Labour/Management Programme

ECONOMIC EFFECTS OF AND SOCIAL RESPONSES TO UNFAIR TAX PRACTICES AND TAX HAVENS

Report on a meeting of trade union experts held under the OECD Labour/Management Programme (Paris, 14th April 2000)
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# TABLE OF CONTENTS

FOREWORD ....................................................................................................................... 4

AGENDA ........................................................................................................................... 5

DISCUSSION PAPER ........................................................................................................ 6

1.0 INTRODUCTION ........................................................................................................ 6
2.0 GLOBALISATION AND THE RISE OF HARMFUL TAX PRACTICES ...................... 7
3.0 TAX COMPETITION: A COST-BENEFIT ANALYSIS ........................................... 9
4.0 DUBIOUS EVIDENCE: TRENDS IN TAX MIXES AND AVERAGE TAX RATES ..... 12
5.0 REACTIONS BY POLICYMAKERS .......................................................................... 15
6.0 THE ROLE OF THE OECD .................................................................................. 16
7.0 ISSUES TO DISCUSS ............................................................................................ 18

FINAL REPORT ON THE MEETING .............................................................................. 19

BACKGROUND .............................................................................................................. 19
OVERVIEW OF THE ISSUES ....................................................................................... 19
MAIN CONCLUSIONS .................................................................................................. 23

ANNEX I -- TAX HAVENS AND TAX PLANNING -- A PRIMER ................................. 24

ANNEX II -- ECONOMETRIC EVIDENCE ON THE SENSITIVITY OF CROSS-BORDER DIRECT INVESTMENT TO TAXATION ...................................................... 29

ANNEX III -- LIST OF PARTICIPANTS ........................................................................ 33
FOREWORD

Under the OECD Labour/Management Programme for 2000, a meeting of trade union experts on the "Economic Effects of and Social Responses to Unfair Tax Practices and Tax Havens" was held in Paris on 14 April 2000. The meeting was prepared in collaboration with the Trade Union Advisory Committee to the OECD (TUAC).

Below you will find the Agenda for this meeting, along with the Discussion Paper and the overall report of the discussions of the meeting of experts, which were both prepared by Professor Flip de Kam, designated as General Rapporteur for this activity.

THE OPINIONS EXPRESSED AND ARGUMENTS EMPLOYED IN THIS REPORT ARE THE RESPONSIBILITY OF THE AUTHOR AND DO NOT NECESSARILY REPRESENT THOSE OF THE OECD
AGENDA

Overview of the issues

- Globalisation and tax policy.
- Distinguishing between fair and unfair tax practices.
- The response of governments.

The rise of unfair tax practices

- The role of international taxation (source and residence principles).
- The distorting effects of tax havens.
- Effects of financial market liberalisation and emerging technologies on the spread of tax havens.
- New trends in international tax evasion and avoidance.

Economic implications of unfair tax practices and tax havens

- Impact on tax bases and the tax mix; reliance on taxation of capital, labour and consumption.
- Impacts on employment and labour standards.
- Possible constraints on government to deliver social programmes.
- ITF case study on tax havens and maritime transport.

The need for global co-operation in responding to social concerns over unfair tax practices

- Improving co-operation between countries to counter unfair tax practices: the OECD Forum on Harmful Tax Practices.
- The EU Code of Conduct Group and the work of other international organisations.

Roundtable discussion

- The role of trade unions and civil society in consensus building.
- Strengthening trade union input into the OECD Forum on Harmful Tax Practices.
DISCUSSION PAPER

1.0 INTRODUCTION

1.1 Purpose of meeting; scope of paper

This meeting will consider what harmful tax practices are, why it is important that such practices are identified and eliminated and what the current mission of the OECD in this important area is. In particular, the meeting will be asked to consider what the role of trade unions might be in the process of consensus building that harmful tax practices should be redressed, and how trade union input into the OECD Forum on Harmful Tax Practices might be strengthened.

The present paper seeks to inform these discussions by presenting some evidence on the magnitude of tax planning involving the use of tax havens, reviewing negative impacts of unfettered tax competition and surveying current OECD work to counteract harmful tax practices.

1.2 Globalisation and the rise of tax “avoision”

The globalisation of the economy is a dominating feature of the late 20th and early 21st century. Trade and investment liberalisation, and developments in communications and information technology have broken down previously existing barriers between nations and greatly expanded world trade, including trade with multinational enterprises. Globalisation has resulted in increased geographical mobility of labour and capital in particular. Liberalised capital markets enhance the scope for tax planning, (legal) tax avoidance and (illegal) tax evasion. Examples of “tax avoision” include individuals transferring their savings abroad, at little or no cost, to escape or reduce personal income tax in their home country. Companies, too, are often perceived as exploiting the differences in national tax systems, and changing organisational form to minimise their world-wide tax liabilities. Transnational enterprises may try to shift part of the group’s tax base from subsidiaries based in high-tax jurisdictions to subsidiaries in low-tax jurisdictions. To that end, the subsidiary established in the low-tax country may charge high prices and send invoices for a variety of other costs – such as interest and royalties – which reduce taxable profits of the subsidiary located in the high-tax country, while remaining largely or even totally untaxed in the “tax haven”.

1.3 Tax competition

The term “competition” is used most often with reference to firms. Nations can also be said to compete, in a number of areas, and to varying degrees. “Tax competition” refers to efforts among countries to provide a tax environment that is attractive to individuals and business, both becoming increasingly mobile and sensitive to tax differentials. As in trade and other policy areas, not all forms of tax competition are viewed as acceptable by the international tax policy community.

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Indeed, globalisation has induced a number of countries to use taxation policy to attract highly mobile foreign capital and investment. In turn, such developments have encouraged governments of other countries to respond to the resulting erosion of the national tax base by establishing their own preferential tax regimes (“niches”). The introduction of such regimes may not cost the governments involved much in lost revenue, but the effect on other countries can be profound. The most aggressive examples of tax competition between nations are outside the OECD area: tax havens which offer low or zero rates of taxes on income and profits, in combination with bank secrecy and no exchange of information with authorities elsewhere. But within industrialised countries the extension of special regimes and tax niches and defensive responses to the challenge posed by tax havens may have the same effect. In fact, all developed countries have tested some form or another of income tax relief to foster their own competitiveness.

1.4 Harmful tax practices

Globalisation and new electronic technologies have permitted a proliferation of tax regimes designed to attract geographically mobile activities. Harmful tax practices may exist when such regimes are tailored to erode the tax base of other countries. This can occur when tax regimes attract investment or savings originating elsewhere and when they facilitate the avoidance of other countries’ taxes. The OECD has a ministerial mandate to identify and list tax havens, based on criteria established in a 1998 OECD report on Harmful Tax Competition. The work on identifying tax havens is being taken forward by the OECD Committee on Fiscal Affairs and its subsidiary body, the Forum on Harmful Tax Practices. Jurisdictions included on the list of tax havens could be subject to co-ordinated counteracting measures from OECD countries and from other jurisdictions that choose to associate themselves with the principles of the 1998 report. Work by the OECD in this area is surveyed in Section 6 below.

1.5 Organisation of the paper

The paper is organised as follows. Section 2 discusses how the accelerating process of economic globalisation has contributed to a significant rise of transactions involving tax havens and provides some illustrative figures to evidence this trend. Next, Section 3 reviews potential efficiency gains of tax competition and demonstrates why such gains may eventually be wiped out by negative impacts of unfettered tax competition. The analysis in this section draws on a mix of public finance theory and real-world observations to assess the implications of widespread harmful tax practices, focusing on three principal criteria by which the merits of tax systems are usually judged: equity, efficiency and simplicity. Although empirical and anecdotal evidence indicates that especially capital flows are increasingly sensitive to tax rate differentials, some would contend that concerns about the associated erosion of national tax bases of OECD countries are overstated, as indicators of the tax burden on corporations and on capital do as yet not seem to reflect this trend. Section 4 examines the limitations of commonly used tax ratios and points out some pitfalls of relying on these ratios as indicators of the importance of tax haven activity. Section 5 briefly summarises main reactions of tax policymakers in OECD countries to tax practices deemed harmful and stresses the need for a co-ordinated approach once industrialised countries agree to curb such practices. Section 6 highlights recent policy initiatives in this area, focusing on the OECD project to counteract harmful tax practices launched in 1998. The final section of the paper identifies some topics that participants in the meeting may want to select for in-depth discussion.

