Abstract – The recent uncovered cases of tax evasion in the European Union and the United States have revived the fight against harmful tax practices and spurred impressive progress in the adoption of international standards on information exchange. This paper reviews the theoretical and empirical literature on harmful tax practices and information exchange on the size and consequences of the existence of tax havens and harmful tax regimes. The paper also describes the multilateral approaches developed by the Organisation for Economic Co-operation and Development (OECD) and the European Union and examines recent developments in fighting harmful tax practices.

I. INTRODUCTION

The recent Liechtenstein and UBS tax affairs have put the topic of harmful tax practices under the spotlight. In the first case, the German secret service secretly bought a compact disc in 2006 containing information about hundreds of individuals evading taxes in Germany (and in other jurisdictions it appears) through the use of anonymous Liechtenstein-based trusts. This led in February 2008 to various raids—publicized by the press—against a number of individuals and, as a consequence, to a large number of confessions of tax evasion to the German tax authorities. In the second case, the U.S. Internal Revenue Service, aided by a whistleblower investigated an alleged case of tax evasion facilitated by the Swiss bank UBS that involves tens of thousands Swiss bank accounts held by wealthy U.S. citizens. Facing the threat of losing its charter to operate in the United States, in August 2009 UBS agreed to pay a fine of $789 million and to disclose the identity of (some of) the incriminated account holders as part of a settlement. In addition, these events have occurred during a period of severe global economic crisis that is forcing governments to seek additional revenues to ease their fiscal problems. These events led politicians in many countries to decide that “enough is enough” and that more political pressure should be put on fighting tax evasion. Even if tax havens are not at the root of the financial crisis, dealing with them is increasingly seen as part of the solution.

Toward this end, the leaders of the G-20 countries issued a statement on April 2, 2009 declaring that they “agree to take
action against non-cooperative jurisdictions [that they are ready] to deploy sanctions [and that] the era of bank secrecy is over” (Organisation for Economic Co-operation and Development, 2009, 18). This has led to astonishing developments as many jurisdictions around the world have adopted international standards for information exchange, in particular all “uncooperative” tax havens are now committed to these standards. This paper reviews these recent developments at the OECD and EU levels and assesses them in the light of the economic literature on harmful tax practices.

The remainder of the paper is organized as follows. Section II defines harmful tax practices and reviews the rationales for counteracting them. It also takes stock of the existing theoretical and empirical economic literature on the economic characteristics and consequences of these practices. Section III examines the history and the recent developments of policy actions at both the OECD and EU levels, notably the Harmful Tax Competition projects and the EU code of conduct and other initiatives. Conclusions are presented in the final section.

II. THE ECONOMIC LITERATURE ON HARMFUL TAX PRACTICES

A. Harmful Tax Practices and Capital Export Neutrality

The term “harmful tax practice” is a loose and subjective concept. In this paper, it is defined as setting tax policies to intentionally try to attract a mobile tax base, usually in a non-transparent way or by using unusual tax regimes. Such policies usually contain no or low taxation but this alone is not sufficient; other features, including non-transparency, ring-fencing of mobile activities, or other unusual features are also required. This covers, for example, regimes that are only avail-
in all locations. Such a tax structure is consistent with the concept of production efficiency advocated by Diamond and Mirrlees (1971) since it does not distort the international allocation of investment. The Diamond and Mirrlees (1971) production efficiency theorem, however, is not exempt from criticism, both from theoretical and practical perspectives. Keen and Piekkola (1997, 448–450) argue that the theorem rests on the critical assumption that “any pure profit can be fully taxed and that there are no restrictions on either the distorting tax instruments that can be deployed or the use of intergovernmental transfers” and, when this is not the case, the optimal system depends on elasticities of demand and supply for capital and on the tax rates at which pure profit is taxed. Keen and Wildasin (2004) show that the Diamond and Mirrlees theorem rests on the assumption that there is a single (joint) budget constraint and that global welfare is maximized. This condition, however, does not necessarily hold if every country has its own domestic budget constraint and if there are no lump sum transfers between governments. More recently, Devereux (2008, 3) states that in a real-world situation, “… all traditional forms of taxation would be distorting unless they are completely harmonised.” Nevertheless, capital export neutrality remains a common benchmark against which to assess the efficiency aspects of international tax systems. That said, a residence-based tax system is considered to be impractical by some authors because it requires domestic tax authorities to have information on revenues generated abroad, and it is not in the interest of countries practicing harmful tax practices to provide such information (Tanzi and Zee, 2001). Finally, it is equally interesting to notice that while economists see the problem of harmful tax practices through its efficiency aspects, policymakers seem to be at least equally focused on equity aspects. For example, the G-20 Statement on Transparency and Exchange Information for Tax Purposes in Berlin in November 2004 indicates that “… the Finance Ministers … regard [information exchange] as vital to enhance fairness and equity in our societies and to promote economic development” (Organisation for Economic Co-Operation and Development, 2009, 21). This concern has gained importance at a time of increased revenue needs following the financial crisis.

