Much has changed since the emergence of the offshore finance industry during the 1960s. Offshore activity has grown to such an extent that it can no longer be considered marginal to the global economy and it is therefore necessary on grounds of economic efficiency that offshore activity is made more transparent and subject to proper regulation.

There are legitimate concerns about the damaging impact of rapid movements of portfolio capital via the offshore circuits. The near collapse of the Brazilian real in January 1999 demonstrated the extent to which wealthy citizens of large economies have been able to evade exchange control mechanisms and national tax regimes by extensive use of offshore finance facilities. National and international authorities are challenging tax havens to abolish the secrecy space that facilitates money-laundering in the offshore arena. In addition economists and politicians are examining more closely the questionable proposition that all tax competition – no matter what its nature - is healthy for the global economy. It is therefore long overdue that offshore should be subjected to greater scrutiny, not only to ensure more effective regulation, but also to examine more rigorously some of the untested assertions that have been made about the usefulness of offshore to the global economy.

The core of the offshore issue lies with the debate about fiscal and regulatory degradation, that is, the process of undermining the tax and regulatory systems based
mainly upon the nation state. Tax havens and their supporters argue that tax competition provides a vital counter-weight to high tax / high spending regimes. Practitioners defend the rights of individuals and trans-national corporations (TNCs) to ‘optimise their tax efficiency’ through the use of offshore tax vehicles. From this perspective tax competition between jurisdictions extends the disciplines of global competition into the very heart of the democratic process. Nations compete with one another to attract ‘customers’ according to their tax and service delivery record. Setting aside the issue of whether it is appropriate for tax havens to act as disciplinary agents in this way, the OECD has engaged in an important debate about the nature of unfair or harmful tax competition.

The ability of TNCs to structure their affairs via tax havens provides them with a significant tax advantage over their nationally or locally based competitors. Local competition, no matter whether it is more efficient or innovative than its TNC rival, will be competing on an uneven field. The logic of this uneven competition requires either that all businesses ultimately move offshore in order to compete on a level basis, or that onshore tax authorities adjust their tax regimes to place a greater burden on other factors of production (particularly labour) and onto consumption.

The free market tax competition model assumes that all tax-paying citizens and businesses are perfectly mobile and are therefore able to migrate between different jurisdictions according to preference. Ironically the majority of tax havens have adopted elaborate defence strategies to prevent such migratory flows, but the otherworldliness of the perfect mobility assumption has not deterred these arguments in defence of the ‘discipline’ imposed by tax havens. The counter-argument notes
that small places like the Cayman Islands (population circa 30,000) will inevitably be able to underbid major nation states like India (population circa one billion) in the tax bidding stakes, and are able to offer TNCs tax rates on profits of less than half of one per cent. Competition on such an uneven basis is neither healthy nor sustainable.

The 1990s swing away from free market fundamentalism towards a more moderate brand of economic liberalism has challenged the view that fiscal competition is necessarily a good thing. The OECD argues that tax competition between states can be economically harmful in a number of ways. For example, tax competition shifts the tax burden between different types of economic activity, thereby encouraging short-term speculative activity to the detriment of fixed, long-term investment. The greater mobility of high net worth individuals and TNCs enables them to make full use of offshore tax vehicles, thereby undermining the integrity and equity of tax structures. The use of elaborate tax avoidance structures increases the administrative burden of revenue collection. And perhaps most importantly, widespread tax evasion and avoidance increases income disparities within and between nation states, and is symptomatic of the withdrawal of wealthy elites from their economic and social obligations.

In addition, intense competition between tax havens - the majority of which are based in micro-states with relatively unsophisticated governments - enables TNCs to exert their considerable political influence to sponsor favourable tax and regulatory legislation.
The tax havens that facilitate the process of tax escape claim their right to exercise jurisdictional independence in tax affairs. Fair enough. But the fiscal privileges of these minor jurisdictions should not be abused by the adoption of tax measures that deliberately distinguish between residents and non-residents and enable the latter to use the offshore circuits as a means of disguising the origins of taxable incomes and profits.