2.0 GLOBALISATION AND THE RISE OF HARMFUL TAX PRACTICES

The process of globalisation and its acceleration during the 1990’s, while yielding important economic benefits, has significantly increased opportunities for tax avoidance and evasion. For example, recent technological developments have rendered it easy for mutual funds and other investment companies to locate in geographically remote tax havens and yet be in real time communication globally with both clients and securities markets. A rapidly increasing number of individuals can now consider the possibility of tax planning – that is, transferring their savings to tax havens and earning tax-free offshore investment income.
Similarly, advances in data management, telecommunications and transportation technologies have changed the outcomes offered by tax incentives for foreign direct investment. For many activities, in particular services requiring only rented office space, computer and telecommunication equipment and staff, the tax treatment in one location as compared to another can now be the deciding factor in locational choice. The expanding list of mobile business activities includes a variety of financial/risk management, head-office and co-ordination activities, leasing and distribution activities, spanning a wide and growing range of service sectors, notably banking, financing, insurance, telecommunications, and entertainment industries.

Locating savings and mobile business activities in offshore jurisdictions frustrates attempts by home country authorities to tax their residents on income derived from offshore investments and activities. The inability to tax residents on income from capital beneficially owned by them and located in tax havens stems typically from a lack of exchange of taxpayer information between the home country and the tax haven authorities. A background document can be made available to participants which illustrates in general terms some common techniques to shelter income offshore.

Obtaining figures on the amount of business activity being financed through offshore tax havens is difficult. The most comprehensive data to address this question is compiled by the Bureau of Economic Analysis (BEA) of the United States. BEA data show that the percentage of outbound U.S. foreign direct investment channelled through tax haven jurisdictions has grown significantly over the past fifteen years. Fourteen per cent of all U.S. foreign direct investment is now being held through tax haven jurisdictions.

![Chart 1: U.S. Direct Investment Position in Tax haven Jurisdictions](chart.png)

Source: U.S. Bureau of Economic Analysis database.

As noted, determining the total amount of foreign direct investment (FDI) of all OECD countries routed via tax haven jurisdictions is difficult, given the lack of comprehensive data and the specific listing of ‘tax haven’ jurisdictions. However, the available data suggest that the book value of U.S. FDI in jurisdictions that many would consider to be tax havens is currently above $200 billion, and could easily exceed $400 billion when measured at current market value.
Chart 2 considers the growth of foreign portfolio (as opposed to direct) investment, where offshore investment funds now manage in excess of an estimated U.S. $1 trillion in tax-free environments. The number of offshore funds has increased six-fold within less than a decade. Empirical work confirms that tax effects on cross-border direct investment are significant and increasing. A background paper with a review of recent empirical findings can be made available.

3.0 TAX COMPETITION: A COST-BENEFIT ANALYSIS

This section considers the benefits of tax competition, and the negative effects (“costs”) of harmful tax practices. The following analysis draws on a mix of public finance theory and practice to assess the implications of harmful tax practices. In the theory of public finance, there are three principal criteria by which tax systems are judged: equity, efficiency and simplicity. Tax policy choices depend on a balancing of policy goals. It is argued here that there is no compelling line of reasoning that could support deferral or exemption of home country tax on foreign source income earned in the context of tax haven activities.

3.1 Benefits and costs of tax competition

In its early stages, tax competition can lead to efficiency gains. Fiscal pressures linked to tax competition encourage countries to continually assess their tax systems alongside those in other countries, with a view to improve the “fiscal climate”, taking into account not only the tax structure, but also tax administration and taxpayer compliance costs. At the same time, fiscal pressures force countries to assess the expenditure side of the budget equation. Tax competition encourages countries to search for more efficient means of public program delivery and to rethink the appropriate role of government in the provision of services and income-support. This impact is also positive where it eliminates waste and generates efficiency gains through improved resource utilisation. At some point however, increasing pressures to reduce government expenditures, or shift the tax burden to less mobile factors (labour, consumption) can generate net costs to society at large.
Direct and Indirect Costs of Harmful Tax Competition

A number of negative indirect costs (“externalities”) can be linked to the direct costs of harmful tax competition (i.e., domestic tax base erosion linked to capital flight and domestic earnings stripping.) Where base erosion forces a transfer of the provision of services from the public sector to the private sector, efficiency losses may be incurred if the services are more efficiently provided by the public sector (e.g., national defence). Where base erosion forces a reduction in the availability or quality of services provided by the public sector on equity grounds (e.g., health care), or forces a reduction or elimination of transfers from one group to another in society, societal welfare and the desired redistribution of income may be unduly compromised. Similarly, where base erosion leaves a country unable to pay down debts racked-up by previous generations, the inequities of passing the costs associated with this debt onto future generations cannot be addressed. And where payroll taxes must be increased and those taxes are borne by labour, the resulting shift of the tax burden may not be judged to be fair. Or more generally, where a country is forced to rely on less progressive tax bases (e.g., consumption taxes), this may impede the government’s ability to achieve its distributional targets. These negative effects all raise significant efficiency and equity concerns to be addressed.

3.2 Violation of the equity criterion

The equity criterion is concerned with how the burden of taxes used to finance public expenditures should be distributed among individuals in society. This inevitably involves a value judgement of what distribution of the tax burden is “fair”. This value judgement is specified in contemporary society through voting activity and the political mechanism. In virtually all developed countries, residents have long indicated their desire that the tax system be horizontally equitable, treating equals equally, generally with reference to their ability to pay. Thus, horizontal equity requires that a similar tax burden be imposed on individuals benefiting from shared public expenditures who have the same ability to pay.

An outcome where certain individuals share in the consumption of public services (e.g., national defence, law enforcement, infrastructure, educational services) but avoid paying domestic taxes required to finance those services and thus “free-ride” on the fiscal system is clearly unfair. Paying a fair share of the costs of public services demanded by the majority, as voiced through the political process, is the cost of maintaining residency/citizenship in that country. Where levels of public services and taxes do not suit an individual’s tastes, that individual is free to vote for change, or take-up residency somewhere else. The alternative is to pay one’s fair share.

Regimes that allow individuals to avoid domestic tax on foreign-source investment income earned in offshore savings vehicles – through bank secrecy provisions, and/or weak or non-existent exchange of taxpayer information – violate the horizontal equity principle. This follows simply from the fact that such regimes allow individuals to cheat and pay often significantly less tax than other individuals with the same level of income and the same ability to pay who comply and report such income. Similarly, where residents hold equity in domestic corporations which in turn hold controlling or direct investments in foreign affiliates earning passive investment income, equity considerations call for current (as opposed to deferred or exempt) taxation of such income. Satisfaction of the equity criterion therefore requires that the domestic (parent) corporation be taxed on a current basis on its share of the investment income being earned by its foreign tax haven-based affiliate, and that penalty provisions apply to ensure that the income is reported.

3.3 Violation of the efficiency criterion

Under the efficiency criterion, policy-makers are tasked with minimising the efficiency or dead-weight loss associated with the choice of the tax system. In the process, policymakers have to
assess the costs and benefits associated with alternative tax arrangements accruing to society –
individuals, corporations, other business entities, and governments.2

In the case of foreign portfolio investment, investments by individuals in offshore tax haven
regimes can be shown to compromise the efficiency criterion, with too much private investment
capital being allocated to zero/low tax regimes, when judged from the perspective of all residents of
the affected (residence/home) country and not just those benefiting from the tax relief. This inefficient
allocation of resources results from the fact that individuals sheltering funds in offshore investment
vehicles fail to value the contributions that their taxes would make towards financing public services.
That is, tax dodgers do not take into account the social costs they impose on other resident (honest)
taxpayers who must shoulder the tax burden avoided by tax-evaders, suffer a reduction in the level and
quality of public expenditures, or some combination of these (and potentially other) costs.

In the case of foreign direct investment, capital market efficiency achieved through
satisfaction of the capital export neutrality (CEN) condition requires that the combined foreign (host)
and domestic tax rate on foreign source income be the same as the tax rate on domestic source
income.3 Thus regimes that allow firms to shelter earnings from taxation tend to violate the CEN
principle, implying resource (efficiency) losses.

3.4 Violation of the simplicity criterion

In response to tax haven activities, countries are pressured to introduce extensive and
complicated tax legislation to protect their revenue base. Examples include passive foreign income
rules to cover controlled foreign company and passive foreign investment structures, special transfer
pricing rules, thin-capitalisation rules, and other base protection measures. Often companies must
comply with such rules, providing authorities with requisite information on their business transactions,
even where they have not used tax haven structures. This can introduce significant complexity and
cost for taxpayers.

3.5 Negative labour market effects

As noted in Section 3.1, tax competition may pressure governments to shift part of the tax
burden to labour. Many, if not most economists would argue that because labour supply is inelastic,
an increased reliance on taxes on labour will improve economic efficiency because it reduces
economic distortions. An alternative view is defended by Daveri and Tabellini (1997)4 who argue that
observed increases in unemployment and the slowdown in economic growth in Europe stem from a
common cause – the (largely tax-induced) excessively high cost of labour. With imperfect, non-
competitive labour markets, an increase in labour costs reduces labour demand. As companies
substitute capital for labour, the marginal product of capital falls. Over long periods this erodes the
incentive to accumulate capital and thus economic growth. Daveri and Tabelline find strong support
for these mechanisms using evidence from a panel of fourteen OECD countries over the 1965-1991
period. They conclude that in a world with imperfect labour markets, labour taxes not only harm job
growth but can also be as distorting and harmful to growth as capital taxes.