B. Tax Havens and their Economic Importance

Most harmful tax practices are closely linked to the existence of so-called “tax havens.” A formal definition of tax haven that goes beyond a reputation test was given by the Organisation for Economic Co-Operation and Development (1998, 22), which defined a tax haven as a jurisdiction that “… imposes no or only nominal taxes (generally or in special circumstances) and offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape tax in their country of residence.” The absence of a significant level of taxation is a necessary but not a sufficient condition, as a jurisdiction must satisfy several other criteria before it is black-listed as a tax haven. These criteria include a lack of effective exchange of information, a lack of transparency in its provisions, and the

---

1 Alternatively, capital import neutrality ensures that the rates of return on all investment in the same location are the same regardless of the country of origin of the investor. This corresponds to source-based taxation.

2 Actually, it is unclear whether capital export neutrality is always endorsed by policymakers. For example, residence-based taxation is not actively promoted in the case of dividend taxation, for which withholding taxes seem to be accepted instruments despite the potential double-taxation problems they create.
absence of a requirement that the activity of firms be substantial. Based on this definition, the Organisation for Economic Co-Operation and Development (2000) issued a list of 35 jurisdictions classified as tax havens. Given the inherent subjectivity of criteria, several other authors have come up with different definitions, but the bottom line is that tax havens are jurisdictions that offer favorable tax regimes and a relatively high degree of secrecy for investors.

The characteristics and economic effects of tax havens have been studied by several researchers. Dharmapala and Hines (2006) analyze the 41 tax haven jurisdictions listed in Hines and Rice (1994) and find that countries labeled as tax havens are usually small in size and population, are more likely to be islands and located near large capital exporting countries, have homogenous populations, are poor in natural resource endowments, and are likely to be of British legal origin and use English as an official language. Interestingly, such countries are also likely to have high levels of GDP per capita and, even controlling for their wealth, to score high on governance indicators (political stability, rule of law, control of corruption, effectiveness of the government, and accountability). It appears that good governance is a necessary condition for a favorable tax regime to be credible in the eyes of capital exporters. Finally, the authors find that the levels of taxation and government expenditure relative to GDP are comparable to those of non-tax havens.

Tax havens have also grown substantially and represent non-negligible parts of the world economy. Hines (2007) reports that real GDP in tax havens grew at a 3.3 percent rate over the period 1982–1999, compared to 1.4 percent for the rest of the world. In 1999, tax havens’ combined share of the non-U.S. world population was only 0.8 percent, but their share of GDP was 2.3 percent. Hines also finds that while tax havens accounted for a relatively modest share of foreign property, plant and equipment and of foreign employees of U.S. multinationals (about 6 percent and 8.5 percent, respectively), their share in foreign sales and net income were 15.7 percent and 30.0 percent, respectively. In addition, 59 percent of U.S. multinationals with significant foreign operations had affiliates in tax havens (Desai, Foley and Hines, 2004). Finally, the most recent estimates put capital held offshore in the range of $5–7 trillion; although not all of this amount reflects tax evasion, the large revenue intakes from recent policy initiatives such as tax amnesties or measures to uncover tax evasion suggests that tax evasion in tax havens is far from negligible (Owens, 2007).

3 Those jurisdictions were Andorra, Anguilla, Antigua and Barbuda, Aruba, The Bahamas, Bahrain, Barbados, Belize, British Virgin Island, Cook Islands, Dominica, Gibraltar, Grenada, Guernsey, Isle of Man, Jersey, Liberia, Liechtenstein, the Maldives, Marshall Islands, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, Samoa, Seychelles, St Lucia, St Kitts and Nevis, St Vincent and the Grenadines, Tonga, Turks and Caicos, US Virgin Islands, and Vanuatu. Six additional jurisdictions fulfilled the criteria but were not included in the list because they committed to eliminating their harmful practices before publication of the list. Those six jurisdictions are Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and San Marino (Owens and Sanelli, 2007). Note that the OECD list was reduced to seven “uncooperative” tax havens in 2002 and eventually to zero in May 2009.

4 Such alternative classifications can be found in Hines and Rice (1994), Zoromé (2007) or Tax Justice Network (2007). The two latter papers broaden the definition of tax havens to include jurisdictions with offshore financial centers whose activities are large compared to the domestic economy.

5 Dharmapala (2008) provides an excellent survey of this literature.

6 Note that the Diamond and Mirrlees (1971) theorem also explains why small open economies may become tax havens in the absence of economic rents as it is optimal for them not to tax foreign investors, a point stressed by Gordon (1986) and Dharmapala and Hines (2006).
C. Harmful Tax Practices Involve the Establishment

Harmful tax practices that involve the establishment by some countries of preferential tax regimes designed to attract footloose companies, passive investments, or paper profits. Those measures are the target of both the OECD work on harmful preferential tax regimes and of the EU code of conduct on business taxation. The OECD applies four key factors to identify such practices (Organisation for Economic Co-Operation and Development, 1998): (1) a low or zero effective tax rate on such income, (2) a tax regime that is “ring-fenced,” that is, at least partly insulated from domestic markets, (3) a tax regime that is non-transparent, and (4) a lack of effective exchange of information. In addition, the OECD also uses an array of other criteria such as whether the tax base is artificially defined, the country adheres to commonly accepted transfer pricing rules, full exemption is applied to foreign-source profit, the tax base or tax rate is negotiable, there are secrecy provisions, there is a wide network of tax treaties allowing treaty-shopping, and the regime is flagged as tax minimizing or encouraging operations that are purely tax-driven.\footnote{OECD (1998) provides a detailed description of these factors.}

Based on these criteria, the Organisation for Economic Co-Operation and Development (2000) identified 47 regimes that were potentially harmful.

