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TURN DOWN THE HEAT, SWITCH ON THE LIGHT

A rational analysis of tax havens, tax policy and tax politics

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Summary

- Tax havens have existed for many centuries and are certainly not limited to ‘sunny places for shady people’ as suggested by Vince Cable.
- The Netherlands, Luxembourg, Belgium and Switzerland all have some of the characteristics of tax havens.
- There are many senses in which the UK has become a leading tax haven given the effect of government’s policy in recent years, and particularly over the last ten years or so. Criticism by UK politicians of tax havens in the context of the UK’s own declared policy is hypocrisy.
- Much of the recent controversy has surrounded payments for intellectual property. There are some important issues here which require serious attention. Much of the value in modern companies is added by intellectual property, patented processes and brands. The profits generated by such brands do not necessarily belong in the countries in which sales take place. Given their nature, there is always going to be room for dispute as to how payments out of the UK for intellectual property should be determined; however, there would be little change in the UK tax base if such intellectual property were not located in tax havens.
- International action on tax havens is bound to be influenced by political rather than economic criteria and is therefore likely to be extremely unsatisfactory.

- In fact, tax havens bring many benefits to countries – including to high-tax countries. High-tax countries can attract mobile capital if tax havens can be used to reduce the overall rate of tax paid by those who control that capital. Without tax havens, high-tax countries would have to either lower the tax charged on all capital (mobile and immobile) with the subsequent loss of revenue or put themselves in a position where they could not attract any mobile capital which would flow to low-tax countries.

- Tax havens facilitate international fund management business - particularly in the form of collective investment vehicles (used to pool and invest the capital of investors) which could otherwise be subject to tax at the level of the pooling vehicle (even though the investors themselves may be subject to tax on the income derived in their home jurisdiction). As such, tax havens allow the financial services industry - including that of the UK - to provide services globally without triggering unintended and potentially penal rates of taxation.

- Tax havens facilitate the creation of financial products that improve efficiency and liquidity in financial markets, including for retail investors. Without tax havens, many innovative products might be stifled by penal tax regimes.

What is a tax haven?

The conventional wisdom on tax havens - reinforced in recent months in the discussion on tax and the corporate sector (for example, Starbucks, Google, Amazon, and so on) - is that they are the scourge of responsible countries with 'proper' tax regimes. As with much conventional wisdom, the reality is different.

Tax havens have existed for some considerable time. In the Middle Ages, for example, the City of London exempted merchants of the Hanseatic League from all taxes in order to attract new commerce to the city. Later, in the fifteenth century, Flanders removed duties on much of its trade and imposed relatively few exchange restrictions, helping it to become a flourishing commercial centre. Similarly, from the sixteenth century to the eighteenth century, the Netherlands imposed low duties and thereby created thriving business centres at its major ports.[1]

The existence of tax jurisdictions which provide a fiscally advantageous environment in which to conduct business is therefore nothing new. However, the use of tax havens has changed radically in the late twentieth century. Historically, business activities in tax havens have related to the local market of the tax haven itself. Following technological advances in communications and the globalisation of business in recent decades, tax havens have increasingly been used for activities which are far removed from the place or places where the impact of such activities is felt. Given

[1] See United Nations (1984: 13) and Doggart, (1987).

that many businesses can be sited almost anywhere, it is no surprise that features of the tax system will influence the choice of location - although tax alone will rarely make a business location sufficiently attractive given the need for political and economic stability, banking and financial services, developed company law, access to good communications, and so on.

Vince Cable's description of tax havens as 'sunny places for shady people' reflects the common view that the term 'tax haven' denotes a well-defined grouping of territories which are easily identifiable as tax havens: typically small islands in the Caribbean characterised by low or zero rates of tax. This is wholly inadequate. Tax haven status is measured on a continuum, not by a binary test, and there are many countries which have some characteristics of a tax haven.