Labour is no homogeneous factor of production. Mobile workers – typically better educated
and higher salaried individuals and members of the liberal professions – are best placed to escape from
increased taxes. As a result, the tax burden on labour will be disproportionately borne by relatively
immobile workers.

Arguments discussed in this subsection may strengthen the determination of national
policymakers to tackle tax avoision by capital owners using tax havens.
3.6 Race to the bottom

In addition, other sources of inequity, inefficiency and complexity tied to harmful tax practices may be identified. In an effort to attract or retain capital attracted to offshore preferential tax regimes, countries may be pressured into introducing special “niche” regimes operating within their (otherwise high-tax) system and targeted at mobile business activities. Over time, pressures would mount to broaden the list of qualifying income to include more and more mobile activities, adding further to income inequalities, capital market distortions and complexities in tax administration and compliance.

Moreover, in an environment where each country struggles to retain investment capital and its tax base, and a co-ordinated tax policy response is lacking, a dynamic is set in play in which countries feel compelled to further enrich their tax incentives each time another country does the same. The outcome is a proliferation of such regimes and a “race to the bottom” as countries struggle to cope in a tax environment gone awry. Such an outcome not only escalates inequities, inefficiencies and complexities – it also threatens the stability of existing international tax agreements, and the growth and prosperity supported by this framework.

3.7 Tax policy: balancing act

Most countries are willing to forego current domestic (home country) tax on undistributed earnings of foreign affiliates of domestic firms. By deferring any additional home country tax on such earnings, this policy helps foreign affiliates of domestic firms compete with rival firms operating in the same foreign markets, placing them on a more level playing field with each firm subject to the same host country tax burden. This policy choice involves a balancing of business “competitiveness” concerns against equity and efficiency considerations calling for current taxation of foreign income at domestic tax rates.

However, it is important to note that recognition of the business competitiveness factor is conditional upon the existence of (non-tax) business reasons for operating in the foreign market in the first place. This follows simply from the logic that equity and efficiency criteria calling for current taxation should not be compromised if the sole reason for operating offshore is simply to avoid current taxation. A real competing societal interest must exist.

In summary, the taxation of foreign active business income of domestic corporations involves a weighing of equity, efficiency and business competitiveness concerns. While the exemption and deferral/credit methods involve a different balancing of these considerations, both approaches presume the existence of legitimate and compelling business competitiveness reasons for operating in the foreign market. (A brief review of the main approaches for taxing foreign source investment income can be provided upon request.) In instances where such arguments cannot be found, the preceding principles suggest that any weight attached to the business competitiveness argument should be dropped, and full respect be observed for equity and efficiency concerns. As already noted, certain financial and service activities involving highly mobile capital can be located in virtually any jurisdiction at negligible cost. In such cases, it is difficult to use business competitiveness arguments to justify reducing the weights attached to equity and efficiency considerations, calling for immediate taxation of such income at rates equal to domestic rates.

4.0 DUBIOUS EVIDENCE: TRENDS IN TAX MIXES AND AVERAGE TAX RATES

Empirical and anecdotal evidence indicate that capital flows are becoming increasingly sensitive to tax rate differentials, with globalisation providing expanded opportunities for taxpayers to plan investments so as to minimise the amount of tax they pay. Yet some would contend that such
concerns are overstated, as income tax paid by corporations measured as a percentage of GDP (or as a percentage of tax revenue) in some cases shows an upward drift in recent years. Also, average (or ‘implicit’) tax rates for corporations and for capital, based on National Accounts data, do not give a clear indication of a significantly reduced tax burden.

This section briefly examines the pitfalls of relying on tax-to-GDP ratios and average (‘implicit’) tax rates, as indicators of the seriousness of harmful tax haven activity. Both indicators, by relying on aggregate data, mask important differences in the effective rate of taxation on income from different business activities and thus are imprecise tax burden measures.

4.1 Assessing trends in tax mixes

Contrary to what is sometimes suggested, tax revenue data reported for OECD countries provide no firm indicators for the magnitude of base erosion tied to tax haven activity. Similarly, these data cannot be used to assess whether the tax burden is being fairly distributed across households and corporations, labour and capital. This is because expressing tax revenues as a percentage of GDP (or as a percentage of total tax revenues) does not address the issue of whether an appropriate level of tax has been paid on the relevant tax base. Thus one cannot assess on this basis, whether the tax mix – or the relative contribution to total tax revenues of each tax revenue source (personal income tax, corporate income tax, employee and employer social security taxes, payroll tax, property tax, taxes on goods and services) is fair.

To take an example, corporate income tax revenues as a percentage of GDP can increase from one year to the next – without a change in tax rates or the definition of taxable income, and despite growth in offshore tax planning – if business profits are larger, or more business is undertaken in an incorporated rather than an unincorporated form, or if the tax is collected more efficiently. In fact, aggregate corporate tax revenues as a percentage of GDP (or as a percentage of total tax revenue) in a number of OECD countries show little change, and in some cases show an upward trend in recent years, despite increasing difficulties in collecting tax on a growing subset of mobile business activities (see Chart 3). This is largely explained because in many countries the share of pre-tax corporate profits relative to GDP has increased (see box).
Holding tax policy constant – i.e., assuming the rules determining corporate tax rates and the tax base are fixed – and assuming unchanged tax practice (administration and compliance), an increase in corporate profit relative to GDP would cause the corporate tax-to-GDP ratio to increase. This result could be mistakenly interpreted as indicating an increase in corporate tax on corporate profits, when the effective tax rate remains in fact unchanged. Among several other problems associated with tax-to-GDP ratios, one is that such ratios include a varying amount of aggregate losses in the denominator (GDP), which should be excluded when measuring the effective average tax rate on profitable firms. In summary, a stable or increasing corporate tax-to-GDP ratio cannot be taken as evidence that difficulties in taxing income from mobile capital are exaggerated.

**Why tax-GDP ratios can be deceptive**

Assume the ratio of corporate income tax revenues to the value of GDP in countries A and B is 2.5 per cent and 5 per cent, respectively. This suggests that tax burdens are higher in country B. However, this need not be the case. If corporate earnings in countries A and B constitute 10 per cent and 20 per cent of GDP, respectively, the average effective tax rate for the corporate sector is 25 per cent in both cases since in country A corporations pay 2.5 per cent of GDP on their profits equal to 10 per cent of GDP, and corporations in country B pay relatively twice as much in taxes on profits that in relative terms are twice as high as in country A.

**4.2 Assessing trends in average tax rates**

It is common place to attempt to assess the relative tax burden on labour and capital, or particular groups of taxpayers by examining average tax rates on labour income, capital income, or more narrowly on income generated at the corporate level. However, one should be careful in drawing policy conclusions from observed average tax rates derived from National Accounts data, even though these tax rates are generally more informative than those calculated as a percentage of GDP or total tax revenues (see Section 4.1). This is primarily due to the fact that the tax revenue and income measures used to calculate such rates are both compiled typically on an aggregate basis, entailing a number of inconsistencies in the coverage of the numerator and denominator amounts. Careful consideration of these measures brings to light several pitfalls in using corporate and capital average tax rates to assess the seriousness of tax haven activity, thus stressing the need to look beyond aggregate data.
Implicit corporate tax rates derived for the economy as a whole include in the numerator aggregate tax revenues collected on corporate income. Corporate operating surplus as reported in the National Accounts enters the denominator. Different from accounting definitions of business profit, operating surplus is measured gross of (that is, including) interest, rent and royalties paid by corporations. This means that expanded use of debt (rather than equity) finance or greater reliance on foreign intangible property, for example, would not affect the denominator, but would lower corporate taxes, as interest and royalties are deductible for tax purposes. Thus one would observe in this case a reduced average tax rate, when in fact both tax policy and compliance had not changed. For these and other reasons, variations in corporate implicit tax rates over time and across countries need not be indicative of tax policy or tax planning developments.

Similarly, while corporate operating surplus is a domestic value-added concept that excludes foreign branch and foreign affiliate income of domestic firms, the numerator includes net domestic tax collected on foreign profits. In this case, the implicit corporate tax rate would increase (reflecting domestic tax on foreign income), with unchanged domestic operating surplus included in the denominator. This could be interpreted incorrectly as a policy adjustment towards a higher corporate tax rate. Note also that if offshore tax planning kept corporate taxes from rising, then in this case the average corporate tax rate would remain unchanged. Again, the result is misleading as it would not capture the true reduction in the effective corporate tax rate (which would be caught if the denominator included domestic plus foreign profit, not simply domestic operating surplus.)