The European Union has a similar approach, characterizing as harmful tax regimes that offer low or zero taxation and satisfy at least one of five criteria (Council of the European Union, 1999): (1) the tax advantages are for non-residents only, (2) the regime is ring-fenced, (3) the advantages are granted despite the absence of real economic activity, (4) the rules for computing the tax base depart from generally accepted practices, and (5) a lack of transparency. The European Council (1999) identified 66 measures that were potentially most harmful. Both institutions work exclusively on the tax systems of their Member States but whereas the OECD focuses on internationally mobile activities, the EU code of conduct in principle covers all economic activities.

D. Economic Effects of Harmful Tax Practices

The economic effects of tax havens and of preferential regimes for mobile income are the subject of an intellectual debate in the literature between the partisans of the thesis that tax havens are parasitic and detrimental because they increase tax competition and incur enforcement costs for other countries, and the disciples of the thesis that tax havens may tame tax competition and increase efficiency by allowing non-tax havens to keep high tax rates on immobile firms while allowing mobile firms to benefit from preferential regimes.\footnote{Dharmapala (2008) provides a thorough description of the arguments.}

Slemrod and Wilson (2006) construct a model of tax competition with parasitic tax havens and show that removing preferential tax regimes increases welfare. In their model, the presence of tax havens increases tax competition and leads to a decrease in corporate tax revenues in non-tax havens. In contrast, Keen (2001) constructs a similar model but introduces two types of firms: mobile or immobile. Because countries cannot tax discriminate between these two types of firms, tax competition would drive tax rates down to suboptimal levels. The presence of preferential tax regimes targeted to mobile firms allows them to decrease their tax burden and permits countries to maintain high tax rates on immobile firms. This form of Ramsey-type taxation implies that tax competition applies only to mobile companies, leaving countries...
with more tax revenues than under “ordinary” tax competition. Note that Keen’s results differ from those of Janeba and Peters (1999) who find that tax revenues are lower when preferential regimes are allowed. This result obtains because their model includes differences in the share of the immobile sector in each country, which implies that the country with the higher share decides not to compete on tax rates and lets the other country impose preferential regimes to attract the mobile firms.9Hong and Smart (2007) provide a slightly different model that allows for shifting of the incidence of the tax to wages and for redistributive policies and comes to similar conclusions: tax havens are used by mobile companies to lower their tax liability, which in turn increase their ability to invest in the non-tax haven country, increasing the welfare of domestic workers and allowing for higher corporate tax rates on immobile capital and more redistribution to workers. These results complement some other papers using the same type of model to examine the complementarities between tax havens and non-tax havens. In particular, Desai, Foley and Hines (2006a, 2006b) find that the presence of tax havens stimulates investment in non-tax havens because it allows companies to decrease their overall cost of capital.

Bucovetsky and Haufler (2008) extend the Hong and Smart (2007) model by allowing firms to choose whether to stay domestic or become multinationals, and find that the tax elasticity of this decision is crucial for assessing whether or not preferential regimes are beneficial. If firms’ decisions on whether to become a multinational are inelastic to the presence of preferential regimes, non-cooperative countries will choose to deploy extensive preferential regimes to attract mobile firms and set high tax rates on immobile firms, and the optimal coordinated policy is to try to curb such preferential regimes. If, however, firms’ decisions are elastic, non-cooperative countries will choose minimal preferential tax regimes and tax competition in rates will reduce tax rates to suboptimal levels. The optimal coordinated policy in this case is to try to increase the number of preferential regimes to reduce competition in tax rates.10

E. The Choice of Instruments to Fight Tax Evasion

As exemplified by the various proposals to deal with the taxation of savings instruments (discussed below), European Union policy making has always been a struggle between using a system of exchange of information between tax authorities to ensure a fair level of tax burden and using a system of withholding taxes to simply avoid the difficulties of implementing efficient information exchange (although the two systems need not be mutually exclusive). In particular, the goal of achieving capital export neutrality is made difficult by the fact that information exchange is not necessarily in the interest of low tax jurisdictions which can use secrecy as a strategic variable.

9 Janeba and Smart (2003) endogenize the size of the tax base to make it dependent on the level of tax rates in the two countries. They find that Keen’s result is less likely to occur under this assumption. Haupt and Peters (2005) also dispute Keen’s result if investors have a home bias and if preferential tax regimes can be partly restricted (as opposed to a dichotomous choice assumed by Keen); they show that full tax competition is always inferior to moderate restrictions on preferential regimes. Marceau, Mongrain and Wilson (2007) also find that non-preferential regimes generate larger global tax revenues, unless cross-country differences in productivity are sufficiently large. Finally, Wilson (2006) assumes highly mobile tax bases, which allows countries to undercut each other’s rate and get all revenues. This implies tax revenues are no longer a concave function of the rate, so that preferential regimes are desirable.

