U.S. Defection from the OECD "Harmful Tax Competition" Project: Rhetoric and Reality

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"The United States alone cannot deal with tax havens. The policy must be an international one by the countries that are not tax havens to isolate the abusive tax havens. The United States should take the lead in encouraging tax havens to provide information to enable other countries to enforce their laws."

Gordon Report (Gordon, 1981:10)

This study treats an area of European resistance to U.S. preferences that few persons – even in the attentive public – have heard much about. The core topics of the story, however, tax avoidance and evasion, will likely emerge among the premier public policy challenges of the 21st century. The logic is hard to deny: globalization as economic enmeshment across political boundaries is proceeding at a rapid pace. Few signs from either private markets or public policy suggest that this trend will abate, and almost nothing points to a reversal. The increased mobility of goods, services, capital, and labor, has, in turn, posed ever-increasing challenges to national tax authorities.

This discussion of foreign resistance to U.S. preferences differs from most others in this project for several reasons. First, the present study examines the relations between the U.S. and most of the rest of the OECD in a context in which the combined economic weight of U.S. opponents matched or exceeded its own. Economic power is particularly important in the OECD because it deals mainly with economic issues.[1] Second, unlike so many cases of resistance to U.S. hegemony, the main moving force was not the U.S but the EU and Japan. A determination by the U.S. to resist part of the initiative after it had begun provided the proximate cause of the rift. Hence the "resistance" in the terms of this set of studies is unusual. It began from mid-course *U.S.* resistance to part of an OECD plan pushed by others but for which the U.S. had earlier provided enthusiastic

support. As will be seen, the OECD's initial scenario for a solution to what it chose to call *Harmful Tax Competition* (*HTC;* 1998*)* turned out so badly that it provided the U.S. with the unusual opportunity of claiming the cause of the world's small developing states against rich-state presumptuousness.

The unfolding of the OECD tax haven story illustrates one set of dynamics drawn from Davis Bobrow's typology of resistance to hegemony: temporize, maintain good relations based on a declared and actual willingness to engage in some compromise, and fully recognize the extent to which one's own position is shared by important segments of opinion within the hegemon. More specifically, international business on both sides of the Atlantic found much fault with the *HTC* project, while government fiscal professionals all over the OECD warmed to it, and domestic politics ebbed and flowed -- with a sharp discontinuity in the U.S. following the election of George Bush in 2000.

The appearance of *HTC* in 1998 appeared to signal a new determination by the high income countries to coordinate their attack on both (illegal) evasion and (legal) avoidance of personal and corporate income taxes. U.S. Treasury losses from evasion and avoidance using the international system are difficult to estimate because personal tax evasion is based on secret activity while corporate avoidance is largely open but must be compared with specific counterfactual assumptions about how much would be collected with alternative rules. One recent estimate of U.S. losses from individual evasion puts the number of culprits at about three-quarters of a million and annual tax losses at $20-40 billion (Baucus and Grassley, 2004). One worldwide estimate, based on a straightforward methodology, puts individual tax evasion losses at $255 billion (Tax

Research Limited, 2005). Annual U.S. corporate tax losses may range from $10-$20 billion (Sullivan, 2004: 15).

HTC declared a special interest in "mobile economic activity," and it was seen as only the first of a series of attempts to address the broader problems. More than a half dozen years later, as the *HTC* project reached its final stage, few predicted a similar approach to other tax issues. Moreover, commentators disagreed on the how much the project had accomplished and what the entire episode implied for U.S.-EU relations and for the OECD. The U.S. had moved from a champion to a revisionist critic of the OECD efforts early in the Bush Administration, and the most influential actors in the OECD and the EU were obliged to adapt as they could. But the project had already changed considerably in the U.S. direction before the open rift, and how much developments would have differed under a Gore administration remains in doubt.

The Bush administration took a very different public position on the *HTC* project from its predecessor. But the project cannot be understood without a consideration of three other major conditioning factors : 1) growing European concern in the early nineties about inappropriate tax competition *within* Europe that led to the Code of Conduct of 1996; 2) rich country concern about money laundering and the mobility of criminal finances that spawned the Financial Action Task Force in 1989, an innovation that was given enormous impetus by the attacks of September 11, 2001; and 3) and the galvanizing effect of the Asian financial crisis on a widespread conviction that global stability demanded attention to all elements of the world financial system regardless of location -- this resulted in the Financial Stability Forum of 1999.

The four factors can be seen in two broad categories: changing politics based mainly on domestic conditions within the set of acting states and the EU, and the changing global environment. Each category unfolded in a complex way that the following narrative can relate only very imperfectly.

INTERNATIONAL TAXATION: ACTORS AND OPTIONS

At the highest level of abstraction, the immediate actors in this drama of tax avoidance and evasion consist mainly of government enforcement officials on one side and corporations and high income persons (along with their agents, interest groups, and other political supporters) on the other. The issues have seldom had much salience with the general public, and the role of NGOs has been quite modest because the issues are so complicated, both to understand and to mobilize about, that other policy area look more attractive. When the policy discussion gets specific, defenders of avoidance and evasion tend to outgun their opponents.[2]

The Development of International Income Taxation

The U.S. has always insisted that all of the earnings of its citizens are subject to American taxation; this is a "global" approach. Nevertheless, shortly after the U.S. introduced the corporate income tax in 1909 [3], it was recognized that American firms were discouraged from foreign operations if they incorporated their overseas activities in jurisdictions with non-negligible corporate taxes of their own. The profits would first be taxed abroad and then what was left over would be taxed again at the domestic rate. Neither of the two main actors, private business or the U.S. government, favored such

double taxation. Many in the Treasury Department viewed similar profitability from similarly productive investments around the world as the fiscal equivalent of the free trade that they favored while the affected corporations saw double taxation simply as a threat to profits. And both sides recognized the competitive disadvantage of double taxation *vis à vis* local foreign firms or third-country firms from states that did not tax foreign income. In response, Congress acted decisively in 1918 to allow foreign income taxes to be credited against -- and not merely deducted from -- what would otherwise be U.S. corporate income tax liability (Bergsten, Horst, and Moran, 1978: 166). Avoidance of double taxation takes place, however, only after a treaty has been signed between the U.S. and the other jurisdiction.

Another important aspect of the tax also came early: payment of corporate income tax due could be deferred until it was repatriated to the United States.   This provision was proposed for elimination by the Kennedy administration (Picciotto, 1992:111) and by many analysts for the next couple of decades (see for example, Bergsten, Horst, and Moran 1978: 196-202; 462-63), but the growth of foreign competition from firms based in states with more permissive regimes diminished the pressure for reform and led many economists increasingly to defend deferral (Hines, 1999).

Other states dealt with the double taxation problem by using a “territorial” system that draws a sharp distinction between foreign-earned corporate income that is not taxed at home and domestic earned income that is.   Such major trading and investing countries as Germany and France employ this system (Hufbauer, 1992: 57).   This method of taxation would appear to give a competitive advantage to firms with subsidiaries in low

tax jurisdictions.[4] More generally, nation-states faced a choice that became increasingly important over the twentieth century: positive corporate tax rates meant higher immediate revenues but, all else equal, a lower attractiveness for foreign firms – as well as smaller shares of the global operations of home-based firms over time.

The taxation of borrowing from abroad posed another challenge. Decision-makers in most states had concluded by the last quarter of the 20th century that *any* tax on local borrowing was paid, not by the lender, but by the borrower.[5] Hence most modern states (those not looking for immediate revenue above all else) greatly reduced or abolished such taxation, leaving earnings to be taxed by the lending country.

Just as corporate taxation can be treated on a global or a territorial basis by the home country, so too can personal income tax liability. Income from labor services sold abroad has historically been exempt from home income tax by most of the countries of Europe, again in contrast to U.S. practice. But another category of taxes on foreign personal income has bedeviled tax authorities in virtually all countries: the treatment of personal asset income. Nearly all states try to tax the earnings of their own citizens' investments made elsewhere. Nevertheless, the increasing ease with which virtually anyone can place funds abroad has created a huge opportunity for tax evasion because, unlike domestic investments, foreign earnings are not accompanied by automatic or easily obtainable information for the home government.

The taxation of corporate and personal income contrasts sharply from a broad policy perspective. National competitive concerns can create an incentive to moderate the effective level of corporate taxation. Nothing analogous yet importantly conditions policy towards the individual income tax: each state can tax its citizens' incomes with

little fear of emigration on that account alone.[6] This latter claim will certainly become increasing less true of Europe over time, but it will remain true comparing the U.S. and the EU as a whole (as well as Japan) for the foreseeable future.