5.0 REACTIONS BY POLICYMAKERS

5.1 Uncoordinated policy action

For the most part, until recently countries have not voiced serious concerns over tax haven activity and the adoption of special tax incentives to attract investment and savings capital. Part of the reason is that capital was less mobile and responsive to tax incentives in the past, and thus the amount of tax base at risk was considerably less. Increasing awareness that the economic impact of harmful tax practices is now significant and rapidly growing has cast views on tax incentives for savings and investment and their use in a markedly different light. Harmful tax practices and their effects, measured in terms of the distortions on cross-border portfolio and direct investment, is a much more pressing issue today than it has been in the past. And it would be prudent to expect a continued trend towards greater sensitivity of capital to tax differentials across competing tax jurisdictions as an ever-increasing set of production inputs and outputs become geographically mobile. This fact has not been lost on policymakers either.

To date, a number of OECD countries have reacted to harmful tax practices by adjusting the tax mix towards less mobile tax bases, including taxes on consumption and payroll. Some countries have also reacted by introducing preferential tax regimes of their own, in an attempt to dissuade capital managers from choosing the tax haven route. However, it is widely recognised by OECD tax authorities today that, just as in trade policy, countries cannot take the position that the setting of national policy is an entirely sovereign issue and expect that the outcome of a non-co-operative tax incentive game will be in their own interest and in the interest of the global community as well.

The weight policymakers now attach to tackling harmful tax practices is seen from the fact that this issue is near the top of the political agenda – with systematic references to the importance of this work in the 1999 G-7 Finance Minister’s meeting in Cologne. The G-7 Heads of State have specifically endorsed the OECD work (refer Section 6.0), calling for an intense dialogue between the OECD and jurisdictions that are found to be tax havens.
5.2 Recognition of the need for a co-ordinated approach

At the present time, to the majority of OECD countries, the most appealing approach is for a co-ordinated effort amongst nations to work within the current international tax framework to address harmful tax practices. The analogy with the observed need for co-ordination of fiscal policies within single countries, between central and sub-central levels of government, is worth making.

Virtually all countries with decentralised taxing powers recognise the need for mechanisms to minimise incentives for capital to migrate to low-tax states or municipalities within the country. This is accomplished in most countries by limiting the amount of decentralisation, and providing the central government with significant taxing power which can be used to collect revenues uniformly across all states/localities that can be then distributed across those states/municipalities and bring about a desired sharing of taxes and expenditures. This has the effect of largely neutralising the distortions introduced when sub-central tax rates differ widely across sub-central levels of government.

At the multi-country level, individual countries have expressed their desire to not give up their fiscal autonomy in the way that sub-central levels of governments are required to in the context of the equalisation structures noted above. This view recognises that an equitable and efficient outcome will not be observed if countries are constrained to public expenditures and revenues set by the lowest common denominator. The equity and efficiency gains from maintaining fiscal autonomy and curbing harmful tax practices can be realised in tandem, but the prescription calls for a different set of instruments to neutralise the effects of harmful tax distortions than under an equalisation structure (which limits rather than protects fiscal autonomy, at the cost of equity and efficiency.) In particular, what is required is a set of co-ordinated measures to eliminate the tax savings offered by harmful tax practices, supported by measures that force taxpayers to take into account the costs of (potential) tax avoision they impose on others.

Finally, it should be pointed out that an equitable, efficient tax result does not require that – and in fact is not obtained where – all countries’ taxing capabilities are pushed to the same level. This follows from the fact that the residents of one country as compared with others can be expected to have different preferences over the direction and level of public outlays, for old age security, infrastructure, national defence, debt repayment and so on, due not only to differences in the current preferences of residents, but to a large extent dictated by past government policies and commitments – e.g., education policies, fiscal and monetary policies. Also, it should be noted that the criterion of capital export neutrality does not require a uniform tax rate across countries, but rather that residents of a given country face the same tax rate on domestic and foreign source income.

6.0 THE ROLE OF THE OECD

6.1 The OECD Report on Harmful Tax Competition

In early 1996, OECD governments initiated a project on harmful tax practices. That project led to the adoption by the OECD Council (Switzerland and Luxembourg abstaining) in April 1998 of a Report and Guidelines on harmful tax practices, entitled Harmful Tax Competition: An Emerging Global Issue. The Report concludes that tax competition is harmful unless it is transparent, non-discriminatory, and aimed at attracting real activities, not just facilitating tax minimisation strategies or the evasion of tax in other countries. The Report also contains nineteen Recommendations to counter harmful tax practices in OECD member countries, in their dependencies, and in non-member economies. The scope of the work is limited to geographically mobile financial and other service activities. This work is being taken forward by the OECD’s Forum on Harmful Tax Practices, a body comprised of representatives of all twenty-nine
OECD Member countries, under the supervision of the main tax committee, the Committee on Fiscal Affairs.

6.2 Criteria for Harmful Practices

All of the Forum’s work involves the identification of harmful tax practices. A harmful tax scheme works principally by limiting the availability of information about the amount or existence of offshore investments. Such schemes give a non-resident beneficial owner of income an opportunity to place that income in a tax-free environment that facilitates the non-reporting of that income to the beneficial owner’s country of residence. These schemes can arise (1) in a jurisdiction that has no income tax system and (2) in the context of a jurisdiction that has a general income tax accompanied by preferential regimes that exempt from taxation or reduce the rate of tax on offshore income. It should be emphasised that a low, no, or nominal tax rate alone would not be seen as constituting unfair tax competition under the OECD’s current work. The jurisdiction should generally also meet one of the following criteria:

i) lack of effective exchange of information;

ii) lack of transparency;

iii) ring-fencing (where there is a substantial domestic economy), or attraction of investment without substantial activities (where the offshore sector dominates the economy).

A “tax haven” is a jurisdiction that meets the above criteria. Jurisdictions that are not tax havens may nonetheless have preferential tax regimes that meet the above criteria of harmful tax practices.

6.3 Implementation

To implement these criteria and counteract harmful tax practices, the Forum is proceeding on three fronts.

1. Harmful Tax Practices of OECD Member Countries

One front involves counteracting harmful tax practices in OECD member countries. The Forum is mandated to draw up a list of harmful preferential tax regimes, and OECD countries that endorsed the Tax Competition Report have agreed to roll-back the identified regimes within five years. Also, these countries have agreed to a “standstill”, that is, not to adopt new measures or to extend the scope of existing measures that constitute harmful tax practices. The Forum is expected to report on harmful tax practices in Member countries at the OECD Ministerial meeting in June 2000.

2. OECD List of Tax Havens

A second front involves jurisdictions outside the OECD area that do not have an incentive to co-operate in the fight against tax poaching. The OECD Report refers to these jurisdictions as “tax havens”, but their definition may differ from that which is normally understood. For the OECD, a tax haven is a jurisdiction that engages in harmful tax practices under the criteria discussed above and that does not have a significant tax base of income beneficially owned by its own residents. In such circumstances, the jurisdiction would have little or nothing to gain from the demise of harmful tax competition. Under the OECD criteria, a tax haven could be a jurisdiction with no income tax (or a nominal income tax system), but it could also be a jurisdiction with preferential tax regimes that are so significant and pervasive that the zero or nominally taxed offshore sector dominates the economy. In either case, the
jurisdiction would have to be engaged in harmful tax practices, under the criteria described above, to be classified as a tax haven.

The Forum is mandated to prepare a list of jurisdictions that meet the criteria of being tax havens. Jurisdictions on the OECD tax haven list could be subject to co-ordinated counteracting measures by OECD member countries. The Forum’s mandate gave a one-year time frame to carry out this work, meaning that the analysis was to be completed by the end of the Forum’s last meeting, in November 1999. The Forum met this mandate, by completing technical evaluations of jurisdictions under the tax haven criteria of the 1998 Report. The Forum’s approach was influenced by extensive dialogue with jurisdictions under review during the last twelve months. All the jurisdictions were invited to in-person consultations with the Forum. During these bilateral contacts, many jurisdictions expressed an interest in a more extended dialogue and in the prospect of making a certain level of commitment to the work. As a result of the Forum’s process, both the OECD and jurisdictions under review have more time to work together, not only to effect change but also to mitigate the economic impact of the transition. No OECD list of tax havens will be made public until after June 2000.

Any jurisdiction that chooses not to work towards elimination of their harmful tax practices could be the subject of co-ordinated counteracting measures by OECD governments (and any other governments that choose to participate).

3. **Associating OECD Tax Outreach Economies**

The third front of action involves other countries and jurisdictions that are part of the OECD outreach in the tax area. The OECD is engaged in a dialogue with outreach partners such as China, Brazil, Argentina, and others, to encourage them to associate themselves with the principles and recommendations of the OECD Report. A high-level meeting with these OECD Outreach Economies will be held in June 2000.

