions, from the constructivist perspective this is the main reason for why tax havens complied with the OECD terms, despite the lack of sanctions.

This rationalization seems to overstate a country's reputation, while understating the relevance of rational interest calculations. Even though that the blacklisting had a negative effect on investors - where they withdraw or reduced capital flow to listed jurisdictions. For instance, one study concluded that Barbados experienced a fall in new firm registrations due to the blacklisting, and the growth picked up after the removal from the list. On the basis of this Sharman (2009) states that reputation does matter. But, reputation does matter to named jurisdictions and to those investors who exploit them for tax benefits as long as it imposes additional investment risk where likely consequence can be based. This implies that reputation matters to states only if it imposes actual or anticipated economical effect on states interest.

In world markets, investments decisions are usually based on expectations and are speculative. The most common valuation methods used for valuing firms or investments are based on assumptions on how well the business will do in future, thus it's prospective. Reputations which may affect certain investments are rapidly assessed by investors to reevaluate the risk level and probability of surplus given the new information. The reputations significance depends on its influence on investors interests, usually defined in terms of expected profits. The potential sanctions that might consequently follow with the blacklisting would be interpreted as increased risk for rational investors. Therefore they would factor the risk of such sanctions being carried out into their decisions of whether the investment would pay off. This reflects the investors aim to minimize the probability of a loss and maximize the probability of a higher profit.

On the basis of this tax havens were therefore intuitively worried being blacklisted and that it would affect investors risk evaluations negatively. Tax havens economies are heavily depended on investments from abroad, therefore it were in there interest in maintaining and increasing these investments. The jurisdictions that accepted the OECD terms in response to the blacklisting had different reasons. Some responded to economic loss due to capital flight since investors were withdrawing or reducing investments through the jurisdictions financial system, since parts of their national income were based on fees on transactions through the financial system. While other jurisdictions anticipated economic loss and thus wished to preempt this harm (Sharman and Mistry, 2008). This indicates that those jurisdictions behavior

were not a response to logic of appropriateness (constructivism) but to logic of consequence (neoliberal institutionalism).

Even before the blacklisting following the publication of the Harmful Tax Competition report in 1998 it was reported that the economic growth of Mauritius was negatively affected via its financial services sector. Since the report did not mention Mauritius as a tax haven one couldn't claim that it unilaterally changed the state's reputation. A logical explanation would be that the investors evaluated Mauritius as a possible jurisdiction for defensive measures forced by the OECD member states and thus the investors hesitated to increase their investments in a risky jurisdiction (Sharman and Mistry, 2008).

According to Sharman (2009) various sources claim that several countries such as the US, Poland, Indonesia, Brazil, Italy and France have their own blacklists of tax havens. These national blacklists might have been affected by the OECD blacklist, but still there are significant differences. Even though the OECD has removed states from its list continuously, the countries mentioned above have not updated their lists accordingly. The purpose of the domestic blacklists is to serve as basis for distinguishing tax treatment. Independently if a country has published a formal list, most tax authorities have a high focus on transactions containing low-tax jurisdictions.

As a part of due diligence several major multinational banks have created their own blacklists. The use of some tax havens, such as Vanuatu have sometimes caused more implications than they are worth, as a result many international banks refuse to allow transactions from or to such jurisdictions. When such circumstances occurs national banks in tax havens must strive for making new banking relationships to survive. Also, these private blacklists are usually not updated according to changes in the OECD blacklist. As a result in addition to the harm that the OECD blacklist causes where tax havens national revenue decreases due to capital flight, jurisdictions also struggle for removal for the various lists of other high-tax countries and transnational banks (Sharman, 2009).

Still, there are several countries such as Liechtenstein that did not respond to the blacklisting, and repeatedly refused to collaborate with the OECD. Sharman (2009) argues that both public and private officials were straightforward in accepting that tax havens low-tax levels in combination with secrecy legislation served as the main factors for attracting overseas investments. This national behavior proves that the intuitive estimation of interests in which the material economic loss of not accepting the OECD terms is lower than accepting. Since

Liechtenstein strived for advancing its national interests, it continuously kept the same path regardless of the harm to its reputation. If harm to countries caused by reputation was the main factor to accept the OECD demands, then this rationalization cannot justify why some countries such as Liechtenstein did not comply.

Most of the countries which agreed to the OECD terms after the release of the blacklist. Where small developing countries with few means to attract foreign investments other than tax benefits. While these jurisdictions may never be able to recover from a significant economic shock, well established and major financial center such as Switzerland and Liechtenstein were able to manage economic scandals without significant loss. This may suggest that for some states the economic cost of accepting the OECD standards was higher than non-compliance. Even if the blacklist may have harmed several jurisdictions reputation it does not necessarily imply that it's the only factor for the countries that complied with the OECD demands. It rather proves nations rational calculations of their interest are consisted with logic of consequence.

The OECD made it clear that tax havens would not be met with sanctions until the institution was capable of using the same sanctions against Switzerland, Liechtenstein, Belgium, Austria and Luxembourg who also refused to cooperate. This issue seems to have made tax havens confident that actual sanctions would never occur as long as those key states refused to cooperate with the OECD. Therefore the OECD was not able to achieve any real breakthrough in their fight against tax evasion.

3.6 A new path for the OECD Campaign against Tax Havens.

In November 2001 the OECD published its next progress report outlining the developments since the 1998 report. The progress report enclosed significant revisions that resulted in reducing the scope of the campaign against tax havens. Among all the modifications the most significant one was that the campaign would no longer chase jurisdictions based on no substantial activities and that it never viewed the criteria no or low tax rates by itself as a justification of identifying a jurisdiction as tax haven. Consequently, two of the five criterions the OECD had presented in its definition of a tax haven were removed. This

implied that the institution would only pursue commitments from countries with respect to effective information sharing and transparency.