Even the OECD, at the height of its work on 'harmful tax competition' in the mid-1990s, did not regard the existence of low or zero taxes as a sufficient definition of a tax haven. The obvious difficulty with definitions that focus only on the nominal tax rate aspect of tax havens is that no account is taken of many important tax havens, or states with preferential tax regimes, which have high domestic tax rates but which have specific tax rules designed to reduce materially (or remove altogether) the burden of tax that might otherwise apply to mobile businesses.

Indeed, a number of European countries have attributes of tax havens, for example:

- Belgium has a relatively high rate of corporate income tax (34 per cent), but offers very attractive tax deduction rules. Specifically it has a notional interest deduction on non-interest bearing capital and generous 'thin capitalisation' rules which permit extensive use of tax-deductible debt financing. The result is that the effective rate of tax may be well below the nominal rate.

- In the Netherlands, it is possible to combine the extensive Dutch tax treaty network (which normally operates to remove or materially reduce withholding tax on in-bound payments) with its 'participation' exemption system under which those payments will often not be subject to Dutch tax.

- Luxembourg has various notional deductions, specific exclusions and tax clearances.

- Switzerland has a number of specific tax-privileged regimes for different types of business where the combination of federal, cantonal and communal taxes may in aggregate lead to tax rates not much above 10 per cent.

- Ireland has an across-the-board low level of corporate income tax of 12.5 per cent.

Of course, all the above countries are OECD members. There are also regimes such as in Hong Kong which combine a low rate of tax with a strictly territorial basis of taxation (with the result that non-Hong Kong source income and profits are not subject to tax) and Singapore has various tax incentive schemes.

The UK is arguably an even better example of a country which provides a number of tax privileges that could be regarded as reflecting features of a tax haven. As a result of a number of changes over recent years, the UK no longer taxes gains on material equity investments or dividends flowing into the UK from overseas subsidiaries. However, it is still possible to make use of generous interest deductions for tax purposes in relation to the costs of financing such investments. The UK government has also down-scaled the impact of its own anti-tax haven (‘Controlled Foreign Company’) rules and, of course, as discussed further below, two consecutive governments have led a sustained campaign to bring down the rate of corporation tax. In addition, there is also the recently-introduced special regime for the taxation of income from patents, the so-called ‘Patent Box’, which represents a way of taxing a more mobile form of income more lightly (at a special 10 per cent rate) with the aim of making the UK a more attractive location for this important and mobile form of intellectual property (IP) income. In effect, the UK government is aiming to create onshore the kind of preferential fiscal regime that would otherwise be available in a traditional low- or no-tax haven state. The UK is not the first country to introduce a special IP tax regime - similar regimes exist in Belgium, Luxembourg, the Netherlands and Switzerland (IFS, 2013: 299).

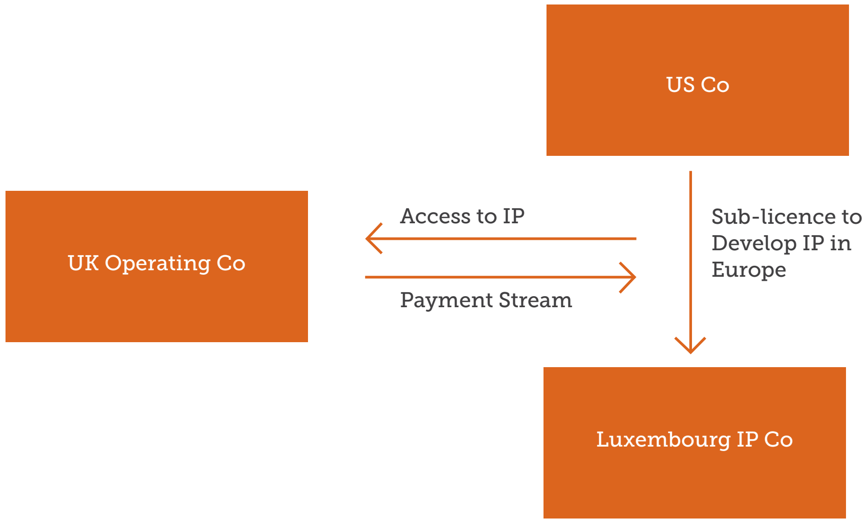
It is estimated by HMRC that the Patent Box will cost £720 million in 2014-2015, rising to £910 million in 2016-2017 and the cost will probably be higher once the full effect of the policy is realised (ibid.).