6.4 **Related Work**

The OECD fight against tax poaching is not an isolated one – it is supported and facilitated by efforts underway by other groupings of countries acting towards the same goal. The G-7 Heads of State have specifically endorsed the OECD work and called for an intensification of dialogue between OECD and jurisdictions that are found to be tax havens. Also, the European Union has drafted a Code of Conduct, for consideration by its members, that seeks to eliminate harmful tax practices. The Code of Conduct report identifies potentially harmful regimes in the field of business taxation. Whilst the scope and operation of the EU Code and the OECD Guidelines differ in certain respects, they are broadly compatible and mutually reinforcing.

7.0 **ISSUES TO DISCUSS**

1. Experiences of unions with harmful tax practices.
2. Examples of how unions are addressing the issue of harmful tax practices.
3. The extent to which the interests of unions and government coincide on the need to signal and counteract harmful tax practices.
4. Steps that unions may consider to take to contribute to consensus building on the need to counteract harmful tax practices.
5. Suggestions for work at the OECD to eliminate harmful tax practices.
BACKGROUND

The objective of the meeting was to address capital market inefficiency and tax burden inequity concerns posed by the spread of unfair tax practices, and in particular the operation of tax havens, and to review possible social responses to this challenge. Participants were also to examine how governments and trade union representatives can intensify their co-operation to better respond to these challenges, including a strengthened and expanded role of TUAC in relation to ongoing work of the OECD Forum on Harmful Tax Practices.

For this meeting, participants had received a discussion paper prepared by the Rapporteur, Professor Flip de Kam, Department of Economics of Groningen University.

A full list of participants is attached as Annex III to this report.

The meeting was chaired and opened by Mr. Gosta Karlsson of the Swedish Confederation of Professional Employees (TCO), who pointed out that the tax issues on the agenda for the meeting were apparently important from a trade union perspective. At the same time, the Chair noted that in the past trade union representatives had tended to focus most on other economic and social policy issues, perhaps in part because tax issues are generally viewed as complex and belonging in the exclusive domain of tax specialists. In his introduction the Chair underlined that in his view unions and their representatives – at home and through TUAC – should pay more attention to current efforts of the OECD to counter harmful tax practices and the use of tax havens by transnational concerns and wealthy individuals seeking to minimise their tax obligations. The Chair invited participants to discuss how trade unions might get more involved in this work, in their own countries and by supporting work being done at the level of international organisations.

OVERVIEW OF THE ISSUES

Jeffrey Owens, Head of the OECD’s Fiscal Affairs Division made the first presentation. He explained that the OECD has a long tradition of work in the tax area, including the design and further development of a model tax treaty and guidelines on transfer pricing. Mr. Owens outlined how tax systems of industrialised countries are in certain respects under threat. In a world with liberalised capital markets and greatly improved communications systems, national tax authorities find it increasingly hard to effectively tax capital income. With the rapid rise of electronic commerce, segments of consumer spending also get more vulnerable as a tax base. As a result the tax burden shifts to the least mobile tax bases: wages of lower-paid workers, consumption of goods – as opposed to financial and IT services. The inevitable outcome is that working people pay more through a flatter tax system. Mr. Owens reminded participants that tax administrations operate in an increasingly open environment offering more opportunities for international
financial crime, including tax evasion. Taxpayers have now easy access to tax havens and today the aggressive use of tax shelters is common practice. Mr. Owens pointed out that tax systems have been developed for a world dominated by physical transactions which is currently being replaced by a virtual environment.

He felt it quite understandable that unions are concerned by these trends and identified three potential policy responses: (1) unbridled competition – let markets decide; (2) full harmonisation with a World Tax Organisation setting and enforcing rules of the tax game, or (3) co-ordination. The first option will probably evoke unacceptable negative social effects and the second option is unrealistic, given that countries cherish their sovereignty. This leaves co-ordination as the only practical solution.

The OECD work on harmful tax practices aims to define which legal provisions embody harmful practices and how they may be rolled back. The goal is to work towards a set of international standards, stating what countries can legitimately do, and to agree on what they should not do so as not to erode the tax basis of other countries.

Participants showed some concern that transnational corporations do not fully disclose relevant information in financial statements. The OECD Secretariat pointed out that transnational corporations are required to provide increasingly detailed information to tax authorities in countries where they operate. As a result, the business community is complaining loudly about the heavy burden of compliance costs. On the other hand, exchange of information thus collected between national tax administrations is of vital importance. Currently, this is not always effective due to practical constraints and cumbersome procedures.

Two background documents containing an in-depth discussion of the topics reviewed by Mr. Owens were made available to participants during the meeting. The first paper, on “Emerging Issues in Tax Reform”, addresses a number of complex issues that face tax reformers in OECD countries as they attempt to devise, implement and administer tax systems appropriate for today’s (and tomorrow’s) global economy. The second paper, titled “Tax Administrations in the New Millennium” focuses on changes in the environment within which tax administrations will operate in the next decade, discussing the impact of major social and economic trends such as the rise of the information economy, the liberalisation of markets, an increased dominance of large transnational enterprises and a move towards individualism.

Professor Hugh Ault of the OECD Fiscal Affairs Division then made a presentation of tax provisions that have been developed over the past decades to prevent double taxation of income that is earned in one country (the ‘source’ country) and ultimately accrues to beneficial owners resident in another country (the ‘residence’ country). Since both the source and the residence country have a legitimate right to tax, international tax treaties aim to prevent double taxation which can be an impediment to an efficient allocation of resources. However, tax planning – by using tax havens and niche programmes instituted by industrial countries – increasingly results in situations characterised by double non-taxation. Rules are used and manipulated to create situations where no tax is paid at all. To this end, part of the tax basis is shifted to jurisdictions without tax, without relocation of real activities. The liberalisation of financial markets and rapid technological innovation made it easier to use pockets of non-taxation.

Professor Ault continued by identifying the main properties of a tax system that make a jurisdiction a tax haven:

1. no or only nominal taxation;
2. no exchange of information on income reported in that jurisdiction;
3. ‘ring fencing’ – where the regular system of taxing own people is isolated from a no-tax regime for foreigners who shift income to this jurisdiction;
4. no transparence, i.e. the jurisdiction does not require that taxpayers make certain relevant information available.
Delegates agreed that the tax system must be observed to be fair and that to this end harmful tax practices should be curbed. The Fiscal Affairs Secretariat observed that the equity criterion is defined in a domestic setting and may differ from one country to the next. Similarly, countries may differ in their judgement of how the taxation of corporate income at corporation and shareholder level affects marginal factor productivity and the efficiency of the economy. The OECD work accepts these differences while stressing that countries should follow fair practices with regard to each other’s tax base. The OECD strives to create the framework conditions for this.

Professor Flip de Kam, drawing from his introductory paper, illustrated how harmful tax practices violate the main criteria for a good tax system (equity, efficiency, simplicity) and explained why commonly used indicators of tax burdens – such as tax-to-GDP ratios and implicit tax rates – are not appropriate to test for revenue losses due to harmful tax practices. In response to several requests two background documents would be made available to participants. The first note gives a general overview of tax planning strategies that may be used, under certain conditions, to defer or fully avoid domestic (home country) tax on foreign source income (Annex I). A second note summarises the main findings of recent empirical analysis of the sensitivity of cross-border direct investment to taxation, which shows significant tax effects that are increasing over time (Annex II).

In response to this presentation, Delegates stressed the negative impact of harmful tax practices on vertical equity which becomes more difficult to achieve. It was also broadly recognised that international co-ordination is the only way to counteract such practices as long as harmonisation of tax systems in all relevant jurisdictions remains in the realm of Utopia.

The impact of globalisation and the race to the bottom were examplified by a discussion of special regimes for shipping in a range of industrialised European countries. This exchange of views had been preceded by a discussion of how international co-operation between trade unions has served to address the challenges posed to employment conditions of seamen by the rise of Flags of Convenience (FOC). The representative of the International Transport Workers’ Federation (ITF), Mr. Jean-Yves Legouas presented this case study and a “Note on Flags of Convenience and Tax Havens” was distributed. This document concludes that those countries operating a flag of convenience virtually invariably satisfy the OECD criteria for tax haven jurisdictions. The note supports the fight of the OECD for a better and level fiscal playground.

Professor Hugh Ault started the afternoon session by outlining the institutional structure and current and projected activities of the Forum on Harmful Tax Practices, stressing that the OECD addresses harmful tax competition, not all tax competition. Its goals are to eliminate advantages available only to well-advised taxpayers and to move more closely to a level playing field for business and governments. He also distributed a “Background Note on the OECD Tax Competition Project”.

Participants were first informed about progress with the tax haven work achieved thus far. Representatives of many of the jurisdictions examined have shown an active interest to enter into a productive dialogue with the OECD countries. It is envisaged that a list of jurisdictions which meet the technical criteria for being a tax haven will be published in June 2000. Some jurisdictions that find themselves on that list may nevertheless want to continue the dialogue with the OECD anyway.

