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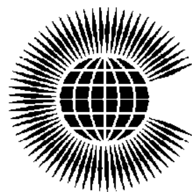

Commonwealth
Finance Ministers Meeting
Limassol, Cyprus, 30 September – 2 October 2009

Provisional Agenda Item 6 **FMM(09)6**

International Financial Centres: Status of the Debate, Challenges, and Ways Forward

Paper for the Commonwealth Secretariat*

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September 2009

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Executive Summary

The global economic crisis has intensified the debate about the role of International Finance Centres (IFCs). Serious concerns have been expressed that IFCs deprive developed states of tax revenue because of a lack of transparency, and facilitate capital flight and the laundering of the proceeds of corruption from developing states. In response, it has been countered that significantly increased IFC transparency over the last decade has failed to reveal substantial illicit funds, and that onshore centres are at least as likely as offshore to receive flight capital and corruption funds from developing countries. Hosting an IFC can potentially provide benefits for small, isolated developing countries in terms of economic diversification, government revenue, foreign currency earnings and highly-skilled employment in an environmentally sustainable manner.

2. Current challenges for Commonwealth IFCs include the need to rapidly conclude tax information exchange agreements given the prospect of G20 counter-measures and the proposed US Stop Tax Haven Abuse Act. The Commonwealth Secretariat can play a positive role in this environment. Potential contributions include: continued support for the Level Playing Field Group; offering technical assistance and training in negotiating and operating international financial information exchange agreements; conducting research on, *inter alia*, better integrating measures to combat tax evasion, money laundering, and corruption; and generally encouraging all parties to adhere to previous commitments on reaching impartial standards in a consensual and co-operative manner.

Introduction and Definitional Issues

3. The global economic crisis which originated in the housing and financial sectors of some developed economies has nevertheless intensified the debate about the role of International Finance Centres (IFCs), a large number of which are hosted by Commonwealth members.

4. This paper seeks to examine issues including: the concerns that have been expressed about IFCs; the concerns of Commonwealth IFCs given recent developments; the potential benefits that IFCs may provide for host economies; the impact of proposed international regulatory reforms on IFCs; challenges to implementing these reforms; and how the Commonwealth Secretariat can assist in this controversial area.

5. There is no generally agreed definition of IFC or related, more pejorative terms, like Offshore Financial Centre or tax haven. The most credible objective test carried out by the IMF in 2007 identified 13 Commonwealth members as Offshore Financial Centres, including the United Kingdom.[1] Reflecting the rather arbitrary nature of the distinction between ‘offshore’ and ‘onshore’ financial centres, the IMF has recently abandoned this division altogether for its

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[1] Ahmed Zoromé, *Concept of Offshore Financial Centers: In Search of an Operational Definition*, 2007 IMF Working Paper WP/07/87.

financial assessment program. But in general, international policy debates seem to rely on the reputation test spelled out in a 1981 United States IRS report ('A country is a tax haven if it looks like one and if it is considered to be one by those who care')[2] in deciding which jurisdictions qualify as IFCs. This yardstick conventionally includes a substantially larger number of around twenty five Commonwealth jurisdictions.

Concerns About IFCs

6. Even before the current crisis, prospects such as under-funded pension liabilities made large developed countries concerned about tax losses through cross-border tax avoidance and evasion. The higher levels of government borrowing associated with higher fiscal deficits in these countries has only sharpened this concern. Particularly since the OECD publicly launched its Harmful Tax Competition project in 1998, IFCs have been widely accused of facilitating international tax evasion and avoidance.[3] The US Senate suggests that wealthy American individuals use 'tax havens' to avoid paying $40-70 billion in tax each year that would otherwise be due. However, because of the difficulty of measuring any illicit activity, any statistics must be treated with caution.

7. The debate between IFCs and their detractors in relation to revenue loss is largely not about differing tax rates as such. It is broadly agreed that determining how much tax, if any, should be levied on labour, capital, land or anything else is a sovereign decision for individual jurisdictions. Instead the primary concern has been on the need for information exchange. G20 countries in particular are especially keen to gain information on the overseas activities of their individual and corporate nationals to ensure that they are paying their proper share of tax. Aside from the money itself, ensuring that wealthy individuals and large corporations contribute their fair share to government revenue is seen as important for the legitimacy of the tax system overall.