U.S. AND EU POLICY CONCERNS

Some Initial Context

An comparison of several aspects of U.S. tax collection with that of many EU members might suggest that the former was more geared to social democracy and the latter more compromised by incentives and global competition. The U.S. leans relatively heavily on revenue from income taxes. The U.S. collected just about half of its total revenue from personal and corporate income taxes in 1999 – 40.7 percent and 8.3 percent respectively -- while the EU collected only 25.6 percent from the personal income tax and just slightly more than the U.S. in corporate income tax: 8.7 percent (Heady, 2002:1).

The U.S. has also been unexcelled in the comprehensiveness of the taxation of its citizens' overseas earnings. Even some states that share the American global approach to corporate taxation, such as the U.K., forgive overseas labor earnings by their citizens (Bhagwati and Wilson, 1989).

Finally, the U.S. has traditionally been more insistent that any other state on gaining disclosure from other polities about the earnings of its natural and corporate citizens by insisting on information-sharing in tax treaties and by pressuring states with strong bank secrecy laws and traditions to relent.

The U.S. has also long realized that it cannot enforce its tax policy without regard to what other states are doing. In particular, the same concerns about competitive disadvantage that increasingly led economists to doubt the wisdom of eliminating corporate income tax deferral bred a cautious, if not sympathetic, view of some nominally "abusive" U.S. corporate practices to lower effective rates on overseas earnings. Such contortions could sometimes be seen as merely putting U.S. firms on a more level playing field with the their foreign rivals. This concern has grown in recent years as U.S. corporate tax rates have moved above more and more competitors: in 2001 the average effective EU marginal rate was four percentage points below the U.S.'s 24 percent, while the average effective rate of only two European states was higher than that of the U.S. (Engen and Hassett, 2002: 23, 24).[7]

Europe's Tax Problem

Much of the character of the *HTC* project can be seen as a projection of European concern about fiscal threats to high tax states. A meeting of European finance ministers in 1996 led to a series of proposals including a Code of Conduct on business taxation. Although only "soft law," the Code of Conduct attempted to identify and remove those measures, directed at foreigners, that "provide for a significantly lower level of taxation, including zero taxation, than that which generally applies in the member state in question (Commission of the European Communities, 1997: 8 cited in Mutti, 2003: 87). The same meeting also considered information barriers within Europe that were allowing considerable personal tax evasion. The policy response to this concern later complicated negotiation with the tax havens.

This paper treats US-EU relations as the heart of the OECD dispute over the harmful tax practices initiative because the U.S. and Europe dominate the OECD. When Europe is construed as both the EU and the Associated European Area, 21 of the OECD's 30 members are affected by some EU rules (Easson, 2004: 1047). Japan is the largest other member, but its tax positions have typically matched dominant OECD opinion, and it was particularly supportive of the drive against the tax havens (Horner 2001:3)

The U.S. takes a global approach to income taxation and most EU countries have a territorial approach. But there is another, arguably far more important, reason why the two jurisdictions would view international taxation differently. As Andrew Moravcsik (2001) has stressed, the EU continues to be a multistate rather than a "superstate" project (see also Alesina and Perroti, 2004). Nowhere is this more apparent than in the fiscal realm.

\ Each state in the EU – and this includes the new low-income members – depends overwhelmingly on its own fiscal resources. Only about two percent of EU expenditure takes place at the union level, and this is provided from member state coffers (Demertzis, 2000 15). The transatlantic contrast is startling: American federal government tax collection is about two-thirds of U.S. total.[8] The federal corporation income tax is now 35 percent, and state corporate tax rates are nearly all below 10 percent. Corporate taxation in Europe is almost entirely national, and rates are lower than the U.S. federal level. Although the fraction of total EU government revenue from corporate income taxation is about the same, the fraction of national income collected is considerably higher than in the U.S. because of much larger government budgets: from 42 percent larger in the UK. to 115 percent larger in Sweden.[9]

The U.S. discussion of interstate tax competition has been somewhat inconclusive, and, as a political issue, it appears to ebb and flow (Oakland and Testa, 1995; Burstein and Rolnick, 1996). Nothing similar can be said of Europe. Recent years have seen some convergence of VAT, personal income, and corporate tax rates, but this has come mainly from independent adjustment. Although several attempts had been made to coordinate tax rates across the EU, all except a minimum VAT rate have ultimately been rejected as a violation of sovereignty by some members (Tanzi, 1995: 117). Nonetheless, fears of "unfair competition" and a "race to the bottom" rivet the attention of both politicians and voters in Europe where competition as a general ordering mechanism is viewed more skeptically than it is in the United States. Both France and Germany, the two most influential states in the EU, have long favored a floor on corporate tax rates and perhaps even harmonization (Webb, 2004: 17).

Several intra-European tax issues were under close scrutiny as the OECD project was begun. Ireland had emerged as the fastest growing country in Europe (and, after China, the fastest growing state anywhere) in part by "ring fencing": using systematically more favorable corporate (and other) tax advantages for entering foreigners than for domestic firms (and persons). Banks in Luxembourg, Belgium and Austria were notorious for giving other Europeans the opportunity to evade taxes on earnings from savings because accounts there were essentially as safe as domestic accounts but without automatic reporting to fiscal authorities.[10] Finally, nearly all EU states had some special advantages for non-national business investors that could be construed as a violation of a level playing field. In short, tax competition within Europe – and not just with the rest of

the world – appeared to threaten the resource base for national budgets that were relatively much higher than that of the United States.

THE HARMFUL TAX COMPETITION PROJECT

Is there any objective content to the idea of "harmful tax competition," or, as much of the American right argues, is the entire idea one that only a pro-government ideologue could entertain? Conceptually, one can distinguish the *autonomous choice* that a democratic state might make if it were essentially a closed economy, *competition* to attract resources from elsewhere, unilateral *defensive adaptation* to the choices made by other states in an attempt to retain domestic resources, and *cooperation* with other states on rates or bases that could range from various degrees of coordination to complete harmonization.[11]

Some would argue that the "autonomous choice" option is not ideal because it allows the state to function as a Leviathan. From this perspective, "firms and highly skilled labor will face rising incentives . . . to move away from high tax jurisdictions that are not providing a *compensating* (emphasis added) level of public services . . . This will gradually intensify pressure on all governments to eliminate funding of unnecessary programs and subsidies . . ." (Robert Litan and William Niskanen cited in Kudrle, 2002: 72-73). But this libertarian insight holds limited relevance for most citizens of high income countries who see a vital – if limited – redistributive function for the state.[12]

"Harmful" tax competition can be considered in terms of the previous typology. If a group of states wanted to cleave strictly to the autonomous choice standard, they would harmonize their taxes completely, necessarily compromising differing preferences.

Michael Webb has associated this tendency with the interests of the Social Democratic left in Europe (Webb, 2004: 17), but such agreement has so far been rejected in the EU.

An alternative approach would be to identify and remove aggressive tax competition that appeared to shift factors across jurisdictions. But, given that all states have independent, differing tax structures, some benchmark must be used to identify foul play. Much previous literature as well as *HTC* endorses a fairly weak but easily observed standard: if countries are willing to live with a uniform tax structure and the same rules for foreign and domestic factors, that will pass muster.

The international consistency standard aims to control competition for real economic activity. But states may also lose tax revenue, rather than productive factors, from a kind of legal fiction: the mere appearance of activity in a place so that tax can be avoided in other jurisdictions. This fiction is mainly of three kinds. Firms may utilize subsidiaries in a "harmful" jurisdiction that absorb and reinvest funds that would otherwise be taxed at higher rates in the jurisdictions where the owners reside,[13] firms may directly incorporate there and avoid any residual headquarters corporate tax payments where owners reside[14], or individuals' funds may be secretly routed through such jurisdictions as a means of tax evasion.[15]

The tax literature prior to *HTC* was replete with a range of possible home government responses to such practices. Governments acting alone can attempt to disallow firms from making purely financial investments abroad to run up untaxed returns before bringing the proceeds home; they can police intrafirm pricing to prevent profits from showing up in low tax areas out of proportion to the firm activity there

(including the siphoning of profits out of the home country); and they can take measures to prevent artificial claims of activity location or nationality.

Collective action among states can improve information flows about firm activity in various jurisdictions to assure reporting completeness and consistency and to facilitate decisions about what foreign state actions either suppress information or apply rules that discriminate between foreign and domestic firms to "poach" some combination of tax revenue and real economic activity.

States can also institute various controls to prevent personal income tax losses. They can monitor the use of foreign corporate forms to generate untaxed gains for individuals abroad, and they can stiffen penalties for the failure to declare foreign income. Acting cooperatively, they can exchange information on individuals' personal and asset earnings or they can agree to institute withholding taxes that might be forgiven only when the owners demonstrate that the earnings have been reported to the residence country authorities.

