

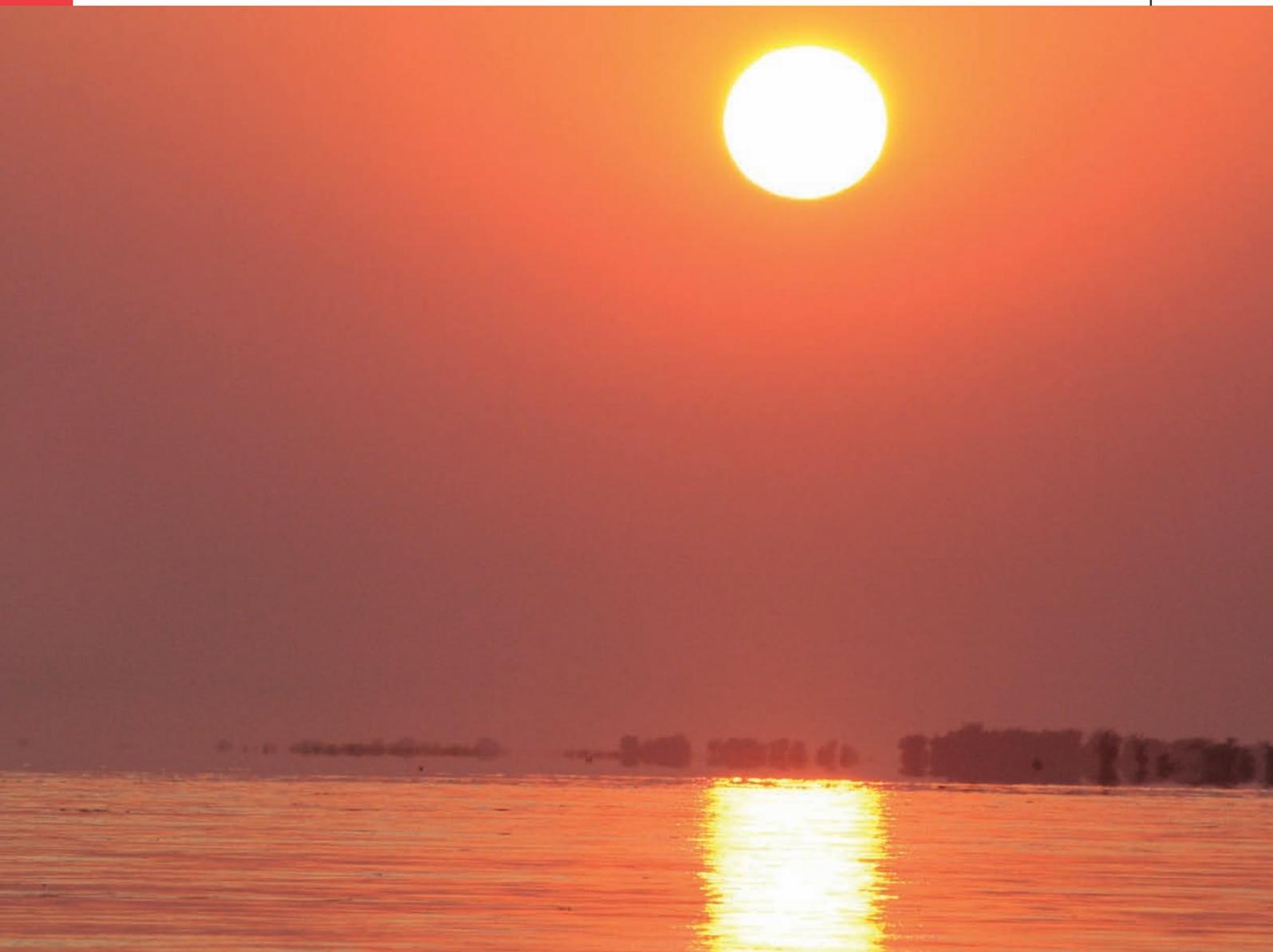
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2009: 19

Tax havens and development

Status, analyses and measures



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Tax havens and development

Report from the Government Commission on Capital Flight from Poor Countries.

Appointed by Royal Decree of 27 June 2008.

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To the Ministry of Foreign Affairs

A government Commission was appointed by Royal Decree on 27 June 2008 to examine the role of secrecy jurisdictions in relation to capital flight from developing countries.

The Commission hereby presents its report.

18 June 2009

Guttorm Schjelderup
Chairman

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Chapter 1

Mandat and summary

A government Commission was appointed by Royal Decree on 27 June 2008 with the following mandate:

The Commission shall examine the role of secrecy jurisdictions in relation to capital flight from developing countries. In the context of the aims of Norway's development policy, the Commission will also consider Norway's position on the investment of funds via such jurisdictions. The Commission will build on the development policy guidelines embodied in the government's policy platform, the International Development Minister's addresses to the Storting (parliament), the fiscal budgets and the Storting's deliberations regarding such budgets, and on the white paper on development policy when this becomes available.

The Commission will apply the OECD definition of "secrecy jurisdictions" (offshore financial centres/tax havens) and will, as a basis for its assessments and recommendations, utilise studies carried out under the auspices of the World Bank on the effect of illegal capital flows on development and other relevant work carried out under the direction of international organisations and initiatives. The Commission will also, as a basis for its assessments and recommendations, familiarize itself with national legislation and practice in relevant countries and jurisdictions.

