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Extensive Economic Research Paper

# Offshore Financial Centres in the Global Economy

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This independent research document was made possible with support from the St Andrews Society of Philadelphia and the University of Pennsylvania

We currently live in a greatly interconnected world economy that has liberalised financial markets and reduced trade barriers across borders. Against this economic backdrop of globalisation, the governments of large developed economies have looked on anxiously as the number of tax havens, or Offshore Financial Centres (OFC's) as they prefer to be known, have proliferated. Under this economic environment, the economies of small and often remote countries or states have experience rapid growth, particularly made possible by the onset of telecommunications and widespread Internet access. Today, many small jurisdictions that were otherwise small specks in the ocean[1] fill an important niche in the market for international finance.

According to the London Times Newspaper[2], [over] half of the world's money now moves around in an offshore environment, and this substantial sum has caused some disquiet in the developed international community. At the heart of this concern is the belief that offshore centres distort the financial system on a threatening scale by undermining the ability of high tax onshore nations to raise revenues through taxation. By consequence of this, a number of internationally approved documents and independent reports have been published in an effort to contest this effect and rebalance the direction of financial flows; most prominent and controversial of which was produced by the Organisation for Economic Co-operation and Development (OECD).

Whereas there has already been much research into how to manage a large economy and the governance of an international financial system[3], little research has been conducted into understanding the role of tax havens in an increasingly globalised environment. This research paper provides an economic analysis of

[1] Though it is recognised that tax haven jurisdictions are not necessarily geographically remote or islands by necessity.
[2] Johns, R.A. and LeMarchant, C.M. (1993) *Finance Centres: British Isle Offshore Development Since 1979*, London Pinter and Peagam, N. *Treasure Islands* Euromoney Supplement 1989
[3] Eatwell, J. & Taylor, L. *Global Finance at Risk: The Case for International Regulation,* Cambridge: Polity 2000

OFC's through the extensive use of the Commonwealth of the Bahamas as a case study. This country has been chosen as a focal point for analysis for a number of reasons; but particularly as it offers the opportunity to investigate a specific OFC whilst also being representative of the condition of many offshore jurisdictions, and the challenges they face in light of the OECD-led impetus for reform.

Overall, three areas for discussion are established on the topic of harmful tax practices and international tax competition; namely these are:

I. Free market theory and tax competition
II. Sovereignty and legal jurisdictions and political considerations
III. Development of offshore economies

The results of this analysis, although mixed, suggest that tax competition is often misrepresented and economic policy in this area poorly understood. Furthermore the current action is found to be a significant infringement on the fiscal sovereignty of affected nations. Lastly, the impact on the development of OFC's is considered and found to be the single most critical concern in considering the future of tax havens in the global economy. Often far from being a global optimum for all nations tax competition can provide exceptional benefits in assisting undeveloped countries that have limited options to generate GDP.

In offering an overall understanding of the development implications to offshore countries and how their economies could be impacted by this exogenous influence, this paper concludes by weighing both the positive and negative qualities of offshore activity. Lastly, this paper has been written at a very interesting point in time. The pending action over the directives for this topic are yet to be fully implemented and we await the result and full impact on the economies of OFC nations.

*NB. The term 'Offshore Financial Centre' (OFC) is used interchangeably with 'tax haven' in this document, although as there are negative implications with the term 'tax haven' OFC is used in preference.*[4]

[4] The respectability of the term tax haven varies greatly, as Caroline Doggart puts it: at one extreme the tax-free Vatican basks in divine approval, at the other fallen havens struggle to regain credibility.

## Introduction

In April 1998, the Organization for Economic Cooperation and Development (OECD) produced a seminal report entitled *Harmful Tax Competition: An emerging global issue.*[5] The report formalised the criticisms of offshore financial centres which had otherwise only previously been denounced by higher-tax onshore states as conduits for money laundering, tax avoidance and evasion. Although report concluded with a set of nineteen recommendations to solve the problems associated with supposedly harmful tax competition, it lacked a threat of sanctions to those who would did not observe them.

In June 2000, two further multilateral reform projects were announced by the Financial Action Task Force on Money Laundering (FATF)[6] and the Financial Stability Forum (FSF). The projects each aimed to campaign against money laundering or financial misconduct, and encouraged rules for best-practice in financial industries, respectively. The significant effect that both these initiatives established was that they named and shamed tax havens where regulations were considered to be inadequate and secrecy excessive.[7] The FATF report noted fifteen jurisdictions[8] with "serious systematic problems"[9] and strongly urged such states to "adopt measures to improve their practices as expeditiously as possible in order to remedy the deficiencies identified in the reviews"[10]. It also alluded to damaging commercial reputation by recommending that "financial institutions should give special attention

5 OECD, *Harmful Tax Competition an Emerging Global Issue*, OECD 1998. This grew out of a request two years earlier from OECD member-country ministers in which they called upon the organisation to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decision and the consequences for national tax bases".
6 FATF, *Review to Identify Non-cooperative Countries or Territories: Increasing the Worldwide Effectiveness of Anti-Money Laundering Measures*, June 22, 2002
7 Doggart, Caroline *Tax Havens and Their Uses 2002 (10th Ed)* Economist Intelligence Unit (EIU) London
8 Including the Commonwealth of The Bahamas, which is used extensively as a case study within this document. The remaining 14 were: the Cayman Islands, Cook Islands, Israel, Lebanon, Liechtenstein, Marshall Islands, Nauru, Niue, Panama, Philippines, Russia, St. Kitts and Nevis and finally St Vincent and the Grenadines.
9 Ibid
10 Ibid

to business relations and transactions with persons, including companies and financial institutions from the non-cooperative countries and territories mentioned"[11].

Also published that year[12] was the OECD's much awaited second report[13] into the topic with similar objectives as the FATF and FSF, but with an added threat of sanctions[14]. The report, seemed aimed at intimidating OFC countries with its declaration that "governments cannot stand back while their tax bases are eroded through the actions of countries which offer taxpayers ways to exploit tax havens and preferential regimes to reduce tax that would otherwise be payable to them."[15] It included a blacklist of thirty-nine uncooperative "tax havens"[16]. By April 2002, however, a revised list was issued with only six remaining countries - the other thirty-one jurisdictions from its June 2000 list had chosen to adhere to the OECD's principles of transparency and the effective exchange of information.

The motivation behind so much recent attention on the economic and financial activities of OFC's has been the culmination of mounting concern from the governments and treasuries of onshore countries, particularly during the 1990's. Increased financial liberalisation, demonstrated in greater capital mobility and coupled with truly impenetrable secrecy laws, offers a tempting solution to those looking to avoid or evade their tax bill[17]. As a result, offshore centres continue to find themselves in an unwelcome spotlight. After being discussed at the G7 summit in Japan in 2000, ministers expressed concern that offshore centres were distorting the

[11] Ibid
[12] A progress report has been published since (2004), which is discussed later in this paper. The original report published in 1998 grew out of a May 1996 request from OECD ministers in which they called upon the organization to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decision and the consequences for national tax bases."
[13] OECD, *Towards Global Cooperation – Progress in Identifying and Eliminating Harmful Tax Practices*, OECD June 26th 2000
[14] The OECD employs a number of interchangeable phrases to describe the punishments for those jurisdictions failing to make a commitment, including: countermeasures, enforcement measures, counteracting measures and defensive measures. The use of the phrase sanctions encompasses all of these but does not suggest that actual sanctions would be imposed.
[15] Ibid
[16] Under eight offending harmful tax practice categories: Insurance, Financing and Leasing, Fund Managers, Banking, Headquarters Regimes, Distribution Centre Regimes, Shipping and Miscellaneous Activities.
[17] Woodward, Richard *The Case of the OECD's Harmful Tax Competition Initiative*, Working Paper, Centre for Global Political Economy, University of Hull January 2004

financial system on a threatening scale by undermining the ability of high tax onshore nations to raise revenues through taxation. Essentially, OFC's have been a victim of their own success in attracting capital to their shores.

The supporting evidence for this is clear: the amount of capital deposited offshore alone has seen exceptionally rapid growth. In 1968, deposits held by offshore banks totalled US$11bn, by 1978 this had swelled to US$385bn, and by the end of the 1980's the Caribbean region alone held in excess of US$400bn[18] deposited in accounts. Even more telling is the growth in funds directed towards tax havens when between the years of 1985 and 1994 a five-fold increase to more than US$200bn of funds was recorded in flows to tax havens in the Caribbean and South Pacific alone[19]. Today, the present value of assets held offshore is estimated to be worth anywhere between US$5-7 trillion, equivalent to a third of global GDP[20]. However, it is likely that these figures are in reality an underestimate of the true extent of offshore financial activity as they do not include any non-bank financial intermediaries and most likely ignore any "off-balance sheet" payments.

The question is not whether OFC's have an effect on international financial markets, as they jointly represent a major player. It is whether or not they should be allowed to compete by enticing capital away from onshore economies. A broader question is whether international tax competition is "fair" to the parties involved and whether it makes economic sense to implement controls to ensure that this is the case. In fact, part of the OECD's definition of a tax haven is that countries should be allowed to attract investment, and use low tax as a tool for this, but they cannot do this if the low tax offshore is the only reason for the investment.

[18] Hampton 1994 and Peagam 1989
[19] OECD, *Harmful Tax Competition an Emerging Global Issue*, OECD 1998 (from 1996 original OECD initiating report)
[20] Diamond & Diamond 1998 quoted in Palan 2002

The research conducted within this document supports the now widespread agreement that the acceleration of global interconnectedness poses formidable new challenges to those charged with managing the world's financial markets.[21] With the advent of new technology, our global village allows us to make decisions and movements in financial assets from great distances and across borders with ease that was previously not possible.

A further point to note is that the clandestine nature of offshore financial activity has made it difficult to carry out the research for this report. Though many sources are open and available, there have also been instances where it has been impossible to gather data. This is clearly presented by the difficulty in gauging the extent of fiscal leakages as a consequence of funnelling capital to tax haven jurisdictions, although anecdotal evidence has been strong enough to suggest that the losses are sizeable and growing.[22]

[21] Woodward, Richard *The Case of the OECD's Harmful Tax Competition Initiative*, Working Paper, Centre for Global Political Economy, University of Hull January 2004
[22] According to Woodward, Richard *The Case of the OECD's Harmful Tax Competition Initiative*, Working Paper, Centre for Global Political Economy, University of Hull January 2004

## A. Context

### A Brief History & Origin of Tax Havens

The practice of using "tax havens", or Offshore Financial Centres[23] (OFC's) as they prefer to be known professionally, is to limit tax exposure to an individual or business and is almost as old as taxation itself. It is now reported that there are in excess of 100 jurisdictions throughout the world offering offshore financial services. Of these, at least 65[24] have taken steps to specifically position themselves as OFC's attracting fleeting capital from around the world.

A Definition of OFC's & Continued Growth

Currently, there is no universally accepted definition of a tax haven, which is a reflection of the clandestine and varied nuances in tax jurisdictions that give a tax haven its financial benefits. This itself is a relative concept that varies in a dynamic political and economic setting. The dictionary defines a tax haven is:

> "A country that provides foreign residents with opportunities to reduce their tax payments by doing business there. Tax havens can be used for tax avoidance, when tax liabilities can be legally reduced by using foreign financial intermediaries. They can also be used for tax evasion for example, by the use of confidential bank accounts, to facilitate concealment of income and money laundering. Tax havens are not entirely evil in their effects however: they have provided facilities to allow the victims of political and religious persecution to keep part of their assets out of the clutches of tyrannical governments."
>
> John Black, Oxford Dictionary of Economics

Whereas former economic advisor to the States of Jersey, (Channel Islands, UK) Colin Powell[25] defined a tax haven as an area with the "existence of a composite tax structure established deliberately to take advantage of, and exploit, a worldwide demand for opportunities to engage in tax avoidance and evasion."[26] Perhaps the

[23] Abbreviated to OFC's from here onward. Sometimes also referred to as an International Financial Centre (IFC).
[24] Neal, Terry L., *The Offshore Solution: Privacy Asset Protection, Tax Shelters and Offshore Banking and Investing*, MasterMedia Publishing Corporation 2001
[25] Not the former US Secretary of State Colin L. Powell
[26] The offshore institute at www.offshoreinstitute.com

most intuitive and most easily measured definition is that of the International Monetary Fund (IMF): “the banking system, acting as a financial entrepôt, acquires substantial external accounts beyond those associated with economic activity in the country concerned”[27].

In an attempt to remove harmful tax practices from the global economy, the OECD has its own set of criteria to identify tax havens with rogue financial or secretive regulation. It cites the following three key factors to identify tax havens[28] and harmful preferential tax regimes:

> “We define harmful tax practices by any of three operative criteria: lack of effective exchange of information, lack of transparency, and attracting business with no substantial domestic activities (e.g. ring-fencing) where coupled with low or zero tax rates. By discouraging these practices, the Report will serve to strengthen and to improve tax policies internationally. These efforts will improve overall economic well-being for all taxpayers.”[29]

The OECD report later more explicitly identifies a tax haven if:

I. The country is a tax haven, and, as such, generally imposes no or only nominal tax on that income. It offers itself, or is perceived to offer itself as a place to be used by non-residents to escape tax in their country of residence.

II. The first country collects significant revenues from tax imposed on income at the individual or corporate level but its tax system has preferential features that allow the relevant income to be subject to low or no taxation.

III. The first country collects significant revenues from tax imposed on income at the individual or corporate level but the effective tax rate that is generally applicable at that level in that country is lower than that levied in the second country.

Similarly, the term ‘offshore’ is used to connote a “special territorial or juridical enclave characterised by a reduction in regulations”[30], and thus is characterised by less burdensome fiscal and regulatory practices. These offshore jurisdictions are therefore attractive to foreign residents as they reduce the cost of, or can facilitate the ease with which business can be conducted. Often this is conceptualised as an

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[27] International Monetary Fund, *Direction of Trade Yearbook*, IMF 2004
[28] Previously, in a 1987 report, the OECD recognised the difficulties involved in providing an objective definition of a tax haven, and concluded to use a dubious “reputation test”.
[29] Ibid
[30] Palan, R. *Trying to Have Your Cake and Eating It: How and Why the State System Has Created Offshore*; International Studies Quarterly Vol. 42(4) December 1998.

idyllic island paradise detached from the rest of the developed world. However, one should take care not to assume that all offshore activity actually takes place "offshore". The significance of offshore activities lies not in physical location, but in the juridical properties of the country or state that is favourable to offshore investors.

## OECD-led Criticism of OFC Activities

The OECD essentially recognises harmful tax competition occurring when a jurisdiction combines low or no rates of taxation on foreign owned assets with restrictions on the flow of information to overseas tax authorities from identifying the owners and hence levying taxes on them[31]. Hence, low levels of tax are only judged to be harmful if they are applied in conjunction with this "lack of effective exchange of information"[32] that permits offshore investors to escape taxation. The organisation also notes that the absence of substantial local business activities is also an indicator[33]. This, the OECD claims, is indicative of a jurisdiction trying to lure investment motivated solely by tax considerations, in a process it refers to as 'ring-fencing'. Ring-fencing takes advantage of applying different tax rates such that it can appeal to mobile capital seeking to avoid taxation in its home country.