10 Bucovetsky and Haufler (2008) also find that small countries are more likely to utilize preferential regimes.
This issue has been investigated in game theory settings. Bacchetta and Espinosa (1995) use a two-stage non-cooperative game in which each country first decides on the level of information exchange they will provide to the other country, and then decides on the level of the withholding tax rate applied to non-residents. They show that the equilibrium is a partial information exchange, as the countries face opposing effects from information exchange. On the one hand, exchanging information may make a country less attractive for foreign investors but, on the other hand, exchanging information allows the other country to maintain higher levels of taxation, which in turn also allows the first country to maintain high tax rates. Eggert and Kolmar (2002) modify the assumptions of the model to show that when investment decisions in physical capital can be separated from investment decisions in financial capital—therefore removing the tax-base effects of information exchange—countries no longer have incentives to use information exchange as a strategic variable and should engage in full cooperation.

Turning to a repeated game setting, Bacchetta and Espinosa (2000) show that countries might engage in cooperative behavior because they know that deviating from exchange of information will lead other countries to apply the same (harmful) policy. The possibility of such punishment is sufficient for exchanges of information to become equilibrium policies. The same repeated game framework is used by Huizinga and Nielsen (2003) who construct a model in which countries choose between the mutually exclusive alternatives of exchanging information or imposing a withholding tax. In such a setting, mixed regimes can arise with some countries exchanging information (usually large countries) and other countries (usually small ones) using withholding taxes. Finally, considering the case of perfectly mobile capital, Eggert and Kolmar (2004) find a “tax competition paradox,” as increasing capital market integration and capital mobility eventually makes source-based withholding taxes unsustainable and leads countries to opt for information exchange. That is, somewhat paradoxically, greater capital mobility enables residence-based taxation.

Keen and Ligthart (2006b) provide another important contribution to the literature by allowing countries to opt for both a withholding tax or information exchange but also giving them the option to use the revenues collected from either approach to be transferred to the other country. The paper derives three key results. First, when only withholding taxes are used and a share of the proceeds is returned to the country of the investor (such as in the EU savings directive), the level of withholding tax rates in equilibrium is independent of the share of proceeds transferred. Second, allowing transfers of part of the revenues collected due to information exchange back to the country providing the information increases equilibrium withholding tax rates and the total sum of revenues collected. Finally, while large countries would prefer information exchange, small countries could also choose this system, provided that they are not too small relative to the large country.

Keen and Ligthart (2006a) provide an interesting summary of the possible theoretical and practical arrangements for international information exchange. Interestingly, information exchange and withholding taxes appear to be substitutes in the real world. Huizinga and Nicodeme (2004) review the arrangements in place for the member countries of the Bank for International Settlements and find that, with the exception of Australia which adopts both policies, the two instruments appear to be substitutes. They also find that information exchange is generally a reciprocal arrangement. Ligthart and Voget (2009) come to the same conclusion.
on reciprocity, and also find that information is more likely to be exchanged when the domestic income tax rate is high, the marginal cost of public funds is high, and the country has sizeable interest-bearing deposits that are held abroad. Empirically, Huizinga and Nicodeme (2004) find that for the sub-category of international deposits, a 1 percent increase in the domestic interest tax burden increases deposits held abroad by about 2.4 percent, and that having a domestic exchange of information between banks and tax authorities increases deposits held abroad by 28 percent on average. However, they fail to find a significant impact of international information exchange on deposits held abroad.

III. OECD AND EU INITIATIVES IN FIGHTING HARMFUL TAX PRACTICES

The attempts to curb harmful tax competition practices at a multilateral level have so far been led by the OECD and the European Union, with numerous political interactions involving the G-20 countries. This section will review these efforts and comment on the very latest developments.

A. The OECD Work on Harmful Tax Competition

The OECD work on harmful tax competition accelerated in 1996 when the G-7 countries called for the OECD to pursue its work on establishing a multilateral approach to limit tax schemes aimed at attracting mobile activities, as these “… can create harmful tax competition between States, carrying risks of distorting trade and investment and could lead to the erosion of national tax base.” (Weiner and Ault, 1998, 602). This led to the report on harmful tax competition (Organisation for Economic Co-Operation and Development, 1998) that established the criteria for identifying tax havens and harmful tax practices discussed above, as well as a set of recommendations on possible counteracting measures against countries engaged in harmful tax competition. A follow-up report issued a list of countries and measures that met the criteria (Organisation for Economic Co-Operation and Development, 2000). This list was not intended to name and shame countries. Nevertheless, a majority of countries rapidly made commitments to implement transparent practices and allow exchange of information, leaving only seven jurisdictions—Andorra, Liberia, Liechtenstein, Monaco, the Marshall Islands, Nauru and Vanuatu—on the list of uncooperative tax havens by April 2002 (Owens, 2007). In 2003, Nauru and Vanuatu issued similar commitments and were removed from the list. The same commitments were made by Liberia and the Marshall Islands in 2007 and, following the recent increase in political pressure, the remaining three countries followed suit in May 2009, leaving no countries classified as uncooperative tax havens.