The work on potentially harmful preferential regimes in OECD countries resembles the European Union’s Code of Conduct, although there are also some important differences. First, the OECD only addresses mobile financial services, whereas the EU also looks at real investment (“mortar and bricks”). Second, the EU recognises that state aid will sometimes be acceptable. Furthermore, it is important to realise that the OECD spans a wider range of countries whose economies differ more than those of Member States of the European Union.

The document published in November 1999 which identifies regimes violating the Code has not been accepted by the ECOFIN Ministers and is scattered with footnotes that countries disagree with identified regimes. The OECD aims for consensus. Member countries try to agree on a list of special regimes being
potentially harmful, and aim to identify their best practices so that countries who want to adjust their tax rules can follow the example set by others. Once more, transparency is the key word.

The work with non-OECD Member Countries on harmful tax practices has been formalised in three regional meetings in the developing world. These conferences have shown that in many respects developing countries share the concerns of OECD Member Countries about tax havens and a tax race to the bottom.

During the discussion that followed, several among the participants showed some concern as regards the pace of progress made with the project on Harmful Tax Practices. One Delegate wanted ‘hard’ numbers on the scale of tax haven operations. In reply, Professor Flip de Kam explained how difficult it is to get hard data. He referred to some of the data in his paper, while noting that there is scope to increase our knowledge in this area. Another Delegate suggested that the introduction of a Tobin tax on international financial flows – of a speculative character – might solve part of the problem. However, participants recognised that to operate such a tax, close international co-operation of all countries concerned is needed and will not easily be effectuated.

The Fiscal Affairs Secretariat stressed the many substantial steps forward made with the project on harmful tax practices over the past two years. Very important, there is full agreement on matters of principle. Greater international co-operation is part of the nineteen recommendations included in the Report on Harmful Tax Competition. Also, the Report contains a “stand-still” provision which obliges countries to abstain from introducing new preferential regimes. The Forum has been created and a dialogue with 47 jurisdictions earmarked as potential tax havens is underway. Indeed, some tax havens have already indicated their willingness to engage in an effective exchange if information. In the end there will be sanctions for those who do not comply with the rules of the game.

Delegates stressed the importance that tax administrations “get teeth”. Often it seems that tax evaders still have the upper hand. Real co-operation between national tax authorities, better training of tax officials, making better use of available information technology and improving pay and work conditions were suggested as potential strategies to increase the effectiveness of tax administrations. Standardisation of accounting practices and company accounts were also mentioned. In their own countries, unions as social partners should move these issues higher up the societal agenda.

In reply, the Fiscal Affairs Secretariat informed participants about the work of the OECD Forum on Strategic Management which aims to exchange information on best administrative practices between national tax administrations.

Delegates also felt that social partners and the government should promote more actively the idea of citizenship, pointing out that people (have to) pay tax for services provided, while recognising that generally individuals are not too eager to pay more tax. But in a real democracy, free riders cannot be tolerated. At the national level, unions should take the initiative and stimulate the debate on the impact of the lack of tax co-ordination on an equitable distribution of tax burdens. One delegate suggested that unions, through their control over pension funds, might be able to raise concerns about taxpayer behaviour of certain companies in which these funds own shares. Another delegate suggested that trade unions could be more closely associated with the OECD work on harmful tax practices by giving observer status to union representatives.

Delegates urged the OECD to collect more data about revenue gains that can be made as a consequence of curbing harmful tax practices. Such data would show what revenue countries are losing due to low compliance and can serve to fuel the debate, both at home and at the international level. They stressed that unions take no anti-globalisation stand, but want to reinforce tax administrations and increase the awareness that a shift of the tax burden to the least mobile parts of the labour force can – apart from violating the equity criterion – also harm employment prospects.
MAIN CONCLUSIONS

Delegates recognised the importance of the OECD work aimed to curb harmful tax competition. They concluded that TUAC should become more involved in this area, given that tax systems are under threat and that – without international co-ordination – options to tax capital are increasingly limited. Participants felt that the OECD work to weed out harmful tax practices needed full support and that the dialogue between TUAC and the OECD Committee on Fiscal Affairs should be more regular and much intensified. In responding, the Fiscal Affairs Secretariat stressed the great weight that is attached to having inputs from the trade union’s perspective and that full support from civic society is critical for this project to be successful.
ANNEX I -- TAX HAVENS AND TAX PLANNING -- A PRIMER

This annex gives a general overview of tax planning strategies that may be used, under certain conditions, to defer/avoid domestic (home country) tax on foreign source income.

(A) Benchmark taxation of income from capital

As a benchmark, consider the normal operation of OECD country systems for taxing income from capital, as depicted below in Figure I.

![Figure I](image)

Taxation of Operating Company (OpCo) Profits

In the example, profits earned by an operating (e.g. manufacturing) company (OpCo) are subject to tax at source (e.g., in an OECD country in which the firm is resident.) Corporate income tax (CIT) imposed in the source country plays a withholding function, subjecting undistributed OpCo profits to tax. This ensures that the parent company (PCo) shareholders cannot indefinitely defer tax on income on capital beneficially owned by them (i.e., by retaining profits at the corporate level). Distributed profits (i.e., dividends) are subject to tax in the hands of PCo, with typically either a full or partial deduction allowed for dividend received so as to avoid double taxation of income from capital at the corporate level.
Where OpCo is resident in a foreign jurisdiction with a residence-based tax system, ‘gross-up and foreign tax credit’ provisions typically apply. Under this structure, the source jurisdiction is given the first right to tax income generated by OpCo in the source country. Additionally, the home country taxes parent company PCo on dividends received from OpCo, while giving a foreign tax credit in respect of foreign withholding tax and corporate income tax imposed at source, to avoid double taxation. The foreign tax credit is typically limited to the amount of home country tax on the gross dividend receipt, in some cases with foreign tax credit averaging possibilities.

Profits distributed by PCo are subject to personal income tax at the shareholder level, with the degree of integration (tax relief) of home country corporate and personal income tax integration relief dependent on the home country tax system (corporate tax deduction under classical system vs. full or partial integration relief under imputation systems, in some cases with an equalisation tax at the corporate level on distributions, creditable against basic corporate tax, to ensure corporate-level taxation at a rate that is consistent with shareholder credit.)

In short, the normal operation of the international tax framework, taking into account host and home country taxation, ensures that shareholders are subject to tax on income from capital beneficially owned by them, with various arrangements and tax reliefs to avoid double taxation.

Factors affecting PCo/OpCo profit division

Payments to PCo for a loan (with debt capital denoted by B in Figure I) or for the rental of factors of production (e.g., labour services (L), tangible/intangible capital (K), materials (M)) are deductible at source by OpCo, and are included in PCo’s taxable income. Where OpCo is resident in a foreign jurisdiction, gross-up and foreign tax credit provisions apply in respect of withholding tax at source (if any) on these payments. Profits booked in OpCo vs. PCo depend on OpCo’s financing (B/EQ) structure, and prices charged OpCo for debt capital and other factors of production (summarised in Figure I by vector Z.) The exact profit-split is important where OpCo and PCo are resident in different jurisdictions. Exchange of information between tax authorities is necessary to ensure that arm’s length prices are charged and an appropriate division of profit and tax base between jurisdictions occurs.

Taxation of bank profits

Bank profits are realised for the financial intermediation role (capital/risk management) played by banks in the supply of debt capital to PCo. Interest paid by PCo on bank loans is deductible against its tax base, with receipts included in the bank’s taxable income. Interest paid on deposits is deductible against the bank’s tax base, with receipts included in depositor’s taxable income, ensuring (single) taxation of the return on savings. Bank profit (dependent on interest spread and amount loaned) is subject to corporate tax (withholding function), and dividends paid to bank shareholders subject to personal income tax, with the degree of corporate/personal tax integration relief dependent on the home country tax system (classical versus imputation with/without a creditable equalisation tax.) The structure ensures that bank shareholders are subject to tax on income from capital beneficially owned by them, with various possible relieving provisions to avoid double taxation.

(B) Separation of intermediary functions

Consider now the implications of a separation of certain intermediary functions from PCo. The intermediary corporation (INT) may act as holding company (making equity investments in lower-tier operating subsidiaries, receiving and reinvesting dividends), provide group (debt) financing and/or other co-ordinating functions, such as the purchase/rental of intangible capital, or purchase/sale of intermediate goods. It is important to note that the profits of INT, including OpCo profits, are beneficially owned by PCo shareholders.
Figure II examines the case where INT and OpCo are resident in different jurisdictions. OpCo may reside in same jurisdiction as PCo, or in a third jurisdiction.

Treatment of OpCo profits

OpCo profits are subject to tax at source – possibly at a low effective tax rate due to special tax preferences/relief (e.g., R&D tax credits.) Distributed profits are possibly subject to tax in the hands of INT in the (host) jurisdiction in which INT is resident.