It is this persistent exposure to high-level taxation in developed onshore economies that the growth in OFC activity is attributed. Although globalisation, relaxation of international trade barriers and a greater interconnected world have all contributed to the growth in the number of tax havens, a substantial reason behind their proliferation has been a steady rise in the tax burden for industrialised onshore economies. A rough indicator in comparing national tax burdens is the use of tax ratios, calculated as tax revenues as a percentage of gross national product. For the OECD, the average tax burden ratio rose from 35% to 37% between 1990 and 2000

[31] OECD, *Harmful Tax Competition an Emerging Global Issue*, OECD 1998.
[32] Ibid
[33] This specific stipulation was later dropped in 2001 by the OECD after negotiation with the US.

with a total of ten countries' governments taking charge of between 40% and 53% of their nations incomes[34].

The evidence of this diverted finance is alarming, with IMF research demonstrating that for every 1% point increase in industrialised countries' top corporate tax rates capital inflows to offshore centres rose by 5% in general and by 19% for Caribbean Countries[35]. In this analysis, the industrialised countries were essentially the OECD member states plus Hong Kong, Singapore and Taiwan.

To address this link in financial leakage, the OECD conducted a review of global financial activities and later published an OECD report published in 2000, titled *Towards Global Tax Cooperation*[36], which had allowed member states to assess their own preferential tax regimes and report back, but did not allow non-OECD countries to perform the same self-diagnosis. These non-member countries were instead considered before a panel in a tough "inquisition type setting"[37] that alleged that they had harmful tax regimes.

GDP Choices for OFC's & US Interests in Regional Stability

The dilemma that has faced many small territories and countries in the Caribbean and other parts of the world is that as remote nations often removed from international markets they have little opportunity to trade, and often as "small countries with scarce raw materials"[38], they have little to trade in. In 1982 a Caribbean Basin Initiative[39] (CBI) was created to address these difficulties for small

[34] EIU figures Source: Economist Intelligence Unit, (EIU) *Country Report Bahamas, Barbados, Bermuda, British Virgin Islands, Netherlands Antilles, Aruba, Turks and Caicos Islands, Cayman Islands*, 1999-2003, Economist Intelligence Unit Press, London and Country Watch Report, Bahamas CW 2005
[35] IMF Country report No 01/3, Table 5, Fund staff estimates.
[36] OECD, *Harmful Tax Competition an Emerging Global Issue*, OECD 1998.
[37] Sanders, R. *The Fight Against Fiscal Colonialism, Round Table* No.365 July 2002
[38] With reference to the 1984 Miami Conference on the Caribbean speech given by the Honourable Maria Liberia-Peters, Prime Minister of the Netherlands Antilles to the CBI December 4th, 1984
[39] Originally devised by President Ronald Reagan as a US$350m aid package and trade liberalisation agreement to promote trade and investment, but with a wider remit to improve the partnership between the US and Caribbean Basin Nations

nations with an ultimate goal of mutually improving access to markets between the US and the Caribbean. Within a year, at the 1984 Miami Conference on the Caribbean, the then Prime Minister of the Netherlands Antilles – a group of small islands that are literally specks in the Caribbean Sea was concerned that the US did not fully implement its part in the CBI. Part of this agreement was to provide "III. Special tax incentives for the US firms to invest in Caribbean". Today, this incentive is represented in the form of some of the lowest tax exposure available for internationally mobile capital.

By investing in the Caribbean, the US has a hand in shaping the future of these growing nation states. In return for providing offshore financial services to US businesses, OFC's (certainly in the Caribbean) purchase goods and services which they would not otherwise be able to do given their relative size and scarce resource base. Now that the economic and political landscape has changed slightly, the threat to the US is no longer the spread of communism from Cuba, but are instead the loopholes in US tax policy. These dangerous leakages siphon tax revenues away from the US as well as facilitate money-laundering activities for illicit and possibly even terrorist activity.

In essence, the success of OFC's to attract investment has been so successful, that the wider economic community has looked on worryingly that the operations of OFC's are anything but fair. This is particularly acute for countries that are prone to terrorist attacks such as the US, as well as those that are undergoing stage five of the demographic transition model. Under this unprecedented phase, the inhabitants of a developed country (such as in Western Europe) reach a stage where their population is mostly aging and anything but a reduction in taxes is required to maintain a healthy economy. The US is perhaps most exposed to both of these socio-demographic and geo-political effects.

## Moral Uses of OFC's

As the dictionary definition suggests, although tax havens continue to act as shelters from high onshore taxation, they also continue to play a more virtuous role as refuges for capital from collapsing currencies or wars. It is therefore important to note that the role that OFC's perform in the economy is not necessarily always damaging.

Although the specific virtues of tax haven activity is discussed to some depth within this report, it is important to recognise overall that preventing a government from collecting tax by either (legally or illegally avoiding or evading) is not intrinsically evil in nature. Switzerland has held a strategic position in the European financial world during both world wars, and though many assets were seized by the Third Reich (most notably gold), many assets were also kept out of the hands of the tyrannical regime by virtue of Switzerland's ability to act a tax haven.

## The Commonwealth of the Bahamas as a Case Study

### Growth as a Tax Haven

The Bahamas comprises of approximately 700 islands (or 2,000 if you include all the low-tide cays), spread over 100,000 square miles of the Caribbean. The Capital Nassau, is located 90 miles from Miami, Florida, and today represents a global centre for international offshore finance.

The country has had a rich history, most notably beginning in 1492 with the first landfall made by Christopher Columbus - although the actual site of his arrival is an issue of some contention among historians. Since World War II, during which the islands were used as a strategic location for the Allies, the Bahamas has developed into a thriving destination for tourism and offshore financial services.

The origin of the Bahamas' competitive financial services offerings grew out of the 1967's Progressive Liberal Party's (PLP) principle focus of improving economic development and reducing unemployment, with many policies designed to make the Bahamas an attractive location for foreign investment. In the 1990's the party evolved into the Free National Movement (FNM) that further succeeded in hinging the development of the islands on tourism and in attracting new investment to the Bahamas[40]. Today, the yearly published *Bahamas Handbook and Businessman's Annual*[41] which is renowned in financial circles for being a key source on transacting local business provides an insight into the country's economy. The magazine-styled book is littered with as many photographs of lush beaches as it is with advertisements from private trusts and banks touting secure and favourable opportunities for investing in the islands. The Bank of the Bahamas even advertises

[40] Country Watch, *Bahamas* Report CW 2004
[41] Dupuch Jr, Ettiene Publications, *The Bahamas Handbook and Businessman's Annual* Ettiene Dupuch Jr Publications 2003

within the book itself, publicising the islands as a "[…] stable and independent democracy, with laws that guarantee banking confidentiality while preserving offshore sector integrity through compliance with the best international practices, proximity to North America, and an Environment free of taxes"[42], where it is "smart, safe and simple to do business"[43]. This strategy has greatly improved the country's economic dynamism, but it is recognised that it has not come without its costs. The latest status report published by Country Watch 2004 describes the conscious decision to attract investment as "carrying significant economic and political risk"[44]. One of the largest factors of this has been the link between relaxed banking practices with money laundering and drug trafficking. To reduce this risk though, the government passed stronger legislation to prevent money laundering in the banking sector in 1995. Consequently the US-based International Narcotics Control Board (INCB) has now approved this and has greatly improved diplomatic relations in the subject.

A further piece of legislation, the International Business Companies Act was particularly successful in attracting offshore operations. There are currently over 100,000 such companies many of them no more than a brass plate[45] on a lawyers door in Bay Street, Nassau. The new legislation created an automated registration procedure that now makes it possible to incorporate an international business company (IBC) in a few hours.[46]

## An Archetypal Tax Haven

The Bahamas have been chosen as a case study to further analyse the question set out in this report for a number of reasons. Firstly, the extent to which tax laws are relaxed as well as the favourable economic environment makes the islands

[42] Ibid
[43] Ibid
[44] Country Watch, *Bahamas* Report CW 2004
[45] See appendices photographs for one such example of brass name plates outside Ansbacher House, Nassau. Many of the names are recognisable foreign firms and banks, incorporated or passing transactions through the Bahamas to reduce tax exposure from their onshore operations.
[46] Doggart, Caroline *Tax Havens and Their Uses 2002 (10th Ed)* Economist Intelligence Unit (EIU) London

particularly attractive to offshore investments. In addition to this, the proximity to the US and strong political ties to the UK make them especially attractive to investors from both of those markets, and ensure that the islands have a hand in two of the three largest financial markets in the world. Lastly, but by no means of least importance is the favourable climate that visitors to the islands can enjoy, which in turn ensures a pleasant place to carry out business or integrate into a holiday.

Caroline Doggart has gone so far as to call the Bahamas the “archetypal tax-haven”[47], whilst the Financial Bankers Trust has recognised the country as an excellent measuring stick because recently as a result of massive increases in international liquidity in both volume and mobility, “it is perhaps the best known and most securely established”[48].

For the combination of these reasons[49], the Bahamas is an ideal case study to use, especially as the country is representative of a number of other tax havens around the world. It is out of the scope of this document to consider every tax jurisdiction, and for the purposes of this document it would be unnecessary to account for the nuances of every tax haven economy. The Bahamas is therefore exceptionally representative of Offshore Financial Centres and the challenges they face under the current international climate. The Bahamas will also be particularly useful in the context considering political responses by the USA later in the report, as over half of the foreign direct investment received by the Bahamas is sourced from America alone.

[47] Ibid
[48] Financial Bankers Trust Statement 1988
[49] A further reason not to be overlooked, was that for the purpose of researching this report, it was important to have a somewhat accessible government system to work with. The Central Bank of the Bahamas, the Bahamas Institute for Finance and Public Treasury Department were all open to interview and allowed the collection and analysis of data from their libraries or archives.

At the root of using the Bahamas as a case study is that the country is practically a comprehensive tax haven such that almost everybody, as far as taxation is concerned can be satisfied. Direct taxation is almost non-existent, but in particular, the essential ingredient of secrecy that is attached to the relations and transactions between financial institutions, businesses and private persons has been a vital factor in attracting business to Nassau. The law has even improved to this end, as the statute ruling of the Bahamas superimposed upon English Common Law has strengthened the inviolability of secrecy and confidentiality for financial purposes. However, this is also not to say that the Bahamas has been a place of excessive illegal activity. Although favourable development has attracted financial institutions to operate in the Bahamas, those with doubtful business methods have had licenses revoked, essentially improving the quality of the financial community and increasing confidence in the country as an investment destination. It is therefore useful to use the Bahamas as a case study of a country that is keen to retain it's tax haven status, but also faces the difficulty of balancing this with international relations around the world.

## The Bahamian Economy

The following section provides an analysis of the Bahamian Economy to better understand its economic and demographic composition as well as the value of the Financial Services industry for the country and the impact that imposed legislation will have on the economic well being of the nation.

Figure 1: Leading Economic Indicators[50]

| | |
|---|---|
| GDP at Market Prices[a] | US$5,360m |
| Real GDP Growth[a] | 1.9% |
| Population[a] | 314,000 |
| Consumer Price Inflation | 3.0% average |
| Current Account Balance | -US$426.7m |
| Public Foreign Debt[a] | US$567.4m |

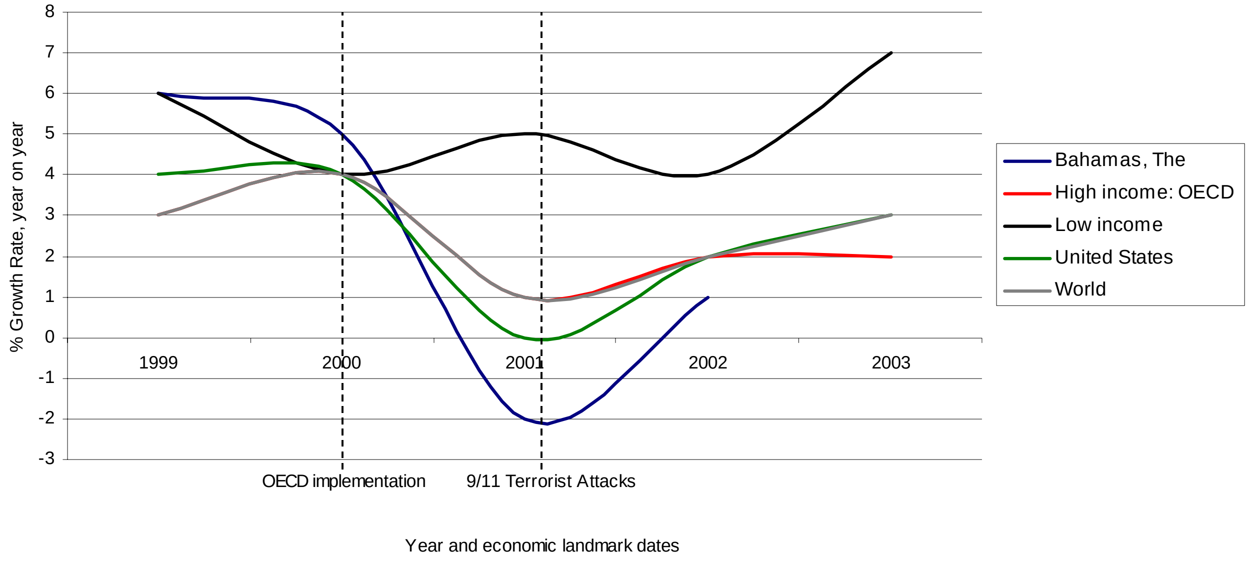
[a]EIU Estimate, latest available data, 2003

### GDP Growth & Composition of the Economy

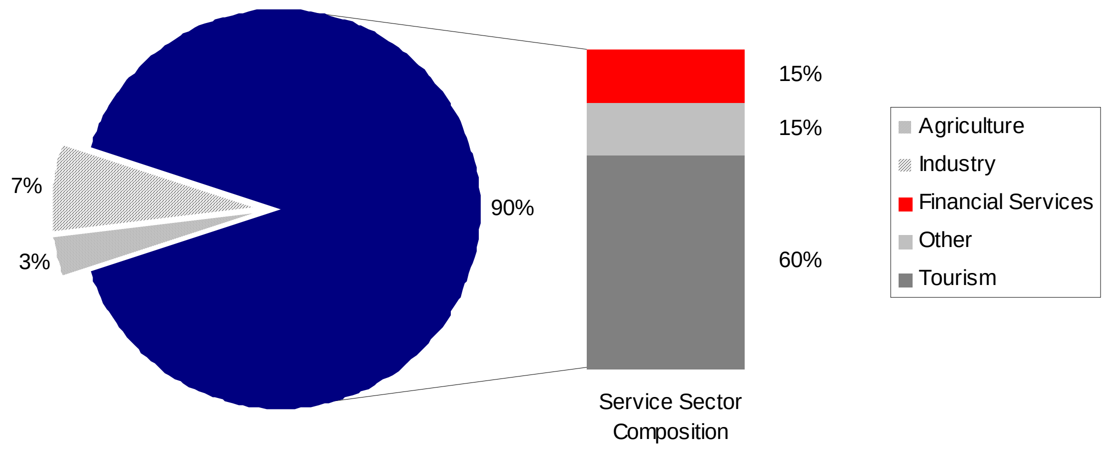
The Bahamas is one of the most prosperous economies in the Caribbean with GDP per capita as high as US$17,000 in 2003. The country continued to enjoy a combination of brisk economic growth and macroeconomic stability up to the year 2000, where the economy expanded by 4.9%. By 2001 however, amid a global slowdown and terrorism related concerns, tourism slowed markedly. GDP shrank by –2% and virtually stalled by 2002. There is a concern that this was exacerbated further by the flight of foreign businesses as a result of anti-tax haven directives of the OECD, FATF and FSF. The repercussions of a slowed economy not only affected citizens, but the government purse when import demand – the chief source of government income – dropped off, causing a narrowing of the current account deficit.