11 Based on Dutch data, they find that on average 85.4 percent of information exchanges are made on an automatic basis.
12 There are also some initiatives, not discussed in this paper, at the level of the United Nations, such as the work of the Committee of Experts on International Cooperation in Tax Matters (http://www.un.org/esa/fld/tax/overview.htm). Initially, the group’s mandate was to find ways to facilitate the adoption of tax treaties, but it has been broadened to include issues of transfer pricing, mutual assistance, interaction of tax, trade and investment, tax treatment of cross-border interest income and capital flight, etc. Some initiatives are also taken at the level of individual countries by ways of Controlled Foreign Corporations rules and other instruments. Those are also not reviewed here.
13 Previous initiatives include the Draft Double Taxation on Income and Capital in 1963 and the Model Convention and Commentaries in 1977 (Jackson, 2009).
Following the publication of the OECD list of tax havens in 2000, a group of 32 cooperative countries was invited to participate in the OECD’s Global Forum on Transparency and Exchange of Information. The goal of the forum was to encourage fair competition between the jurisdictions involved by achieving high levels of transparency and exchange of information based mainly on five key principles: (1) an agreement to deliver information upon request if it is “foreseeably relevant” to the Treaty partner, (2) no restrictions on transparency or information exchange due to domestic bank secrecy laws or domestic tax interest requirements (which allow information to be obtained only if it serves a domestic tax interest), (3) making available relevant information and granting the powers needed to obtain it, (4) respect of taxpayers’ rights, and (5) strict confidentiality of the information exchanged. Those standards have been successfully elaborated in both article 26 of the OECD Model Tax Convention on Income and Capital, and in the 2002 Model Agreement on Exchange of Information on Tax Matters, which was released in April 2002 by the Working Group on Effective Exchange of Information and became the basis for subsequent Tax Information Exchange Agreements (TIEAs).

The work of the Global Forum subsequently grew in geographical scope, as it now includes close to 90 jurisdictions, including OECD members, observer countries, cooperative tax havens and other financial centers. The Forum has been relatively successful during its first few years. By early 2004, 18 of the 47 harmful tax regimes identified in 2000 had been abolished or were in the process of being abolished, the harmful features of an additional 14 regimes had been removed, 13 regimes had been considered as not harmful after further analysis, and by 2006 only the Luxembourg 1929 holding company regime remained on the list of harmful tax practices (Organisation for Economic Co-Operation and Development, 2004, 2006).

The Bush administration, however, marked a turning point for the OECD in two respects. First, U.S. Treasury Secretary O’Neill expressed the administration’s view that no country or group of countries should dictate the features of other countries’ tax systems. This led the OECD to divert its efforts from harmful tax practices to focus on exchange of information (Jackson, 2009). Second, the terrorist attacks of September 11, 2001 caused a profound shock and led the U.S. to link exchange of information and tax transparency with the issue of terrorist financing. Accordingly, the Financial Action Task Force on Money Laundering (FATF), a body created in 1989 by the G-7 countries and whose secretariat is hosted by the OECD, refocused its efforts from money laundering to terrorist financing. Both activities are still being pursued by the task force.

Between January 2000 and January 2008, only 23 Tax Information Exchange Agreements were signed, 17 of them involving the U.S. or the Isle of Man. The revelation of the Lichtenstein affair in February 2008 and the strong political condemnation of tax evasion practices that followed provoked an impressive reaction in many countries. Between February, 2008 and April 2009, an additional 41 agreements were signed. The G-20 Communiqué of April 2, 2009 left no doubt regarding the willingness of the member countries to take tax haven issues seriously, including a commitment to develop a set of countermeasures that would be utilized.

14 The OECD Model Tax Convention on Income and Capital is available at http://www.oecd.org/document/ 53/0,3343,en_2649_33747_33614197_1_1_1_1,00.html.

15 Luxembourg eventually passed legislation in 2006 to remove the regime by 2010 (OECD, 2009).
against non-cooperative countries. On the same day the OECD published a progress report on the implementation of the tax standards regarding transparency and information exchange. The report contains three lists. The “white list” initially included 40 countries that have substantially implemented the OECD tax standards. Specifically, the progress indicator used by the OECD is whether the jurisdiction has signed at least 12 TIEAs that meet the OECD standards, taking into account the identity of the treaty partner, the willingness to sign additional agreements in the future, and the effectiveness of implementation (Organisation for Economic Co-operation and Development, 2009). The “grey list” included 31 tax havens and eight financial centers that have committed to implementing the standards but had not yet done so. Finally, four jurisdictions—Costa Rica, Malaysia, the Philippines and Uruguay—were on the “black list” of countries that had not agreed to the standards. This “name and shame” exercise had immediate and significant consequences. By April 7, all four jurisdictions had agreed to commit to the standards and could be moved to the “grey list.” Over the next six months, more than 150 TIEAs were signed and 12 jurisdictions had signed a sufficient number to be moved to the “white list.”