THE DEVELOPMENT OF THE PROJECT

The OECD decided to study various types of possibly "harmful" tax competition in 1996, and its initiative was ratified by the G-7's Lyon Summit of 1996.[16] The OECD's Committee on Fiscal Affairs set up a task force in 1997 that reported in 1998.

The Initial Report

HTC (1998) identifies two broad categories of unacceptable behavior: "harmful tax regimes" and "tax havens." The former were implicitly the province of OECD members themselves, while the latter term refers generically to perhaps two score

typically small polities[17] that appear to gear their corporate and personal income taxes to the enticement of foreign investment that is overwhelming financial rather than real. These jurisdictions typically have stable governments (about two-thirds are members of the Commonwealth) good transportation and communications, and, of course, freely convertible currencies.[18]

According to *HTC* the tax havens 1) impose little or no tax on relevant income along with one or more of: 2) lack of effective exchange of information, 3) lack of transparency, and 4a) "insubstantial" activity attached to the claim of haven location. 2) and 3) are linked because if no local laws compel appropriate transaction recording, there is no information for the authority to share.

"Harmful tax regimes" are identified by: 1) and one or more of 2) and 3) and a final criterion, which can be designated 4b). The latter is the only criterion that deviates from the tax haven standard. Instead of requiring that the activity be "substantial," the standard is "ring fencing," i.e. whether the jurisdiction in question essentially uses a different tax rate for foreign business than it does for domestic firms. The apparent rationale is that non-havens will have a substantial domestic sector to serve as a benchmark for tax comparison, while the havens will not and instead present the threat of "sham" activity. But there is a larger difference between the two lists of criteria. The havens are attacked as "jurisdictions" while preferential regimes within the OECD are essentially treated as unfortunate policy anomalies of otherwise respectable polities.

The original Report has been subject to great scrutiny and much criticism. It professed to target only one category of "harmful tax competition": the inappropriate enticement of "mobile" financial and similar services, leaving other problems for

subsequent investigations. But this drew the abstention of Luxembourg and Switzerland; they saw no reason that the particular questionable activities in which they specialized should be singled out.[19]

OECD documents often begin as analysis but become increasingly ambiguous as representatives of approving governments add their contributions. In the present case, an inadequately formulated aim contributed to a generally confusing report. The core problem is not solely, or perhaps even primarily, that financial services are "mobile" but that 1) the physical proximity of the intermediary to either lender or borrower is almost irrelevant, giving rise to tax evasion problems when foreign placement of funds lowers visibility to home authorities and 2) the value added in service production may be either locationally complex, opaque, or both, a situation inevitably giving rise to tax-driven and challengeable claims of jurisdictional location for corporate income taxation.

The financial secrecy that facilitates tax evasion was the really critical "service" for individual investors, and, although not given special emphasis in *HTC*, this ultimately became the focus of the entire project.[20] A jurisdiction's competitive advantage for individuals may lie entirely with that secrecy, which must distinguished from the location of value-added, a candidate criterion for corporate tax liability. When activity is claimed by a tax haven, but the actual depositor interface, accounting, lending and all important decision-making actually takes place in Europe or North America, the haven may be little more than an address. This was presumably what the "substantial activity" criterion was aiming at, but no operational measures were suggested.

Although *HTC* distinguishes three different categories of "tax competition," the discussion fails to examine the phenomenon carefully. It merely distinguishes 1)

“substantial” direct investment (e.g. manufacturing) from 2) “more mobile” direct investment (e.g. financial services) from 3) “passive portfolio” investment. The Report declares a focus on the second category, but fails to acknowledge that the distinction between 1) and 2) is largely one of degree with (nearly) zero value-added in the claimed polity marking one end of the spectrum. And much really “harmful” tax competition, such as tax haven banking, involves a combination of 2 and 3) while another large part, such as Luxembourg’s banking that allows safe and effortless tax evasion by other Europeans combines 1) and 3). *HTC* moves across virtually all income tax avoidance and evasion problems at one point or another without adequately relating them to each other or linking them carefully with remedies.[21]

HTC makes a series of recommendations for joint action by OECD members that include tighter surveillance and control on the activities of tax haven subsidiaries; the strengthening of rules on information provision by the tax havens including a diminution of bank secrecy; better control of internal (transfer) pricing by MNCs; more thorough exchange of information among OECD members on tax haven activity and better coordinated administration among them; new and renegotiated bilateral treaties with tax havens that would embody elements of the Guidelines recommended by the Report; endorsement of the Report by the OECD membership; and the establishment of a new institution, the “Forum” that would implement the Guidelines and draw up a list of offending jurisdictions.

HTC also mentions a number of retaliatory measures including restricting tax deductions made for payments to tax havens, the introduction of withholding taxes on earnings paid to offending jurisdictions, new rules for corporate residency, new transfer

pricing rules, more attention to mechanisms that draw profits from high tax to low tax areas through non-arms-length borrowing, better monitoring of new financial instruments such as derivatives, and various unspecified non-tax measures. A more extensive and detailed list was presented in the *2000 Progress Report* (OECD, 2000).

HTC deals with intra-OECD tax competition by calling for a self study of possibly harmful policies along with the examination of member countries' policies by each other. Despite *HTC's* initial and heavy emphasis on tax havens, its nominal logic implies that the OECD will clean up its own house but cannot do so without a coordinated response to what could otherwise be opportunistic behavior from the outside (Easson, 2004, 1040). This jibes with the observation of Frances Horner, head of the OECD's tax competition unit in 1998 that "The Report added the tax haven section almost an as afterthought." (Horner, 2001:3). And subsequent events demonstrated that far too little attention was paid to the extent of the threat and to effective means to counter it.

Very significantly, parts of *HTC* virtually duplicate the language of European Code of Conduct of 1996: "the code proposes evaluating tax systems on the basis of whether they grant benefits only to non-residents; whether the benefits are ring-fenced from the domestic market so that they do not affect the national tax base; whether benefits are granted without any real activity occurring; and whether the measures lack transparency." (Mutti: 87-88).[22]

Early Implementation

The OECD was apparently surprised by the furor HTC produced among the havens – loud protestations of unfairness and neo-imperialism began immediately. But the OECD was also apparently unprepared for the eagerness of many of the havens to reach an agreement – even before any "name and shame" list had been published.

The *2000 Progress Report* identified 47 potentially harmful tax measures in 21 OECD countries [23] as well as a list of 35 tax havens from an initial candidate group of well over forty. Those omitted from the list made advance commitments to the principles of the original Report. The remaining 35 were essentially put on notice that if they did not similarly subscribe to those principles by July of 2001 and agree to end inconsistent practices by the end of 2005, they might confront a set of "defensive measures" discussed at some length in *HTC*.

There was an immediate outcry from the tax havens that they could not possibly conclude one-on-one negotiations with the OECD by the deadline. In response, the OECD developed a "fast track" escape from the blacklist in late November of 2000 in the form a Collective Memorandum of Understanding (OECD, 2000a) to which a haven could simply adhere through public declaration This commitment was both more detailed and more limited that the letters of acceptance that kept six havens from being black-listed in the first place. It focused on transparency and the exchange of information on criminal tax matters (by 31 December 2003) and then all tax matters (by 31 December 2005).

The tax havens' distinguishing "substantial" activities criterion underwent an odd metamorphosis during 2000. The OECD Fiscal Committee presented a report in May that was adopted by the Council of Ministers in June. The criterion of offense that was to

apply exclusively to the tax havens was rendered as: "the jurisdiction facilitates the establishment of foreign owned entities without the need for a local substantive presence or prohibits these entities from having a commercial impact on the economy." (OECD 2000:10). In other words, a kind of ring fencing has been grafted on to insubstantiality as an alternative source of concern. By the Collective Memorandum of Understanding in November, however, the new material had essentially replaced the old: "Not attracting business without substantial domestic activity" had a short term (31 December 2003) and a longer term (31 December 2005) version. In the short term jurisdictions could not deny firms "qualifying for preferential tax treatment" the opportunity to do business in the domestic market. The long run requirement is worth quoting in full:

> For any preferential tax treatment accorded to other service activities, each Party will remove any restrictions that deny the benefits of that preferential tax treatment to resident taxpayers, to entities owned by resident taxpayers, or to income derived from doing the same type of business in the domestic market. (OECD 2000a: 4)

This was a bizarre and wholly inadequate operationalization of "substantial" activity, both because it was predicated on explicit tax preference (a jurisdiction may have no corporate income tax for anybody) and because it essentially treats the absence of "ring fencing" as an exoneration of insubstantial activity.[24] A major state will care if subsidiaries of firms incorporated in that state can avoid tax by claiming operation in a tax haven with little value added there; scant interest attaches to how legally sequestered that possibly almost non-existent activity is from the rest of the tax haven economy.