[50] Source: Economist Intelligence Unit, (EIU) *Country Report Bahamas, Barbados, Bermuda, British Virgin Islands, Netherlands Antilles, Aruba, Turks and Caicos Islands, Cayman Islands*, 1999-2003, Economist Intelligence Unit Press, London and Country Watch Report, Bahamas CW 2005

## Figure 2: GDP Growth Annual (%)




## Figure 3: Composition of Bahamian GDP & Components of Service Sector



Other factors that could have contributed to this sharp fall in percentage GDP[51] growth rates between mid-2000 and mid-2001 could be due to a reduction in tourism during this period and market collapses and stagnations felt worldwide (for example, the dot-com bubble) reducing the amount of financial activity in the Bahamas. It is not clear[52] how much of this reduction in GDP during this time can be accounted for by the OECD's public blacklisting and threat of sanctions on the Bahamian economy; although it is unambiguously clear that the effect was negative, at a time when the global economy was already in recession.

CIA reports on the economy of the Bahamas suggest that the reason for the stifled economic growth between 2000-2001 is linked to the fact that the Bahamian economy is so closely tied to the activities of the US economy. More than 80% of visitors originate from a US departure point, and as the country's largest earning sector, this strongly affected the revenues received from tourism. However, the GDP growth rate fell only to 0% at its lowest point, in 2001 for the US, whereas the Bahamas experienced a shrinking economy to –2% for the same period. The CIA reported that "since December 2000, when the government enacted new regulations on the financial sector [as a direct result of OECD directive], many international businesses left The Bahamas"[53]. Essentially, the OECD's actions forced the Bahamas to pass legislation reducing the competitiveness of the country's financial services offerings. In consequence, this exacerbated the economic downturn for the Bahamas, which experienced a negative growth rate during that time.

In terms of economic composition, it is surprising that the largest proportion of the economy is driven by the services sector at 90% of GDP, which is in contrast to most

[51] Annual percentage growth rate of GDP at market prices based on constant local currency. Aggregates are based on constant 1995 US dollars. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources.
[52] It has been difficult to find accurate or available information specific to the invisible trade in financial services for the Bahamas during the period in question.
[53] CIA World Factbook Bahamas Publication 2004-5 at www.cia.gov/cia/publications/factbook/geos/bf.html

other developing countries where primary and secondary activities are of relatively major importance. Even today with such high import duties[54] levied by the government, the manufacturing industry has never developed well despite such high protection offered by the high import duties. This is essentially the result of a small domestic economy that despite the cheaper option of buying from locally manufactured goods, does not afford the efficiency of producing them in the first place.

As is typical for island nations with strong financial and tourism industries, intuitively the Bahamas runs large annual merchandise trade deficits that are partially offset by large surpluses in services trade with the rest of the world. In 2001, the Bahamas' trade deficit was US$1.15bn while its surplus on services trade was US$950m. The country's net international debt position and substantial equity returns being repatriated to foreign owners of tourism and banking facilities in the country ensure that it has a deficit – almost US$200m in 2001 – in net factor income payments.

Agricultural developments in the Bahamas have also been surprisingly minimal as there continues to be a massive reliance on international trade and the tourism and finance industries. In 1970, some 90% of the B$57 million food bill was imported and this dependency on other countries (in particular the US) for such basic commodities is still maintained today. In essence, both foreign trade and foreign direct investment continue to ensure the survival of the nation.

[54] Up to a massive 72% import duty on cars and other motor vehicles; although most import duties were relaxed in the aftermath of the hurricane's that hit the islands in late 2004.

Financial Services as an Engine for Economic Growth

With some 4m travellers visiting the Islands in 2000, GDP remains largely fed by tourism[55], which accounts for 60% of total GDP followed by financial services as the second largest component at 15%[56]. The next two revenue sectors are manufacturing and agriculture, which are tiny by comparison and have demonstrated little growth beyond production for domestic consumption only, and subsistence farming in agriculture as a result of the weak natural endowment in terms of both the availability of labour and land on the islands.

In a recent address to other Caribbean states and US officials the Prime Minister of the Bahamas explained that; “small in size, and lacking in natural resources, the Bahamian economy rests on industries concerned with the provision of services to the outside world. A relatively large tourism and international finance sector with its related services account for the country’s foreign earnings and the marketing and distribution of imported goods account for the bulk of the domestic economy.”[57] Clearly the Bahamas as a group of otherwise isolated islands are in the position to utilise tourism and finance as sources of income. An estimated 35%[58] of the economy is related to the country’s status as a tax haven. This complemented by a number of factors including relative proximity to the US[59], as well as being favourably climatic, and both of which have encouraged the islands to further maximise revenue generated from the finance industry. This economic focus is second only to the tourism industry, accounting for 40% of GDP - although a proportion of that itself is also indirectly associated with the country’s role as a financial centre. The Bahamian Handbook and Businessman’s Annual notes that visitors may be attracted to staying at high-end luxury resorts who are potential investors themselves, and likewise, they

[55] Some 4m tourists; 2.5m of them cruise-ship passengers visited the islands in 2000.
[56] Although the exact figure for the component of financial services sector in the Bahamian Economy is difficult to determine: estimates have ranged from 10-20% of GDP.
[57] Economic Forum 2003
[58] Interview, *Central Bank of the Bahamas* January 2005
[59] The Bahamas boasts to be accessible by only “1½ hours (45 miles) travel distance from the coast of Florida”, *Bahamas Tourism Publication* 2004

may be staying for the very reasons that their trip has a business purpose. For that reason, it is difficult to determine, without access to immigration records[60] exactly which visits are exclusively for holidays and which are business related. Potentially, this suggests that the amount of GDP income classified under tourism could in large part be due to the country's status as an OFC location.

The importance of the country's offshore operations has been key in creating growth and development for the country. It is clear that the international nature of business in the local economy has supported the growth of "an outstanding infrastructure for commercial and industrial activity and a highly skilled workforce of accountants, investment specialists and experienced law firms"[61]. This in turn, has had the effect of encouraging further growth in the financial sector as well as a greater dependency on the presence of international financial business to keep the domestic economy buoyant.

This is also worrying however, as tourism and financial services are the only two strong sectors in the economy, and as such represent a markedly apparent lack of diversity for the Bahamas. As this paper later discusses, this reliance on two channels of income - both of which are closely linked - increases the risk of income volatility should there be an exogenous shock such as an imposed sanction by the OECD. Despite this obvious need to diversify the economy, there may be little scope to plausibly strengthen any other industry sector. In recognising the fundamental importance of financial services to the economy, the Minister for Financial Services and investment in the Bahamas[62] has announced that the government is now

[60] An attempt was made to further uncover immigration records detailing the proportion of visits related to either tourism or business (of which it is estimated a large proportion is finance related), though Bahamian government restrictions on information of this sort made this an almost impossible task. There is also an effect where many visits may be business-related or both, but are only recorded as a trip with a touristic purpose. For example, the author's own trip to the Bahamas was recorded as a tourism visit, although a number of interviews and meetings with government and private businesses for educational purposes could have described the visit as a business related trip.
[61] Bahamas Tourism Publication *What to See and Do*, Bahamas Tourism 2004
[62] Minister Allyson Maynard Gibson

"actively pursuing growth of the financial sector by creating a more streamlined and efficient industry, able to compete with the top offshore jurisdictions". According to the minister's statement; "[the country is] replacing red tape with a welcoming red carpet, and the Bahamas is open for business"[63].

Even at the current 15% level, the share of GDP that the financial services sector represents is not insignificant, and it is clear that the government is aware that this sector of the economy has massive growth potential. The latest Country Watch report noted that the "government jealously guards this reputation as financial services is both a large segment of the economy and one with good growth potential"[64]. Currently, according to the Central Bank of the Bahamas, the sector employs 4,227 Bahamians[65] - over 3% of the workforce, provides a yearly payroll of US$203m, generating more than US$15.5m annually in government revenues. Although this added employment accounts for only 5% of the labour force, salary earnings are well above the national average. Furthermore, as the Economist Intelligence Unit (EIU) notes, the employment opportunities are not limited to jobs in offshore fund offices, as there is a strong - though difficult to measure - multiplier effect that runs through commercial and professional services throughout the rest of the economy[66].

In fact the extent of importance to the economy was noted in a recent Caribbean Financial Action Task Force Mutual Evaluation Report on the Bahamas, noting that "with combined balance sheet assets of US$300bn and over US$1tr in assets under administration, financial services makes a significant contribution to the Bahamian

[63] Bahamas Tourism Publication *What to See and Do*, Bahamas Tourism 2004
[64] Country Watch, *Bahamas* Report CW 2004
[65] This is a particularly high local content ratio. Total employed in the sector is 4,523 people.
[66] The EIU lists the countries that have benefited the most from offshore fund business in this way are the Bahamas, Bermuda, the Cayman Islands, the Isle of Man, Luxembourg and particularly the Channel islands.

economy"[67]. With these phenomenal figures of wealth, the Minister of Financial Services and Investment[68], further remarks that "there is every opportunity, if seriously pursued for the financial services sector to become the first pillar of our economy"[69] that is to say - to overtake the tourism sector as the number one generator of national income. From the latest government agenda and the changes in legislation, it appears that the current government strategy is to focus on both the higher-end tourist market and the financial services industry in an attempt to improve another key ingredient in building a robust economy: market predictability.

Bahamas Taxation & OFC Status

The Bahamas is a truly attractive destination for mobile capital, as there is no corporate tax, no personal income tax, no capital gains tax, no turnover tax, no profit tax, no inheritance or estate tax. Similarly, there are no withholding taxes on dividends, interest or royalties, no payroll taxes and even no sales taxes. In return for receiving such generous tax benefits, foreign-owned businesses are expected however to contribute generously to various civic projects in addition to their normal annual licensing payments. A further tax incentive is the Bahamas Ship Registry which was re-launched after the adoption of the Bahamas Maritime Authority Act in 1995 and is the world's largest in terms of cruise ship registry and third largest in terms of gross registered tonnage, behind only Panama and Liberia.

Thus it may be wondered how a government that maintains a tax haven status in a country where the principle industries are tourism and finance obtains the necessary funds to provide the social and economic needs of a nation in its varying stages of development.[70] The answer to this is that the Bahamian Government is incredibly

[67] Dupuch Jr, Ettiene Publications, *The Bahamas Handbook and Businessman's Annual* Ettiene Dupuch Jr Publications 2003
[68] Minister Allyson Maynard Gibson
[69] Dupuch Jr, Ettiene Publications, *The Bahamas Handbook and Businessman's Annual* Ettiene Dupuch Jr Publications 2003
70 Financial Times, *The Commonwealth of the Bahamas: Profile of an Offshore Investment Centre The Central Bank of the Bahamas & The Bankers Research Unit*, 1996 FT London

dependent on imports; almost 70%[71] in 2000, of government revenue is derived from imports that can be as high as 72%[72] on the import of cars and other motor vehicles. These high tariffs are not even imposed on the economy as shelter for local industries - as in most cases there are no local producers to protect, but are simply a necessity for government revenue. The result is that the greatest share of this tax burden is not placed upon the local people – as it allows the government to receive customs duties on the enormous volume of imports necessary to satisfy tourist consumption in a country that produces almost no consumer goods of its own.

The remaining government revenue is received from other tax sources in smaller more selective forms such as a hotel occupancy tax, area-specific gaming tax, motor vehicle tax and departure tax, all of which target tourism, whilst stamp tax and business or professional licenses reflect an intention to target the country's second most important income generator; financial services. For example, this smaller but still significant amount of revenue is paid in banking fees which range from US$5,000 for small restricted operations up to B$310,000 for an unrestricted license (for authorised agents and dealers). However, even these more specific taxes are far from excessive: the highest Stamp tax rate is 5% rising to 10% for non-Bahamians (on B$100,000 or more at port of entry), and a maximum of B$1,000 registration fee for a company owned by 60 more by non-Bahamians.

Ultimately the success of the Bahamas as a tax haven has been its ability to attract investment so well as it has a number of factors that constitute a favourable jurisdiction; namely and foremost – low or no taxation, a strong legal system with protection of property rights and a commitment to encouraging international trade as well as personal and corporate privacy. Other less important factors, but of some

[71] The remaining 30% is accounted for as explained in the following pages, but also includes stamp duties, property tax and departure fees.
[72] Source: Central Bank of Bahamas interview, December 2004

significance is language, quality of telecommunications, convenience of time zones and geographical location, availability of professional and paralegal or financial services[73], as well as the quality of the weather, leading the Bahamas to once be the third largest financial centre in the world.

Historically Strong OFC

In the past, and before the most recent political changes, the Bahamas made a conscious effort to implement OFC aimed economic policies. This was particularly necessary following the economic contraction in the late 1980s and early 1990s as a result of declining tourism revenue and a decline in illicit drug transhipment income as interdiction efforts were stepped up. The reduction in flow of illegal funds had a knock-on effect with legitimate businesses on the islands which widened the budget deficit to as much as 4.2% of GDP in 1989 as the government increased expenditure. In January 1990 the Bahamas enacted the International Business Companies (IBC) Act, which was aimed directly at simplifying and reducing the cost of establishing an offshore company in the Bahamas and coupled this with a further act in 1991 to allow the establishment of asset protection trusts in the Bahamas. A further step in 1993 established the Bahamas Investment Authority (BIA) which was intended to be a 'one-stop-shop' as a central point of contact to assist foreign investors with initial government approval of their investment applications and to cut through further red tape for approved investments. These measures achieved their principle aim: to attract foreign business and FDI to the Bahamas and by 1999, more than 84,000 offshore businesses had been established in the Bahamas.[74] Yearly, the level of FDI has been strong and in the US$150m to US$250m per year range, although in 2001 it dropped sharply to just US$100m.

[73] Estimated at 600 attorneys and 300 chartered accountants.
[74] Country Watch, *Bahamas* Report CW 2005

**Response to Fiscal Authorities' Countermeasures**

On June 6th 2000, the Bahamas appeared on a watch list of fifteen countries suspected of harnessing money-laundering activities as well as being on a list of thirty-five tax havens that maintained harmful tax practices causing an "undue opportunity for tax avoidance by foreign nationals availing themselves of the financial services offered"[75]. The initial offending forty-one jurisdictions were narrowed down to thirty-five after six[76] of them were offered a commitment to eradicate harmful tax practices by 2005.

The blacklisting came as the third blow to the financial community in Nassau as only four days previously the Bahamas had been classed as 'non-co-operative' by the Financial Action Task Force (FATF), an international body to fight money laundering, and earlier that year on May 25th, a report on bank supervision from the Financial Stability Forum (FSF), a group of international regulators, had ranked the islands in the lowest grade (GroupIII)[77]. Further still the FSF had threatened to strip the Bahamas of its Qualified Jurisdiction (QJ) and Qualified Intermediary (QI) status that allow it to trade in US securities.

Almost immediately after this, the Bahamian Government hurried a new package of financial legislation that was passed in 2000-01 to adjust the tax code and improve regulation through parliament that attempted to remove the country from the blacklisting. As part of the clean-up, thirteen bank and trust company licenses were suspended in early 2001. The Minister for Financial Services and Investments[78] bravely proclaimed later that these legislative changes would be able to "retool, retrain and reinvent" the sector.