Benchmark case – effective information exchange between tax authorities in countries in which PCo and INT are resident, enabling PCo country tax authorities to apply controlled foreign corporation (CFC) rules to undistributed INT profits, and to tax dividends paid by INT to PCo.

Tax haven case – lack of effective exchange of information between two countries, frustrating the ability of tax authorities in the country in which PCo is resident from taxing income from capital beneficially owned by PCo shareholders. Tax base erosion on account of several factors:

- inability to apply CFC rules on CFC-targeted income of INT;
- non-reporting of dividends received by PCo paid out of OpCo profits received by INT;
non-arm’s length transfer prices on debt, labour services, tangible/intangible capital, intermediate inputs supplied by PCo to INT, and on-loaned to OpCo; and

interest deduction by PCo on funds borrowed to capitalise OpCo, through INT, with the deductible interest taken against domestic source income.

**Result:** Inability to tax income from capital beneficially owned by PCo shareholders, due to lack of effective exchange of information (note that proper result does not require taxation of income at INT level.)

(C) **Offshore banking centres**

Consider the possible implications of offshore banking centres. The illustration in Figure III considers the case where the parent bank (Bank I) is resident in the same country as PCo. Bank II, a subsidiary (or branch) of Bank I is located in another jurisdiction (e.g., an offshore financial centre.)

![Figure III](diagram.png)

**Treatment of bank profits**

In the example, Bank I on-loans deposits to Bank II, which in turn loans funds to PCo. Interest paid by PCo on the bank loan is deductible against PCo profits, with interest receipts included in Bank II’s income. Bank II earns a ‘turn’ on the loan, with the profit on the loan determined by the interest spread (the difference between the rate charged by Bank II, and the rate charged to it by Bank I) and the amount loaned. Bank I may also take a turn on the loan. Bank II profits may or may not be subject to tax in the host jurisdiction. Interest paid by Bank I to depositors enters the taxable income of individual savers.
Benchmark case – effective exchange of information between the tax authorities of the jurisdictions in which Bank II and Bank I are resident, enabling Bank I tax authorities to a) apply CFC rules to CFC-targeted undistributed Bank II profits; b) tax Bank I on dividends received from Bank II; and c) determine whether arm’s length interest rates are charged to Bank II, to ensure a proper allocation of profit to Bank II consistent with its activity/value-added. Profits distributed to Bank I shareholders, derived from capital beneficially owned by them, are subject to personal income tax (classical or integration treatment.)

Tax haven case – a lack of effective exchange of information between tax authorities, frustrating Bank I authorities from taxing Bank I shareholders on income from capital. Tax base erosion on account of several factors:

- inability to apply CFC rules to CFC-targeted income of Bank I;
- non-reporting of dividends received by Bank I from Bank II;
- non-arm’s length transfer prices on debt and factors of production (e.g., labour services, intangible capital) supplied by Bank I to Bank II; and
- interest deduction by Bank I on funds borrowed to capitalise Bank II, with deduction of interest taken against domestic source income.

Result: Inability to tax income from capital beneficially owned by Bank I shareholders, due to lack of effective exchange of information.
ANNEX II -- ECONOMETRIC EVIDENCE ON THE SENSITIVITY OF CROSS-BORDER DIRECT INVESTMENT TO TAXATION

This annex briefly summarises the main findings of recent empirical analyses of the sensitivity of cross-border direct investment to taxation, which find significant tax effects that are increasing over time.

The empirical work focuses on direct investment broadly defined, and does not isolate the tax sensitivity of financial services and related business activities. The aggregate approach is driven by the restriction that the empirical data are typically compiled in a highly aggregate form, and do not provide separate measures at a detailed sector/business activity level. Given that certain business sectors/activities (e.g., holding company services) tend to be more geographically mobile than others (e.g., resource activities, capital-intensive manufacturing), the tax elasticities found for broad measures of direct investment covering many different forms of business activities can be taken as lower bound estimates of the tax elasticities for more mobile activities.

A second observation is that, even in the most recent empirical work, the data are several years old or more, and therefore the findings may further understate the sensitivity of direct investment to differential tax treatment today, to the extent that the ongoing process of globalisation means increased tax sensitivity over time.

Early empirical investigations of the impact of host country tax incentives on inbound FDI – which generally find significant positive effects of host country after-tax rates of return and negative effects of domestic (home country) after-tax rates of return (see Hartman (1981, 1984, 1985), Boskin and Gale (1987), Newlon (1987), Slemrod (1990)) – suffer from a number of modelling and data measurement problems that render the empirical results questionable.

More recent studies of the effects of taxation on direct investment flows focusing on (outbound) U.S. direct investment abroad (DIA) have exploited both time series and cross-sectional data. Given that DIA is subject to multiple host country tax regimes, allowing for variation in host country data both across countries and over time, empirical analyses of DIA are generally better suited to identify host country tax effects.

Grubert and Mutti (1991) and Hines and Rice (1994) take advantage of cross-sectional data prepared by the U.S. Bureau of Economic Analysis (BEA) in its 1982 benchmark study on U.S. direct investment abroad. The disaggregation of U.S. DIA into various host country recipients improves prospects for the identification of host country tax effects, as noted above. In addition, the data provide balance sheet information on U.S.-owned property, plant and equipment (PP&E) in 1982. In contrast to empirical work relying on financial flows investment data, studies focusing on PP&E enable a more targeted approach to the assessment of tax effects on real investment capital.

Grubert and Mutti (1991) analyse the distribution of the PP&E capital of manufacturing affiliates across 33 host countries by regressing the log of the end of previous year net PP&E stock on two average tax rate measures. The first regression using a natural log of one minus the average tax rate (ATR) gives a constant tax elasticity of 1.5 based on data on all manufacturing affiliates of U.S. parents, and a value of 2 for majority-owned manufacturing foreign affiliates. However, the coefficients are not found to be statistically significant. The second specification using the inverse of the tax rate produces a highly significant tax
PAC/AFF/LMP(2000)5

coefficient (-0.11). This estimate suggests that halving the host country ATR from 20 to 10 per cent would increase the stock of U.S. direct investment abroad in the host country by 65 per cent.

Hines and Rice (1994) use a larger data set than Grubert and Mutti (1991), considering all majority-owned non-bank affiliates of non-bank US parents, which draws into the sample a total of 73 host countries. The inclusion of affiliates in all industries (not just manufacturing) and more host countries than in the study by Grubert and Mutti (1991), including 41 tax havens with little physical capital, may explain their finding of a greater tax response. They report a statistically significant coefficient on their ATR variable of –3.3. This estimate suggests that at the mean ATR of 31 per cent, a one percent increase in after-tax returns generates a 2.3 per cent increase in the PP&E stock of U.S. affiliates.

One of the most recent analyses of the effects of host country taxation on the investment location decision of U.S. multinationals is Altshuler, Grubert and Newlon (1998). They use information from the U.S. Treasury corporate files giving balance sheet and income statement data for two years (1984 and 1992), for 58 host countries. The use of two years of data permits a test of whether U.S. DIA has become more responsive to host country taxation over time, and also allows for a control over unmeasured host country fixed effects. As with the studies by Grubert and Mutti (1991) and Hines and Rice (1994), the focus is on the effect of host country taxation on locational choice, not on the choice of investing at home or abroad.

The main host country tax explanatory variable used in the investment equation is the natural log of one minus an averaged average tax rate (ATR) variable. The ATR variable, based on subsidiary-level (controlled foreign company) data aggregated up to the country level, is derived by dividing total host country income taxes paid by a total earnings and profits measure meant to capture net economic income (as opposed to taxable income as defined by host country or U.S. tax rules). To smooth out business cycle effects, current period ATRs are averaged with ATRs of the previous two even years. To control for non-tax factors that may impact on locational decisions, the authors also include as explanatory variables the natural log of host country gross domestic product (GDP), the natural log of host country population, regional dummies, and a trade regime variable to control for the degree of openness of the host country economy.

The basic investment equation used by Altshuler, Grubert and Newlon (1998) is as follows (see the bottom of this annex for the derivation):

\[
(\ln K_{j92} - \ln K_{j84}) = c + \beta_{92} (\ln(1-\text{ATR}_{j92})-\ln(1-\text{ATR}_{j84})) + \beta_{\text{diff}} \ln(1-\text{ATR}_{j84}) + \gamma (Z_{j92} - Z_{j84}) + \lambda \text{TRADE}_j (\ln(1-\text{ATR}_{j92})-\ln(1-\text{ATR}_{j84})) + \nu_j
\]

where \( \beta_{\text{diff}} = \beta_{92} - \beta_{84} \).