So, returning to the above discussion as to how we can describe or categorise tax havens, it may be concluded that the reason why it is so difficult to produce a simple definition of tax havens is the diverse nature of tax havens, as illustrated by the examples above.[2] To be meaningful, therefore, the term 'tax havens' should be used - as in this paper - to denote a wide continuum of states with preferential tax features. In short, warm, sandy beaches are by no means a pre-requisite for tax haven status and many developed countries close to home may well have characteristics of tax havens – such as the UK itself.

[2] The UN has previously recognised that no internationally agreed definition is possible - see UN (1984: 30).

The uses of tax havens

Tax havens are used in a variety of ways but the most important and topical policy questions relate to the role of tax havens in enabling tax planning by multinational corporations. This typically involves multinational companies setting up subsidiaries in tax havens to supply services to other companies within the group. These services might include lending money within the group or providing other treasury services; the provision of group insurance services; or the provision of group intellectual property functions, such as licensing the use of patents, brands, etc. The following diagram illustrates a simple IP structure:



There has been considerable focus on the use of tax havens for IP functions and a lot of negative publicity surrounding this. It is worth noting that this is an area in which the UK, with its new 'patent box' rules discussed above, is aggressively seeking to attract business. A common allegation is that the claim to make payments to entities in tax havens for the provision of such IP is bogus. For example, Vince Cable has stated: 'Our own tax authorities have got to be very tough on things like royalty payments, which is where a lot of the subterfuge takes place'.[3] These concerns have also been echoed by the Public Accounts Committee which has struggled to understand the relevance of IP to retail and consumer business. Austin Mitchell, for example, commented: 'Another fiddle lurks in intellectual property, where the intellectual property of making coffee - a caramel macchiato or whatever - is so expensive that they have to pay a tribute to Luxembourg for making coffee in that way.'[4]

It is, however, a reality of modern business that IP, branding etc. have become commercially important and this is especially important in the area of retail and consumer business: IP may not be needed to make the coffee but it will often be needed to get customers through the door. For example, in a recent survey of the top global 500 brands, the top five are all retail and consumer businesses, as are eight of the top ten (which includes Apple, Google and Amazon). The value of the Apple brand is estimated at $87.3bn, with Amazon's brand value estimated to be $36.7bn.[5] The survey results are in line with other similar recent surveys.[6]

[3] Vince Cable, speaking on the Andrew Marr show, reported on the *Guardian* website at http://www.guardian.co.uk/politics/2012/nov/18/vince-cable-tax-crackdown.

[4] Austin Mitchell, House of Commons, Committee of Public Accounts, HM Revenue & Customs: Annual Report and Accounts 2011-12, proceedings of 5 November 2012, question 48.

[5] See Brand Finance survey, Global 500 2013, http://brandirectory.com/league_tables/table/global-500-2013.

[6] See, for example, http://www.interbrand.com/en/best-global-brands/2012/Best-Global-Brands-2012-Brand-View.aspx and http://www.wpp.com/~/media/SharedWPP/Reading Room/Branding/brandz_2012_top_100.pdf and a recent Financial Times report on the value of global brands - http://www.ft.com/reports/global-brands-2012.

The topic of how IP charges are recognised and computed for tax purposes is an area of current study by the OECD but the material value of IP and branding is indisputable.

The commercial value of IP, therefore, means that, whether it is located in a tax haven or not, the effect on the UK in terms of IP or branding charges paid out of the UK (for example, in cases such as Starbucks, Amazon, Google, Apple etc.) will be the same: challenging such structures which locate IP in tax havens - even if successful - will therefore not lead to any more UK tax being collected. If the IP were not located in a tax haven, it is likely that it would be located in and purchased from the country in which the company would be domiciled if there were no tax considerations – presumably the USA in these cases. If profits are generated by brands or other forms of IP, such profits do not belong in the place where companies make their sales.