The reason for such a move by the OECD according to O'Neill (2001) was that the US government was troubled by the underlying premise that low tax rates are somehow suspect, and by the notion that any state, or group of nations, should interfere in any other state's decision about how to structure its own tax system. The US did not want to support attempts to dictate to any state what its own tax levels or tax system should be, and will not get involved in any initiative to harmonize world tax systems¹². Therefore, the OECD project in its format at that time no longer aligned with the policy goals and perceived national interests of the US government. He argues that the US needed information from tax havens in order to prosecute its own citizens for tax evasion and therefore the key issue it wanted to see the OECD address was secrecy, hence information exchange. This may suggest that the OECD made this move due to pressure from the US government.

Even though it was stated in the 2001 report that two of the five criteria were eliminated from the scope of the campaign, the OECD cautiously noted that these changes did not make the removal of them less relevant for the identification of a tax haven as stated in the 1998 report. The removal of the "no substantial activities" criterion was definitely the biggest defeat since the launch of the campaign. The essence of this factor was to force tax havens to stop offering tax advantages to foreign investors and companies which did not operate substantial business in the jurisdiction. The removal of this factor meant that the OECD would no longer make any attempts by using force against tax havens to change their tax system.

The scope of the campaign was dramatically reduced and all that remained was to pressure tax havens to share information when requested by foreign tax authorities. Secrecy rules had to be handled with in such a way that the requested information could be gathered and revealed. Despite this down-scale of the campaign the OECD made very little attempt to explain it, from the 2001 report it only emerges that both member countries and tax havens had communicated unease concerning the "no substantial activities" criterion and the use of defensive measures against tax havens.

¹² <http://www.treasury.gov/press/releases/po486.htm>

Another modification regarding the campaign was the change of its name from *Harmful Tax Competition* to *Harmful Tax Practices*. There was a noteworthy change in rhetoric with the report where the OECD acknowledges that there are no specific grounds why two nations should have the same level and structure of taxes, and that these are vital political decisions for state governments and their domestic policy. States should be free to design their own tax system as long as they abide by international accepted standards in doing so.

The OECD's aim is to advance free and fair tax competition to accomplish its overall goals to stimulate economic growth globally. This standpoint was at a later date addressed by Angel Gurría, the current OECD Secretary General stating that: one of their capital principles is the free flow of capital. Therefore the capital can flow freely; the question is disclosure of information so that every tax authority is able to do their duty¹³. This rhetorical change adjusted the course of the campaign significantly.

Since the OECD attacked tax competition, it captivated the attention to the central principles of free market capitalism that the OECD was founded on. And its controversy through its project *Harmful Tax Competition*, where it stated that tax competition could be damaging and should be terminated (Sharman and Mistry, 2008).

According to the constructivists these developments were a result of the ability of tax havens to exploit the inherent normative weaknesses of the campaign, thus eroded the OECD's legitimacy (Sharman, 2007b). Tax havens exploited this contradiction by stating that the OECD was hypocritical since it preached one thing while practicing another, tax havens had therefore a strong argument for defecting from earlier commitments and could avoid harm to their reputation since the OECD lost its credibility. Tax havens were able to take up these principles in a "mimetic challenge" to powerful OECD-member countries and other institutions such as Pacific Island Forum and Caribbean Community, where havens used the principles of the powerful for their own subversive ends. According to Sharman (2006b) this resulted in tax havens succeeding to persuade powerful OECD member countries that the campaign was inconsistent with dominant liberal economic theory and as well as the norms of sovereignty, multilateralism and fairness. The OECD was unable to continue consistently with the task in its existing format since the credibility of the campaign was compromised.

¹³ http://www.oecd.org/documentprint/0,3455,en_2649_37427_43601579_1_1_1_1,00.html

As a result the OECD had to change the course of its campaign, scaling down its scope and even changing the projects title with its related rhetoric. According to Webb (2004) the OECD's conflicting and protective reaction apparently demonstrated that the tax havens formulation of the projects as hypocritical was effective. This was acknowledged among OECD member-countries and even within the institution itself.

The changes of the campaign meant that the OECD would no longer target tax-systems of tax havens but rather focus on forcing tax havens to share information on those who use it. This method would permit member countries to take action against their residents of tax fraud, additionally scaring future potential tax evaders of. This would eventually lead to tax havens losing their customers base, and thus would be forced to change their economic strategies.

The US as the OECDs most powerful member undoubtedly used its position to change the OECD project, which can be explained by national pressure existing at the time when George Bush Administration ruled. Moreover, since the campaign went against the tax havens national interest they used every mean to lobby against it. In the following section the national interests of the OECD member countries, especially the US and tax havens interests are outlined. The developments lead to the conclusion that the OECD eventually favors the norms that serves the interests of its most powerful member-countries.

3.7 Lobbyism by Tax Havens and its impact.

As previously mentioned in chapter two, tax havens due to their very nature have few other means to attract foreign investors aside from tax benefits. As long as these tax concessions remains central to their economic strategies, the removal of them would most likely lead to devastating consequences for their economies. When it comes to the OECD *Harmful Tax Competition* project it's very clear that the project went against the state interest of tax havens. As a countermeasure tax havens initially began lobbying within their geographical area, especially in the Pacific Island Forum (PIF) and the Caribbean Community (CARICOM). Since most of these organizations' members were blacklisted by the OECD it created therefore a collective interest among tax havens.

In 2000 several Pacific States had been blacklisted and it was estimated that approximately 10% of their GDP came from offshore financial sector (Carlson, 2002). By the use of PIF for lobbying against the OECD the jurisdictions required compensation for the business that would be lost to its member economies as a consequence of their deference with the OECD terms. In February 2001 a conference was held in Japan for the Pacific region. It was attended by PIF and the Commonwealth Secretariat. The next following conference was hosted by Fiji in April 2001 as a joint OECD-Pacific Island Forum.