The challenging task of the Global Tax Forum will now be to maintain the momentum of the new agreements and to effectively organize peer monitoring of progress in the participating countries.

B. The EU Work on Harmful Tax Competition

The European Union has been closely associated with the OECD initiatives from the outset. Nevertheless, the presence of an internal market with free movements of goods, services, people and capital required additional measures. Cooperation in tax matters in the European Union has traditionally been organized under the auspices of the 1977 Directive on Mutual Assistance (Commission of the European Communities, 1977). Under this directive, EU Member States are required to exchange any information that appears relevant for the correct assessment of taxes due. It covers value-added taxes, excise duties on alcohol and alcoholic beverages and on manufactured tobacco, and all taxes on income or capital.

In the early 1990’s, the European Union faced two problems. First, several Member States had developed specific tax regimes with a goal to lure business and financial activities. Second, while the taxation of dividends received by non-resident individuals was generally effected with final withholding taxes in many countries, the situation was different for interest-bearing instruments, as little or no taxation was the general rule and each Member State in effect acted as a tax haven for residents of other Member States. Because of the unanimity rule regarding issues of EU taxation, little progress could be made. At the informal council of Finance Ministers in Verona in April 1996, the Commission, under the leadership of Commissioner for Taxation Mario Monti, presented a new strategy to make sure that tax policies would be better directed to achieve the objectives of growth and employment and to fight harmful tax competition. The Council agreed to consider these issues in a high-level discussion group, and the end result was the so-called “tax package.” The idea for this tax package

---

16 These include additional disclosure requirements, withholding taxes, revision of treaties, revision of investment and development policies, and more focus on tax transparency and information exchange in aid programmes.

17 These countries were Aruba, Austria, Belgium, Bermuda, British Virgin Islands, Bahrain, Cayman Islands, Luxembourg, Monaco, The Netherlands Antilles, San Marino, and Switzerland.
was to manage the diverse interests of the different Member States by offering more avenues for compromise. The package was formally accepted by the ECOFIN on December 1, 1997. Following this agreement, three main developments took place in 1998: a new proposal for the taxation of savings, a proposal on interest and royalties payments, and a code of conduct on business taxation (see below).

This was not the first attempt by the EU to fight harmful tax practices. The first proposal linked to taxation of savings dates to 1975 with a proposal for a directive that concerned both the harmonization of corporate taxation with a single corporate tax rate between 45–55 percent and a 25 percent withholding tax on dividends (Commission of the European Communities, 1975). This proposal was rejected by the European Parliament in 1977 since the Parliament’s agenda was to harmonize the tax base prior to the tax rate. In 1977, the Council adopted the directive on mutual assistance which could have been a major breakthrough in terms of exchange of tax information, but it was limited dramatically by provisions that authorized Member States to withhold information if domestic law or administrative practices prevented its exchange. The first proposal on taxation of interest payments was issued in 1989 under Commissioner for Taxation Christiane Scrivener. The proposal was to establish a common regime of a 15 percent withholding tax rate on interest for both residents and non-residents in the EU (Commission of the European Communities, 1989). The proposal was never discussed by the Council, practically blocking its adoption, and it was eventually removed in 1998 when a new proposal for a directive was issued introducing the “coexistence principle.” Under this principle, Member States could choose between a system of exchange of information and a minimum 20 percent withhold-

ing tax on non-residents (Commission of the European Communities, 1998).

No progress was made until the Feira European Council in June 2000. At that meeting, the Council agreed on the elements of the tax package, and in particular on the contents of a new proposal for a directive on taxation of savings. Moving away from the coexistence principle, the new proposal was designed to implement a final system based on the exchange of tax information, with a transitional period of seven years for Austria, Belgium and Luxembourg. However, some Member States, fearing the loss of competitiveness of European financial centers, made the agreement conditional on the adoption of equivalent measures by important third countries (e.g., the United States, Switzerland, Liechtenstein, Monaco, San Marino, and Andorra) as well as the adoption of similar measures by Member States’ dependent territories (e.g., Netherlands Antilles, Jersey, Guernsey, Island of Man, etc.). The Commission started to negotiate with these countries hoping to finalize an agreement in the Council.

Rapid agreement was not possible, essentially because Switzerland did not offer to implement measures that were considered as “equivalent” to those contained in the EU agreement. Switzerland instead proposed to levy a withholding tax, called an “EU retention tax,” and to exchange tax information on request in the case of “fraud or similar misbehavior.” This created an important stumbling block for several Member States, as the Swiss penal code is more restrictive in what it considers fraud. Finally, following further negotiation, the Council reached a new political agreement on the tax package on January 22, 2003 (Council of the European Union, 2003). Although the Council officially maintains an ultimate objective of requiring exchange of information, it allows Austria, Belgium, and Luxembourg to levy a withhold-
ing tax\textsuperscript{18} until the Council unanimously agrees that third countries also exchange information as defined in the 2002 OECD agreement.\textsuperscript{19} It actually reverts to the “coexistence principle” for an open-ended transitional period, allowing the three mentioned Member States to retain a withholding tax system as long as (1) Monaco, San Marino, Andorra, Lichtenstein and Switzerland do not exchange information upon request as required in the OECD Model Agreement on Exchange of Information on Tax Matters, and (2) there is confirmation that the U.S. is committed to exchange of information upon request as defined in the 2002 OECD Model Agreement with all EU Member States in relation to interest payments. The Directive went into effect on July 1, 2005.