In this debate it is worth distinguishing between two issues that are often implicitly treated as a single issue. If, for example, Starbucks is only able to market coffee at the price at which it retails in the UK because of the intellectual property in the brand, methods of roasting and so on, then two things will affect the amount of UK tax paid. The first is the price paid for the intellectual property to the subsidiary that owns it – this is known as the transfer price. (The basic requirement for transfer prices between associated companies is that they are set at market rates applicable to the transaction concerned in any particular case). The second is the location of the subsidiary that owns the intellectual property. Corporation tax is not charged on sales but on profits and the profits are generated by the brand. The transfer price can be, and often is in practice, contested by the tax authorities. It is not clear that any change in the law could make any material difference to this situation: tax law already contains all the mechanisms necessary to resolve whether transfer prices conform to the required market rate standards. With regard to the location of the IP, it is highly unlikely that a US-based firm operating in the UK would locate the IP in the UK if the tax system were wholly neutral in this regard.

‘Initiatives’ on tax havens

Although states - including tax havens - should arguably be free to adopt whatever tax rules and tax system they wish, there have been various attempts to curtail this freedom on the basis that there are - or should be - limits to fiscal autonomy and, in particular, that states should not engage in harmful tax practices.

The OECD’s work on harmful tax practices, which is the most well-known such initiative, commenced in 1996. It initially targeted tax havens as one of three specific work streams but this proved problematic and the work soon merged together with the other work streams on member and non-member countries. The output of this work required that, by the end of 2005, member states of the OECD in particular refrain from adopting any new harmful tax regimes and remove any existing ones. As will be evident, this work has both fallen into abeyance and also been largely overtaken by the OECD’s shift in focus to one of ensuring that states enter into transparency and exchange of information obligations.[7]

One of the difficulties of the previous work on harmful tax competition is that it seemed influenced by political factors as well as technical factors. For example, it was difficult, in the absence of any specific guidance, to understand exactly how an assessment was made of whether a particular tax regime was actually harmful.

[7] There are clear indications that tax havens well understand that they will need to measure up to the emerging international standards on tax transparency as this is material to their economic sustainability. The renewed international focus on tax transparency has led to a number of tax havens, such as Switzerland and Singapore, to commit to the standard for the first time.

Both Australia's Offshore Banking Unit and Canada's International Banking Centre regimes were initially regarded as a cause for concern but then, for reasons that were not particularly clear, they were determined not to be not *actually* harmful by the OECD. There were also claims that the OECD seemed willing to take on the smaller states such as Jersey but not, for example, the more politically charged tax regime in Hong Kong because of concerns about the attitude of China.

It is likely that, in the longer term, the focus over the last four years on transparency and exchange of information will lead to a system of automatic exchange of information (i.e., the systematic and regular transmission of taxpayer information from the 'source' country - which may be a tax haven - to the country of residence of the taxpayer concerned).

Given the recent direction of the OECD's global efforts on tax transparency and the general level of compliance with this agenda by tax havens, it may seem odd that politicians now seem to want to go back to a more interventionist approach with regard to tax havens, potentially resuscitating the harmful tax competition debate. This is, however, precisely what has emerged from the recent debate on multinational corporations and tax.

Tax havens and the recent corporate tax debate

The recent debate on tax has raised a number of quite different, difficult and fundamental tax policy issues - for example, the requirement to create a sensible set of global tax standards to apply to digital business and the need to develop the existing global tax framework so that it can apply across the global marketplace and not just in the developed OECD states. These are enormously important matters which raise some major questions about the suitability of the current international tax framework. These issues need to be addressed urgently - and carefully - to avoid material disruption to global business and the allocation of resources.