[75] OECD, *Harmful Tax Competition an Emerging Global Issue*, OECD 1998.
[76] These were; Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino.
[77] Three bands of jurisdictions were conceived by the FSF: Groups I, II and III. The Bahamas was classified in the lowest band, Group III in a list of 25 jurisdictions including the Bahamas the British Virgin Islands, Cyprus, Liechtenstein, Mauritius, the Netherlands Antilles and Panama. The FSF considered these nations to have serious weaknesses in their supervisory practices and levels of co-operation.
[78] Allyson Gibon MBP

Figure 4: Bahamian Banking Legislation 2000

On 29th December 2000 the Bahamas enacted a series of updated banking laws as follows:

| Banking Act | Purpose | Details |
|---|---|---|
| 1. Banks and Trust Companies Regulation Act 2000 | Anti-money laundering | Increased level of reporting requirements. Bank is liable for breaches, inadvertent or not. |
| 2. Central Bank of the Bahamas Act 2000 | International communication | Expands the functions of the Central Bank including powers to communicate account information abroad. |
| 3. Criminal Justice (International Cooperation) Act 2000 | International communication | Allows government to assist foreign courts in obtaining evidence from the Bahamas. |
| 4. Dangerous Drugs Act 2000 | Anti-drug trafficking | Aligns the Bahamas with the Vienna Convention. |
| 5. Financial and Corporate Service Providers Act 2000 | Anti-money laundering | Stricter licensing requirements for IBC's and Know Your Client Rules (KYC) |
| 6. Financial Intelligence Unit Act 2000 | International communication | Created an investigative body the Financial Intelligence Unit (FIU) |
| 7. Financial Transactions Report Act 2000 | Anti-money laundering | Makes it an offence for financial organisations to engage in business without the correct KYC procedures |
| 8. International Business Companies Act 2000 | Anti-tax competition | IBC's must have a more local presence and have restrictions on running the business. |
| 9. Proceeds of Crime Act 2000 | Anti-money laundering | Provides a statutory definition of money laundering. |

Source: Dupuch Jr, Ettiene Publications, *The Bahamas Handbook and Businessman's Annual* Ettiene Dupuch Jr Publications 2003

There was a conscious effort to improve the quality of financial service offerings in the Bahamas, and to focus on high-end - albeit fewer financial products that were better aligned to pressures from the OECD and other financial bodies. This was pioneered by Allyson Gibson, the Minister of Financial Services and Investments, who pushed for a series of bills designed to remake the centre into "an international financial centre of the first rank"[79].

Whilst interviewing the staff at the Central Bank and the Finance Department of the Bahamas, they spoke about the sense of urgency that availed the political scene in Nassau at the time and the pressure to shed disrepute that the blacklisting had caused. The reasoning behind this political hurry was that the OECD's blacklisting was accompanied by an announcement by the organisation to impose sanctions if

[79] Dupuch Jr, Ettiene Publications, *The Bahamas Handbook and Businessman's Annual* Ettiene Dupuch Jr Publications 2003

after a year had passed with countries that had not made a satisfactory efforts to comply. The Bahamas appeared determined to pay any price to maintain a good international reputation for its financial sector.[80]

In February 2000 to continue the fight against crime associated with the country's OFC status, the Bahamian Government established a financial investigations unit to "explore additional ways to strengthen curbs on money laundering and any other financial sector abuses"[81]. Despite demonstrating to the international community a commitment to tackling crime in taking this initiative that employed more stringent regulatory standards when compared to other countries offering comparable financial services, the country was still blacklisted later that year. The finance minister explains that "The Bahamas position has been clearly stated: We have no desire for businesses seeking to hide or shelter money derived from corruption, drug trafficking or the proceeds of other criminal activities". Essentially, the Bahamas has no issue with the eliminating the use of financial centres as forms of cleaning money from criminal activities, but it does maintain that it should be able to dictate its own fiscal affairs and compete fairly in the international market for financial services.

In an attempt to bring itself out of disrepute, on the 15th of March 2002 the Bahamian Minister of Finance, William Allen sent a formal letter of intent[82] to the OECD Secretary-General Donald Johnston stating that the Bahamas would make a commitment to improve the transparency of its tax and regulatory systems and establish effective exchange of information for tax matters with OECD countries by 31 December 2005.

[80] Country Watch, *Bahamas* Report CW 2005
[81] Ibid
[82] A copy of the original letter is attached in the appendices of this document (available only in hardcopy versions of this paper).

As part of this improvement process, the letter outlined the steps that had already been taken in this area, including recalling all bearer shares[83] and abolishing any future issues to International Business Corporations (IBCs) as well as now requiring that records of beneficial ownership of all shares of IBC's established in the Bahamas be maintained under license underwritten by two new acts of parliament. The letter further stated that "these commitments […] are offered on the basis that the Bahamas is not included on the OECD list of un-cooperative Tax Havens nor subject to any framework of co-ordinated defensive measures" and that "The Bahamas will protect its economic interest and fiscal policy in all negotiations with the OECD. The Bahamas considers the establishment of a level playing field among all OECD member countries and also those non-member jurisdictions in which it is materially in competition in the provision of cross border financial services to be critical to its economic interest." The letter also further pointed out that the agreements where on the condition that "[…] jurisdictions including the OECD member countries and other countries and jurisdictions yet to be identified, that fail to make equivalent commitments or to satisfy the standards of the 1998 Harmful Tax Competition report would be the subject of a framework of co-ordinated defensive measures". This is a direct reference to the two tax havens that were notably absent from the original 35-country blacklist: Switzerland and Luxemburg – both countries stated their difficulty over the criteria used to identify 'harmful' tax practices.

As a result of the OECD's pending action, the Bahamas adopted a host of measures to address the problem of money laundering, including the formation of a financial intelligence unit. Largely in response to new regulations and increased government vigilance, international businesses began to close their operations in the Bahamas

[83] These are shares that have no formal registration when issued, apart from physical ownership of a certificate. This makes them particularly attractive for money laundering when owners wish to escape identification for fraudulent or otherwise criminal activities.

and by 2002 their total number had declined to 45,000. Likewise, the number offshore banks registered in the Bahamas decreased significantly.[84]

The Bahamas, along with many other Caribbean islands accepts that the OECD "cannot guarantee a level playing field for smaller players in the international business"[85] and that it was important to separate "the attack on offshore centres, which was basically a form of economic neo-colonialism"[86] from the legitimate concerns raised by the FATF regarding money laundering and concealing funds related to drug trafficking and other major crimes[87]. A further added pressure to these crimes is an effort to combat the financing of terrorism as part of the purpose of the US Patriot Act (October 2001). The conflict in agreements arises from the European Union (EU), many of whose members are also OECD members. The EU has clearly stated itself that it is not prepared to recognise any member country as having potentially harmful tax regimes, as well as not requiring some member countries to exchange information regarding its Savings Tax Directive.

The Bahamian government however, has recognised that the country as well as many other OFC's have been overdue in making an international commitment to basic standards of transparency and information exchange with regard to criminal activities, with the Prime Minister accepting that "we have now done that, although it came about in a very nefarious way"[88]. Going forward, the Allyson Gibson the Minister for Financial Services and Investments told Parliament in May 2003 that "the

[84] Although the 2005 Bahamas Country Watch Report notes that employment in the banking industry actually increased from 4,181 in 1999 to 4,586 in 2001 – an indicator that the damage from the flight of foreign business did not have such a negative effect as may have been expected.
[85] Quoted from Attorney-General Alfred Sears
[86] Neal, Terry L., The Offshore Solution: Privacy Asset Protection, Tax Shelters and Offshore Banking and Investing, MasterMedia Publishing Corporation 2001
[87] Quoted from James Smith, Minister of State Finance
[88] Parliament speech records

challenge now is to reclaim our competitive advantage without compromising the integrity of our financial sector"[89].

However the government is unlikely to concede on using low or no taxation as a tool for attracting investment; despite recognising that a tax on imports, especially when it is almost the only source of income is not a reliable revenue generator for the government, and it is determined to not introduce any new taxes. The Prime Minister, Perry Christie[90] confirmed this strategy in the 2003-4 budget stating that although the "budget contains revenue enhancement measures, it does not contain any major taxation increases and only very modest increases in a small number of fees". As a result of this, in order to cover the existing liabilities of B$125m the government chose to raise US$200m through a US bond issue instead of the more customary approach of raising taxes.

In conclusion, the importance of the financial services sector to the Bahamian economy is clear: with over 200 registered banks and 721 locally operating mutual funds in Nassau manage approximately B$407.4bn (US$407.4bn) in assets (2003). The sector is estimated to account for 15%-20% (and potentially as much as 35%) of GDP without considering the component of tourism that is itself inevitably linked to the country's status as an offshore financial centre. With a sizable annual burden of importing such basic goods such as food in exchange for receipts from offshore investment, it is not surprising that the government is both eager to protect as well as expand the role of financial services in the economy. This plausibly, provides much of the reluctant context for the Bahamas' as well as many other OFC's response to fiscal authorities' countermeasures.

[89] Ibid
[90] Perry Christie is also the Bahamian Minister of Finance

## B. Case Evidence

### I. Free Market Theory

In May 2001, Professor Milton Friedman supposed that:

*“Competition among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or enterprises in the goods and services they offer for sale and the prices at which they offer them. Both lead to variety and innovation; to improvement in the quality of goods and services and a reduction in their cost. A governmental cartel is no less damaging than a private cartel.”*

If we have learnt anything from economic theory, then it is that interference with market forces and competition is largely inefficient, creating outcomes that are far from pareto-optimal but provide (in the case of this study), well for governments of developed nations at the expense of those in OFC’s.

This positive effect of tax competition had been politically acknowledged a year earlier when after an annual assembly, Commonwealth Finance Ministers agreed that, “…tax competition could in fact be helpful, and not harmful, because it can further spur governments to create fiscal environments conducive to generating growth and employment”[91]. The WTO had also suggested caution in its response to the OECD’s actions; claiming that they might be harmful as “[tax harmonisation] should be treated with considerable caution, as the fight against a ‘race to the bottom’ in tax rates may be used as a pretext for introducing a tax cartel”[92].

[91] Commonwealth Finance Ministers Communiqué, September 2000
[92] WTO 1998 Annual Report

Soon after the OECD report was published in 2000, the financial expert Walter Williams agreed that "the OECD […] released a report […] that should worry us all. The bottom line agenda for the OECD is to establish a tax cartel where nations get together and collude on taxes" [93]. He further notes that in general, we should be weary when there is action to eliminate competition of any sort, including tax competition.

The Business and Industry Advisory Committee (BIAC) itself, an agency that that advises the OECD has pressed the organisation to reconsider its view on tax competition stating that tax competition is a healthy economic phenomenon, and that it is unwarranted taxation by governments, rather than competition between them, which is harmful. Beyond this, the BIAC have also stressed tax havens play an essential role in maintaining efficient financial markets. They have been argued to be a key component in the movement towards a truly international financial stage, as they can simplify or solve conflicts between jurisdictions by introducing a third jurisdiction which avoids the convoluted interplay between rebates and competing tax incentives altogether.

## Social Justice in Taxation

Offshore financial centres compete for mobile capital by offering a combination of low tax and secrecy that allows investors to shield their assets from onshore tax collection authorities. Many of the free market crusaders and organisations that support the current operations of tax havens claim that tax competition is beneficial, akin to the socially optimal outcome from opening up a monopolistic market to a competitive one. As such, competition acts as a spur to innovation resulting in more choice and a lower price with better quality goods for consumers[94], and that these

[93] From the *Jewish World Review*, December 27th 2000
[94] Friedman, Milton, Letter to the Centre for Freedom and Prosperity 2001, at

innovations in state tax systems give consumers – in this case wealthy individuals and corporations – the opportunity to select from a greater number of differentiated tax regimes, (in effect more choice), and exerts a downward pressure on tax burdens, (representing pressure on prices) as states compete to attract footloose capital[95]. The greatest benefit from this is the resultant reduction in the tax burden, which generates greater incentives for taking risk and entrepreneurship which itself corresponds to greater economic activity and growth. This would at first suggest that overall, there is a great benefit to having an open market of tax competition. However, on closer inspection, the effects of tax on economic activity and growth are more vague and there is some disagreement within the literature,[96] such that the evidence for tax competition leading to lower tax burdens is at best, mixed. There is also little evidence to support the link between high levels of taxation and poor economic performance except at outrageously high rates of tax[97].

Since 1970 the tax burden among OECD countries has grown steadily from 29% of GDP to 39% in 1999[98], and whereas there has been a trend towards the lowering of tax rates, there has also been a broadening of tax bases and an overall increase in the tax burden. Theories on the impact of capital mobility and tax policies is still very much in its infancy, but as Richard Woodward points out, it is plausible that the lowering of tax rates has been driven by an ideological conviction about the benefits if low taxes rather than demand for global tax competition.

It is clear too that the true winners of offshore financial services and greater tax competition are limited to only a few members of society, as well as the largest

http://www.freedomandprosperity.org/update/u05-15-01/u05-15-01.shtml

[95] Woodward, Richard *The Case of the OECD's Harmful Tax Competition Initiative*, Working Paper, Centre for Global Political Economy, University of Hull January 2004

[96] A comprehensive literature review undertaken by Leibfritz, Thornton & Bibbee 1997 concludes that "the effects of taxes on economic performance are ambiguous in some areas and unsettled and controversial in others".

[97] Hutton, W, *The World We're In*, London, Little Brown and Company 2002

[98] Doggart, Caroline *Tax Havens and Their Uses* 2002 (10th Ed) Economist Intelligence Unit (EIU) London

multinational businesses. High Net Worth Individuals (HNWI's)[99] and corporations with a global reach are best positioned to reap the greatest benefits from using tax havens. This is not to say that these groups escape all forms of taxation - as they still pay a massively large tax bill by any measure, but they are able to greatly reduce what they would otherwise pay by the use of offshore facilities. Both of these groups can benefit from a reduced tax bill whilst still enjoying the public goods from the onshore country in which they operate[100]. The unfairness arises in these two groups being able to effectively free-ride by using public services and ultimately "participating in the benefits of general taxation without making a fair contribution to the public purse"[101]. Reports suggest that the British tax system alone allows as many as 60,000 HNWI's to reside in the UK but to dodge taxes on income and capital gains taxes made in the rest of the world. In the US, tax avoidance alone is reckoned to cost the Treasury somewhere in the region of US$70bn[102]

The predicament for onshore states is that this apparent tax revenue leakage has left them with highly undesirable solutions of reducing public expenditure and shifting taxes onto less mobile factors of production, and even though the OECD recognises that tax havens have played an important role in facilitating international capital flows and have improved financial market liquidity, "any potential benefits brought about by tax havens are more than offset by their adverse tax effects".