8. A further serious accusation levelled against IFCs is that they negatively affect the growth prospects for non-IFC developing countries. Some NGOs and government-sponsored reports have claimed that in relation to these countries IFCs encourage capital flight, offer themselves as havens for the proceeds of corruption, and facilitate tax evasion among elites.[4] Finally, critics have in the past accused IFCs of lax supervision, particularly with regards to AML/CFT standards.[5]

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[2]United States IRS, *Tax Havens and their Use by United States Taxpayers: An Overview*, 1981.
[3]OECD, *Harmful Tax Competition: An Emerging Global Issue*, 1998.
[4]*Tax Havens: Releasing the Hidden Billions for Tax Eradication*, Oxfam Briefing Paper, 1 June 2000; *Tax Havens and Development: Status, Analyses and Measures*. Report from the Norwegian Government Commission on Capital Flight from Poor Countries, 18 June 2009.
[5]FSF, *Report of the Working Group on Offshore Centres*, 5 April 2000; FATF, *First Non-Co-operative Countries and Territories Review*, June 2000.

The Concerns of the IFCs

9. Small state IFCs inside and beyond the Commonwealth have long had reservations about the means, if not the ends, by which international standards to increase financial transparency have been advanced. To simplify greatly, after a period of at times sharp conflict between IFCs and OECD states between 1999-2001, a rough *modus vivendi* had been reached. Key elements of this arrangement are now in question, which is a source of great concern to IFCs.

10. For the OECD, since the re-launching the OECD Harmful Tax Competition initiative in 2001, the efforts of this body (in parallel with those of the FATF and IOSCO, see below) have been focused on promoting transparency and information exchange. Considerable progress has been made on this score. All Commonwealth members are committed to the principle to exchange information on criminal and civil tax matters in line with the current version of the OECD model tax convention Article 26. However, despite some progress on tax information exchange, it is difficult to discern any extra revenue accruing to non-IFC developed or developing countries as a result. Whether this is because there is much less IFC-facilitated tax avoidance than is widely believed, or because the implementation of information exchange agreements has been slower than expected, but will bear fruit in the future is unclear at this stage. It should be noted that even the NGOs and tax specialists who are most critical of IFCs in relation to tax losses are also highly sceptical of the efficacy of the OECD's solution.[6]

11. With respect to developing states, the available evidence suggests that domestic factors far outweigh international in raising sufficient government revenue for public goods and development.[7] In terms of hosting the proceeds of corruption, the available evidence, which is far from complete, tends to implicate developed countries in general rather than IFCs in particular. Reports by the joint World Bank/United Nations Stolen Assets Recovery initiative but especially the NGO Global Witness[8] suggest that if IFCs were to disappear tomorrow, the continued existence of OECD financial centres would provide ample facilities for the proceeds of corruption.[9]

12. An area of consistent concern in the application of OECD's approach has been that IFCs are expected to meet higher standards for information exchange than those required of OECD members. This has led to some push back in terms of implementation of information exchange agreements. Initially, IFCs committing to the OECD's information exchange standards included a clause which sought to level the playing field. This clause stated that, *inter alia*, the IFCs would only exchange information when all OECD members agree to do so on the same terms

[6] See especially the writings of David E. Spencer in the *Journal of International Taxation*, various issues; Tax Justice Network, *Tax Havens Creating Turmoil*, Submission to the Treasury Committee of the House of Commons, June 2008.
[7] Deborah Brautigam, Odd-Helge Fjeldstad and Mick Moore, *Taxation and State-Building in Developing Countries*, Cambridge University Press, 2008
[8] UNODC/World Bank, *Stolen Assets Recovery (StAR) Initiative Report*, November 2007; Global Witness, *Undue Diligence: How Banks do Business with Corrupt Regimes*, 2009.
[9] See especially Global Witness, *Undue Diligence*, 2009, chapters 3, 4, 6, 7 and 8.

(the original letters clearly including the level playing field clause are available on the OECD website); and reflected the fact that OECD members Switzerland and Luxembourg (and more ambiguously Belgium and Portugal) did not meet the standards of information exchange required of IFCs. Until early 2009 Switzerland and Luxembourg were still not in compliance. As a result, some jurisdictions up until this time continued to hold back from the entering into the information exchange agreement process.

13. The existence of the `level playing field' clause reflected a consensual approach through which all countries would be expected to achieve the same results on the same timetable with the same consequences for non-compliance. Furthermore, it was agreed that arrangements to share information between IFCs (referred to as 'participating partners') and OECD member states should proceed on the basis of mutual benefit. From late 2008, however, the consensual, dialogue-based approach that had evolved has been eclipsed by a return to the earlier style. 'Participating partners' are once again 'tax havens', a new list was released by the OECD 2 April 2009, and IFCs are again threatened with 'counter-measures'.