Tax havens and offshore finance centres (OFCs) also justify their existence by claiming to provide a role as conduits for investment assets entering the international capital markets. This is mere assertion. Why should investment flows, whatever their destination, need to be routed via tax havens and OFCs other than to hide their origins or obtain unfair tax or regulatory advantages? Many OFCs came into being as a result of their usefulness for circumvention of exchange control regulations. Much of the capital routed via the offshore circuits is ‘laddered’ through successive OFCs for money-laundering purposes. A significant proportion is flight capital from economies such as Russia, Brazil, Indonesia, Nigeria and the Congo. The impact on less developed countries of capital flight, including the proceeds of tax evasion, fraud, mis-appropriation, and corruption is immense, and very few of these nations have the means to pursue lengthy investigations through the offshore circuits.

Secrecy is a prerequisite for offshore financial activity. Offshore secrecy manifests itself either as literal bank secrecy, enforced by statute, or as the effective secrecy resulting from the creation of opaque ownership structures. The extensive layering of transactions between various offshore vehicles - often based in a variety of jurisdictions – provides an effective secrecy space within which to hide the nature of
transactions. Secrecy space undermines market transparency, encouraging illegitimate transactions and wasting considerable resources, both on tax planning and on regulation and investigation.

Whilst it is unclear why legitimate businesses should have a need for secrecy in any of their transactions, a clear distinction needs to be made between secrecy and the acceptable practise of confidentiality. Secrecy does not allow legitimate investigation by accredited authorities, whereas confidentiality does.

Changing bank secrecy rules, however, will not be sufficient in itself to tackle the harmful effects of money-laundering and tax evasion and escape. Over the past three decades tax havens and OFCs have enabled the introduction of a wide range of devices, including foundations, trusts and captive insurance vehicles, that can be mixed and matched across a variety of jurisdictions. All too frequently these jurisdictions pay no more than lip-service when it comes to actively co-operating with criminal and tax investigations. It is not unknown for tax haven authorities to justify their activities by suggesting that higher standards of regulation in established tax havens will simply encourage the transfer of activities to even more remote and unregulated jurisdictions. The argument is pure humbug, but is interesting in so far as it reveals the extent to which the senior government officials of tax havens see their role as being to defend the interests of economically and socially harmful activities.

The activities of tax havens and offshore finance centres can no longer be ignored. They have become what a recent United Nations report on money-laundering has described as “an enormous hole in the international legal and fiscal system.” The
rapid integration of the global financial services industry has increased the need for
the international community to address the issue of whether it is acceptable for
sovereign states and dependent micro-states to provide the means for citizens and
corporate entities of other countries to circumvent the laws of their own societies.

Recommendations.

- Minimum regulatory standards should be agreed and adopted by all offshore
  finance centres. OFCs that are unable to adopt these minimum standards should be
  assisted with economic reform programmes that enable diversification into new
  activities. OFCs unwilling to conform with minimum regulatory standards should
  be ‘blacklisted’ and a substantial levy be charged to those companies and
  individuals that continue to use them for their business transactions.

- The Bank for International Settlements should accept responsibility for regulatory
  oversight of global offshore financial activities in all tax havens and OFCs.

- In order to improve knowledge of capital flows the IMF should take on the task of
  collecting, collating and publishing data on the volume, composition and origins
  of assets held in all tax havens and OFCs.

- Bank secrecy should be completely removed from all international financial
  transactions with sanctions applied to non-complying OFCs.
• The 1998 Edwards Report recommendations that all offshore companies be required to produce audited accounts should be implemented without exception. In addition all offshore companies should also be required to disclose the identity of their ultimate beneficial owner.

• The Offshore Group of Banking Supervisors should appoint a Director-General with proven global regulatory experience, preferably on secondment from a recognised regulatory authority of stature such the Federal Reserve Bank or the UK Financial Services Authority.

• To combat transfer pricing a unitary tax is proposed whereby the TNCs’ global profits would be known and a proportion allocated for taxation by each state in which the TNC had a functional presence. Any TNC wishing to operate within a given nation state should contribute taxes to that nation state or be required to cease operations in that jurisdiction. This approach is equitable and fair. It introduces measures to counter the widespread tendency towards fiscal free-riding, and provides TNCs with a clear choice between accepting or rejecting the prevailing tax regimes of the countries in which they choose to operate.