<u>Trade Liberalisation</u>

Under the current climate of removing barriers to free markets, the liberalisation of trade is a further item on the international agenda that has the potential to harm the

[99] Although Terry Neal in *The Offshore Solution: Privacy Asset Protection, Tax Shelters and Offshore Banking and Investing*, MasterMedia Publishing Corporation 2001, suggests that it is in an individual's financial interest to consider the use of a tax haven they have an income in excess of $50,000 per annum.
[100] A famous example of this is the Rupert Murdoch News Corporation, which operates over 800 subsidiaries and is incorporated in more than 60 tax havens. In the 1990's however, the corporation paid an effective tax rate of only 6% instead of a 30-35% tax rate in the major countries in which it does business.
[101] OECD, *Harmful Tax Competition an Emerging Global Issue*, OECD 1998
[102] Wechsler, W.F. *Follow the Money* in *Foreign Affairs* Vol. 80(4) July-August 2001

Bahamian economy. This could have particularly damaging effects for the Bahamas' own fiscal policy, which could in turn damage the economy. At both the South Summit in Havana, Cuba in April 2000 and the Quebec Summit of the Americas roughly a year later, Bahamian officials were among many other representatives arguing that small states and less developed or less diversified economies in general should receive special concessions to offset the increased revenue raising obligations and constricted scope for domestic production they are likely to experience as a result of more open world trade.[103] In an economy where taxes are almost non-existent, the Bahamian government resorts to imposing high tariffs and import fees. With the planned launch of the Free Trade Area of the Americas (FTAA) this would almost certainly mean that the Bahamas would have no alternative but to introduce other forms of taxation on the home economy to recover lost revenues from import taxes, and therefore lose the very meaning of being an offshore financial centre. This fiscal reliance on tariffs is the same reason why the Bahamas is a member of the Caribbean Community (CARICOM), but is not party to the CARICOM's common market in trade, as it would be forced to accept the Common Market's tariff elimination policies.

It is also important to note that liberal low tax regimes were encouraged by high levels of economic, financial and monetary regulation and high taxes in other countries, and that the competition provided by these regimes helped to spur international financial liberalisation which has generally been beneficial.

The OECD Should Reform Approach to Taxation

For the most part, low or no-tax jurisdictions have maintained tax policies that were implemented some 60 years ago - not initially designed to lure foreign investors and tax avoiders, but were levels of taxation that were needed to raise sufficient revenue

[103] Country Watch, *Bahamas* Report CW 2004-2005

for domestic public expenditure needs. The Economist Intelligence Unit (EIU) argues that this imbalance should be remedied by the onshore tax jurisdictions reconsidering their fiscal policies, rather than "crying foul and unfair tax competition and bullying others [countries] into raising their taxes"[104][105]. An example of the upward trend of taxation prevalent in the UK, is that Tax Freedom Day, the day of the year when the average UK worker has earned enough to pay of the tax bill, moved from May 27th to June 10th over the period 1997 and 2001[106].

It is shadow or black economies that account for the bulk of tax evasion in most developed, and many developing countries with both positive and negative attributes to their operations. (It was reported that Enron had approximately 600 subsidiaries registered in the Cayman islands alone[107]). The practical aspect is that that they perform a role in the economy that would otherwise be absent, but they also have a darker characteristic in that it is often linked to crime and illicit activities such as smuggling, prostitution and drug-trafficking.

The research on determining what the percentage of GDP is accounted for by the underground economy is enlightening: Switzerland comes out on top with only 8% of GDP generated informally whilst on the other end of the scale, both Nigeria and Thailand in the developing world recorded rates of more than 70% of GDP generated from the black market.[108] The result of this is not necessarily due to tax evasion but to corruption and protection-rackets, where small businesses are reluctant to pay government taxes, if they have already bribed another third parties to continue trading.

[104] Doggart, Caroline *Tax Havens and Their Uses* 2002 (10th Ed) Economist Intelligence Unit (EIU) London
[105] Interestingly, the OECD is itself a tax-exempt organisation and does not face any tax exposure as a result of its operations.
[106] This concept is taken from the Adam Smith Institute, London – a free market economics think-tank.
[107] Johnston, David Cay, *New York Times*, December 8th 2001
[108] Soto, de, Hernando, *The Mystery of Capital*; Basic Books, Perseus Books Group, 2000

There is an argument to suggest that if high-tax onshore countries were able to pull their informal sectors into the tax and regulation nets as they currently exist, such economic activities would soon disappear.[109] Tax havens have argued that if they amended their fiscal and regulatory systems to be more like those in the European OECD region, the offshore business would disappear or move elsewhere – but almost certainly not return to the high-tax, heavily bureaucratic countries in which it originated. The result is that low-tax countries economic growth opportunities would be blighted and high-tax countries would be not be any better off; a resultant lose-lose situation.[110]

In terms of open trade, we can think of countries around the world trading to exploit their comparative advantage – wine from Portugal, clocks from Switzerland, Oil from Saudi Arabia and motorcars from Germany, and Financial Servicing from the Bahamas? OFC's have the comparative advantage of having little need for high taxes as a result of the small population, low development and isolated markets[111]. Can this as a legitimate source of comparative advantage be used competitively in an open economy? Instead of purchasing goods and services from overseas, agents in high-tax economies are able to reduce their tax bill by routing funds – by whatever specific means – through tax havens.

This would not be deemed harmful under any other circumstances would it be for the fact that it is a cost saving on a tax bill instead of normal expenses. The massive shift in work created by the current offshore job market phenomenon that we currently observe is a legitimate version of the same effect. China and India are both countries that have factor endowments that make them suited to attract jobs. This

[109] Ibid
[110] This argument that high-tax countries should rethink their own fiscal policy and not bully other jurisdictions into doing so, stems from the Economist Intelligence Unit's research and the Peruvian Economist Hernando de Soto's development arguments.
[111] Although, the lack of taxation on the residents of the Bahamas has been blamed for the high disparity between incomes because of the absence of progressive income taxes, meaning that real living standards for the poor remain low and the price of basic consumer items remains high because of the large import tariffs placed on goods entering the islands.

has been a contentious issue, but imagine a system where a country attracts taxpayers, not for their tax bill, (the amount charged is negligible by comparison to the reduction in tax exposure), but to let them escape those payments, in return for a relatively small fee:  This is the essence of the tax haven.  Would it have been any other cost saving in a factor of production, then it would not be rebuffed in the name of capitalism.  This is not the case with tax revenue.

In conclusion, it is still unclear as to whether open cross-border tax competition is beneficial as a global optimum for all economies. However, it is fair to suggest that taxation should in fact be treated differently to other forms of free market competition in the fact that taxation itself has an ultimate goal of social good, and at worst this could lead to collusion on tax rates in some form of cartel.

### II. Sovereignty & Legal Jurisdictions and Political Considerations

After the publication of the OECD's 2000 report, many of the affected jurisdictions as well as international policy observers at the highest levels of government, questioned whether the actions of the OECD were legitimate. In essence, is pressurising OFC's to change fiscal policy on taxation legal?

The actions by the OECD were seen to be an infringement of national sovereignty in domestic taxation matters. Historically, fiscal matters have been carefully guarded by sovereign states and protected in international law for many years, with civil unrest and political upheaval occurring when they have been breached. The American Civil war was itself an example where the imposed taxes on colonial America led to civil disorder when American settlers rallied to the claims of "no taxation without representation" in their struggle for independence.[112] Similarly, small and alarmed jurisdiction states of the British Commonwealth also argued that the OECD initiative eroded rights of all jurisdictions to compete freely in the provision of international financial services; rights that had been recognised by the commonwealth heads of government at Durban in 1999.

As a result, many asked whether the OECD, as a select and un-elected group of twenty-eight of the most advanced and developed countries was a legitimate body to impose global standards on tax competition on the rest of the world. The OECD had decided on these measures without consulting smaller nations in any way, and some understood them as a deliberate attempt "to kneecap the opposition and reinforce offshore practices in Europe and the US"[113].

[112] Biswas, R. *International Tax Competition: Globalisation and Fiscal Sovereignty;* London: Commonwealth Secretariat
[113] Scott-Joynt, J. *2002 Commonwealth Finance Ministers* Meeting: Policy Brief, Commonwealth Policy Studies 2002

A fundamental part of the OECD's approach was that there was no clear separation between 'low and no-income tax' fiscal policy and 'low or no tax' regimes. The assumption that the absence of income tax or having low income tax was synonymous with having 'no or low tax' is dismissive of the right of a jurisdiction to choose to raise revenues through indirect taxation. This seemed to aggravate many OFC's who felt that they had been lumped together as one and unfairly categorised in having harmful tax practices. When interviewing staff at the Bahamas Public Treasury and the Central Bank, both institutions repeated the importance in the Bahamas having the right to impose zero-level taxation on income tax. This stems from the strong Bahamian belief that citizens should be free to spend their earnings as they wish without having the government forcibly seize a portion of their spending ability.

<u>EU Tax Saving Directive</u>

Recently, the European Union (EU) has joined the OECD, FATF and FSF in attempting to reduce the revenue lost from undeclared savings held offshore by improving the exchange of information between jurisdictions. The Brussels directive requires a paying agent in a Member State who pays savings interest payments to individuals tax resident in another Member State to pass on information to the paying agent's authority or (in certain jurisdictions) levy a withholding tax at 15% rising to 35%. The principal purpose of the Directive is to allow a taxpayer's local tax authority to identify that the taxpayer is in receipt of savings income that may otherwise not be declared.

This approach to offshore savings has not been without causing controversy from both within and outside of the EU, and especially from countries such as Switzerland and Luxembourg. These two countries have been in strong opposition to the proposed directive and have had some success in delaying its original enforcement date of 1st January 2005 and may possibly stall it enough to never be operative at all.

The free market think-tank of the Centre for Freedom and Prosperity (CF&P)[114] claims that under this current internal disagreement between EU Member States, the European Union's Tax Saving Directive has collapsed, and conclusively demonstrates that there is no 'level playing field' in the tax competition arena. Without this fair treatment, smaller tax havens are concerned that a two-rule approach to preferential tax regimes would ensue, and effectively shift financial investment away from non-EU or OECD member tax havens whilst protecting those jurisdictions that are members, and hence greatly damage the finance-dependent offshore economies. The CF&P further encourages the Bahamian government to resist pressures from external bodies, and suggests that the country should follow "the examples of Antigua, Panama, and the Cayman Islands, the Prime Minister should inform the EU and OECD that the Bahamas is no longer obligated to eviscerate its tax and privacy laws for the benefit of high-tax nations"[115]. The Bahamas eventually did act against some of the economically harmful legislation, and in 2004 the country officially withdrew from a 2002 commitment to the exchange of information on criminal tax investigations by 2004, and civil tax investigations by 2006, on the grounds that some OECD members had failed to take similar steps.

The response from the Bahamas has generally been much more co-operative, with an initial reaction by the government to change domestic legislation and commit to open communications with tax authorities[116]. However, Julian Frances, the Governor of the Bank of Bahamas also explains that the 15-20% share of GDP that is

[114] The Centre for Freedom and Prosperity (CF&P) is a non-profit organization created to lobby lawmakers in favour of market liberalization. The primary interest of the CF&P is the Coalition for Tax Competition, which is fighting to preserve jurisdictional tax competition, sovereignty, and financial privacy.
[115] CF&P, Topics in Taxation, homepage; www.freedomandprosperity.org
[116] See *Figure 4: Bahamian Banking Legislation 2000*, later in this paper.

generated from the islands' status as an OFC reflects the society, social structure and preference of the Bahamian people, and that as an independent and sovereign right the Bahamas does not necessitate a higher tax rate such as that of large industrial countries because it has neither the infrastructure nor a large domestic population to attend to. The Minister of Finance[117], has also vigorously expressed the same views, and in a formal statement at the OECD forum on Harmful Tax Practices has stated that "The Bahamas has never had, throughout our entire history, a tax on income and capital and does not hold the view that such taxes are inherently a natural component of an appropriate tax regime"[118].

<u>An Already Well-Regulated Economy</u>

One of the main arguments of the OECD's action against the operations of OFC's is that they have failed to act responsibly in maintaining well-regulated financial markets. This is an allegation that the Bahamas, as well as many other OFC's have vehemently contested. On this accusation, Francis Allen noted, "We [the Bahamas] operate a highly regularised environment. Our objective is to have a financial centre of the highest integrity, and as a properly supervised centre we believe our regulations and our supervisory regime is equal to that of any of the industrialised countries". This claim appears to be in line with an analysis by the International Monetary Fund (IMF) which studied the Bahamas Financial Services system and reported that the country runs a "well-supervised centre"[119].

However, it may be possible for the Bahamas to continue to play a role as an effective international tax haven whilst also satisfying some of the requests of the OECD. The Chairman[120] of Financial Services Consultative Forum (CFSC), which

[117] Minister William Allen
[118] OECD Harmful Taxation forum, 2002
[119] Doggart, Caroline *Tax Havens and Their Uses 2002 (10th Ed)* Economist Intelligence Unit (EIU) London
[120] Brian M Moree is chairman of the Financial Services Consultatitve Forum, and senior partner in the law firm McKinney, Bancroft & Hughes

was created solely for the purpose of recommending products and services that would "enhance the nation's performance in international business"[121] has stated that the strategic direction for the Bahamas is to target the upper-end of the financial services business – such as mutual funds and hedge funds, which are low volume high-return products. This key manoeuvre would escape two crucial problems that would help satisfy organisations such as the OECD as well as create a future for the Bahamas in having a more specialised role with a steady amount of turnover. The two concerns that would be eased under this change are money laundering and loss of onshore tax revenue.

With a more focused financial product offering and therefore fewer transactions, new legislation to more closely guard financial transactions and know-your-customer rules would be more realistically feasible to implement. Likewise the focus on both mutual and hedge funds would allow for the industry to continue operating a lucrative operation whilst focusing less on other financial products that are more damaging to onshore government revenue services such as a preferential corporate profit reporting jurisdiction.

Either way, regardless of the chosen strategic direction of financial services in the Bahamas, it is important to recognise that as physically smaller and politically weaker states OFC's are at the mercy of the fiscal decisions of high tax countries, rather than their own economic and regulatory policies in individual tax havens. Although it is widely recognised that the benefits of globalisation are balanced by a tendency to dilute sovereignty, it is important that process is not allowed to progress without restraint so far as to render the capacity for free fiscal action by small states powerless; which is a completely separate and political matter.

[121] Dupuch Jr, Ettiene Publications, *The Bahamas Handbook and Businessman's Annual* Ettiene Dupuch Jr Publications 2003

Modifications to the OECD Report

The largest and most threatening obstacle for the OECD's 2000 report has been the political actions of the US, which have played a central role in the progress of the OECD's objectives in eliminating harmful tax practices. After the publication of the OECD's 2000 report, the US joined smaller nations in questioning the legality of the organisation's actions with the US Treasury at the time Secretary Paul O'Neill stating that the US had "serious concerns […] about the direction of the OECD initiative". Although the US supported improvements in the exchange of information and greater transparency, there was concern over the lack of a level playing field which left many small (especially Caribbean states) at a major disadvantage.

The OECD nations were quick to recognise the importance of collaborating with the US in reaching an agreement, and that without doing so would completely stall the progress of the OECD in at least curbing the 'harmful' tax practices of offshore nations, and consequently modifications to the original report were announced in 2001, which included several changes to ensure that the US was kept on board. One of these was that the OECD guaranteed that the co-ordinated defensive measures would not be applied to non-OECD tax havens any earlier than they would be applied to an OECD member hosting a preferential tax regime, which greatly allayed the fears of the smaller offshore jurisdictions.[122] With this change to the OECD's original document, tax havens suddenly had the potential to completely escape the pressures of the OECD and allowed them to include a clause that would remove the offshore commitment to the OECD's obligations - unless OECD nations themselves eliminated 'harmful' tax practices or OECD members unilaterally agreed to impose sanctions on offshore nations. Both of these factors are unlikely to be supported within the organisation.