There has also been much discussion on the levels of tax paid by multinationals. In fact, many politicians have tended to focus exclusively on this last issue as if it were the only issue to be addressed (rather than being a consequence of the way the current tax rules designed by politicians, work), ignoring the more fundamental tax policy points. In consequence, tax havens have been featured heavily in the debate and the overall picture presented is that they are a major part of the problem.

Ed Balls comments are typical of the views expressed by politicians: 'We need to revive stalled efforts on an EU and international level to tackle the problems that are caused by the use of tax havens.'[8]

[8] Ed Balls writing in the *Huffington Post*, 25 November 2012.

There is also the recent comment from David Cameron, speaking in Davos earlier this year: ‘Any businesses who think that they can carry on dodging that fair share…and setting up ever more complex tax arrangements abroad to squeeze their tax bill right down. Well, they need to wake up and smell the coffee because the public who buy from them have had enough’.

This concern is by no means restricted to the UK. For example, Angela Merkel has recently complained: ‘It’s not right that giant global companies have huge sales here…and then only pay taxes somewhere in a tiny tax haven’. Mrs Merkel wants to put tax havens out of business altogether: ‘That’s why we’re going to put an end to tax havens at the G8 meeting this year in Great Britain’.[9]

Although largely presented in the public debate as a new issue, the same concerns about the use of tax havens by corporations have been around for many years. Over twenty-five years ago, for example, the government of New Zealand stated its determination ‘to prevent the erosion of the income tax base by cross border transactions which enable the deferral or complete avoidance of tax...The use of tax havens in particular has become widespread and has been a drain on government revenue’.[10]

The big problem with all these political pronouncements on the use of tax havens by multinational corporations is that they lack any honesty - perhaps understanding - of the issue that is at the heart of the debate. That issue, which relates to the actions of states, not corporates, is tax competition.

As indicated above, many UK politicians of all parties have been particularly vocal in complaining about tax havens. However, they seem almost oblivious to the fact that a main plank of UK tax policy is to attract business to the UK by making it the most attractive location in which to do business. This objective has been explicitly stated by George Osborne but earlier governments have been no

[9] 13 February 2013, speech in the northern town of Demmin, as reported on the *Telegraph* website.

[10] New Zealand Ministry of Finance, Consultative Document on International Tax Reform, December 1987.

different in their general approach. Attracting business inevitably means developing a range of measures (such as the patent box discussed above) which have the effect of creating a tax haven or preferential tax features in the tax system, typically targeted at attracting mobile capital into the UK. UK tax policy on this point has been pretty constant. For example, successive Chancellors have made much of their rate-reducing actions including Gordon Brown in 1999: the reduction of the corporation tax rate (to 30 per cent) made it, he boasted, 'now the lowest rate in the history of British corporation tax, the lowest rate of any major country in Europe and the lowest rate of any major industrialised country anywhere'. Later, in 2007, it was noted by HM Treasury and HMRC that 'the challenge of globalisation is not new and it has consistently influenced Government policy since 1997'.[11] The same document also notes that foreign ownership of the corporate sector had then reached 50 per cent, up from 30 per cent in 1995.

The tax policy goal could not be clearer, as confirmed recently by David Gauke: 'We are delivering a bigger set of pro-business tax reforms than our global competitors or predecessors ever managed... In three years the UK has moved from being an also-ran to the most competitive regime in the world, overtaking Ireland, the Netherlands and Switzerland…over five years the total fiscal impact of changes to the corporation tax regime introduced by George Osborne, excluding the North Sea, amounts to a reduction of almost £7bn… capital is now more mobile and competition greater, so governments have to work harder to attract investment. But by historical and international standards, we have made our business tax system much more competitive'[12] . It is not surprising that, as the IFS has recently highlighted, in the next two years corporate tax receipts will fall to below 6 per cent of total tax receipts and will be at the lowest level since 1984/85. The tax policy of many other developed countries is similarly engaged in a tax competition strategy.

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[11] Para 2.7, 'Taxation of foreign profits', June 2007, HM Treasury and HMRC.