The tax haven members of the Commonwealth Secretariat brought their issue to institutions finance ministers meeting in September 2000 (Payne, 2005). After these meetings the Commonwealth made an official statement where they disparaged the *Harmful Tax Competition* project as partial, coercive and a violation of the principle of non-intervention. January 2001 the Commonwealth held a conference in Barbados where CARICOM, PIF 13 OECD states, 13 Caribbean countries and 5 Pacific Island countries attended (OECD, 2001 report)

With resources from CARICOM, PIF and the Commonwealth Secretariat these meetings resulted in the establishment of the International Tax and Investment Organization (ITIO), so that the tax havens could correlate their lobby against the OECD project. ITIO's main task were to pursue several key OECD member countries to change their position towards the OECD project. Commonwealth high tax member countries such as Canada, New Zealand and Australia with close links to tax havens that were blacklisted stressed the OECD to search for more diplomatic solutions instead of coercive methods which most likely would cause great harm to tax haven economies (Sharman, 2006b).

United States position towards the OECD campaign was also influenced by tax havens lobby in addition to those three countries. Sharman (2007b) argues that tax havens managed to persuade the US to withdraw their support from the project in 2001, eventually convincing the Bush Administration with their rhetoric. This standpoint neglects the essential interest of tax havens and the countries they have said to influence. It is well established that the OECD orient went against the interest of the tax havens, and most of the points presented purely in the terms of their calculated interests. Therefore it could be argued that state interests were the underlying driver, thus the norm were barely instruments applied to promote those interests.

Furthermore, the probability of influencing the most powerful country in the world in modifying its view on the campaign only because of the normative arguments from self-interested tax havens is considered to be very low. If tax havens state interests did not align with the interests of financial services industry and the right-wing lobbyists in the United States, it is improbable that the US government would have paid any attention to the tax havens cause. It is more probable that the domestic lobby within the US successfully managed to pursue its government to reconsider its interests compared to those promoted through the OECD campaign. When the US eventually changed its view towards the campaign, where it perceived the campaign as no longer in accordance with its own national interests, the US's interests had now aligned with those of tax havens.

The OECD quickly changed the projects goals, where it adapted in accordance with changing collective interest of its member states. In addition modifying its normative rhetoric in accordance with that used by the US, this result illustrates that the OECD will eventually implement whichever norms that suit the interest of its most powerful member countries. In turn this modification of the campaign affected secrecy and its developments.

3.8 Secrecy and its Development.

As stated in the 2001 progress report the OECD changed its strategy where they now only concentrated on information exchange and transparency. This new strategy's aim was to empower OECD's member countries to put into force their national tax laws instead of demanding tax havens to reconstruct their tax systems.

In support of the OECD's "*Harmful Tax Competition*" project 32 states established a "*Global Forum on Taxation*" in 2000. The forums purpose was to create a place for dialog on ways non-OECD states could be evaluated for their compliance regarding exchange of information (EOI) standards. The OECD Model contains an article on EOI which provides for governments to share their tax records when requested by their treaty partners for the purposes of carrying out the domestic tax laws of the requesting state. These standards gave a foundation for OECD's bilateral Double Taxation Agreements (DTAs) negotiations. Tax havens rarely sign on Double Taxation Agreements (DTAs) due to the logical reason that

there was no double taxation to relieve, since havens did not have any taxes to levy. As a result high tax countries also wished to avoid these agreements, and therefore DTA's were not a well-functioning instrument for tax havens to commit to information exchange. As a solution to this issue the "*Global Forum on Taxation*" constructed a Model Agreement on tax matters in 2002. The purpose of this was to offer a better foundation for bilateral agreement to tax information sharing among countries. The agreements between countries that were based on this model were referred to as Tax Information Exchange Agreements (TIEAs). For tax havens these agreements gave no benefits other than a warranty that making sure of no future OECD sanctions (Nicodeme, 2009).

According to the OECD, TIEAs were acknowledged as the internationally agreed standard for evaluating effective information sharing by the G20 Finance Ministers in their conference held in 2004¹⁴. TIEAs were designed to provide information between countries when required were it was "foreseeable relevant" for enforcement of the treaty parties tax rules. TIEAs also required that information flow could not be refused due to secrecy rules and additionally demanded that the information exchanged must be strictly confidential.

April 2002, the OECD released a new list of "uncommitted jurisdictions", only seven states remained on the blacklist, this shows that most listed jurisdictions agreed to the OECD demands after the projects down-scaling. In 2007 only three jurisdictions remained on the list, Andorra, Monaco and Liechtenstein.

Webb (2004) states that even after these developments havens could still offer tax breaks to foreign firms and investors, thus the OECD demands were no longer onerous to tax havens. Many TIEAs were negotiated but few were actually signed and put into legal effect. Furthermore, the OECD made clear that tax havens would not be met with sanctions if they did not act in accordance with their obligations until such a time as the OECD was capable of to use the same sanctions against Switzerland, Belgium, Austria and Luxembourg who also refused to cooperate. Due to these four key OECD countries immovable position many perceived it as an indication that the OECD had small chances to ever realize its goals of a "level of playing" (Webb, 2004).

¹⁴ <http://www.oecd.org/dataoecd/50/0/43606256.pdf>

3.9 The Effects of the Global Financial Crisis

Until 2008 the standstill which existed since the release of the OECD 2001 progress report ended in the cognizant of the Global Financial Crisis (GFC). After that the GFC reached its peak with the bailouts of AIG and Merrill Lynch and the collapse of Lehman Brothers, Washington hosted a G20 summit on Financial Markets and the World Economy in late 2008. One of the main issues discussed was the reasons behind GFC, such as the role of International Financial Institutions (IFIs) and regulations of the financial markets. Since this summit gave high expectations for significant reform to the global financial system it was referred to as Bretton Wood 2¹⁵.