Remarkably little commentary has focused on the "substantial" activity criterion for the tax havens, either at the time or since, by contrast with its explicit removal at the insistence of the U.S. the following year. But two points are essential. First, the text

above demonstrates that the criterion was already effectively gone before the outcome of the American election of 2000 was known. Second, if the OECD had attempted to pursue the criterion seriously, defining "substantial" operationally would have posed difficulty, as foreseen in paragraph 55 of *HTC* (OECD, 1998: 24). Many havens could claim varying degrees of non-negligible value added relative to the typical organization of comparable activity of similar volume in a high income country. And even within the financial services sector, a reasonable standard of substantiality might differ across activities. So some guidelines would have been needed, and they might not have been easy to devise. The requirement for a very high level of value-added could have counterproductively increased the migration of real activity from the OECD countries to certain havens rather than reducing it. And the intensity of use of "sham" havens differs across both activities and MNC home countries even within the financial services sector. Competitive concerns could therefore have generated friction among the OECD states as specific cases were examined.

And what would the haven itself be expected to do if the original meaning of "insubstantial" had been retained? Was it really to insist on a minimum level of real activity or refuse an investment? Each rich state, after all, was legally in a position to bar its firms from using any of the havens. Moreover, the U.S. position was necessarily conditioned by its global approach to corporate taxation. Some of the flexibility the havens provided to U.S. firms put them on a more equal footing with competitors based in other states.

The main rationale for an OECD agreement on a minimal level of acceptable activity in a jurisdiction would be to remove any competitive disadvantage from acting

alone. But attempting to forge a common position could involve complex judgments and possible national disadvantage and might have been foreseen as a cause of conflict within the OECD. Moreover, the difficulty of the task would have forced prolonged bilateral consideration of the situations of each of the tax havens prior to any imposition of "defensive measures." In sharp contrast, a set of information-gathering requirements and a willingness to share such information could be easily and generically stated for everyone. Therefore, transforming "no substantial activity" into something equally simple, if largely irrelevant, may have seemed an obvious solution. And by appearing almost indistinguishable from the criterion facing the OECD countries, some might have concluded that greater equity had been achieved as well.

The initial opposition to *HTC* by the havens and various established business voices within the OECD (International Chamber of Commerce, 2000) was soon joined by a formidable new organization. The U.S.- based Center for Freedom and Prosperity was founded in October of 2000 under the leadership of Andrew Quinlan, who also formed a "Coalition for Tax Competition" that involved other conservative Washington think tanks including the Heritage Foundation and the Cato Institute. The Center for Freedom and Prosperity pursued two goals, one at home and the other abroad. Within the U.S., it aimed to persuade the Congress and the Administration to oppose the OECD efforts. The CFP declared that if the U.S. resisted the entire effort would fail. And it also urged the tax havens to resist. In the following years, the CFP not only visited the havens to give them advice and counsel but even participated in their delegations at meetings with the OECD (Webb, 2004: 35-36; Easson, 2004:1053, 1054).[25]

U.S. Rethinking and Formal Project Revision

The U.S. election of 2000 resulted in an administration that differed substantially from its predecessor in two respects that are very relevant to this study. First, the Republicans were strongly opposed to tax increases and viewed the size of government in the EU as an important contributing factor to poor economic performance there.

The first Bush term saw considerable cuts in marginal tax rates and a proposed abolition of the estate tax. One of Bush's opponents for the 2000 Republican nomination, Steve Forbes, made the introduction of a "flat tax" the cornerstone of his campaign. While much of the flat tax closely resembles the EU's value added tax – it taxes only that part of income that isn't saved – proponents often see it as a virtually complete substitute for the current personal and corporate income taxes (Cassidy, 2004) rather than a complement to them as is the VAT's role in Europe. When such a flat tax is combined with the removal of an estate tax, the tax haven problem essentially disappears. Advocates could argue that government revenue difficulties with the tax havens are well deserved and should serve as a stimulus to rethink government revenue sources rather than as an occasion to beef up enforcement efforts.

The Bush administration did not endorse the end of the personal income tax, but key figures including Treasury Secretary O'Neill openly questioned the corporate income tax.[26] The Bush administration also differed sharply from its predecessor in a determination not to be bound by the precedents of international cooperation. In both style and substance the Republicans stressed unilateral internationalism rather than cooperative joint-venturing far more than the Clintonites had done.[27] The incoming administration certainly saw the tax haven project as doubly suspicious: it seemed

tailored by high tax Europeans for their own purposes, and its rhetoric about "coordinated defensive measures" involved U.S. cooperation in undefined enforcement. Nonetheless, much of the project served a long-standing U.S. goal: thwarting the evasion of U.S. taxes.[28]

Acceptance of the logic of *HTC* on tax evasion implied a U.S. policy adjustment that the new administration did not deny. The U.S. had not taxed portfolio investments and had therefore not collected information on ownership and earnings since 1986. But collecting information on financial investments made in the United States and a willingness to share that information formed the core of a cooperative fight against tax evasion. This measure of cooperation to satisfy both OECD information sharing demands and European aspirations to reduce EU tax evasion infuriated groups such as the Center for Freedom and Prosperity (2004), however, and pressure to withdraw the regulation permanently continued to this writing in the name of a right to "financial privacy" (Hamilton, 2003) that no administration has acknowledged.[29] Some Republicans even attempted to withdraw U.S. funding from the OECD.[30]

The CFP argued from its inception that the *HTC* project was anticompetitive, would result in higher taxes, infringed on national sovereignty, discriminated against non-OECD countries by treating them more harshly, and threatened privacy (Easson, 2004:1054). Some of these arguments clearly resonated with the new Bush administration. Treasury Secretary O'Neill failed to endorse the OECD initiative when asked about it in February, 2001, and in May he declared a concern that the initiative involved interference with countries' abilities to set their own tax rates and a constituted a step to "harmonize world tax systems." (Easson, 2004: 1061).

O'Neill explained to the Congress in July of 2001 that the United States had been far more successful that other high income countries in gaining information exchange agreements with other countries -- including some jurisdictions seen as tax havens -- but that some were not interested in cooperation; others resisted cooperation without the assurance that they were not moving alone. On these grounds, he argued that action within the OECD framework could be seen as constructive. But he also made clear that his only objective was to shore up the enforcement of U.S. tax laws and that the OECD should not "stray" into other areas (O'Neill, 2001, 2, 3). Consistent with this view, O'Neill announced that the OECD project had eliminated the "no substantial activities" criterion (even in its largely meaningless "ring-fencing" reformulation) from its criteria for haven cooperation, noting that it was surrounded by a "lack of clarity" (O'Neill, 2001: 4, 6). Moreover, he appeared to distance the Administration from the project more generally by noting that *HTC* and the 2000 *Progress Report* ". . . take a notably condemnatory tone with respect to the issues addressed, and the advocacy of internationally coordinated action against targeted countries represents an approach that is more aggressive than is typical for the OECD." (O'Neill, 2001: 3)

In retrospect, it appears that O'Neill was largely pushing on an open door. The project had already been refocused on transparency and information exchange. Yet the Administration probably saw two major advantages in putting a bright line around what it regarded as appropriate activity. First, the U.S. was then embroiled in a WTO dispute with Europe involving the use of tax havens for the relief from corporate taxation of export sales by U.S. firms made to third countries through Foreign Sales Corporations. This policy device purported to compensate for the ability of EU firms to escape value

added taxation on their export sales, but it could be seen as both substance-less jurisdictional manipulation and ring-fencing.[31] Moreover, some subnational U.S. practices, such as Delaware's treatment of foreign corporations, were suspect. No U.S. administration, let alone one committed to maximum sovereignty, wanted to become embroiled in federal-state disputes solely to meet foreign demands.[32]

Another motivation was certainly partisan political. Part of the Republican right was not getting its preferred "privacy." This might be swallowed more easily with a chaser of rhetoric about the horrors of a high tax cartel and the virtues of tax competition. So, instead of glossing over differences with the EU in the interest of OECD solidarity as a Gore presidency might have done, the Bush administration appeared anxious to exaggerate those differences. This triggered a barrage of criticism at home and abroad accusing the Administration of softness on tax avoidance and evasion (as examples, see *New York Times*, 2001, Giridharadas, 2001).[33] But O'Neill's Congressional testimony announcing the OECD project changes began with a ringing endorsement of the essential need for increased transparency and information exchange. Moreover, the final budget request of the outgoing Clinton administration seemed to regard those two elements as the sole requirements for tax haven compliance (Sheppard, 2001:2021).

The Reactions from Business

The OECD had been subject to attack from its own Business and Industry Advisory Committee (BIAC, 1999) before taking fire from the new U.S. administration. And the two assaults were not independent. The misgiving of U.S. business was largely mirrored in Europe because the OECD had not engaged in what the BIAC regarded as

sufficient consultation. The American legal scholar, Hugh Ault, who served as a major consultant on *HTC,* has argued that the initially closed preparation of the project was due to the anticipated difficulty of finding common ground among the OECD governments (Weiner, 2000: 12). But this led to a document that big business everywhere regarded with suspicion in both tone and content. It was hard to find a substantial business unsympathetic to the view that much corporate tax avoidance was legitimate "tax planning."