The main empirical results can be summarised as follows. The estimate for \( \beta_{92} \), measuring the tax elasticity for 1992 is positive at 2.8 and statistically significant. Note that the tax elasticity gives the percentage change in the end of prior year DIA stock (depreciable assets plus inventories) resulting from a one percent increase in the after-tax rate of return (measured by one minus the ATR for 1992). The implied estimate for \( \beta_{84} \) (given by the difference between \( \beta_{92} \) estimated at 2.77 and \( \beta_{\text{diff}} \) at 1.24) is 1.5, which is also found to be statistically significant.

Finally, the authors experiment with alternative investment equation specifications (e.g., lagged ATRs are tested, and the ATR variables are tested in linear form as in Hines and Rice (1994)), and find that the tax coefficients remain positive and statistically different from zero at the five percent confidence level or higher. At the mean tax rates for 1992 and 1984, the coefficients under the linear investment equation specification imply that a one percent increase in the ATR in a country would on average increase the real capital stock by 1.7 per cent in 1984 and 3.2 per cent in 1992.
The results of this recent work indicate that the location of real capital by manufacturing firms is sensitive to taxation and has become more so over time. The authors point out that this finding is consistent with the increasing international mobility of manufacturing capital and globalisation of production, and with earlier empirical work finding significant tax effects.

In summary, recent empirical work relying on improved data sets and estimating models finds statistically significant tax effects. Given that the nexus between business activity and geographical location tends to be more of an important element in the context of manufacturing activities compared with financial service activities, it would seem reasonable to conclude from the findings that the tax sensitivity of FDI in the tax haven context is even greater than that implied by results focusing on manufacturing data. Moreover, the empirical results tend to confirm the increasing tax sensitivity of FDI over time.

**Derivation of the investment equation used by Altshuler, Grubert and Newlon (1998)**

The basic investment equation used by Altshuler, Grubert and Newlon (1998) shown above, used to explain U.S. direct investment abroad into the host countries indexed by \( j \), is as follows:

\[
\ln K_{jt} = \alpha_t + \beta_t \ln(1-ATR_{jt}) + \gamma Z_{jt} + \lambda \text{TRADE}_j \ln(1-ATR_{jt}) + \epsilon_j
\]

Under this specification, the investment equations for the two years of data (1992, 1994) are:

\[
\ln K_{j92} = \alpha_{92} + \beta_{92} \ln(1-ATR_{j92}) + \gamma Z_{j92} + \lambda \text{TRADE}_j \ln(1-ATR_{j92}) + \epsilon_{j92}
\]

\[
\ln K_{j84} = \alpha_{84} + \beta_{84} \ln(1-ATR_{j84}) + \gamma Z_{j84} + \lambda \text{TRADE}_j \ln(1-ATR_{j84}) + \epsilon_{j84}
\]

Differencing these equations gives:

\[
(\ln K_{j92} - \ln K_{j84}) = c + \beta_{92} \ln(1-ATR_{j92}) - \beta_{84} \ln(1-ATR_{j84}) + \gamma (Z_{j92} - Z_{j84}) + \lambda \text{TRADE}_j (\ln(1-ATR_{j92}) - \ln(1-ATR_{j84})) + \nu_j
\]

Rearranging terms gives the following estimated investment equation shown on the previous page.

\[
(\ln K_{j92} - \ln K_{j84}) = c + \beta_{92} \{\ln(1-ATR_{j92}) - \ln(1-ATR_{j84})\} + \beta_{diff} \ln(1-ATR_{j84}) + \gamma (Z_{j92} - Z_{j84}) + \lambda \text{TRADE}_j (\ln(1-ATR_{j92}) - \ln(1-ATR_{j84})) + \nu_j
\]

where \( \beta_{diff} = \beta_{92} - \beta_{84} \).
REFERENCES


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ENDNOTES

1 Tax systems can also be assessed in terms of vertical equity. The vertical equity criterion is concerned with how to treat persons with different abilities to pay (with ability to pay – comprehensive income – typically used as a proxy for an individual’s welfare/utility, as in the horizontal equity case), and also involves a value judgement. Residents in many developed countries have expressed (through majority voting) their desire to tax resident individuals on a progressive basis, on the view that individuals with higher incomes, and thus higher abilities to pay, should pay proportionately more of their income in tax. This view is supported by the “utilitarianism” principle that society should aim to maximise the sum of utilities/welfare of all individuals, implying an equal distribution of (after-tax) income. While tax relief from the avoidance of domestic tax on offshore passive investment income accrues mainly to higher-income individuals, violating standards of vertical equity calling for progressive taxation, the focus in the text is on the horizontal equity principle, given its virtual universal acceptance. Where residents of a given country voice through the political process their desire for a progressive tax result, the existence of “harmful” tax regimes can be said to violate both horizontal and vertical equity.

2 Analyses of dead-weight losses (welfare costs) are based on an assessment of gains and losses in consumer surplus, producer surplus and government revenue under alternative tax structures through their differential effect on resource allocation.

3 Under this condition, in a competitive market pre-tax rates of return will be equalised. At this point, reductions in capital employed in one jurisdiction, accompanied by a corresponding increase in capital employed in another, will not result in an overall net efficiency gain, implying no net increase in gross investment returns over investment costs at the margin.


5 To protect the domestic tax base, the regimes may be targeted at non-residents only in order to restrict the application of reduced tax rates to the income of non-resident investors (and not host country investors, so as not to diminish the host country tax base). Another observed practice is to target the tax relief to cross-border transactions alone (i.e., impose low/zero tax rates on cross-border receipts from parent corporations as payment for headquarter/co-ordination/financing services provided by its offshore affiliate.) Imposing low/zero tax rates on such income erodes the tax base of the high-tax jurisdiction of the parent. Denying the low/zero tax rate on receipts from other firms in the host country for services provided protects the host country tax base (i.e., avoids a host country deduction from the payment that exceeds the host country inclusion from the receipt.)

6 On the portfolio investment side, in the past a relatively small number of wealthy individuals had access to secret bank accounts and offshore tax havens (due to high fixed and variable costs of tax planning, which have come down with information technology advances and increased competition in the financial services field) – a situation which fed perceptions of inequity in the tax system, but generally did not significantly threaten the revenue raising abilities of countries. The use, by any given country, of incentives to attract foreign direct investment was also largely accepted in the past by other countries competing for economic activity and the associated tax base, given that virtually all countries were in the tax-incentive game, thus making it difficult to cry foul play. In addition, tax incentives were judged by many, either rightly or wrongly, to be ineffective in influencing global investment patterns. Foreign direct investment decisions were seen to be driven primarily by real economic considerations. Where government policy affected these decisions, it was often more in the way of impeding rather than encouraging foreign direct investment, either through regulatory restrictions, exchange controls or other policy impediments.

7 For a listing of preferential tax regimes in EU countries, see the report of the Code of Conduct group on business taxation (Primarolo group) submitted to the ECOFIN Council on 29 November 1999 (see http://ue.eu.int/newsroom under “miscellaneous”.)
Under a “pareto-optimal” allocation of resources, a given (pure) public good/service is supplied up to the point where the marginal cost of supplying the last unit of that good/service, in terms of private goods foregone, just equals the sum of the marginal benefits that all users of the increment obtain (the Samuelson condition.) Under the assumption that competitive producers satisfy production efficiency conditions (follow marginal cost pricing), this efficiency condition can be interpreted in terms of marginal benefits and costs. In particular, at the optimum level of a given pure public good/service, the sum of the marginal benefits to all individuals from that good/service justs equals the marginal cost of producing it. Where harmful tax competition restricts the satisfaction of this condition by limiting the ability of government to raise the funds required to finance the desired level/quality of public good/service, an inefficient outcome is observed.

On the other hand, empirical analyses of (inbound) foreign direct investment are generally better suited to identifying home county tax effects. However, gathering consistent data on relevant home county taxation, taking in to account financing structures, is a relatively more difficult task.

The PP&E data are not, however, without difficulties. First, the asset measures are based on historical book values, rather than current price or market values. Second, the end-of-year depreciable assets reported by foreign affiliates resident in a given host jurisdiction may not be located in that jurisdiction. This problem is particularly important in the case of holding company and financial foreign affiliates located in tax havens.

The definition of reported earnings and profits set by the US Internal Revenue Code closely matches book income.

The trade regime variable, which ranges from 0 (most open) to 3 (most restrictive) developed by the World Bank is based on observations of (I) the host country’s effective rate of protection, (ii) its use of direct controls (e.g., quotas); (iii) its use of exports and (iv) the degree of overvaluation of its exchange rate.

The authors also run separate single year cross-sectional equations. The estimated coefficient on the log of one minus the ATR for 1992 (measured as the average of ATRs for 1992, 1990 and 1988) is positive and statistically significant at 2.7. This estimate is referred to as the ‘open regime’ elasticity estimate (where the TRADE variable takes on a value of zero.) On the other hand, the estimated tax coefficient in the 1984 tax equation is found to be positive, but not statistically significant. The trade regime variable is found to be highly significant and negative, indicating reductions in DIA accompanying increased trade restrictions.