3.9.1 The OECD and G20 Coalition

The G20 Washington summit was honoured for a political incentive to deal with tax fraud¹⁶. The G20 leaders declared that they would commit to advance “Information Sharing”, as well as to states that refused to accept international standards when it comes to transparency and secrecy rules. In addition the G20 presented an Action Plan to implement principles of reform. Addressing tax authorities that draw upon the work of important institutions such as the OECD must maintain progress to advance tax information sharing¹⁷.

This shows that there was a significant revival of the OECD in the months that followed. The OECD’s public announcement regarding its work was released before the next G20 summit in London, April 2009. On an exceptional week in March 2009 where Switzerland, Belgium, Austria and Luxembourg agreed to the terms regarding Exchange of Information (EOI) of the OECD Model Tax Convention¹⁸. There was no longer any opposition from the OECD member countries and proved to be a breakthrough for the OECDs campaign.

¹⁵ <http://www.guardian.co.uk/politics/2008/nov/14/g20-summit-key-aims-imf>

¹⁶ http://www.oecd.org/document/35/0,3343,en_2649_201185_43731875_1_1_1_1,00.html

¹⁷ <http://georgewbush-whitehouse.archives.gov/news/releases/2008/11/20081115-1.html>

¹⁸ www.oecd.org/documentprint/0,3455,en_2649_34897_43592376_1111,00.html

The Swiss public notice was made after a meeting with the OECD¹⁹. Swiss officials disapproved publicly to the evaluations and the warnings headed for Switzerland by several countries regarding the exchange of information in tax issues²⁰. Several news agencies announced that these developments were a result of pressure from the US and the EU²¹. Additionally, various media extensively emphasised that Switzerland admitted since their government was informed that it was going to be listed in a new blacklist of uncooperative jurisdictions, however the OECD refused this²².

The French President Nicolas Sarkozy published just ahead of the London Summit that discussions were proceeding with Andorra regarding commitments towards the exchange of information. Since Sarkozy is also functioning as Andorra's co-prince he used this position and claimed that he would resign if the microstate Andorra didn't fully cooperate. Moreover, various sources claimed that he told several of the MP's of his ruling party: *"I want a list of tax havens and want to punish them"*²³ Nearly instantaneously the three remaining jurisdictions on the blacklist, Andorra, Monaco, and Liechtenstein accepted the OECD demands on information exchange on tax matters (OECD, 2011).

During the G20 London Summit the ministers agreed to take coordinated action against tax havens to protect their financial system and public finances, in addition claiming that the era of banking secrecy is over²⁴. The G20 additionally released a supportive annex: "Declaration on Strengthening the Financial System" Alluded to an important necessity to protect public finances against non-cooperative states which do not satisfy the international laws and regulation regarding tax transparency²⁵.

¹⁹<http://news.bbc.co.uk/2/hi/business/7941717.stm>

²⁰ <http://www.efd.admin.ch/dokumentation/medieninformationen/00467/index.html?lang=en&msg-id=29205>

²¹ <http://news.bbc.co.uk/2/hi/business/7941717.stm>

²²<http://theonlinecitizen.com/2009/03/singapore-among-nations-on-tax-havens-%E2%80%9Cblacklist%E2%80%9D-no-such-list-says-oecd/>

²³ http://www.rfi.fr/actuen/articles/111/article_3281.asp

²⁴ <http://www.londonsummit.gov.uk/en/summit-aims/summit-communiqué/>

²⁵ <http://www.londonsummit.gov.uk/resources/en/PDF/annex-strengthening-fin-sysm>

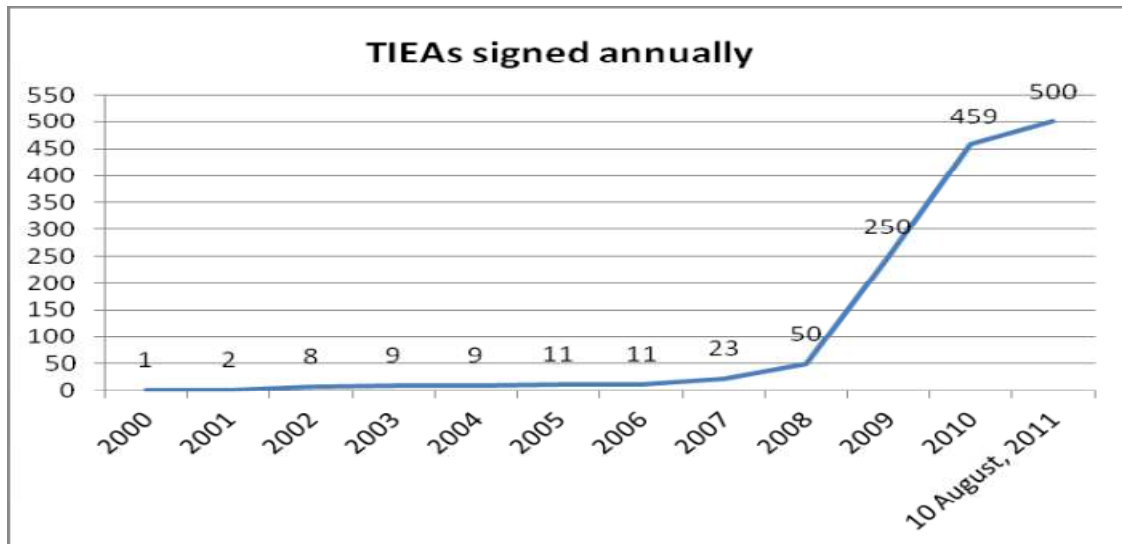
September 2009 at the following G20 Summit in Pittsburgh the G20 leaders claimed that their efforts from the fighting against non-cooperative jurisdictions has resulted in remarkable progress, and that they stand ready to use countermeasures against tax havens from March 2010²⁶. By the end of 2010 all the jurisdictions had committed to the OECD EOI standards where each jurisdiction had to sign at least 12 TIEAs to be removed from the blacklist.