14. A similar change in approach is evident in the evolution of the FATF's efforts to raise anti-money laundering standards. After a period when a consensual approach has been taken, since 2008 the FATF, at the urging of the G20, has increasingly favoured more direct action. The FATF's International Co-operation Review Group is presently conducting a 'prima facie review' of 39 jurisdictions identified as deficient in their AML standards, with those judged to be unco-operative to be publicly listed, and possibly subject to 'defensive measures'. This despite the fact that systematic reviews of IFCs by the IMF has reinforced that these jurisdictions are no more vulnerable to money laundering than other jurisdictions; and that 'Compliance with standards in OFCs is, on average, better than in other jurisdictions assessed in the FSAP'.[10]

15. Although receiving much less publicity, IOSCO has also sought to pressure a number of Commonwealth IFCs into regulatory reform on pain of being publicly listed as unco-operative. Again there are serious concerns about consistency and double-standards. While existing members only had to commit to ***introduc*****ing** the features of the Multilateral Memorandum of Understanding targeted states and new members had to ***actually*** introduce these standards. The main reason provided by IOSCO for this double standard is that it would have been politically impossible to hold existing members to the same but higher levels of regulation demanded of small state IFCs.

The Potential Benefits of Hosting an IFC

16. For many small, developing Commonwealth members, hosting an IFC confers a number of benefits on small developing states that might otherwise struggle for economic viability. Geographical distance and small size is irrelevant or at least much less important than for most other industries. This underlay the encouragement which developed countries and multilateral development banks gave to small states to establish IFCs to diversify their economies and aid

[10] IMF, *Offshore Financial Centers Assessment Program: A Progress Report*, 2005: 3.

development. For around half-a-dozen Commonwealth members, the international financial services sector represent key revenue generating industries, while for the majority they provide perhaps 2-5 per cent of GDP. The data indicates that while some Commonwealth countries have been successful in their quest, often expectations have out-run actual results in terms of the development boost IFCs have delivered. This however, is not to deny that they have produced some real benefits.

17. International financial services have been one of the fastest growing sectors world-wide over the past two decades, at least until the advent of the credit crunch in August 2007. In terms of employment generation, the sector generates a relatively small number of highly-skilled jobs. Its major contributions are increases government revenue through the licensing fees for activities like company registrations, as well as through direct and indirect taxes on the associated activities that support the corporative service providers, banks, accountancy firms and the like. For a few jurisdictions like the British Virgin Islands, Cayman Islands and Jersey the finance industry may provide more than half the government's revenue, though this is not typical of most IFCs. The foreign income earned helps to counter-act the strong import-dependence of small island economies. Finally, financial services have much less of an environmental impact than tourism, agriculture or manufacturing and are comparatively resistant to natural disasters.

Challenges Facing the Industry and the Likely Impact on IFCs

18. Despite the recent financial crisis and the threats supposedly posed by IFCs, there are few wholly new proposals for adapting the regulation and supervision of IFCs. However, since the G20 summits in Washington in November 2008 and London in April 2009, the initiatives proposed have acquired a harder edge, with short deadlines coupled with threats of 'counter-measures' for those jurisdictions that do not comply. It is the conduct as much as the substance of these initiatives that may impact IFCs. Proposals that can significantly impact on Commonwealth IFCs relate to programs defined as promoting financial market integrity and co-operation (led by Working Group 2 of the G20), and the proposed United States 'Stop Tax Haven Abuse Act'. At present, the proposed regulatory changes are works in progress, and the debates that have erupted make it difficult – to make predictions on the final outcomes. Nevertheless, it is possible to venture some generalisations about the likely impact of these changes on IFCs.

19. The proposed 'Stop Tax Haven Abuse Act', put forward by Senator Levin and then-Senators Coleman and Obama, contains a long list of discriminatory measures to be taken against a group of specified 'offshore secrecy jurisdictions'. Thirty-four jurisdictions[11] are include on this list, including 17 Commonwealth members. The list notably includes many jurisdictions that have already concluded tax information sharing agreements with the United States. Most worryingly, the proposed Act links in with the provisions of the USA Patriot Act

[11]Anguilla, **Antigua and Barbuda**, Aruba, **Bahamas, Barbados, Belize, Bermuda**, British Virgin Islands, Cayman Islands, **Cook Islands**, Costa Rica, **Cyprus, Dominica, Gibraltar, Grenada,** Guernsey/Sark/Alderney, Hong Kong, Isle of Man, Jersey, Latvia, Liechtenstein, Luxembourg, **Malta, Nauru**, Netherlands Antilles, Panama, **Samoa, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Singapore,** Switzerland, Turks and Caicos, and **Vanuatu.** [Commonwealth countries shown in **bold]**

section 311 by which the Secretary of the Treasury can exclude designated jurisdictions from all US-dollar-denominated financial networks, including correspondent banking arrangements. This measure, however, is presented as a last resort for 'unco-operative' jurisdictions.