[122] Woodward, Richard *The Case of the OECD's Harmful Tax Competition Initiative*, Working Paper, Centre for Global Politial Economy, University of Hull January 2004

This intervention by the US has great consequences to the future of any action from the OECD and related recommendations by the FATF and FSF. The requested changes by the country may ultimately have the effect of completely stalling the progress of the OECD's tax competition charge by virtue of the agreement clauses that ensure that member as well as non-member countries are accountable to tax practice elimination or all countries must move together on imposing sanctions. Despite having the opportunity to recover some of the US$70bn lost by the US IRS each year by tackling the problem of tax evasion, the US has chosen instead to ensure fairness in the OECD's recommendations to countries outside of the organisation.

<u>Separation of Tax Avoidance and Tax Evasion</u>

By forcing the OECD documentation to address only the transparency and exchange of information factor of offshore states and by allowing them to have preferential tax policies that attract foreign capital, the US was clear in separating tax evasion and avoidance. The decision to do so was not taken lightly[123] and can also be attributed to the action of pressure groups and global think tanks such as the CF&P.

Unfortunately however, the matter is further complicated by the fact that OFC's as an indirect[124] result of their favourable economic environment for foreign investors attract two forms of illegal activity; money laundering and tax evasion. The effect of publishing the three reports by the OECD, FATF and FSF almost immediately after each other not only served to increase the pressure on OFC nations, but also as the offshore finance expert Terry Neal argues, helped blur the distinction between tax

[123] The change of government from the Clinton to Bush administration has been put forth as a strong factor in that supported this approach.
[124] Though onshore governments have argued that illegal financial malpractice is a direct benefit that OFC's have knowingly accepted and even specifically designed their economic climates to attract.

avoidance[125] – generally recognised as legal practice - and tax evasion and money laundering which are both illegal[126].

The result is that the onshore countermeasures reports that were led particularly by the OECD's Committee on Fiscal Affairs were heavy-handed in their blanket approach by tarnishing all countries and financial transactions with the same "harmful tax competition" brush, resulting in a failure to distinguish clearly between money laundering and tax evasion and tax competition in OFC's. Most tax havens and OFC's named in the reports are in their own interests, committed to combat money laundering and to the promotion of world financial stability, though they fall short of giving up their right to use fiscal competition as a tool for economic development[127]. The publication of these reports has done much to create confusion as well as place pressure on the activities of offshore jurisdictions. The latest Economist Intelligence Unit (EIU) report suggests that the many small jurisdictions highlighted in the OECD's damaging report are now "co-operating to replace the OECD's Fiscal Committee's blunderbuss approach with dialogue".

However, this may be more difficult than it at first appears. It is likely that by separating tax avoidance and tax evasion, offshore jurisdictions will lose out substantially. As most states in the world levy taxes on a worldwide basis, having assets exposed to zero tax in an offshore location will still be liable to taxation in their country of residence wherever it arises in the world. This is wholly dependent on allowing onshore tax authorities access to offshore account information, which for offshore institutions is rarely the case. Bank secrecy laws and the use of complex financial vehicles deliberately designed to obstruct an audit trail allows account

[125] According to Dr Arnold Goldstein, a widely published expert in offshore matters, "about one in four who earn over $100,000 a year now enjoy the use of one or more safe haven jurisdictions".
[126] Neal, Terry L., *The Offshore Solution: Privacy Asset Protection, Tax Shelters and Offshore Banking and Investing*, MasterMedia Publishing Corporation 2001
[127] Doggart, Caroline *Tax Havens and Their Uses 2002 (10th Ed)* Economist Intelligence Unit (EIU) London

owners to remain anonymous. As a result the ability for revenue collection services to receive tax payments on foreign income rests heavily on the honesty of the taxpayer. In effect this type of tax is now tantamount to a "voluntary tax"[128], and by forcing jurisdictions to conform to the exchange of information has the effect of obstructing the amount of financial investment diverted away from onshore countries, as the two are inextricably linked.

Withdrawal of US Support

Central to the US's opposition to the OECD's original course of action is its direct benefit gained from the status quo. The US itself gains from financial flows into the country and has tailored its economic policy to make it attractive to foreign investors - to the extent that the country has attracted in excess of US$9tr of foreign investment[129], making it the "world's biggest beneficiary of tax competition"[130].

Clearly, with such a large amount of foreign direct investment inbound to US through tax competition a change in global policy that would reduce the amount of finance invested 'offshore' would have a detrimental effect on US economy. This is further highlighted by the fact that businesses in the US economy are dependent on the use of offshore financial facilities themselves in order to reduce their tax bill. An estimated one-third of profits for US corporations are earned from low, or no tax jurisdictions ensuring the profitability and viability of US firms and thus the basis of the domestic economy. Although the IRS incurs a massive US$70bn loss in tax avoidance alone, the effect of an economy-wide reduction in profitability for US firms and the resulting effects more than outweigh the original loss in avoidance. The extent of this benefit and dependency on tax havens represents a large portion of the

[128] Owens, J. *Globalisation: the implications for tax policies,* Fiscal Affairs, Vol 14(3), 1993
[129] Mitchell, D.J, *Don't Scapegoat Tax Havens* Heritage Foundation Press Release 2001 at http://www.heritage.org/views/2001/ed1000501.html
[130] Ibid

US economy - in 1998 it was reported that as much as a quarter of Fortune 500 companies paid no net tax in the United States[131].

Perhaps this represents one of the greatest obstacles to the OECD's plans to removing harmful tax practices is the US's – the realisation that they are "unable to afford the cost of lost investment that would inevitably follow any international crackdown"[132]. As such a major stakeholder (albeit often unrecognised) in the offshore financial investment market, the actions of the OECD if pursued unchecked could have a detrimental effect on the US economy. From the point of the US, the development of the country's neighbours in the Caribbean Basin – which holds a particularly high concentration of OFC's is an essential part the political agenda. To forcibly remove the region's basis for development would have unfavourable effects for the US that are potentially characterised by regional instability.

[131] Mitchell, D.J, *Don't Scapegoat Tax Havens* Heritage Foundation Press Release 2001 at http://www.heritage.org/views/2001/ed1000501.html
[132] Palan, R. *Trying to Have Your Cake and Eating It: How and Why the State System Has Created Offshore*; International Studies Quarterly Vol. 42(4) December 1998

### III. Development of Offshore Economies

One of the most important arguments in support of international tax competition and the continued use of tax havens as favourable financial locations for international wealth is due to the development of their economies.[133] The fact that a large proportion of small states have turned to offshore financial services is an indication of their needs arising from the limited range of economic opportunities available to them.

Many (but certainly not all) jurisdictions are undeveloped states whose economic growth can often depend on the financial services component of their economies. An IMF report published in 2002, noted that the "international tax scene has grown rich in initiatives and programs" stemming from action in the 1970's when a number of international financial institutions and leading states tacitly encouraged the use of offshore finance as a vehicle for development[134]. An example of this importance was when the British Virgin Islands were at risk from being turned into a bird sanctuary, after colonial administrators could not think of an alternative sustainable economic activity for long term employment of the local population. As a result of those policies, it is now widely agreed that "the provision of such offshore financial facilities has lifted a host of small jurisdictions from the poverty of the developing world to levels of affluence few would have believed within their grasp"[135].

A major challenge affecting the tax haven elimination initiatives is the fact that most of the jurisdictions named are far less economically developed than most of the OECD members, and have relied on tax incentives to attract foreign investment to

[133] Although Oxfam has stated that it believes that tax havens themselves represent an obstacle to overcoming world poverty as they deprive countries of receiving tax revenue.
[134] Hampton, M.P. *Treasure Islands or Fool's Gold: Can and Should Small Island Economies Copy Jersey?* World Development Vol.22(2) February 1994
[135] Ibid

their shores almost as a form of survival[136]. This was reflected almost immediately when the OECD announced the blacklist of thirty-five jurisdictions in its 2000 report and there was an immediate uproar from politicians, officials and business representatives from jurisdictions for whom these proposals would have detrimental consequences[137].

The St Christopher (St Kitts) and Nevis Islands were one of the first jurisdictions to take recognisable action to attract foreign investment and in trying to improve the development objectives announced a new legislative programme in 1980 with the direct aim of trying to provide financial services to US investors including tax holidays for up to fifteen years, registration services for aircraft and ships and permission to allow large amounts of US dollars into the country and to set up "accounts in any of the banks and repatriation of funds simply on request to the bank in question"[138]. The tax haven as we know it today was born, and in implementing this legislation, St Kitts and Nevis was able to attract investment interest almost overnight. The Bahamas had also experimented with attracting foreign investment when in 1970, trust funds were set up in the Bahamas, and there was a subsequent rush to establish offshore financial institutions until 1972, when a peak of 344 was reached. Since then, the islands have increased their financial product offering and created a large new income generator for the islands such that the latest CIA country reconnaissance identifies that the Bahamas is "a stable, developing nation with an economy heavily dependent on tourism and offshore banking".[139]

Today the low tax rates that attract foreign funds continue to provide many small states, countries, provinces and overseas territories with a substantial part of their

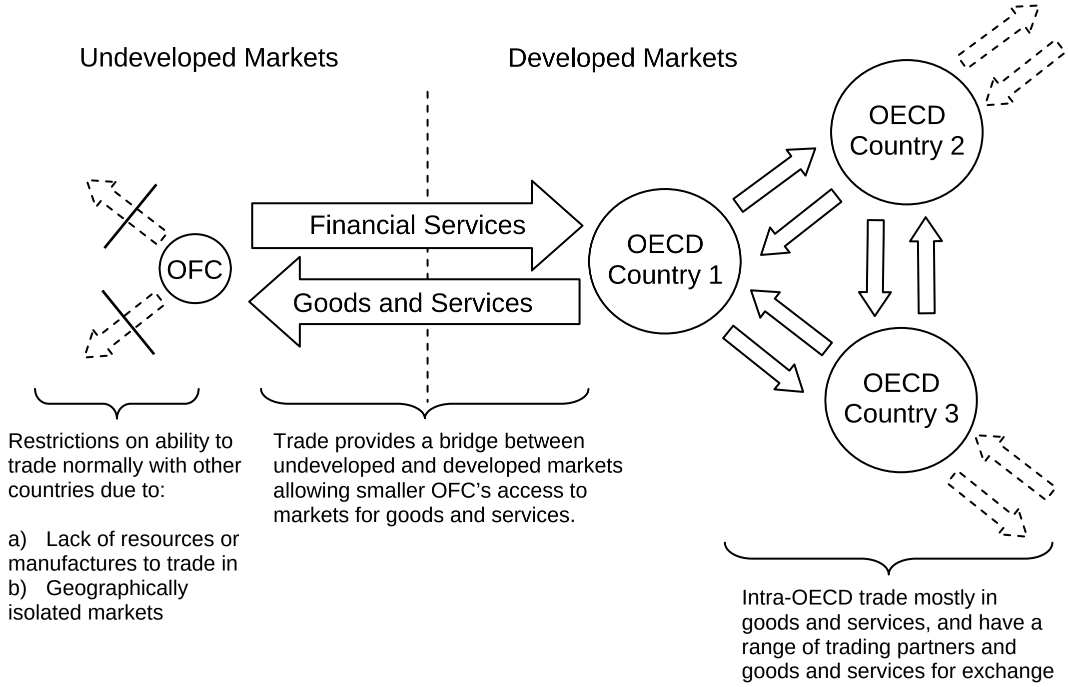
[136]This is epitomised by the Turks and Caicos Islands in the Caribbean.
[137] The OECD recognised that even before any 'defensive measures' or sanctions would be implemented, the naming and shaming involved in a blacklist would begin to have negative effects on the investments and trade of the jurisdictions concerned.
[138] An address given by the Right Honourable Dr Kennedy Alphonse Simmonds Prime Minister of St Christopher and Nevis to the CBI December 6th, 1984
[139] CIA World Factbook Bahamas Publication 2004-5 at www.cia.gov/cia/publications/factbook/geos/bf.html

national income along with multiplier effects that ensure the continued strength of other areas of the economy. As Rajiv Biswas has noted, the issue of international tax competition and economic development is inextricably linked, since fiscal incentives and the tax environment are often critical ingredients in corporate decisions on where to locate investment. Beyond this however, is the ripple effect to the rest of the economy that supports the financial sector and provides a sizable contribution themselves to GDP. The indication is clear for the Bahamas and from the evidence presented in understanding its economy in the previous sections of this document. As a country that receives a large share of GDP earnings from a financial services industry contribution, removing or reducing the size of this vital component could prove detrimental effect to development opportunities for Bahamians.

The Bahamas is far from fully developed, and although a country of small land area much of it remains an uninhabited wilderness. True development is limited only to the capital Nassau and Freeport, and even the more built up areas in other parts have limited amenities and lack in anything beyond the most essential services. The Bahamas was one of many OFC's that expressed concerns about the economic development implications of the OECD initiative, as international advisors had previously urged these countries to diversify in order to reduce dependence on primary commodity exports and subsistence farming.

Diagrammatically we can represent this as a trade bridge between an OFC and other countries that are able to supply goods and services. Without the resources or manufactures to trade in, the OFC can offer attractive low-tax incentives (i.e. effectively a "Financial Service" to a individual clients or businesses), in return for goods and services. This effect is compounded by the fact that OFC's are often in geographically isolated markets, making it otherwise uncompetitive to trade in physical goods, unlike the exchange of monetary funds which can be moved around as virtual transactions on an electronic network of telephony or the internet[140].

Figure 5: The Trade Bridge in Financial Services for OFC's




Any restraint brought by sanctions to lessen or halt completely the ability for tax havens to trade with developed markets would break this key link that small developing countries rely upon. The above diagram also only considers OECD countries themselves, but this effect would most likely be replicated by other developed nations worldwide from OECD diplomatic pressure. The diagram further displays the risk of income volatility that OFC's face. For the Bahamas, the two largest sectors of income are tourism and the financial services industry both of which are strongly intertwined, by removing this opportunity to trade, an OFC would essentially remain in autarky, as well as political and diplomatic isolation.

[140] For example the Society for Worldwide InterBank Financial Telecommunications "SWIFT" network.

The OFC trade diagram also demonstrates the fact that the heavily financial trade dependent composition of the economy is less of an unlawful economic abnormality as the OECD has implied. More simply, because of the small size and special need for low trade barriers for OFC's, success in these areas usually means relatively large sectors in relation to the total size of the economy. This suggests that viewing offshore financial sectors as a sign of artificial and distorted development is not a fair representation but is more a result of their economic and geographical circumstances.

<u>Damage to the Bahamian Economy</u>

Since these reports and lists were issued, but with particular respect to the most damaging – the OECD list, many jurisdictions responded that the OECD clearly made generalisations without investigating each individual country's situation. In the case of The Bahamas, many observers felt that the OECD did not understand the economic structure of the country and how such changes could have a detrimental affect on the Bahamian economy, and although the Bahamas was already better regulated than some other tax havens around the world, it attracted attention partly because of the sheer size of its financial sector. Following the series of reforms and passed legislation, the Bahamas was removed from the FATF list in June 2001, but this has - according to one tax haven expert writing in 2003 - come at the cost of crippling the financial sector in the Bahamas to satisfy the demands of the OECD.[141]

Julian Francis, the Governor of the Central bank has said that, "When one looks at the purpose for which the report has been prepared and the conclusions it draws, it is obvious that they [the OECD] do not understand jurisdictions such as our own. To say that The Bahamas has contrived its fiscal regime simply to attract foreign

[141] Azzara, Thomas P., *Tax Havens of the World, (8th Edition)* Thomas P. Azzara 2003

investment and international banking is really not to understand the evolution of our economy and how it is structured today"[142].