The OECD demands each tax haven to sign minimum 12 TIEAs to be deleted from the blacklist and in turn become a cooperative tax haven. A co-operative tax haven is expected to make yearly scheduled commitments to remain delisted from the blacklist, thus eligible for successive renewals of its status to move to the next stage of the plan of progressive changes. If a tax haven's regimes contains any harmful aspects after the deadline for their elimination and/or the milestones and timetable are not met, and it is not acting in good faith in accordance with its commitments, the OECD will place the tax haven on the List of Uncooperative Tax Havens.

3.9.2 TIEAs

These developments led to impressive results in TIEA and DTA signings. From 2000 to late 2008 before the G20 Washington Summit only 44 TIEAs had ever been signed. Before the G20 Summit in Pittsburgh in September the same year an additional 164 treaties were signed. Since then the TIEAs and DTAs signing increased significantly and in August 2011 a total of 500 agreements were signed (OECD, 2011). This is illustrated in the figure below.

²⁶ <http://www.pittsburghsummit.gov/mediacenter/129639.htm>



Number of agreements signed. Source: <http://www.oecd.org/dataoecd/32/45/43757434.pdf>

Due to these advancements where countries rapidly committed to TIEAs, the OECD has declared its model for EOI as a global standard. Nonetheless, since most countries were knowledgeable of the standard several years before they changed the behaviour, and the fact that so very few were ready to sign on in the lack of political pressure and the high probability of sanctions implies that jurisdictions did not agree to and implement TIEAs due to the new international standards or norms of appropriateness. One cannot assert that jurisdictions were influenced nor by the soft power of the OECD as an institution or its member countries. Therefore, these developments strongly suggest that tax havens were coerced.

3.10 The motivation behind G20 drastic actions

According to Blyth's (2002) studies of significant historical changes to the international system, in cases of institutional stability country interests are generally stable and consistent. But in times of great instability such as financial crisis, the methods used by countries to conceptualise their interest transforms drastically.

The Global Financial Crisis (GFC) which led to the collapse of global financial markets resulted in significant higher instability to the international realm. During this period most major OECD countries experienced ensuing recession which eventually led those states to fund social services and economic stimuli while at the same time struggling to restrain

increasing budget deficit. This environment reduced the politicians' ability to make any dramatic adjustment to their tax rates or decreasing public spending, therefore during high pressure countries interests were redefined to find alternative resources of revenue. Reducing or eliminating tax evasion would imply a potential source of revenue for states. But due to secrecy rules offered by tax havens high tax countries were prevented from obtaining the necessary information for pursuing offshore tax evaders. Almost all OECD states were affected by the GFC in the same way, therefore creating a closer alliance of interests supporting collective action against tax havens.

A structural change of the collapse of the financial markets presented tax havens as destructive to international financial stability and national income. After the market collapse it was revealed that the financial institutions which used tax havens to avoid tax were also those who required bail-out by public funds – funds which their tax avoidance had reduced and therefore mostly financed by other tax payers. Due to the GFC the political pressure for dealing with tax havens increased drastically, and countries interests were changed in accordance with this new reality.

The unexpectedness of the developments in national actions with respect to secrecy implies that it would be hard to rationalise them in terms of global norms or social discourse. The main reason behind OECD member states sudden forceful support to reignite the latent campaign against tax havens were clear material factors, their political and economic reaction were more powerful than ever before. These changes explain largely why the campaign managed a quick success compared to previous slow developments. Before these rapid changes the OECDs "Harmful Tax Competition" project were extremely influenced by the shifting political priorities of dominant OECD member countries. Furthermore, until the GFC in 2008 the structural environment did not give the necessary encouragement for formidable pursuit of information exchange and transparency. The GFC made states realize about the fundamental instability which in turn led to a rapid reconstruction of countries interests. Moreover, the considerable of a structural development that strongly affected dominant OECD countries in a universal way, resulting in their interests to collectively align.

National budgets

Throughout the world and especially the United States and Europe the heavily undeniable negative impact of the GFC on their balance sheets created a new reality. Many states faced high unemployment and stagnant economies at the same time as facing multi-billion dollar deficits. As a result they ended up with the undesirable work of dealing with trade-offs among fiscal austerity. Various methods to increase economic growth and the high need for social services required substantial capital while at the same time states tax income had decreased because of the economic recession. The GFC left governments in such a pressure that they searched for ways to both decrease their spending and boost their income.

Increasing the tax levels were by many considered as a bad solution, since this would most probably slow down economic recovery. The opposite, public spending would have a positive effect on economic recovery and at the same time governments would win votes, but since most governments were struggling with huge deficits, additional capital for funding was scarce. Another solution would be to find ways for attracting capital investments from abroad to accelerate economic recovery. This increased the competition among countries several governments reduced the corporate tax although this strategy would have a negative short term effect on income. But eventually, the ability of authorities to contend with other states for mobile capital is limited by the domestic political economy.

The most important obstacle between OECD states and the huge potential income they could gain by preventing offshore tax evasion are secrecy rules of tax havens and their unwillingness to provide information regarding their foreign tax residents. The resulting structural change of the GFC made states face enormous pressure to obtain economic recovery in short time of period. Thus increasing income became very important and this redefined states interest. One potential source for revenue was reducing the tax income loss due to the existence of tax havens. Therefore reigniting the OECD campaign against tax havens was in the interest if the OECD member states. This led to tax havens compliance with the OECD terms when it comes to information exchange on tax matters. Leading us to the next part of this chapter which presents main reasons for why tax havens complied with the OECDs demands regarding tax information sharing agreements.