[12] David Gauke writing in *City AM*, 7 March 2013: 'We're more radical than Thatcher with business tax reform'. These comments were also echoed by David Cameron during Prime Ministers Questions on 13 March 2013.

It is clear therefore that all the complaining by UK politicians about the use of ‘tax havens’ by multinational corporations simply amounts to pointing the finger at the use of rival tax regimes created by other states. Furthermore, the criticism has been voiced as the UK has, over the last ten years or so, itself laboured to produce the most tax-competitive business environment. Somewhat ironically, given the political noise, the recently-announced cut in the rate of corporate tax rate to 20 per cent now triggers, in relation to UK subsidiaries of Japanese companies, the Japanese anti-tax haven rules, meaning that such companies may potentially be taxed in Japan on their UK earnings because the UK is regarded as operating as a tax haven. A similar situations has already existed for UK subsidiaries of German parent companies under the German anti-tax haven rules.

As is further discussed below, from a business and wealth creation perspective, tax competition and the role of tax havens have been emphatically positive forces. This is discussed in detail in Richard Teather’s IEA monograph on this topic (Teather, 2005). But, when it comes to judging the actions of politicians, this is beside the point. Either, it appears, politicians really have no idea that the general tenor of corporate tax policy in the UK is part of the process of tax competition by states (in which case their grasp of tax policy is surprisingly thin) or they understand this but simply prefer to spin the issue as relating to egregious behaviour by corporations on the basis that this can always be relied upon to score political points (in which case the scale of hypocrisy is stupendous). Either way, the approach to this debate by many politicians who seek to characterise the issue as one of bad behaviour by corporations has not been uplifting.

Effects of tax havens

The effect of tax havens is almost invariably portrayed as negative. It is, for example, a fundamental assumption of recent OECD and EU pronouncements that tax havens have a purely deleterious effect.

There are, however, good reasons to draw a quite different conclusion. Most fundamentally, tax havens play a key role in limiting the taxing ambitions of the state. In the UK, as in many EU states, the government now spends half of our national income. This is detrimental to the general welfare in society and has a particularly damaging effect on business and individuals given that this level of spending is fuelled by high taxation. The existence of tax havens, coupled with the high mobility of capital, means that governments are constrained in the tax rates that they might otherwise seek to apply and this is obviously helpful to business generally and particularly to wealth and job creation. Thirty years ago, corporate tax rates averaged nearly 50 per cent, stifling economic growth. They are now closer to 27 per cent, though this excludes additional taxes on capital gains, dividends and business property taxes such as business rates. Governments have responded to the fear that investment capital - and jobs - will disappear across national borders by lowering corporate tax rates. Tax competition and the role of tax havens have played a material role in bringing this about.

Tax havens also provide a role in removing the damaging distortions in the financial system that would otherwise prevent transactions from happening or materially reduce their incidence. The position can be illustrated by reference to the UK tax ‘distribution’ rules which in various circumstances have the effect of re-characterising interest payments (which would otherwise be tax deductible) as distributions (which are treated as akin to dividends and therefore not tax deductible). There has been a long track record of difficulty in applying these rules to financial instruments - especially the more innovative products. For example, in the late 1980s and 1990s efforts were made to accommodate the bourgeoning structured notes market in the UK as this would have been its natural home given London's international capital markets expertise. Structured notes typically involve underlying reference assets - such as securities and derivatives - being held by an issuer which would issue 'structured' notes - i.e. bonds - the financial performance or return on which would be determined by the underlying assets held. However, the technical difficulties arising with regard to their taxation were not resolved (notwithstanding the complete absence of any tax-driven features being involved) largely due to a reluctance on the part of the UK tax authorities to amend or ease the rules to accommodate the innovative features of these products. Inevitably, the market rapidly concluded that the UK was a wholly unsuitable location in which to issue these instruments and the business left the UK in favour of other - usually tax haven - locations where the tax rules were much clearer (and, critically, did not seek to impose a punitive tax asymmetry on these instruments - as the UK rules potentially did - by taxing the underlying securities or derivatives held but not giving relief for payments in coupon form). The thriving structured notes market therefore developed offshore. There are many other examples of the same 'pressure valve' effect of tax havens. For example, the exchange-traded fund market is centred in Ireland and not the UK due to the perceived onerous nature of the UK stamp duty rules and big ticket leasing transactions were an early refugee from the UK (often going to the Netherlands or Ireland) due to unworkable UK tax rules.