In an attempt to shore up business support for the OECD and acquiescence in the *de facto* refocused project, Jeffrey Owens, OECD's Head of Fiscal Affairs joined Richard Hammer, Chairman of the Committee on Taxation and Fiscal Policy of the BIAC to issue a statement praising tax competition and "legitimate tax planning." (Webb, 2004: 34-35). This statement was issued on March 6, 2001, about two months before O'Neill's public indication of U.S. rethinking. And once the project had been refocused on transparency and information exchange, business opposition, at least in the U.S., largely ceased.[34]

Many observers have treated the Bush response to *HTC* as just one more instance of the pursuit of an extreme conservative agenda. But the right knew all along that one of its prime objectives, making the earnings of savings held abroad more difficult than ever to tax effectively, involved pushing a very big boulder uphill. Neither Paul O'Neill nor any other major Bush administration official ever suggested that the long-standing U.S. policy of promoting foreign cooperation to fight tax evasion was softening.[35]

The 2001 Progress Report reflected U.S. pressure not only in dropping "no substantial activity" as a criterion for an uncooperative jurisdiction[36] but also in extending the deadline for cooperation by several months to November 30 2001. [37] Similarly, no

"coordinated defensive measures" would be taken against the tax havens until they were taken against a similar OECD country.[38]

The Post 9/11 World

The attacks of September 11, 2001 shifted the dynamics of tax haven discussions. Financial secrecy could now be linked to dangers far greater than fiscal loss. The Financial Action Task Force on Money Laundering (FATF) had been established at the Paris G-7 Summit in 1989 mainly as an attack on organized crime.[39] In 1999, as part of an explicit "name and shame" approach to enforcement, the FATF published a list of 15 non-cooperative territories that fell short in 1) financial regulations including customer identification; the permission or mandating of excessive financial secrecy; and a lack of a suspicious transaction reporting system; 2) other regulatory problems including the failure to require adequate information on the beneficial owners of various kinds of businesses 3) obstacles to international cooperation due to administrative and judicial constraint; and 4) inadequate anti-money laundering budgets and agency activity (Reuter and Truman, 2004: 86).[40]

After 9/11, the FATF explicitly shifted its rationale to emphasize terrorist funding, and its prominence began to eclipse that of the *HTC* project. This reflected rebalanced concern in nearly every major polity towards an emphasis on security and away from whatever local privacy norms had prevailed previously. But local authorities found that the information gathering and sharing requirements for the two rich-country initiatives were quite similar. One observer noted that "once jurisdictions had complied with the FATF, they had done 90 percent of what the OECD expected of them." (Sharman, 2004:8)

The post 9/ll period has seen a host of new and pending measures in response to the FATF, the European Anti-Money-Laundering Directive of October 2001, and the USA Patriot Act of October, 2001. Together they greatly increase both intra and inter-governmental cooperation by facilitating information flows, the service of documents, and the attachment of property. In some jurisdictions this has involved a more encompassing view of what constitutes a sufficient level of offense to warrant various measures of international cooperation. Even some observers skeptical of the wisdom of the privacy sea-change sense that the shift is permanent and that, one way or another, secrecy as source of national competitive economic advantage, whether practiced by the Marshall Islands or by Switzerland, will ultimately be stripped away (Zagaris, 2003). Lobbyists such as the Center for Freedom and Prosperity, never very successful at selling financial privacy that appeared to be largely tax evasion, assumed a great additional burden when that privacy seemed to threaten national security.

Another source of concern about haven financial practices grew from the Asian Financial crisis of 1997, which highlighted the unsound practices of many regional financial institutions and the need for much greater supervision. The International Monetary Fund conducted investigations of 44 jurisdictions on behalf of the Financial Stability Forum (FSF) , nearly half which were not Fund members (Reuter and Truman, 2004: 87-88). Initial assessments produced three groups of jurisdictions: several of the largest tax havens were represented in the third group, those least adequately served "by infrastructures and supervisory practices, or /or a level of resources devoted to supervision and cooperation relative to the size of their activity" (Financial Stability Forum, 2000:2)

Moving to Completion

Many havens continued to declare their cooperation with the HTC project's demands during 2002 and 2003.[41] By the issuance of the *2004 Progress Report* (OECD, 2004), only five holdouts remained: Andorra, Liechtenstein, Liberia, Monaco, and the Marshall Islands.[42] And there had also been considerable change within the OECD: of the 47 potentially harmful regimes noted in 2000, 18 had been removed or were being removed, 14 had been amended, and 13 had been found not-harmful. Two were still under consideration.

THE HARMFUL TAX COMPETITION PROJECT IN RETROSPECT

The *HTC* project has now largely run its course, although the Global Forum on taxation continues, as does relevant activity in the FSF and the FATF.[43] And what of the oft-touted "defensive measures?" Although there are still a few recalcitrant jurisdictions, Jeffrey Owens, the Director of the OECD's Center for Tax Policy and Administration has explained that:

> The framework of coordinated defensive measures has always been an option of last resort. As long as progress continues to be made, it is unlikely that resorting to the coordinated defensive measures will be necessary. Also, whether to impose defensive measures is a matter within the individual sovereignty of each country. The OECD is merely a forum in which member countries can share experience and, if they think appropriate, seek the cooperation of other OECD countries. The OECD itself has not power to impose defensive measures." (Gouldner, 2004:1191-1192.

The *HTC* project has been subject to so much criticism from its very inception that nothing comprehensive can be offered here. Nevertheless, several major recurring

themes need to be addressed prior to an evaluation of the project in the context of U.S.-EU relations.

The Presentational Inadequacies of the Original Report

The original *HTC* Report got the entire project off to a bad start. The title has been acknowledged to be a major gaffe (the phrase seems never to have been used again; the project soon became "Harmful Tax Practices"), and the benefits of tax competition may have been given too little emphasis.[44] Overall, the Report seems rhetorical[45] rather than persuasively argued and carefully documented. In addition to some careless editing, the ordering of material in the report makes it hard to follow and understand. The conceptual aspects of the problem are inadequately developed, and remedial policies are often presented as lists of possibilities rather than as carefully thought-through responses.

Although "harmful tax regimes" can apparently exist anywhere, they essentially became an attribute only of the OECD countries, while the "tax havens" were entire jurisdictions. And both "ring fencing" and "no substantial activities" should have been applied across the board to all jurisdictions. As it turned out "no substantial activities" essentially evaporated as a criterion for the havens long before it was formally removed at U.S. insistence: first by adding a variety of "ring fencing" as part of the test and then leaving it as the only test. This set of developments left only the rich states to deal with "ring fencing," which caused Belgium and Portugal to abstain from the *2001 Progress Report*.

More substantively, the failure to think through the practical difficulties of trying to control activity in the havens and the opposition of organized business to attempts to

do so resulted in improvised revision that damaged the project and undoubtedly the confidence of the business community in the OECD itself. And this was matched by the awkwardness with which the tax havens themselves were treated, another failing that generated piecemeal corrections and at least some long-lasting reputational damage.

The Fairness Issue

The non-OECD tax havens complained from the beginning that they were essentially treated as career criminals while OECD countries were regarded as minor offenders. In addition, some important non-OECD financial centers showed *prima facie* characteristics of tax havens were omitted from the original list without explanation. Some of these were identified years later as jurisdictions from which cooperation was to be sought in large part to increase the effectiveness of the European Savings directive (McCloskey, 2004: 1236).[46]

The mid-course corrections of 2001 redressed some of the asymmetry between the OECD countries and the havens in terms of the timetable for "coordinated defensive action," but the 2002 EU Savings Directive added another complication. It aimed at banking secrecy in EU members Luxembourg, Belgium, Austria and non-member Switzerland that clearly abetted tax evasion. Various approaches to the problem were considered, and the final compromise approved in February 2002 allows for a seven-year transition period during which Austria, Belgium and Luxembourg gradually increase their withholding taxes from 15 to 35 percent from 2005 to 2011 while retaining 20 percent of the revenue for themselves. These EU states also insisted that Switzerland, Andorra, Liechtenstein, Monaco and San Marino participate – thus fingering three of the non-cooperating tax havens from the OECD list as well as the most important

problematic tax jurisdiction within the OECD. Banks and other financial institutions in the other states will automatically report information to fiscal authorities across the EU (Kean and Ligthart, 2004: 540-541), but only on interest earnings, a restriction that many see as easy to circumvent (Wright, 2005). After the transition period, the EU states with a special dispensation are expected to shift to information exchange. And the EU Commission intends to pressure Switzerland to do the same (Scott, 2004: 1102).[47] Some commentators, however, think that the recalcitrant Europeans will not be won over and that only information upon request will become universal within Europe (Hay, 2003:5). The withholding compromise seemed to leave some European jurisdictions with greater bank secrecy than the havens were required to relinquish, generating a barrage of criticism from their defenders.[48]

Constructivist Illumination?