3.11 Why did Tax Havens comply to the OECD's demands?

Since 2008 tax havens signed on to numerous bilateral EOI agreements at an exceptional pace. Ratification of the new TIEA entails that national laws are adjusted in line with these commitments and therefore tax havens have had to overhaul their legislative codes to give effect to their agreements. It cannot be disputed that the tax havens accepted the terms under massive international pressure by way of blacklisting and threat of sanctions²⁷.

From a constructivist point of view the change in behavior of tax havens in rapidly agreeing to the EOI standard is hard to explain. The type of pressure used against tax havens did not take the form of normative persuasion. Furthermore, any standard of appropriate behavior that could be said to now exist certainly did not exist at the time when the key tax havens publicized their compliance. Clear indication of imminent material cost for countries that did not comply gives credence to the conclusion that secrecy jurisdictions acted on the basis of anticipated consequences rather than a logic of appropriateness.

Blacklisting

The blacklisting by the OECD in 2000 led to a significant material economic impact on tax havens which have been well documented (Sharman & Ministry, 2008). Havens recognized that the cost of being blacklisted (for a second time in some cases) would most likely result in substantial harm to their economies. Blacklisting negatively influence the risk assessment of investors – the higher risk of sanctions the riskier the investment. Tax havens foresaw that investors would most likely withdraw their capital in response to blacklisting as a result material economic cost would occur. Therefore havens replied to both imminent and actual blacklisting by seeking to avoid consequential damage.

Even though the economic loss was also likely to be high through compliance, havens were vulnerable since they also were affected by the structural change of the GFC. Due to the new

²⁷ Perez-Navarro, Grace. 'The OECD is working with Governments to Clamp Down on Tax Havens. On You Tube at <http://www.youtube.com/watch?v=HrAOW1jAHrk&NR=1>.

international environment with scarce capital havens struggled to retain capital and the confidence of their investors. Tax havens by their nature were heavily dependent on foreign investment as the basis of their economies.

The blacklisting in 2000 proved long terms effects in the form of targeting by countries and the private sector. Some havens had struggled for years to remove their names from copycat lists and even full compliance did not assured removal. These lists provided a basis for extra-scrutiny, compliance costs and outright boycotts of certain jurisdictions by investors. Therefore the possible long-term effects of blacklisting would have given further weight to the case for compliance.

Sanctions

Contrary to the blacklisting of jurisdictions in 2000, this time the threat of sanctions was much more concrete. In addition to the OECD defensive measures all the world's largest economies were jointly threatening tax havens. This time these states had a strongly visible, material cause to implement their threats – they were facing deficits, economic decline and increasing social cost. G20 leaders were clear about the necessity to defend their public finances in this structural atmosphere²⁸ and there were more reasons to believe them than ever before. The sanctions which were outlined were given much wider publicity with their inclusion in the G20 London Summit Declaration²⁹, and their potentially very broad character were bound to have scared both tax havens and investors. Even without the blacklist, the publication of these proposed measures would probably have led to investors to withdraw of tax havens and their authorities to preemptively comply.

Some of the measures (i.e. sanctions) developed by the G20 leaders:

- *increased disclosure requirements on the part of taxpayers and financial institutions to report transactions involving non-cooperative jurisdictions;*
- *withholding taxes in respect of a wide variety of payments;*

²⁸ <http://www.londonsummit.gov.uk/en/summit-aims/summit-communicue>

²⁹ <http://www.londonsummit.gov.uk/resources/en/PDF/annex-strengthening-fin-sysm>

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- *denying deductions in respect of expense payments to payees resident in a non-cooperative jurisdiction;*
 - *reviewing tax treaty policy;*
 - *asking international institutions and regional development banks to review their investment policies; and,*
 - *giving extra weight to the principles of tax transparency and information exchange when designing bilateral aid programs.*

3.12 The future of Tax Haven Secrecy

To assume that the abuse of tax haven secrecy will end in near future is probably too much to hope for. However, since 2001 when the OECD project was significantly scaled down and tax havens seemed unassailable, they have after the GFC reached a point of considerable vulnerability. An important issue is whether the developments during and after the GFC represent a permanent change from the former status quo. According to many quotations based on statements from the G20 ministers and the OECD officials, banking secrecy for tax purposes is no more. Moreover, that most countries have implemented a new global standard, notably the EOI. To make sure the standard is implemented and followed the OECD established a new institution named Global Forum on Transparency and Information Exchange.

This institution was established in late 2009 by the OECD and compared to its predecessor the Global Forum on Taxation significant achievements have been made. While the later had only 32 member-countries and kept a low profile, the new Global Forum has 95 member-countries. Among these are all G20 countries, OECD member-countries and most importantly all offshore jurisdictions. Furthermore, the support of great developing countries has as well been achieved, for instance, South Africa, India, China and Argentina (OECD, 2010).

To ensure that the objectives of collective interests are achieved, it seems natural for countries to form an international organization for mediation of cooperation to prevent free-loading and cheating (Goldstein, Joshua & Pevehouse 1997). Many different methods are used to initiate a comprehensive cooperation, for instance, by facilitating discussion, credibility to commitments,

providing technical assistance, setting agreed standards, sharing information, coordinating actions, lending and through monitoring and sanctions and other means of enforcement (Keohane, Martin & Martin, 1995).

The OECD established the new Global Forum to make sure that all countries implemented the EOI standard in practice this implies monitoring progress of each country and conducting peer re-evaluations. According to OECD Secretary-General Angel Gurría the purpose of the Global Forum is to give all countries the assurance of the collaboration of their peers.