In less than a year at the April 2001 Summit of the Americas[143], and after a great effort make the corrected changes, the Bahamas joined a number of other Caribbean states in an appeal to the OECD's actions. The arguments for this were that as small countries lacking in significant natural resource deposits or the potential to manufacture products and trade cost effectively, they have no other option but to use low-tax incentives to attract investment from overseas as a means of trade income. Furthermore, this has been argued as a legitimate comparative advantage when making transactions between open market economies and liberalised financial markets. The reliance on income of this type was argued to "even approach the level of necessity"[144], as the only means to allow relatively small, import-dependent economies to have the power to trade and ultimately survive.

Start-up incorporation fees, annual filing fees, the issuing of bank and insurance licenses and bank duties provide an essential part of the revenues for small and remote economies. Figures are not always available for this claim, but in 1986 the Netherlands Antilles recorded US$90m in revenue as a result of their tax haven status. The knock on effect to the other parts of the economy are less easily quantified, but it is certain that there is a trickle down effect to other parts of the economy; in trade, lawyers and accountants, banks as well as a component of tourism.

A major challenge effecting the tax haven elimination initiatives is the fact that most of the jurisdictions named are far less economically developed than most of the

[142] Interview, *Central Bank of the Bahamas*, January 2005
[143] Held at Quebec, Canada
[144] Country Watch, *Bahamas* Report CW 2004-2005

OECD members or the US, and have relied on tax incentives to attract foreign investment to their shores almost as an essential part of their income. The Bahamas is a country where only 19% of households in the capital city are connected to a sewerage system and although the Human Development Index (HDI)[145], which is formulated by the United Nations Development Program ranks the country highly in 42nd place, the disparity between the Bahamas and other OECD countries is still very wide. The study also did not take into account the localised hurricane damage that effectively stalls or regresses economic development with some regularity. After the most recent hurricane damage - import taxes - the main source of government income were reduced almost to zero in an effort to help the island's reconstruction in 2004 after the hurricanes Frances and Jeanne both caused severe damage to the island archipelago.

The developmental stage of the Bahamian economy is also reflected in the number of development and trade organisations that the country is involved in such as the Organisation of American States (OAS) to promote peace and security as well as economic and social development. Other related agencies include the Inter-American Development Bank (IADB), the Caribbean Development Bank (CDB), and the CARICOM group for economic integration and development with which the country is heavily involved in part of its development process. In short, the Bahamas is a country that is heavily dependent on development organisations and as part of any political agenda is driven to improving the standard of living of its citizens.

An excellent example of this is the island of Nauru in the central Pacific, which became an independent republic in 1968. The population of 11,000 lives directly or

[145] The HDI is a composite of several indicators, which measure a country's achievements in three main arenas of human development: longevity, knowledge and education, as well as economic standard of living. Although the concept of human development is complicated and cannot be properly captured by values and indices, the HDI, which is calculated and updated annually, offers a wide-ranging assessment of human development in certain countries, not based solely upon traditional economic and financial indicators.

indirectly off the proceeds of phosphate mining and exports. The islanders – on paper at least – used to enjoy one of the worlds highest income per capita levels in the world. The collapse of phosphate prices however, along with a number of other factors drastically reduced the country's reserves and budget revenues. GDP per head dropped from US$33,500 in 1995 to and estimated US$9,100 in 2000. Since that time, the country introduced legislation encouraging offshore investment, and by early 2000 some 200 offshore banks and companies had been registered, many of whom did so over the internet and without investors having to be vetted or evening having ever set foot on the island. This move attracted a large number of criminals and essentially led to the island's detrimental involvement in a disproportionate number of offshore scandals including a Russian mafia scandal in 1996-7 that also led its inclusion on the FATF and OECD blacklists.

The island's response was that it had no other choice other than to attempt to play a role in the international financial market for capital after phosphate mining no longer became a viable GDP generator and that it required financing for development as well as costs associated with environmental damage from the original phosphate strip mining.

Even the US has been party to this economic thinking, which essentially has the development of its land and people at the centre of its intentions. In order to attract investment and stimulate the local economy, the state of Delaware as well as Nevada are tax efficient, sparingly regulated onshore locations which are ideal for offshore-type investment fund operations.

The private sector, who's interests are greatly aligned with those of the government, agrees with this argument that tax competition is a tool for development for the islands. Ian Fare, the chairman of the Bahamas Financial Services Board and of

MeesPierson (Bahamas) Ltd, states that, “The financial service industry here goes back to the 1940s and that is one of our strengths. We have been growing the financial services business for more than 60 years. It is not something that has been contrived to attract people; it is something of bedrock that has been fundamental to the development of The Bahamas,”, or as the offshore author Terry Neal puts it, “to cave in to an effort to destroy offshore financial services will correspondingly destroy the booming business activity spawned by these typically small island jurisdictions and potentially ruin their economies”, and that is “extremely unrealistic for rich nations to pull the financial rug out from under offshore financial centres without offering them viable alternatives to replace those industries sentenced”.

There has been some suggestion of financial ‘compensation’ for the loss of this withdrawal of offshore services industries should the OECD’s plans be fully implemented. However, it is obvious that a one off payment to both entice OFC’s to agree to the organisations demands and provide some form of support, though generous – as with the alleged enticement by the US to the Bahamas - would only be for a short period of time, so that overall accepting the changes would be disadvantageous to the local economy. It would be disproportionately burdensome for OECD nations to perpetually fund the development of OFC states with aid, and as such would most likely provide support below the income originally produced by the financial sectors of OFC’s. It is unrealistic to suggest that a form of compensation would reasonably cover the income lost through withdrawing a capacity for providing financial services.

Indeed, one of the greatest reasons for the US to intervene so strongly in the OECD’s objectives is because of the possibility that the organisations wilful campaign could have the effect of shrinking or even closing OFC’s in small states causing irreparable affects to their dependent economies. The choice set before the economies of the small jurisdictions was announced plainly in a statement from the Pacific Islands Forum in 2001, of; “either committing to the initiative and suffering possible and immediate to long-term loss of economic activity through the loss of offshore sector clients, or not providing a commitment and suffering loss of economic activity through the imposition of defensive measures by OECD members”[146]. Taking either route would leave Caribbean countries with greatly damaged economies that would be forced to search for alternative means of income or would have to shrink their economies. As a characteristic country for the region, the Bahamas is an example of the degree of importance financial services are to a Caribbean country’s economy. At the most conservative estimates the OFC component of the economy represents between 10-15% of Bahamian national income as well as possibly accounting for an even larger slice of the tourism sector and supporting businesses. There are at least 17 states in the Caribbean region that could potentially be affected by the OECD’s policies, with economies that are similarly heavily dependent on offshore financial services industry. A vital concern for US security is that an reduction in the abilities of Caribbean nations to generate income from offshore activity could result a an number of potentially harmful repercussions. These include the potential for an influx of illegal immigrants to the US mainland, an increase in narcotics production and trade as a replacement for income, as well as serious destabilisation of the region. Further still, economic destabilisation could plausibly have an even wider effect as in 2001, a record 47 of the world’s top 50 banks were located or had substantial business practice in the offshore sector. In pushing anti-tax competition legislation, these banks may have financial difficulties that could have market repercussions for the entire globe.

[146] Pacific Islands Forum, 2001

## Conclusion and Closing Observations

The question for this paper was to establish the development implications of recent onshore fiscal authorities' countermeasures on the economies of offshore financial centres (OFC's) as well as to attempt to determine if the action is justified and whether international tax competition is fair.

The context section of this document has allowed us to determine the importance of the financial services industry reflected in many tax haven jurisdictions by using the Bahamas as a case study, and it has been important to establish a historical and economic background to this enquiry and to recognise the importance of financial services to often small and isolated OFC states as an engine for growth and a bridge into international markets of trade. The Bahamas has provided a very representative example[147] for the difficulties that the economy faces in trying to bridge the gap between its own development and maintaining ties with the OECD and the international community in general.

The case evidence section builds on this to recognise that the evidence of tax competition and links to societal benefits are questionable. Once we uncover the actors and beneficiaries of an open tax competition system it is apparent that we encourage tax evasion and avoidance as well as the opportunity for the highest echelons and corporate giants to free-ride. However, as a major factor in the global economic and political stage, the US has placed demands on the OECD that may effectively render the organisation's crusade impotent, as the opportunities to escape taxations costs for individuals and businesses allows them to maintain viability and competitiveness, whilst also providing incentives to entrepreneurial activity. The American response to the OECD's aims has recognised that the rewards of offshore

[147] Whilst only the Bahamas has been used as an in depth case study in this document it is clear that the country provides a good representation of many other OFC's, and more importantly is a helpful indicator of the predicted problems that may arise with increased economic and political pressure by other countries and organisations such as the OECD.

finance are largely gained by the developed onshore nations themselves. Whilst small offshore nations attract capital inflows, the ultimate destination for these investments is actually the onshore countries from where the finance originally came from, thus nullifying or reducing the real effects on economic activities in industrial countries and in their revenue collection. However, this argument itself is unclear, as evidence suggests that leakages from onshore treasuries as a result of tax-escaping capital can be corrected by the many opportunities to pull informal sectors of the economy – which account for the largest share of capital evading tax – into the legitimate, and therefore taxable sphere of the economy.

Furthermore, a recent paper on the OECD Harmful Tax Competition Initiative by Professor Michael Deveraux[148] suggests that corporate revenues in OECD countries have remained steady as a share of GDP over the last two to three decades, despite significant declines in corporate tax rates, suggesting that governments have been effective in sustaining their revenue inflows despite their fears that globalisation is eroding their revenue base. Clearly there is still some ambiguity as to the level of loss from onshore revenue leakage, and if this is the case then the OECD should obviously redress the current harmful tax elimination campaign, as OFC's have maintained an efficient role in international markets rather than by attracting capital away from onshore jurisdictions. Their success may have merely attracted too much attention, when in fact corporate tax revenues for onshore governments have been kept at a commensurate level over time.

This argument has also strongly supported the fact that the OECD's recommendations are practically an economic offensive on the smaller and less developed economies by forcing them to adopt taxation practices that are not in line with current economic development needs or do not suit the structure of their

[148] Professor of Economics and Finance at Warwick University, United Kingdom

economies at this time, and perhaps never will, by virtue of their natural and physical endowments. In the case of the Bahamas for example, it is naïve to expect the government to publicly accept any action that would otherwise contradict an apparent political agenda that has the people of Bahamas and the sustainable development of the nation at its core.

Finally, this paper has also considered the nature of the development of nations that are so clearly dependent on the financial services sectors of their economy. In the analysis of the Bahamian economy it is unclear exactly how closely the tourism and financial services sector of the economy are related, but together they account for almost 90% of GDP earnings for the nation. By removing a slice of both this economic engine and current revenue stream we potentially endanger the population of many OFC states to a regression in economic development, that could even lead to civil unrest. For this reason, the US as a major world player has watched the developments of the OECD-led proposals carefully and has intervened to prevent the full force of an exogenous shock from affecting its close neighbours in the Caribbean, where many OFC are located.

This paper has discussed a number arguments relating to this multifaceted issue, but in summary the effects that the OECD's efforts to eliminate the harmful effects of taxation are still unclear. There are clearly benefits to both onshore and offshore nations with the current situation, but likewise there are very real concerns of onshore nations concerning obvious leakages from tax revenue collecting authorities, and it is important to weigh these alongside each other. There is therefore reason to suggest that the current state of affairs has merits as a relatively fair process to all global stakeholders, and that the OECD's campaign, although well intentioned has substantial inconsistencies in its final goal.

In the same vein, it is important to recognise that any constructive movement forward will need to build a more inclusive dialogue with a co-operative approach to understand cross-border tax competition that incorporates greater respect for the sovereignty of OFC jurisdictions.[149] Further still, the current trend of globalisation hinges on the need for the economy to have more winners than losers, and whereas this may well be determined by the actions of the US, we also expect developing countries such as OFC's to represent the new growth economies of the next century, and as such they should be a focus of our economic and political consideration. In 2001, the president of the World Bank recognised the importance of supporting developing economies, and stated that the developed countries must co-operate with developing countries to create new global governance structures and to redesign the global architecture in order to create a more inclusive global order.[150] Furthermore, it is expected that the greatest share of economic growth will be driven largely by undeveloped economies, and that we will need to have a much more inclusive and integrated approach to our relations with these emergent economies.

In terms of sovereignty, this paper does not attempt to suggest whether the end of the 'nation state' is justified, but instead recognises a movement towards globalisation is well underway. However, it is important to note that we are many years (and possibly never) going to reach a completely globalised world, and as such we cannot implement fiscal solutions that assume our global economy is already globalised.

Essentially, the jury is still out. Perhaps most importantly because we are still yet to observe the full implications of the OECD decisions. In conclusion however, we can see that the result of this is almost as much political as it is economic: The

[149] Interestingly, the OECD is itself a tax exempt organisation and does not face any tax exposure as a result of its operations.
[150] Wolfensohn, James, *IMF Survey*, November 2001

multilateral reform projects announced in June 2000 and the OECD's own initiatives have had the result of imposing an external fiscal policy on often a smaller nation, whose sovereign rights appear to be violated, but can do little to resist the changes in order not to be annexed by the world economy in the form of blacklisting or sanctions.

We are yet to observe the full implications of international tax reform and on two of the three factors discussed. Free Market Theory and the Development effects will be played over the longer term. Without doubt, further study and research will be required to determine the how these factors develop for Offshore Financial Centres in the global economy beyond 2005.