Some commentators have portrayed the unfolding of the *HTC* project as an example of the power of argument and of the usefulness of a constructivist approach to understanding international relations (Webb, 2004; Sharman, 2004). That approach may well illuminate parts of the story for some actors, but the case for its centrality remains to be made. The interests of states and interests of dominant groups within them appear quite consistent with what took place.

Some minds may well been changed by the torrent of rhetoric between 1998 and 2004. But the political dynamics of the *HTC* seems to have resulted far more from a larger role for higher level OECD officials with greater political sensitivity as the project emerged from the obscurity of the Committee on Fiscal Affairs to the stage of

international politics.[49] One observer close to the unfolding conflicts noted that those connected with the fiscal committee were naïve about the politics of tax reform – both *vis à vis* the tax havens and within the OECD – and that if persons with greater political acumen had been involved at the outset, "defensive measures" would have been handled very differently. Yet in the earliest days of *HTC*, these relatively low level national appointees to the OECD appeared to be giving marching orders to prime ministers in the tax havens. Thus, politically as well as technically, *HTC* shows signs of not having been carefully thought through.

Discussions with OECD principals do suggest that their engagement with some of the havens made a deep impression on them and the details of just how and why the substantial activity requirement was gutted have not yet emerged. At least some of the principals seem scarcely aware of how substantial the change was.[50] The nominal parity between the havens and the OECD members that appears to be established by transmuting substantiality into the absence of "no ring fencing," for example, is almost completely meaningless and cannot be based on a careful equity argument. One OECD participant said that he and his colleagues determined that the early formulation amounted to asking the havens to turn business way. To be sure, guidance on substantiality would necessarily have come only from well-drawn agreed rules about sufficient local content (or management, or ownership, or something). But instead of developing such a solution, a quest that presumably promised delay and intra-OECD conflict, the problem was finessed. And, although some of the principals may have honestly believed that this was the correct solution out of sympathy for the havens – there are reports of haven ministers crying in meetings with the OECD -- the jurisdictions most

benefiting from this sham activity, although small, were not poor. The few crumbs that a permissive corporate regime offered – or promised to offer in the future – to the poor havens seems very odd reason for abandoning the quest for a stand on the necessity for real activity.

If the lawyers on the firing line really were confused – as well as surprised – by the havens' reactions to the Report, there were presumably economists back in Paris (or in the national capitals) who were less so. Additionally, it must be remembered that all any of the participants know about motivation is what they observed or were told. For example, if, for their own reasons, the principals took positions that corresponded to the dominant preferences of their national governments, their judgments would not be countermanded.[51]

There is scant evidence that many attentive minds were changed by the torrent of rhetoric between 1998 and 2004. The lack of symmetry in timetables between the OECD and the havens resulted from a politically tin ear, and the problem was easily corrected. The OECD also accepted the havens' demand for a "level playing field" that implied all jurisdictions should meet any minimum standards. More generally, the OECD accommodated the havens by engaging them as partners rather than the opponents sketched in *HTC*. But in the course of doing that, the OECD also gained the endorsement of the basic principle that the tax havens never accepted prior to project and which remains at odds with the "financial privacy" goal of their metropolitan champion, the Center for Freedom and Prosperity. By 2004 nearly all of the original tax havens subscribed to a report that stated "All countries, regardless of their tax systems, should meet [high standards of transparency and information exchange for both criminal and

civil taxation matters] so that competition takes place on the basis of legitimate commercial considerations. . . . In particular, it is important to prevent the migration of business to economies that do not engage in transparency and effective exchange of information for tax purposes." (OECD, 2004a:2). This drive to extend the project to previously unexamined jurisdictions paralleled the EU Savings Directive concern that money driven out of the OECD-tax haven spheres could go elsewhere. Highlighting the need for attention to such additional money centers as Singapore and Hong Kong was scarcely a concession to the havens, particularly as they did not attempt to use it as excuse for inaction. Money is fungible, and fairness for the havens is efficacy for the OECD.

The American politics of the *HTC* project presents a case of a fifth column, most visibly the Center for Freedom and Prosperity (whose funding is not public but is suspected of being supported by both wealthy Americans and foreigners who benefit from "financial privacy") exceeding the rhetorical power of external voices by orders of magnitude. The CFP spearheaded the U.S. propaganda drive, and some of its appeal to part of the Republican base was appropriated by the Administration.[52] But the core "privacy" aim, also much trumpeted by the havens at the level of principle, was largely ignored.

The CFP and some others have also claimed that the *HTC* project not only treated non-OECD countries differently but presumed to intrude inappropriately into the domestic policies of member states. But, as OECD officials periodically stressed, the collective action envisioned by *HTC* was nothing more than a coordinating mechanism for what any single member state could pursue – less effectively – on its own towards *any*

other state. And because all of those acts could be justified as a state's attempt to enforce its own tax laws, nothing done or threatened appears to have violated international law (Gross, 2003: 394, 400).

Unrealistic Expectations

Although the original *HTC* plan envisioned a series of explorations, it now appears likely that no additional initiatives of a similar kind will be taken for the foreseeable future. And the entire project has scarcely extirpated "Harmful Tax Competition" for nominal corporate location and the associated tax avoidance. Even with respect to financial services, the 1998 Report itself provided no useful roadmap for progress. Tax avoidance through "sham" activity, whether for a subsidiary or for a headquarters, could be overcome only by various tests of value-added, day-to-day management, or ownership. And this line of policy development, although acknowledged in the original *HTC* document, appears never to have been carefully explored.

Tax evasion may have been somewhat more effectively addressed. *HTC* aimed to increase transparency and information sharing, and this may be developing, albeit slowly. Its promise will be largely lost, however, unless the standards are extended to another handful of money centers not originally considered. In addition, it must have been understood from the beginning that upon-request rather than automatic information sharing could only have limited deterrent effect, the strength of which is now in the hands of the rich countries themselves. If they devote substantial resources to enforcement along with the imposition of serious criminal penalties for violation, the use of the havens for individual tax evasion could be greatly reduced. But those are stringent conditions.

IMPLICATIONS FOR THE FUTURE

Two kinds of conclusions can be drawn from the story developed here. One concerns the likely future of the international tax system.

Taxes Tomorrow

The politics generated by the *HTC* Project has highlighted as never before the manifold weaknesses of the corporate income tax. "Corporate inversions" are an important U.S. tax haven issue that scarcely existed when *HTC* began. They essentially involve shifting corporate headquarters to a tax haven and leaving most of what was based in the U.S. as a subsidiary. Until the Bush administration, it was generally thought that such action would constitute a public relations disaster for any firm; that administration's critical attitude toward corporate taxation likely had some impact on dispelling such fear. But the option was always there. U.S. practice allows a firm simply to elect nationality while other states, notably the U.K., focus on where directors meet. Shifting the U.K. criterion to the residence of those actually performing day-to-day management, as is Dutch practice, would likely have a catastrophic impact on the tax havens (Avi-Yonah, 2002)[53] If it did not, some minimum threshold of local resident ownership certainly would (Kudrle, 2003).

This inversion problem was hinted at in *HTC* but not really examined. And the control of such activity, widely attacked by many leading Republicans as well as the Administration' opponents, remains to be confronted by the U.S. and other high-income countries.

The inversion problem, however spectacular, highlights weaknesses at the very heart of the corporate income tax. Economists of virtually every stripe have traditionally rejected the tax as anything other than a means of raising substantial government revenue. Although the relative role of the corporate tax in total revenue among the developed countries as a whole has not yet diminished (Griffith and Klemm, 2004), it seems likely that it soon will. First, there is ever-increasing competition among jurisdictions for the real activity of established corporations based on the unique assets that define them. Within the EU, Ireland countered complaints about "ring fencing" by introducing a uniform rate of 12.5, and several recent EU members also have low rates. These rates are most unlikely to rise; instead they will continue to put pressure on other EU states to reduce theirs (Simpson, 2005); uniformly lower rates EU rates will, in turn, put greater competitive pressure on the U.S. Second, there is the increasing and apparently hard-to-control ability of multinational firms to manipulate financing and intra-firm prices to generate nominal profits where corporate tax rates are low (Sullivan, 2004). Both quantitative and qualitative evidence suggests that only a massive infusion of official attention could turn this around. Third, little if anything prevents firms now based in most major high-income states from reincorporating their headquarters in jurisdictions with low corporation tax rates. Finally, and perhaps most importantly, firms with handicaps such as a substantial effective rate of corporate income tax are less likely to prosper in the long run than those without such burdens. In light of all of these factors, the corporate income tax will probably drop substantially in importance before the abuses identified by the OECD are effectively addressed.