In this way “cross-security” is given to tax havens, so when they apply expensive changes to their secrecy laws which affect the whole nation they can feel safe that other countries are not taking advantage by free-riding. Since most havens feared that some tax havens would not implement the new standard and as a result could potentially “steal” all their clients (tax evaders) and hurt their economy. But now the states know they are being monitored and if they chose not to comply they will be subjected to sanctions therefore at the same time this provides security for every state³⁰.

If Angel Gurría’s statements is accepted as true, the Global Forum will be a model of neoliberal institutionalism. It has come into existence with the intended goal of overcoming a collective goods dilemma through coordination of individual state action. Still neoliberals would in addition state that countries will continue to cooperate only as it remains within their own interest to do so (Goldstein, Joshua & Pevehouse 1997).

Whether it will be in tax havens interest to keep their involvement in the Global Forum is unclear. It needed huge pressure to tip the balance of tax havens interests to pursue them to comply with OECD demands given the considerable expenses that information exchange will imply. When the costs related to information sharing systems starts to crunch into tax havens revenue, their rational calculations may eventually give a larger expenditure from sustained compliance.

Since investors and multinationals companies use tax havens to reduce or avoid tax in their country of domicile where they operate from, most of the information flow will go from havens to other high-tax countries. Therefore tax havens will most probably bear most of

³⁰ http://www.oecd.org/documentprint/0,3455,en_2649_37427_43601579_1_1_1_1,00.html

these expenditures. In addition, the EOI is supposed to deal with tax havens rules and practices which limit the access to information. If effective, havens will face material economic loss due to fact that if such practices cease to exist they would no longer be able to maintain and attract potential tax evaders, thus reducing income from their financial sector. These facts may in the long run give stronger economic incentives to havens to break out of the cooperation with the OECD.

Moreover, when the world economy begins to recover from the financial crisis and the instability in financial system which followed, it is believed that the pressure level from G20 countries on tax havens will reduce. Therefore one could state that Global Forum will give assurance to countries where it will monitor and regulate the actions of its members in the short term, but its future is very unclear.

3.12.1 Will TIEAs handle Secrecy?

Since the TIEAs has become the new global standard for EOI or DTAs containing EOI which a country have entered into, the efficiency level of these contract will be extremely important for the Global Forums achievements. Since TIEAs are new there are still too early to make any comprehensive assessment. The tax authorities which require information must have considerable information beforehand about the suspect to be able to require the right facts from a foreign tax authority and since the jurisdictions still are able to sustain secrecy except in situations where specific information is requested, governments basically don't know what they don't know (Nicodeme, 2009).

According to Neoliberals, after the establishment of cooperation, the probability that someone withdraws from the cooperation is present, so the benefit for a single player can be greater if it chooses to cheat or free-load and take advantage of other's cooperation. In this case, this represents a typical example of the collective goods dilemma for tax havens. In a world of increasingly globalized financial markets and numerous tax havens, tax havens fear that if they cooperate with the OECD, it is always a risk that other tax havens will refuse. To some degree this will most likely lead to tax evaders transferring their capital to non-complying havens. Except if all tax havens accepts and implements the new international standards.

More and more countries require that a automatic information sharing system is implemented, where all information on foreign revenue would automatically be sent to taxpayer`s home tax authority³¹. Even though many countries oppose this proposal on basis of their privacy laws and also due to the high costs related to such a comprehensive administrative system.

Since investors and multinationals companies use tax havens to reduce or avoid tax in their country of domicile where they operate from. Most of the information flow will go from tax havens to other high –tax countries. Therefore TIEAs create a situation where tax havens will most probably bear most of the costs of obtaining and providing required information for no compensation. This indicates that tax havens have no motivation for taking TIEAs seriously other than the pressure from the Global Forum, sanctions and its peer reviews.

3.12.2 Mock Compliance

Walters (2008) has theorized that states might have incentives to noticeably signal compliance with international standards even though their underlying actions is not consistent with compliance. The author has named such behavior as “mock compliance”. He argues that mock compliance is most likely to occur where (Walter, 2008, p 36):

1. *Private sector compliance costs are relatively high; and*
2. *the costs of outright compliance costs are relatively high; and*
3. *third party compliance monitoring costs are relatively high.*

This framework for evaluating the probability of mock compliance may inform on whether the new global EOI standard will be adhered to by tax havens.

With regards to the first factor the author give explanation that when the implementation of international standards reduces the profitability of domestic firms, the incentive to deviate will be strong. In case of tax havens they have few domestic firms, and the core business of the ones that exist is the provision of offshore financial services. For their governments to give effective EOI, these companies must create records they most likely have not

³¹ <http://www.guardian.co.uk/commentisfree/2009/apr/02/g20-tax-havens>

maintained previously, such as full details of entity and account ownership. Even though it is uncertain whether such data will ever be requested, complete records need to be available in order to service these requests. Knowing that the majority of tax havens collect only small profits from their financial services, usually attracting income in the form of one-off licensing fees, the cost of compliance with the EOI standards could be equivalently high. When it comes to small developing countries the compliance expenses are likely to be even more onerous.

With respect to outright compliance costs which consist of both the internal costs of adopting new systems in accord with the new standards and the external costs in terms of market reaction to the probable disclosure of harmful information. When it comes to internal costs of EOI, tax havens need to create own systems to meet the requests of foreign tax authorities on tax issues. The cost to private sector in tax havens would most likely surpass those of their governments – governments would not need to hold information on all foreign firms and transactions, they are only required to obtain this information from the private sector when requested. Although, the government's responsibility in regulating private sector compliance would probably be considerable, in particular for developing countries with small public sectors and constrained resources.

Tax havens will most likely face the highest costs from external compliance, because this contains both the loss from the wider economy due to the capital flight and loss of income from licensing fees. With no guarantees of providing secrecy, tax evaders will have less economic incentive to invest in tax havens since offered tax savings may be offset by the possible expense of being caught. Numerous tax havens are heavily depended of their offshore services industry since there are no other large domestic business activities and thus lack the resources to compete in any other industry. This suggests that the cost of EOI may be very fatal for tax haven economies.