After three years of implementation, the European Commission in 2008 reviewed the operation of the Directive on Savings and found several important potential loopholes, such as the use of legal persons to circumvent the Directive, the use of tax-exempt structures such as trusts to channel interest payments, and the development of innovative financial products that have the characteristics of interest-bearing products but are not officially covered by the Directive. The existence of these loopholes could explain why many studies have so far failed to detect an effect of the introduction of the Directive on financial markets (Hemmelgarn and Nicodeme, 2009; Klautke and Weichenrieder, 2008).

The European Union has also made progress on the removal of harmful tax regimes. In March, 1998, a working group composed of Member States and chaired by UK Paymaster Primarolo was established to identify and examine tax measures in the Member States that might reflect harmful tax competition. This group published a report in which 280 tax measures were declared as potentially harmful, with 66 identified as most harmful (according to the criteria described above). The resulting “code of conduct” in the field of business taxation adopted the principles of “standstill” (i.e., refraining from introducing new harmful measures) and of “rollback” (i.e., removing existing harmful measures). In addition, the offending measures had to be dismantled by January 1, 2003, although their benefits could remain until the end of 2005.\textsuperscript{20} The code of conduct was a non-binding peer review exercise and the report was not unanimously adopted, as some countries expressed reservations regarding specific elements. However, peer pressure was sufficient that all regimes have either been dismantled or are currently being removed.\textsuperscript{21}

In April 2009, the European Commission issued an important communication on good governance in tax matters, which defines the EU approach for the implementation of the G-20 decisions (Com-

\textsuperscript{18} Austria, Belgium and Luxembourg are allowed to levy a withholding tax with a rate of 15 percent for the first three years, 20 percent for the following three years, and 35 percent thereafter, with 75 percent of revenues collected redistributed to the country of the recipient of the interest payment.

\textsuperscript{19} Importantly, while third countries would need to comply with the 2002 OECD agreement that foresees exchange of information on request, Member States need to automatically exchange information with each other under the EU Savings Tax Directive (except for those applying the withholding tax). EU tax authorities therefore exchange information on amounts of interest paid to non-resident EU individuals.

\textsuperscript{20} The code of conduct included the provision that, on a case by case basis, certain measures may be extended beyond December 31, 2005. This provision applies to five regimes for which the deadline was set to end of 2010 or 2011.

\textsuperscript{21} Some of the measures covered by the code of conduct could fall within the scope of the provisions on State aid contained in the EU Treaty, so that the European Commission could therefore take action to force Member States to remove them.
mission of the European Communities, 2009). The communication recommends the rapid adoption of two pieces of legislation. First, the European Commission supports the adoption of amendments to the 1977 Mutual Assistance Directive. These amendments, in addition to improving the tools of cooperation (e.g., requiring common administrative forms), would introduce a most favored nation clause whereby Member States would need to provide other Member States with at least the same level of cooperation that they provide to any third country. It would also prohibit Member States from invoking domestic bank secrecy laws to refuse to exchange information. The European Commission hopes that this proposal will be adopted before the end of 2009. Second, the communication calls for amendments to the Savings Directive to make fraud more difficult.

IV. CONCLUDING REMARKS

A remarkable lesson from the recent developments at the OECD and European Union is that obstacles that were considered insurmountable for many years can quickly vanish when there is political will. Sustained pressure from the G-20 countries has the potential to end tax havens. However, the dramatic changes experienced over the last two years owe a lot to the conjunction of various favorable elements: increased scrutiny of tax evasion problems following cases of fraud, the belief that all potential sources of tax revenue should be used in the current economic crisis, and increased emphasis on dealing with tax evasion problems in many administrations. However, it is important to note that the sustainability of current efforts against harmful tax practices still depend on future circumstances.

Some key elements also remain uncertain. First, commitments to accept the OECD standards of exchange of information still need to be put into practice by many jurisdictions. The progress indicator used by the OECD (i.e., the signing of at least 12 TIEAs that meet the OECD standards) is arbitrary and may not be viewed by all as sufficient to add a country to the white list of jurisdictions having implemented the standards. In this respect, the follow-up peer review exercise undertaken by the Global Forum will be crucial in delivering real progress. Second, real progress has been made as these standards imply that a state cannot refuse a request for information solely because it has no domestic tax interest in the information or solely because the information is held by a bank or other financial institution. Nevertheless, requests for exchange of information as foreseen by the OECD standards are at present rare and irregular events (Ligthart and Voget, 2009), most notably because they require suspicion of fraud.