The problem of tax haven secrecy is very different. It is hard to envision a U.S. political climate that would permit complete elimination of the taxation of all asset earnings. No European state or Japan is contemplating such change. This implies an outgoing search for effective prevention of personal income tax evasion on both sides of the Atlantic.

Nothing currently being considered by the OECD will likely stanch a substantial flow to outside tax havens. Increased resources for enforcement and stiffer penalties might reinforce the transparency that may be developing in the havens, but even the most determined efforts are likely to be less judged only a partial success. In the long run the tax havens might be given the choice of employing either an automatic exchange of information or compulsory high withholding taxes. But withholding aims only at earnings tax evasion while automatic reporting can combat a wide variety of criminal activity including terrorism, so only the latter may prove acceptable.

The Strategies of the Rich

The other lessons taught by the *HTC* project concern the relations of the U.S. with Europe and the strategies pursued by each side. The U.S. may dominate with both "hard" and "soft" power, but the "sticky," i.e. economic, power of Europe now exceeds that the U.S. by most measures, and this is unlikely to change over the foreseeable future. This power holds important continuing implications for the major economic institutions, including the OECD, the IMF, and the World Bank.[54]

Both sides showed considerable restraint in their behavior. Secretary O'Neill stated his opposition to both real and fancied weaknesses in the original OECD position in restrained language that included much praise for the *HTC* project -- language that

contrasted sharply with the hyperbole that typified the statements of such project opponents as the Center for Freedom and Prosperity. The original OECD position – which was apparently designed to put maximum pressure on the havens with respect to both avoidance and evasion – always enjoyed much bipartisan support within the U.S. This, in turn, undoubtedly gave Paris grounds for continuing optimism about accommodation.

For its part, the leadership of the OECD publicly treated the U.S. rethinking as a valuable contribution to the development of the project rather than as an attack on its essence. In fact, as argued earlier, the public U.S. policy adjustment might have been merely the *coup de grâce* for "no substantial activities" and inconsistent timetables between OECD members and the other states.

The Bush Administration's actions can be seen as moving on two tracks. On the one hand, Secretary O'Neill made sovereigntist statements that must have reassured part of party's base. But he embraced an attack on personal income tax evasion in much the way his predecessors did. After the official OECD revision there is no record of further U.S. criticism. Indeed, the subsequent signing of bilateral information-sharing agreements was publicly celebrated by the Administration (as an example, see U.S. Treasury, 2003).

Additional Lessons

Four major lessons for future conduct can be drawn. First, the OECD must resist tendencies to see the world in "Eurocentric" terms and proceed according. The U.S. still often dominates the OECD, but when Europe tackles an issue with a high level of internal

cohesion -- as it clearly did to a great extent in the tax project -- trouble can result both with the United States and the rest of the world. But the U.S. shares the fault with Europe. The U.S. apparently paid insufficient heed to the intra-European issues that drove much of the shape and verbiage of *HTC*. A more attentive and forceful U.S. voice during the Clinton Administration might have increased the viability of the project in both tone and content.

Second, the OECD -- both the EU and the U.S. -- should be careful about the way its activities affect non-members. The ill-starred Multilateral Agreement on Investment suggests that the Harmful Tax Competition Initiative was not an isolated instance of OECD failure to map likely reactions by outsiders.[55]

Third, the OECD and its dominant European members should individually and collectively prepare for intermittent "sovereignty eruptions" from across the Atlantic. The EU members that share leadership with the U.S. in the OECD should certainly have engaged in more forward and backward mapping about relevant U.S. developments from the very beginning. The Democrats were never a sure election bet after the Lewinsky scandal broke, and several major elements of the tone and content of *HTC* were clearly red flags for the U.S. right that could not have survived much serious scenario spinning. That said, even if *HTC* had been more carefully drafted, the Republicans might well have found attack on aspects of the project politically irresistible.

Finally, U.S. politicians, at least in the executive, should more fully recognize that world attention to the style and substance of Washington rhetoric rivals domestic attention. This implies little chance of building a domestic base on an international issue without some contribution to solidifying other bases abroad. Paul O'Neill's departure

from the Bush administration was followed by memoir that stressed his differences with the President and some of his colleagues (Suskind, 2004). But O'Neill's handling of the OECD's tax competition project typified the Bush administration by placing U.S. interests on a vastly different plane from others' in both words and actions. As such, it made a small but still damaging contribution to the collapse of European confidence in American leadership.

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[1] For a recent discussion of the OECD that notes its relative neglect in the academic literature, see Porter and Webb, 2004.

[2] One official study of U.S. policy noted: "The provisions of the tax law that apply to international transactions in general and to tax haven transactions in particular are among the most complex in the Internal Revenue Code (Gordon, 1981: 7). A U.S. participant on international corporate tax issues observed: "The interested parties are almost exclusively large, multinational companies, and the only organized opposition to tax expenditures in the international area are academics and journalists." (Stephen Shay quoted in Guttman, 2002:1102).

[3] In the nineteenth century, modern states began shifting their revenue sources from taxes on real property and a variety of transactions towards taxes on personal and corporate income.
[4] Territorial systems must especially guard against the siphoning off of profits from home operations to lower tax areas.
[5] States became increasingly smaller relative to the total world supply of loanable funds; hence the supply curve to any one of them moved closer to horizontal. Just how close to horizontal it is for some very large states, notably the U.S., remains in dispute.
[6] The two types of income tax do not function in isolation. A history of wealthy individuals attempting to use foreign incorporation to escape the personal income tax goes back to the twenties, as does public policy to thwart it (Picciotto, 1992:107).
[7] The standard statutory U.S. rate was 35 percent. The rates paid by various industries differ for a number of reasons, and the average could be slightly different for industries most heavily involved in overseas activities.
[8] Pass-throughs to other governments leave the federal government accounting for only a bit more than half of direct expenditures. Rosen, 2002: 14, 473.
[9] At the dawn of the twenty first century, all U.S. government expenditure was 28.3 percent, while the U.K. was 40.2 percent, Germany was 46.9 percent, France was 54.3 percent, and Sweden was 60.8 percent (Rosen, 2002: 12).

[10] Such evasion became particularly straightforward after the introduction of the Euro in 1999 across all then EU states except Britain, Sweden and Denmark.
[11] Competitive might be roughly distinguished from defensive behavior by estimating how factors would be distributed across jurisdictions in the absence of tax differences. This typology draws on Kudrle, 2000. Tanzi (1995:7) also mentions adaptation and competition without offering a means of distinguishing between them.
[12] States can still stimulate each other to produce vital services more efficiently through demonstration and imitation.

[13] This includes the placement of intellectual property there and also a process known as "stripping" in which profits from home country activity are moved offshore by the payment of contrived debt charges.
[14] Owners may obviously reside in many countries; they seldom live in low income tax havens.
[15] The haven characteristics in this paragraph are those of production, sham, headquarters, and secrecy tax havens respectively (Kudrle and Eden, 2003).
[16] Unless otherwise noted, the factual material in this section is drawn from Easson (2004) and Webb (2004).
[17] For alternative lists of tax havens, see Kudrle and Eden, 2003: 48-49.
[18] They differ from each other in many dimensions including specialization in various financial activities and the extent to which they have been involved in scandals of various kinds (Suss, Williams, and Mendis, 2002; Sharman, 2004). Some of the most successful havens have very high per capita income.
[19] OECD rules formally allowed more than abstention; they could have vetoed the entire project.
[20] In fact, *HTC* excludes "treatment of interest on savings instruments, particularly bank deposits" on grounds that such matters will be considered later and that a special Working Party is considering them (*HTC*, 1998: 10). Unfortunately, this attempt to specialize and focus simply makes the document harder to follow than if a coherent, comprehensive presentation of the tax haven problem had been tightly linked to practical and effective ameliorating policies.
[21] Part of one jurisdiction's concern about another's banking practices can rest on either the "poaching" of a modest amount of real investment or, alternatively, sham claims of real activity. But in both cases, the

principal losses are typically in tax revenue foregone: losses on what would be taxes on depositor earnings. And this evasion is what is motivating most of the diverted real or claimed investment in the first place.

[22] The implementing Primorolo Group documented 40 EU schemes and 26 others in associated and dependent territories that were required to be withdrawn by the end of 2003 (in some cases 2005). Nearly all of the OECD harmful regimes in the EU were also on the EU list. The EU also decided in 1998 to enforce the state aid rules of the Treaty of Rome more strictly; this resulted in the elimination of many special fiscal incentives for a broad range of activities not necessarily involving foreign investment (Easson, 2004: 1048). All of this vividly illustrates pervasive European concern about "harmful tax competition."