To take the example of exchange-traded funds, these are important vehicles that provide liquidity in investment markets and provide retail investors from many jurisdictions with a very effective and extremely cheap way of investing in a diversified range of securities. This is achieved by the ability of such funds to pool the capital of a large number of investors and collectively invest it (usually in businesses in high tax countries) without a significant level of further tax at the pooling stage. By removing such 'fund level' taxation the existence of tax havens allows such products to develop without fear of double or triple taxation (which might otherwise arise at the level of the underlying businesses in which the funds invest; at the level of the fund itself; and when the return is passed back to the hands of the investors).

Furthermore, even on the government's own terms, the effect of tax havens can be positive. One of the usual reasons given for the negative view of tax havens is that they erode the tax base of high-tax countries by attracting activities such as intermediate holding companies, treasury and funding vehicles and companies holding intangible property rights. The 'proof' of this negative effect is typically stated to be the fact that tax havens facilitate a disproportionate percentage of the world's foreign direct investment. For example, Cyprus has for many years been one of the most important sources of foreign investment flows into Russia (and more significant than France, Germany and the US (see De Souza, 2008) and a similar role is taken in relation to investment in India by Mauritius (which has been the largest source of foreign investment in India[13]). However, contrary to this prevailing view, it does not necessarily follow that this makes high-tax countries worse off. There is an emerging body of research indicating that tax havens and preferential tax regimes such as those discussed above actually benefit high-tax countries because they enable them to impose lower effective tax rates on highly mobile businesses while taxing immobile firms more heavily.[14] The efficiency of the approach is recognised by the recent broad-based review of UK tax policy contained in the Mirrlees Review.[15]

[14] See, for example, Keen (2001); Desai and Hines (2006); Desai et al (2002); Hong and Smart (2007).

[15] See comments in the IFS Green Budget, February 2013, p. 290 and Mirrlees et al. (2011).

This is perhaps a difficult point to understand. However, imagine a country that has government spending of the order of 50 per cent of national income – roughly the level in the UK. If tax havens could not be used by multinational corporations operating in this country, then a non-discriminatory single rate of corporate tax would have to be set. If this were set low then corporations would make a small contribution to the overall tax take. If it were set high, on the other hand, mobile capital would leave the country and low-tax countries would become relatively more capital intensive. Tax havens allow corporations employing mobile capital to reduce their tax bill whilst a higher rate of effective tax is charged on returns to less mobile capital as countries compete for that capital. In other words, tax havens benefit high-tax countries by allowing them to target more effectively their tax competition efforts.

This might be regarded as being in some sense unjust or discriminatory – perhaps creating an unlevel playing field. In fact, however, this approach accords with our understanding of how efficient tax systems should work. In order to be efficient, a tax system should tax factors of production in inverse proportion to their elasticity of supply. That is the economic rationale for a land value tax, for example. This approach minimises distortions in the economic system because it reduces the effects of the tax system on economic behaviour. It is true that such a system might not generate what is sometimes known as horizontal equity because different firms in similar circumstances might be taxed differently since it is possible for some types of firm to use tax havens. However, it is highly likely that high tax countries would not readily be able to attract mobile capital in any case and, therefore, the use of tax havens allows countries to benefit from mobile capital whilst still levying high taxes on the rest of the economy, thus leading to lower taxes for all citizens as well as higher levels of economic activity. These comments are not intended to justify the existence of high taxes but to make the point that tax havens do not necessarily erode the tax base of high tax countries.

A recent UK Perspective

Tax havens may also provide other benefits, as shown by a relatively recent independent review into tax havens from a UK perspective.