20. More commonly, the law would establish a series of rebuttable presumptions involving unfavourable tax treatment for transactions from, to or through the 34 jurisdictions. These measures could be especially damaging for Commonwealth IFCs in the Caribbean, with the adverse impact spreading well beyond the financial services industry. In particular, simply the fact of appearing on the list would send a negative signal to international investors who would be more reluctant to conduct business with these jurisdictions. The proposed measures could also reduce the willingness of international banks to maintain correspondent relationships with the affected IFCs. The impact of this reputational damage can have cascading effects on affected jurisdiction and exacerbate the likely impacts of the current recession. Some of the initiatives are gaining speed as noted by the G20 endorsement of the OECD's current listing on international tax exchange agreements.

21. The regulatory changes promoted by the OECD, FATF and IOSCO; and endorsed by the G20 are likely to place significant costs on developing countries. The emphasis on collecting more information on the consumers of financial services, and implementing the new standards will undoubtedly involve greater regulatory costs for the governments and private sector firms and this will increase the cost of supply for IFCs. Although the reforms seek to enhance the integrity of the international financial sector, previous research published by the Commonwealth Secretariat indicate that overall the costs for small developing IFCs of meeting standards designed and drawn up by large developed states outweigh the benefits to these small countries.[12]

22. Less tangibly, the pressure to comply with standards on a very demanding timetable, may detract from addressing much needed local priorities and place pressure on already scare resources as senior policy-makers and regulators concentrate on meeting new international benchmarks. The demands to reach the targeted threshold of 12 information exchange agreements also bring some practical challenges. The G20 has intimated that jurisdictions on its 'grey-list' (inexplicably sub-divided into 'tax havens' and 'other financial centres') that fail to reach this threshold by the time of the next G20 summit in Pittsburgh may be subject to co-ordinated 'counter-measures', and some of its member states have already imposed discriminatory measures. There is now a rush to conclude the necessary 12 information exchange agreements as soon as possible.

23. The push to comply has not come without problems. The first is that the criterion of mutual benefit which was agreed to at the 2005 Berlin OECD Global Forum on Tax, has been weakened. Some jurisdictions preferred to enter into double taxation agreements on the grounds that they conferred genuine mutual benefits, rather than Tax Information Exchange Agreements(TIEAs), which merely benefitted large states though the IFC's collection of tax

[12]J.C. Sharman and Percy S. Mistry, *Considering the Consequences: The Development Implications of Initiatives on Taxation, Anti-Money Laundering and Combating the Financing of Terrorism*, Commonwealth 2008.

information. . For several reasons, OECD countries were rarely receptive to IFCs preference for DTAs, and many IFCs have been forced to abandon their demands for reciprocal benefits and are accepting TIEAs in the quest to meet targets. Those jurisdictions that are on the current 'grey-list' and face the G20's deadline are in a poor bargaining position in concluding information exchange agreements.

24. These problems are exacerbated by the fact that there are limits to the number of TIEAs OECD countries and IFCs can negotiate concurrently. Even large, well-resourced OECD countries have a limited number of officials in their international tax divisions. This bottle-neck is especially evident with regards to the Nordic countries (Denmark, Faroe Islands, Finland, Greenland, Iceland, Norway and Sweden). Because of their multilateral agreement on tax information exchange, one agreement counts for seven in terms of the OECD's scoring, and thus the Nordic area is particularly in demand.

25. But these constraints on the ability to negotiate different agreements concurrently are even more pressing for small state IFCs. For example, most OECD countries have more people in their tax administrations than Niue's entire population (1300). Niue repealed all its offshore legislation 2004-06, yet was still listed as a tax haven by the OECD in April 2009. Nauru, with no functioning financial institutions of any kind, is similarly listed as a tax haven.[13] Even with the best will in the world, there are inherent limits on how may international information agreements small states can conclude, and, further down the track, how many information requests they will be able to field.