[23] These were to be considered by the Forum with the development of suggestions for modifications or removal of practices found to be "harmful." Although the Report suggested that these issues were to be resolved by June of 2003, they were not actually reported on until the 2004 Progress Report.

[24] There is reason to believe that at least some of those committing early really didn't consider the substantial activities criterion or even the ring fencing criterion seriously. Cyprus was reported in August of 2000 to have made a commitment to "full compliance" while home to more than 40,000 companies of which only 1,200 had a physical presence. Moreover, it had an income tax for offshore companies of 4.5 percent and a 25 percent rate for domestic firms (Hope, 2000: 6).

[25] The traditional scope of U.S. tax claims and its long-standing government posture in favor of information sharing well understood by the American right. Both libertarian and more traditionally conservative commentators have long attacked these and other traditional U.S. international taxation practices. They have favored not only a territorial approach but often the complete abolition of the corporate income tax and all taxes on asset earnings (for an example, see Rahn and de Rugy, 2003).

[26] O'Neill suggested consideration of the abolition of a separate corporate income tax in May of 2001 claiming that others in the Administration also favored it (Shlaes, 2001).

[27] Daalder and Lindsay trace this strand of internationalist Republican thinking back to Henry Cabot Lodge, whose opposition to Woodrow Wilson over U.S. membership in the League of Nations was very different from the isolationism of William Borah (2003:7,8).

[28] Even if the corporate income tax were abolished, the tax havens would still threaten the personal income tax – which the administration did not discuss abolishing.

[29] Pressure from the many of the same groups that have opposed the project all along succeeded in getting the Bush Administration to change the original regulation that would have reported bank earnings of all foreign depositors to home governments to make such reporting necessary for citizens of only 16 countries, including the major states of the EU (United States Mission to the European Union, 2002) thus limiting the value of the project to poor countries.

[30] The latter drew a vigorous rebuttal co-authored by Senator Charles Grassley, Republican of Iowa (Baucus and Grassley, 2004).

[31] This interpretation is bolstered by the contemporary testimony of Donald C. Alexander, Director of the Internal Revenue Service in the Clinton administration (Alexander, 2001). The OECD had pointed out that the Foreign Sales Corporations fell under the scope of the project only the extent that they deal with financial services, and this narrow focus would have applied to subnational regimes as well. But *HTC* was originally intended to be only the opening shot in an attack on suspect tax practices.

[32] The U.S. government has sometimes used the difficulties of American federalism as an excuse not to push too hard on some subnational policies opposed by foreigners. And the barrier to agreement is real; some see it as a major contributing factor to opposition to the Central American Free Trade Agreement (Magnusson, 2005).

[33] After Paul O'Neill first took his first shots at the OECD project, seven previous IRS directors, including three Republicans, expressed the collective view that O'Neill misunderstood the project and that its success was vital for the integrity of the U.S. tax system (Johnston, 2001:1).

[34] Some business groups openly embraced the refocused project. The United States Council for International Business stated that support as it opposed the withdrawal of U.S. funding for the OECD spearheaded by more conservative forces in 2004 " . . . we [international business operating through the BIAC] were able to convince CFA [the OECD's Committee on Fiscal Affairs] to redirect its emphasis to

transparency and information exchange. . . . pursuant to a bilateral tax treaty or exchange of information agreement. . . The international business community is in accord with this goal" (2004).

[35] Automatic, as opposed to upon-request, information sharing would have created a major political divide, but any such dispute remains for the future. Many fear that a global, automatic sharing of tax-relevant information such as that developing within the EU could lead to commercial and other abuses stemming from the weaknesses in information control regimes in some jurisdictions, a point made by O'Neill in his Congressional testimony. But automatic information sharing among all jurisdictions was never seriously considered during the *HTC* project, in part because developing a consistent international system of identification numbers would be a massive undertaking even if there were no strong political opposition to doing it.

[36] The previously discussed surrogate, *de facto* "ring fencing," was also dropped, but it had not been officially adopted as an indicator for the havens as opposed to the OECD countries, where the criterion was retained.

[37] It was originally July 31; it was subsequently moved to February 28, 2002.

[38] The 2001 *Progress Report* (OECD, 2001) also documented the ongoing discussion with all 35 of the previous listed havens and noted that several more had committed to the principles of the original Report. Luxembourg and Switzerland again abstained as they had for both previous reports and they were joined by Belgium and Portugal who objected to dropping "no substantial activities" while "ring fencing" was retained (for them).

[39] The FATF was housed with the OECD, but its task explicitly excluded tax issues (Reuter and Truman, 2004: 81).

[40] There were six countries on the non-cooperating list in July 2004, none of which was among the tax project holdouts: the Cook Islands, Myanmar, Indonesia, Nauru, Nigeria, and the Philippines. (Financial Action Task Force, 2004).

[41] The OECD produced a model exchange of information agreement in April of 2002 that had been developed jointly by a working group of the Forum that included both OECD and haven countries. The transparency commitment of the havens was assured by a stipulation of various kinds of mandatory ownership and accounting records so that the information sharing commitment would be meaningful.

[42] Antigua and Barbuda withdrew their assent in October, 2003 on grounds, to be discussed below, that OECD jurisdictions were receiving more favorable treatment.

[43] In 2002 the staffs of the IMF, the OECD, and the World Bank proposed an International Tax Dialogue to coordinate activity and to share lessons among international organizations and country governments on a broad range of tax matters. The UN also participates as an observer. The ITD's activities can be found at http://www.itdweb.org/

[44] But they are not ignored as much as detractors' comments sometimes imply. *HTC* celebrates globalization by noting that it "has . . . been one of the driving forces behind tax reforms, which have focused on base-broadening and rate reductions, thereby minimizing tax induced distortions. Globalization has also encouraged countries to assess continually their tax systems and public expenditures with a view to making adjustments where appropriate to improve the 'fiscal climate' for investment." (OECD, 1998: 13)

[45] The rhetorical tendencies in EU discourse have been recently discussed in Alesina and Perotti, 2004.

[46] The newly cited havens are Barbados, Brunei, Costa Rica, Dubai, Guatemala, Hong Kong, Macao, Malaysia (Labuan), the Philippines, Singapore, and Uruguay.

[47] The prospects for success with the Swiss may be increasingly bright for two major reasons: the expanding EU accounts for an increasing share of Switzerland's trade, and Swiss per capita income has fallen from the highest in Europe to about the middle, creating a greater desire for increased cooperation and integration to spur prosperity (Fairlamb, 2004:69). But progress is likely to come in small increments rather than a sudden volte-face. A complete abandonment of bank secrecy, for example, would take revision of the Swiss constitution. For a discussion of recent progress with the U.S. see Cantley, 2004.

[48] But even these European states are also obliged to cooperate with information in cases of criminal tax fraud (Gnaedinger, 2004). Some of the sharpest responses to OECD action on this and many other issues has come from the International Trade and Investment Organization (ITIO), composed mainly of Commonwealth countries (http://www.itio, visited June 28, 2005). Antigua and Barbuda withdrew from their earlier information sharing commitment to the OECD citing the EU Savings exception as the reason.

[49] The story is sometimes recounted almost as one of David and Goliath with a handful of poor countries giving a good as they got but convincing others of the rightness of their cause. And indeed some rich countries did make limited common cause with the havens. Most did so to ameliorate intra-Commonwealth relations, however, and the basic principle that the havens were merely exercising their right to craft a tax system of their own choosing was never conceded. Nor was it ever conceded by the United Nations. The UN expressed its concern over some of the Project's procedures as a lever for advancing a formula approach to corporate income tax collection for the benefit of poor countries as a group (Horner, 2001a).

[50] Confidential author telephone interviews, Summer 2005.

[51] If the welfare of the Caribbean and the South Pacific were really important to the home governments, they could have provided economic support far more efficiently than by caving in to specious arguments about jurisdictional legitimacy.

[52] The success of the CFP with members of the Congressional Black Caucus, dozens of whom signed a letter opposing the *HTC* project, was an impressive but limited inroad into Democratic ranks. Some Caucus members were impressed by the relative prosperity of several of the major havens despite the fact that haven gains were going overwhelmingly to the corporations and wealthy individuals that employed them. Others expressed concern about the haven well-being without explicitly defending their tax practices (Sheppard, 2001: 2019).

[53] Such a change was advocated by the Gordon Report (1981:7).

[54] For a thoughtful discussion of some of the inner workings of the OECD, see Porter and Webb, 2004.

[55] In the MAI disaster the OECD was blindsided by both elements of domestic civil society and non-member states. For an exhaustive discussion, see Graham 2000.