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## Appendix & Notes

Contribution of International Financial Services Industry to GDP in selected countries:

| Country | Estimate value as a share of GDP (%) |
|---|---|
| Bahamas | 15-20 |
| Barbados | 30 |
| Bermuda | 20 |
| British Virgin Islands | 36 |
| The Cayman Islands | 21 |
| The Cook Islands | 7 |
| Grenada | 5 |
| Isle of Man | 42 |
| Guernsey | 64 |

GNI comparisons for Selected Countries

| **Income Group** | **2002 GNI per Capita & Example Countries** | |
|---|---|---|
| High Income | $9,386 or more | Norway (US$ 38,730)<br>United States (US$ 35,400)<br>United Kingdom (US$ 25,510) |
| Upper Middle Income | $3,036 - $9,385 | Saudi Arabia (US$ 8,530)<br>Trinidad & Tobago (US$ 6,750)<br>Venezuela (US$ 4,080) |
| Lower Middle Income | $766 - $3,035 | Botswana (US$ 3,010)<br>South Africa (US$ 2,500)<br>China (US$ 960) |
| Low Income | $765 or less | Azerbaijan (US$ 710)<br>Angola (US$ 710)<br>Ethiopia (US$ 100) |

'Developed Country' according to World Bank

'Developing Country' according to World Bank

## Historical Overview of the U.S. Government's Attempts to Crack Down on Tax Shelters:

*1984*
*Congress enacts comprehensive tax shelter reform*

*Congress passes the Deficit Reduction Act of 1984, which requires tax shelter promoters to register with the IRS before offering their products to the public. The promoters must maintain a list of all investors in each shelter and make the list available to IRS within 10 days. Shelters are defined as investments that deliver at least $2 in tax savings for each $1 invested in the shelter.*

*1986*
*Tax Reform Act of 1986 passed*

*Included in the Tax Reform Act is a proposal that targets individuals who are taking advantage of abusive tax shelters. The IRS later suspects the 1986 law caused a flow of tax shelter promoters and practitioners -- armed with a glut of specialist knowledge -- to target their activities toward corporations.*

*1991*
*A change in accounting rules helps tax shelter promoters*

*Accountants are now allowed to charge performance-based fees, like investment bankers, as opposed to an hourly rate. This rule change is suspected of having spurred accountants to develop tax shelter products that could be marketed to multiple clients.*

*1997*
*Congress redefines shelters*

*In an amendment to the Deficit Reduction Act of 1984, Congress redefines shelters as transactions where a "significant purpose" is to avoid or evade taxes, where arrangements are offered to potential participants confidentially, and where aggregate promoter fees exceed $100,000. The act requires tax shelter promoters to register their products with the IRS before they are used.*

*April 29, 1998*
*OECD releases report on tax havens*

*The Organization for Economic Co-operation and Development (OECD) releases its report, "Harmful Tax Competition: An Emerging Global Issue," which cites key factors in identifying tax havens, including: no or nominal taxation, a lack of effective exchange of information, an absence of any substantial activities, and a lack of transparency in legislative, legal, or administrative operations. The report grows out of a May 1996 request from OECD ministers in which they called upon the organization to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decision and the consequences for national tax bases."*

*Summer 1998*
*Congress cuts IRS budget after hearings*

*After hearings in which the Senate Finance Committee questions the management and operations of the IRS and investigates the agency's handling of taxpayers, President Bill Clinton signs into law the Internal Revenue Service Restructuring and Reform Act of 1998, which creates a largely private-sector oversight board for the IRS, severely limits the powers* *of its examination and collection division, and cuts the IRS budget just as the tax shelter epidemic is taking off.*

*Oct. 13, 1998*
*Court questions transactions without economic substance*

*The 3rd Circuit Court of Appeals rules in AMC Partnership, Southampton-Hamilton Company, Tax Matters Partner, v. Commissioner that "Tax rules ... which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."*

*February 1999*
*Clinton budget proposal includes provisions targeting corporate tax shelters*

*The New York Times reports on Feb. 3, 1999, that Clinton's federal budget proposal limits the benefits of corporate tax shelter transactions by imposing taxes on some exporters, limiting the creation of company subsidiaries, barring the deduction of damages paid in civil lawsuits, and changing certain outdated rules on life insurance companies that led to large tax increases.*

*In July 1999, the Treasury Department issues a white paper, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals, that works to refine the Clinton proposals.*

*March 22, 1999*
*Deputy Treasury Secretary Lawrence Summers speaks out against tax shelters*

*In a speech at the Tax Executives Institute, Summers voices his concern about the growing problem of tax shelters and suggests an excise tax be levied against promoters and lawyers involved. Summers announces the administration's desire to foster a "culture of compliance" between taxpayers and the IRS.*

*Dec. 27, 1999*
*Treasury Notice 99-59 warns of tax loss schemes*

*The IRS and Treasury Department release a notice entitled Tax Avoidance Using Distributions of Encumbered Property that details how corporations engage in transactions with foreign entities solely to facilitate tax deductions. Notice 99-59 states that taxpayers and their representatives should know that "the purported losses arising from such transactions are not properly allowable for federal income tax purposes."*

*February 2000*
*Summers unveils strategy to discourage corporate tax shelters*

*Summers, now the treasury secretary, unveils a strategy to curb abusive tax sheltering that the Treasury estimates may increase annual tax revenue by $10 billion. The joint Treasury Department/IRS campaign establishes the Office of Tax Shelter Analysis (OTSA) within the IRS Large and Mid-size Business (LMSB) Division headed by former Hewlitt-Parckard executive Larry Langdon. The OTSA is designed to serve as a clearinghouse for all information related to tax shelters.*

*March 6, 2000*
*Large insurance companies propose legislation to close Bermuda loophole*

*Prompted by six small U.S. insurance companies moving their headquarters to Bermuda, purportedly to dodge U.S. taxes, four larger companies -- Chubb, Hartford, Kemper, and Liberty Mutual -- ask Congress to close this tax loophole. The problem is brought to public attention in a New York Times article by David Cay Johnston, who wins the Pulitzer Prize for his work.*

*March 9, 2000*
*Senate Finance Committee holds hearings on abusive tax shelters*

*The Senate Finance Committee begins hearings on abusive corporate tax shelters. Lindy Paul, chief of staff for the Joint Committee on Taxation, testifies that her committee "believes that direct measurement of corporate tax shelter activity through macroeconomic data is not possible. Instead, a more instructive approach may be to analyse specific tax shelter transactions that have come to light and evaluate their effect on corporate receipts." Ken Kies of PricewaterhouseCoopers LLC again speaks out against blanket legislation limiting tax shelters, arguing that new legislation will not "curtail perceived abuses" and instead will create "an unacceptably high level of uncertainty and burdens for corporate tax officials."*

*June 26, 2000*
*OECD publishes list of foreign tax havens*

*A report by the OECD identifies 35 offshore financial centres as meeting its criteria for being tax havens. Six jurisdictions -- Bermuda, Cyprus, Malta, the Cayman Islands, Mauritius, and San Marino -- are removed from the list after pledging to meet the OECD's requirements for change.*

*On April 18, 2002, the OECD issues a revised list of six uncooperative tax havens -- Andorra, Lichtenstein, Liberia, Monaco, Marshall Islands, Nauru, and Vanuatu -- noting that 31 jurisdictions from its June 2000 list had chosen to adhere to the OECD's principles of transparency and effective exchange of information.*

*October 2000*
*ITEP study finds largest corporations paying low tax rate*

*The Institute on Taxation and Economic Policy (ITEP) publishes the results of its survey of the tax rates of 250 of the largest taxpayers in the country between 1996 and 1998, and reports they paid only 20.1 percent of their profits in taxes in 1998 -- far less than the 35 percent corporate tax rate. Bob McIntyre, a principal author of the new study, says 41 of these companies in the top bracket actually received $3.2 billion in tax rebates during this time. The study, however, does not say how much of the reduction in tax rates was due to illegitimate sheltering activity.*

*July 26, 2001*
*Treasury Department issues basis-shifting notice*

*Basis is a purchase price used to determine capital gains and losses for tax purposes. The Treasury Department issues Tax Notice 2001-45 establishing "basis shifting tax shelters," or shelters used to inflate purchase price to create an artificial loss for the taxpayer, as a listed transaction. This ruling covers such shelters as FLIP (Foreign Leveraged Investment Program) and OPIS (Offshore Portfolio Investment Strategy), two tax sheltering products issued by KPMG.*

*August 2001*
*Shelter participants offered settlement*

*IRS and Treasury offers a settlement program to participants in a shelter known as COLI (Corporate Owned Life Insurance) tax shelters purchased after June 20, 1986. COLI participants can settle if they give up 80 percent of the interest deductions claimed while using COLI plans. COLI participants not yet identified by the IRS will have 45 days to enter into this settlement; those who do not come forward are subject to prosecution by the Department of Justice and IRS.*

*Dec. 21, 2001*
*IRS and Treasury initiate blanket tax shelter disclosure program*

*The IRS announces an amnesty program to allow businesses that admit to and explain their tax-avoidance strategies to the U.S. government by April 23, 2002 to avoid a 20 percent penalty on the tax they underpaid. This amnesty leads to 621 disclosures covering 947 tax returns and $16 billion in lost revenue.*

*March 2002*
*IRS says American taxpayers using credit cards, foreign jurisdictions to evade taxes*

*The IRS reports widespread tax evasions by Americans, who secretly deposit money in tax havens such as the Cayman Islands and withdraw the funds using credit cards. The IRS estimates 1 to 2 million Americans may be using such accounts, although critics challenge the number as being too high.*

*On Jan. 12, 2003, the IRS offers a three-month amnesty to people who admit to using the offshore credit cards if those cardholders provide information about promoters who help set up the accounts. The IRS reports in February 2004 that almost 1,300 taxpayers come forward and that it recovers $170 million in lost tax revenue.*

*June 17, 2002*
*New IRS effort to uncover tax shelter schemes*

*The new policy, which primarily affects returns filed on or after July 1, 2002, allows the IRS to demand that companies and accountants turn over sensitive work papers that can serve as a guide to all the questionable tax strategies a company has employed. Whether or not the IRS makes this request is primarily contingent on whether the abusive transaction was initially disclosed by the taxpayer. "The policy change gets us quickly to the heart of the problem," IRS Chief Counsel B. John Williams says. "We don't have to spend months screwing around with rabbit trails."*

*Summer 2002*
*IRS pursues "summons" strategy*

*The IRS begins to issue summonses to shelter promoters to turn over documentation about their tax shelter products. In July, PricewaterhouseCoopers agrees to provide information and pay a substantial undisclosed payment to the IRS, although the firm does not admit wrongdoing or legal liability.*

*On July 2, 2003, Ernst & Young also complies with the IRS summons and pays a $15 million fine to the IRS for failure to properly register tax shelters or properly maintain lists of customers.*

*On July 8, the Justice Department, on behalf of the IRS, files a lawsuit against KPMG for failing to register several shelter types with the IRS. KPMG argues that the information is protected by accountant-client and attorney-client privilege. The case is still pending in federal court. In December 2003, the Justice Department says KPMG's actions "demonstrate* *a concerted pattern of obstruction and non-compliance, threatening the integrity of the IRS examination process."*

*July 11, 2002*
*Report identifies group of wealthy Americans using abusive tax shelter schemes*

*Within its lawsuit against KPMG, the IRS inadvertently publishes the names of California gubernatorial candidate Bill Simon, his late father and former Treasury Secretary William E. Simon, racecar driver Dale Earnhardt, and many other wealthy Americans as participants in KPMG shelter that uses a Cayman Islands bank to save themselves millions of dollars in taxes.*

*July 26, 2002*
*Companies using offshore tax schemes barred from doing business with U.S. government*

*House Democrats win a 318-110 vote on an amendment to the Homeland Security legislation that bars 10 companies that have relocated their headquarters offshore for tax reasons from doing business with the new agency. Four days later, the U.S. Senate approves a military spending bill by a 95-3 vote, which includes a similar provision.*

*Sept. 25, 2002*
*Commissioner Rossotti says IRS is losing the war on tax evasion due to limited resources*

*Commissioner Rossotti reports discouraging results of the IRS Oversight Board in terms of poor compliance rates with the IRS disclosure policy. Rossotti says illegal tax shelters are getting "much more difficult and time consuming for our agents to uncover. Meanwhile, the size of the IRS declined, not just relatively but in absolute terms, because of budget constraints."*

*Fall 2002*
*Treasury announces amendments, regulations on several tax shelter fronts*

*On Oct. 16 and 17, respectively, the Treasury announces the amendment of Treasury and IRS regulations that creates six new definitions of abusive tax shelters and issues Treasury regulations regarding basis-shifting activities.*

*On Oct. 17, Pamela Olson, assistant treasury secretary for tax policy, alerts the Senate Appropriations Subcommittee on Treasury and General Government to corporate inversion transactions, which involve multinational U.S. corporations switching their headquarters to low- or no-tax countries. On Nov. 12, the Treasury issues disclosure regulations on inversion transaction reporting.*

*On Dec. 30, the IRS and Treasury Dept. propose regulations that prohibit taxpayers from using the advice of a tax practitioner as a defence for not disclosing potentially abusive transactions to the IRS.*

*Jan. 1, 2003*
*IRS authorizes accelerated audit program*

*The IRS authorizes auditors to drop some traditional components of business audits and focus instead on big-ticket items such as tax shelters. IRS Commissioner Mark W. Everson declares that corporate audits, which at that time take an average of 38 months, should be completed in less than half that time. The IRS implemented this program, the Limited Issue Focused Examination (LIFE), in its Large and Mid-Size Business (LMSB) Division on Feb. 7, 2004.*

*Feb. 3, 2003*
*Bush administration proposal to collect back taxes*

*The administration asks for an additional $133 million to pay for private collection agents to collect back taxes which allows the IRS to heighten its focus on businesses that may be using offshore accounts and other methods to avoid taxes. The IRS and the administration project using the private collectors will help raise $1.5 billion over the next 10 years.*

*Feb. 11, 2003*
*New senior executive position within IRS*

*The IRS creates a new job in the Office of Chief Counsel to focus solely on potentially abusive tax shelter transactions. Washington attorney Nicholas J. DeNovio fills this position.*

*May 28, 2003*
*Bush tax cut signed into law*

*President Bush signs into law a $350 billion tax plan. The Washington Post reports on May 30 that the White House and Congressional Republicans are facing criticism over a failure to include proposals aimed at cracking down on tax shelters, accounting scams, and the Bermuda loophole in the tax cut.*

*June 23, 2003*
*Treasury issues new regulation to eliminate tax shelter*

*The Treasury says new IRS rules make clear that the Son of BOSS tax scheme can't be used to create accounting losses for tax purposes. A variation of a similar tax sheltering scheme called BOSS, the Son of BOSS is a complex transaction with several variations, one of which is marked by a taxpayer purchasing and writing economically offsetting options, creating a positive "basis" that is then transferred to a partnership. The investor then claims a tax loss on that transaction when the partnership is sold or liquidated.*

*August 2003*
*IRS loses files of tax evaders*

*According to a report by the Treasury inspector general, the IRS has identified nearly 1,841 businesses that are not withholding taxes or are filing frivolous returns, but only 233 of those businesses have been filed in an IRS database of offenders.*

*Oct. 20, 2003*
*Treasury releases a fact sheet on tax shelters*

*The paper highlights the problems, complexities and abuses of tax shelters. The Senate Finance Committee follows this action with a hearing entitled "Tax Shelters: Who's Buying, Who's Selling and What's the Government Doing About It?". IRS Commissioner Mark Everson testifies that the IRS is committed to curbing illegal activity while offering improved service to customers and protecting taxpayer rights.*

*Nov. 20, 2003*
*Senate Subcommittee on Investigations holds tax shelter hearing*

*The Senate Permanent Subcommittee on Investigations holds a two-day hearing on the role of accountants, lawyers and financial professionals in tax shelters. The hearing features a report by the subcommittee's minority staff that features case studies on four KPMG tax shelters -- FLIP, OPIS, BLIPS, and SC2.*

*Dec. 29, 2003*
*IRS restricts use of opinion letters*

*New regulations strip away the "opinion letter" defence that protects taxpayers from IRS penalties if they are using an illegal tax shelter. Opinion letters are recommendations from professional advisers as to the merits of the transaction.*

*Jan. 7, 2004*
*IRS commissioner announces plans to reshuffle workforce*

*The IRS announces plans to add 2,200 employees to beef up tax enforcement divisions -- including criminal investigators, revenue agents and revenue officers -- by 2005.*

*February 2004*
*Bush 2005 budget proposal allocates funding to curb abusive tax shelters*

*Under the Bush FY 2005 budget proposal, the Treasury Department will receive an increase of $300 million to fund investigations and seek criminal prosecution of tax fraud. The funding will support IRS efforts to expand enforcement resources to target promoters and users of abusive tax shelter products.*