For the European Union, the ultimate goal of automatic exchange of information in the context of the Savings Directive is nearly attained as the transition regime is close to an end with the adoption of the OECD standards on information exchange by Andorra, San Marino, Monaco, Liechtenstein, and Switzerland. Belgium has already announced that it will adopt the information exchange rules in 2010 and the Isle of Man will do so in 2011.22

22 Dependent territories are bound by the Savings Directive and, although they can benefit from the transition regime, they will have to switch to information exchange as soon as the transition regime ends. The British Virgin Islands, Guernsey, the Isle of Man, Jersey, the Netherlands Antilles, and the Turks and Caicos Islands apply a withholding tax. Anguilla, Aruba, the Cayman Islands and Montserrat provide automatic exchange of information. In turn, EU Member States have to provide information or levy a withholding tax on the interest income from savings of residents from these dependent territories in the Member States, except for Anguilla, Cayman Islands and the Turks and Caicos Islands which do not tax residents’ savings income.
Interestingly, this shows the important linkages between the EU project and the OECD work to curb harmful tax competition. Pressure from the Global Forum on Transparency and Exchange of Information may convince countries to adopt the international standards for information exchange and therefore fulfill the conditions required to end the transition period under the EU Savings Directive.

Recent progress toward accepting international standards on information exchange has been impressive and might curb the activities of tax havens. It does not necessarily follow that tax evasion will disappear, because implementing the standards is a necessary but not sufficient condition as these standards at the present time only contain provisions on information exchange. However, the current developments mark an unprecedented and crucial step in the effort to fight harmful tax practices.

ACKNOWLEDGMENTS

I thank Jean-Pierre De Laet, John Diamond, Philip Kermode, Germano Mirabile and George Zodrow for valuable comments. All errors and omissions are mine. The views expressed in this article are those of the author and do not necessarily reflect the official position of the European Commission.

REFERENCES


Bucovetsky, Sam, and Andreas Haufler, 2008.
“Tax Competition when Firms Choose their Organizational Form: Should Tax Loopholes for Multinationals Be Closed?” Journal of International Economics 74 (1), 188–201.

Commission of the European Communities, 1975.


Commission of the European Communities, 1989.


Commission of the European Communities, 2009.
“Code of Conduct on Business Taxation.”
Report from the Code of Conduct Group to the
ECOFIN Council. Council of the European
Union, Brussels.
of Savings Income in the Form of Interest
Payments.” Official Journal of the European
Communities L157, 38–46.
Dharmapala, Dhammika, and James R.
Hines 2006.
“Which Countries Become Tax Havens?”
Bureau of Economic Research, Cambridge,
MA.
Dharmapala, Dhammika, 2008.
“What Problems and Opportunities are
Created by Tax Havens?” Oxford Review of
“Taxation and Foreign Direct Investment: A
Synthesis of Empirical Research.” Interna-
tional Tax and Public Finance 10 (6), 673–693.
Desai, Mihir A., C. Fritz Foley, and James R.
“Economic Effects of Regional Tax Havens”.
Bureau of Economic Research, Cambridge,
MA.
Desai, Mihir A., C. Fritz Foley, and James R.
Hines, 2006a.
“The Demand for Tax Haven Operations.”
Desai, Mihir A., C. Fritz Foley, and James R.
Hines, 2006b.
“Do Tax Havens Divert Economic Activity?”
Economic Letters 90 (2), 219–224.
Devereux, Michael P., 2008.
“Taxation of Outbound Direct Investment:
Economic Principles and Tax Policy Con-
siderations.” Centre for Business Taxation
Working Paper 08/24. Oxford University,
Oxford.
Diamond, Peter, and James M. Mirrlees, 1971.
“Optimal Taxation and Public Production I:
Production Efficiency.” American Economic
Review 61 (1), 8–27.
“Residence-Based Capital Taxation in a
Small Open Economy: Why Information is
Voluntarily Exchanged and Why it is Not.”
International Tax and Public Finance 9 (4),
465–482.
“The Taxation of Financial Capital under
Asymmetric Information and the Tax-
competition Paradox.” Scandinavian Journal
“Taxation of Investment and Savings in a
World Economy.” American Economic Review
76 (5), 1086–1102.
“Restricting Preferential Tax Regimes to
Avoid Harmful Tax Competition.” Regional
Hemmelgarn, Thomas, and Gaëtan Nicodème,
2009.
“Tax Coordination in Europe: Assessing
the First Years of the EU-Savings Taxation
Directive.” Taxation Paper No. 18. European
Commission, Brussels.
“Fiscal Paradise: Foreign Tax Havens and
American Business.” Quarterly Journal of
Economics, 109 (1), 149–182.
“Do Tax Havens Flourish?” In Poterba,
James M. (ed.), Tax Policy and the Economy,
Volume 19, 65–99. National Bureau of Eco-
nomic Research, Cambridge, MA.
Hong, Qing, and Michael Smart, 2007.
“In Praise of Tax Havens: International Tax
Planning and Foreign Direct Investment.”
CESifo Working Paper No.1942. Center for
Economic Studies, Institute for Economic
Research, Munich.
“Withholding Taxes or Information Ex-
change: The Taxation of International Inter-
est Flows.” Journal of Public Economics 87 (1),
39–72.
“Are International Deposits Tax-Driven?”