The third factor argue that mock compliance will only be feasible if everyone consider that compliance will be complex and costly to assess and punish. If compliance measurements are only based on the number of TIEAs in force, it would be easy and inexpensive to measure. Even so, most probably providing a true assessment of the extent to which a country complies with EOI requests is unlikely. The Global Forum has communicated that it aims to carry out comprehensive, in-depth evaluation of all its members. To a certain degree this will depend on the full collaboration of member countries and the process of assessing

95 members will most likely require substantial time. A standard penalization do not exist other than having less than 12 TIEAs, therefore the Forum lacks methods to address a lack of effective EOI found even if the jurisdictions has met the 12 TIEA requirement. Provided the uncertainty of each of these important aspects, countries might conclude that the Global Forum peer reviews will not be effective. Countries will be in a better position to create views on the likely success of mock compliance after the first round of peer reviews.

A tax haven`s cost of substantively acting in accordance with the EOI, in terms of government, to their private sector and levels of foreign investment will most likely be significantly high. Tax havens assessment of the probability of being caught will determine whether or not mock compliance will be considered to be in their interests. If a Global Forum`s assessment proves a failing tax haven in terms of EOI standards, this could have similar effect to blacklisting. The tax haven could be rejected by the market powers since investors have revealed low tolerance for the risk of doing business with named jurisdictions. Even though, investors will only sustain their low tolerance of such risk as long as the threats of sanctions remain real.

3.13 Conclusion

The OECD has 34 member-countries which are relatively wealthy and thus capital exporters, these similarities create common interests leading to creation of institutions and projects to promote or protect their interests and goals. The work programme in the tax area is set by the OECD Committee on Fiscal Affairs (CFA), and also gives a forum for interchanging perspectives on tax policy and managerial issues. CFA seniors who are brought in from member-countries contribute their expertise since they also consult with their governments it may indicate that they ultimately serve their own governments. Thus states own interests heavily influence the OECD campaign.

The rationalization given by the constructivist for the establishment of the OECD project in 1998 has been contested. The explanation where capital flight as a normative discourse give too much weight to the degree to which countries have been agents in the development of globalization. While states were in charge for numerous law and policy modifications to trade liberalization, following technological advancements contributed to an incredible rate of irreversible transformative development. According to this chapter's findings the OECD project were launched in the wake of the structural change of capital mobility. Since OECD states were constrained by their national politic economies they were not in a position to compete with tax benefits with offered by tax havens. Thus, this created a common interest among OECD states to prevent harmful competition from tax havens. The OECD therefore gave a way out to the collective goods problem by creating a form of organizational condition that controlled countries behavior to avert cheating.

As an answer to the blacklisting a neoliberal explanation has been given for tax havens compliance. According to the findings in this chapter tax havens action was a response to the actual of anticipated consequences of blacklisting. This caused investors and companies to reevaluate the risk level related to doing business with named jurisdictions due to the threat of sanctions. Therefore tax havens were forced to agree with the OECD demands regarding tax information exchange not because of harm to their reputations, but since blacklisting would probably lead to sanctions.

In 2001 the OECD project was scaled down and it was mainly due to the sifting interests of the dominant OECD member states especially those of United States. These developments were a result of pressure both from domestic and foreign lobbyists and change in the

economic environment. Due to success achieved by lobbyists where they exploited normative arguments, they must have showed a strong propensity to use whatever norm to achieve their objective, thus they aimed at different countries with different norms that supported their existing interests. They managed to influence the United States to change its tact not for the normative rhetoric used by lobbyists, but mainly since the lobbyists displayed that it would damage the US business interest if tax havens were to be eliminated. These developments forced the OECD to adapt to the US interests, since without the support of world's biggest economy the OECD would have struggled to maintain its strong position in international politics. In accordance with their interests and by using economic liberal principles tax havens lobbied through institutions where their collective voice bore greater weight and thus were an important contributor of the down-scaling of the OECD campaign.

The progress of OECD campaign significantly declined between 2001 and 2008 due to the lack of strong collective interests among its member-states to firmly pursue secrecy. Major OECD member states were not ready to confront the heavy resistance of Switzerland and other dominant secrecy states since there was no imperative to do so. As a result no real threat of sanctions existed from the OECD therefore tax havens had no incentive to enter into TIEAs. Even though the OECD had at that time developed a new standard of information exchange, the related norms of transparency were not adequate to transform tax havens actions since their interest apparently supported secrecy.

The swift developments after the GFC in 2008-09 regarding OECD achievements demonstrate that transformative change is only achievable if the interest of politically and economically strong countries align. As a result of the GFC there was a structural change that impacted the national political economies negatively especially those of G20 ministers gave them a fiscal and political imperative to be seen to do something. The powerful pressure by G20 towards tax havens can be clarified by the swift alignment of interests among the G20 – nations. Because of the likely consequences of investors and companies reaction to blacklisting as a sign of sanctions, tax havens were coerced to accept the OECD terms. Since tax havens economies are highly depended on foreign investments a loss of investor confidence regardless of sanctions would most likely have severe impact on their economies. Tax havens had therefore few other options than complying.

When it comes to the likely future of tax information exchange, the establishment of the Global Forum with high profile and a much higher number of members than its predecessor

gives a better assurance to countries that peers will not cheat. Nevertheless, this condition will only sustain only if the collective interests are maintained. As the global economy recovers and the pressure on tax havens decreases as a result of this, the cost of accepting the OECD terms might be greater than the advantages. Therefore TIEAs may not be an efficient evaluation of real compliance with the EOI standard, thus mock compliance could be expected if the likelihood of sanctions becomes remote.

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