In December 2008, the then UK Chancellor of the Exchequer, Alastair Darling commissioned Michael Foot, formerly of The Financial Services Authority, to conduct a review of nine tax havens (three Crown Dependencies, the Isle of Man, Jersey and Guernsey, and six Overseas Territories) with particular focus on their role and impact on the UK economy.

The resulting Foot Report was published in October 2009 and its findings contradict the ‘conventional wisdom’ on tax havens. The Report found that tax revenues lost by the UK government to these tax havens appeared to be appreciably smaller than had earlier been estimated. It also noted that the tax havens considered make a significant contribution to the liquidity of the UK market: ‘The UK has consistently been the net recipient of funds flowing through the banking system from the nine jurisdictions’. The report also states that: ‘Together they provided net financing to UK banks of $332.5 billion in the second quarter of calendar year 2009, largely accounted for by the ‘up-streaming’ to the UK head office of deposits collected by UK banks in Crown Dependencies’. The report noted that financial flows are also generated by insurance business and fees earned by UK asset managers, accountants and lawyers. For example, it stated that Bermuda insurers and re-insurers reportedly wrote 30 per cent of the 2008 premium at Lloyd’s of London, a total of £5.4 billion, and it also referred to the research of the Association of Investment Companies which indicates that 108 companies, which they regarded as being investment companies and which are domiciled in the Channel Islands and Isle of Man, paid management fees into the UK of over £300 million in recent years. Much of this financial business will be conducted on behalf of individuals who are not resident in the UK for tax purposes and would therefore not pay UK tax in any case. The tax havens are necessary to ensure that such individuals can benefit from the UK specialisation in financial services whilst not being subject to taxes that should not, in any event, be due.

The irresistible lure of tax havens

As will be clear from the discussion above, politicians are all too eager to condemn and point the finger at tax havens, secure in the knowledge that criticising the use of tax havens by big business will always be pretty safe ground for a positive sound-bite in a tabloid newspaper. The issue may also be seen as a welcome opportunity to re-assert some ‘moral lead’ on matters of financial probity given the general perception of politicians. The obvious hypocrisy of UK politicians - given that the UK has been working hard at pursuing a tax competition agenda for a number of years - is either not understood or somehow not found too troubling.

Are politicians generally (and the G8 in particular) really serious about addressing the tax issues about which they have been so keen to grandstand? If so, they will need to go far beyond what we have seen so far - posturing about the behaviour of corporations and complaining about some one-dimensional notion of tax havens that safely allocates all blame somewhere else. If the task of tax reform in this area is to be pursued seriously, politicians will instead need to address the various strands of substantive tax policy presented by the recent debate on the taxation of multinational corporations, including the creation of an acceptable tax policy for digital business and the development of international tax rules. These would have to apply with certainty across the global marketplace and not just in the developed OECD countries. Any rule changes will also require careful consideration - and co-ordination - of the process of migration from current rules and standards and, perhaps above all, a realisation that sufficient clarity and precision in any new rules will be necessary to allow businesses to comply in practice. The issues are complex and inevitably raise the way taxing rights are allocated between states. There will clearly be no substantive ‘quick fix’.

Tax havens, however, are not simply shady places. The UK and other OECD countries have been trying to use tax policy to attract mobile capital for some time. In fact, such policies have many benefits given that it keeps pressure on governments to reduce record levels of spending. Furthermore, we have seen that tax havens facilitate financial intermediation much of which would be ‘double-taxed’ or taxed at inappropriate rates if tax havens did not exist. Tax havens enable the UK to take advantage of our comparative advantage in financial services on an international basis.

Policy discussions should be focused on the fundamentals of tax policy and not on tax havens per se. In the current political environment, this may be too much to ask, particularly as it will involve explaining - and defending - the point that the benefits to be achieved by tax competition can be delivered only by creating a more accommodating tax environment for in-bound multinational corporations with mobile capital than is available for domestic citizens. Some honesty about tax competition would be a good start.

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