26. Perhaps the greatest threat to IFCs now in relation to the G20's push for greater tax information exchange is that, because of limited capacity, they will simply run out of time. They may not be able to conclude 12 information exchange agreements before the deadline for listing and 'counter-measures', especially given that some G20 members have independently begun to apply such measures already. Given that the OECD took 13 years to get unanimity among its own members on tax information exchange (and even longer for the European Union), it is unreasonable to expect small developing states to reach 12 information-sharing agreements in a highly compressed time frame. Even absent the difficulties for small state IFCs, OECD states may not be able to accommodate so many offers of TIEAs so quickly. In this context it makes sense to ask for an extension, to postpone the application of both co-ordinated and individual listing and other measures. Intermediate benchmarks of progress might be set to ensure that the process is on track.

27. Even if further multilateral tax agreements like those with the Nordic Council are out of reach in the short term, the extent to which OECD countries can 'piggy-back' on each others' TIEAs would help ameliorate capacity constraints and speed progress on both sides. For example, Australia and New Zealand have developed a rough division of labour in negotiating with Pacific and Caribbean IFCs in a way that produces agreements with each much more

[13] Jason Sharman, *A Study for the Pacific Islands Forum on Offshore Financial Centres: Assessing the Impact of the Proposed US 'Stop Tax Haven Abuse' Act*, November 2008.

efficiently than two separate stand-alone negotiation processes. In the medium term it may be worth seeing the extent it is possible to form multilateral tax information exchange agreements, perhaps on a regional basis within the Commonwealth.

28. Some assistance on how to negotiate TIEAs and DTAs has already been provided by the Commonwealth and the International Trade and Investment Organisation, but the need for such assistance has ballooned over the last year. Returning briefly to anti-money laundering issues, technical assistance to help Commonwealth members to meet core and key recommendations would both help them achieve these standards, and stay off any future FATF list by indicating a willingness to meet international standards. Also useful would be assistance in the expensive and complex business of joining the Egmont Group of Financial Intelligence Units and the IOSCO Multilateral Memorandum of Understanding. Expanding the membership of these bodies would greatly facilitate the flow of international financial information, including that relevant to tax. In this context the FATF's 2010 review of tax crimes as a predicate for money laundering is especially relevant.

29. Finally, it would be very useful to re-affirm the principles of the level playing field, mutual benefits, transparent and inclusive processes, and voluntary and co-operative solutions. At best these have been downplayed; at worst they may have been abandoned altogether.

The Role of the Commonwealth Secretariat

30. The recommendations as to how the Commonwealth Secretariat can support the process of financial information exchange being taken forward in a consensual way follow on closely from the suggestions above. They divide into the provision of technical assistance, research and a more advocacy.

Technical Assistance

31. In the short term, the following could be considered:

- ***Training*** in negotiating TIEAs and DTAs and the inclusion of associated compensating benefits for small developing countries

- Helping Commonwealth members, especially those that are the subject of the FATF 'prima facie review' process, meet core and key elements of the 40+9 Recommendations by co-ordinating with FATF-Style Regional Bodies and other agencies;

- Assisting IFCs in the process of joining the Egmont Group and IOSCO.

32. In the medium term:

- Consideration might be given to exploring less resource intensive means of entering

into multilateral tax information exchange agreements. Models which can serve as an example is that of the Nordic area and the Cayman Islands' solution of offering unilateral tax information exchange. The unilateral mechanism is part of Cayman's 2008 Tax Information Authority Law, by which local authorities gain assent of nominated countries to exchange tax information without requiring formal government negotiations.

Research

33. The Commonwealth Secretariat could also facilitate dialogue between IFCs and their interlocutors by conducting or commissioning ***research***. This can be linked with the Level Playing Field Sub-Group which it supports. Topics might include:

- Increasing the low level of co-ordination between agencies responsible for fighting corruption, money laundering and tax evasion;
- Improving the efficiency and effectiveness of current and future tax information exchange agreements; more precisely assessing the benefits of hosting an IFC;
- Assessing the role of IFCs in hosting the proceeds of corruption and capital flight relative to OECD financial centres;
- Assessing the benefits, if any, that IFCs create for other developed and developing countries;
- The extent to which members of the Commonwealth are disproportionately affected by new actions and the degree of support needed.

Advocacy

- The Commonwealth should seek to highlight the rigid capacity constraints that limit the number of TIEAs and DTAs that can be negotiated at any point in time proposing realistic timescales consistent with the ability of small states to meet them .

- The Commonwealth can utilise its voice and role as a broker on the international forefront to re-emphasise the principles agreed upon with respect to a level playing field and reciprocity of benefits. These principles gained mutual agreement after a much fought negotiation and continue to find support from other important international actors, such as the World Bank and IMF. Agreements in line with these principles are more likely to be durable and effective, as should better conform to accepted norms of international behaviour.