The tasks of the Commission are:

- to improve our insight into and understanding of money flows originating in developing countries and describe both legal and illegal money flows and the consequences thereof
- to provide a thorough review and description of relevant company and trust configurations that make capital flight possible and of the use made of secrecy jurisdictions in that context
- to put forward proposals that can help to curb illicit capital flows and money laundering from developing countries via secrecy jurisdictions
- to propose measures whereby other development partners are invited to share a common approach to the use of secrecy jurisdictions in connection with investments in developing countries

- to propose measures which can increase the visibility of capital flows to and from developing countries via secrecy jurisdictions
- to assess whether and to what extent transparent investments channeled via such jurisdictions serve to maintain the structures used to conceal illicit capital flows from developing countries
- to assess, in the context of the aims of Norwegian development policy, Norway's stance on the investment of funds via secrecy jurisdictions and to propose a study of possible measures in that connection
- to provide recommendations that can be included as elements of the operational guidelines for the investment activity of Norfund, the Norwegian Investment Fund for Developing Countries.

The Commission is not mandated to assess the management of the Government Pension Fund – Global. Nor is it mandated to assess the work of the OECD Fiscal Affairs Committee with regard to tax evasion in secrecy jurisdictions or the initiative by the Financial Action Task Force (FATF) to identify non-cooperative countries and territories in the fight against money laundering and terrorist financing, and Norway's follow-up of this work. However, the Commission will draw on the work done in respect of issues.

The Commission will assess the need to draw on further expertise in the form of, for example, reports and seminars. The Commission's secretariat function is assigned to Norad, but the secretariat can also draw on additional resource persons from the sectoral ministries. The Commission will present its recommendations to the Minister of the Environment and International Development.

1.1 Composition of the Commission

Professor Guttorm Schjelderup (chair) (Norwegian School of Economics and Business Administration)

Professor Alexander Cappelen (Norwegian School of Economics and Business Administration)

Senior state attorney Morten Eriksen (National Authority for Investigation and Prosecution of Economic and Environmental Crime in Norway)

Research Director Odd-Helge Fjeldstad (Chr. Michelsen Institute)

Secretary-General Marte Gerhardsen, CARE Norway

Special advisor Eva Joly (Norwegian Agency for Development Cooperation – Norad)

Investment Manager Lise Lindbäck (Vital)

Chief Executive Jon Gunnar Pedersen (Arctic Securities)

Local authority executive Anne Fagertun Stenhammer

Professor Ragnar Torvik (Norwegian University of Science and Technology)

The secretariat was assigned to Norad and headed by Fridtjov Thorkildsen of The Anti-Corruption Project. Senior economist Audun Gleinsvik, hired from Econ Pöyry has had the main responsibility for the writing of the report.

Its other members have been

Ritha Unneland, Norad

Henrik Lunden, Norad

Hege Gabrielsen, Ministry of Trade and Industry

Geir Karlsen, Ministry of Finance

1.1.1 Work of the Commission

The Commission has based its work on a number of different written documents, as well as on contributions from various experts and other actors who have participated in its meetings. The Commission has also visited Germany, Liechtenstein, the USA and Mauritius, where activities included meetings with representatives of the national governments. The Commission also held meetings in Mauritius with actors from the private sector.

The Commission has had meetings and other communication with Norfund. This institution has been given the opportunity to read the description of its activities in the draft report from the Commission and to comment on the Commission's recommendations related to Norfund.

The Ministry of Finance has also presented its work on tax treaties to the Commission.

A total of twelve meetings have been held by the Commission, with the last taking place on 25 May 2009.

1.1.2 Observations from Mauritius concerning the commission's report

The commission's mandate requires it to make recommendations which can form part of the operational guidelines for investment activity by the Norwegian Investment Fund for Developing Countries (Norfund). Since the latter channels the bulk of its fund investments through Mauritius, it has been important for the commission to investigate legal and tax structures in that country in order to secure the best possible basis for making recommendations on Norfund's operations. The commission has accordingly devoted particular attention to Mauritius in section 7.5.

The government of Mauritius has read the English version of the report, and made its observations in a letter of 26 June 2009 to the commission. Members of the commission have read this letter, and assessed whether any changes or corrections are required to specific points in the report.

Their conclusion has been that no amendments are required to the report.

1.2 Guidance for readers

The Commission has been asked to assess what damaging effects are caused to developing countries by tax havens, and to document the scale of money flows to tax havens. It has also been asked to make recommendations which can alleviate the problems created by tax havens for developing countries and to propose guidelines for Norfund's operations. The Commission's report is structured as follows:

- Chapters 2 and 3 outline the typical features of tax havens and the way their legal systems and tax legislation affect other countries.
- Chapters 4 and 5 explain the damage caused by tax havens, both generally (chapter 4) and to developing countries in particular (chapter 5).
- Chapter 6 outlines the scale of capital flows through tax havens and important characteristics of tax haven economies.
- Chapter 7 provides an overview of and discussion on Norfund's investments in tax havens.
- Chapter 8 provides an overview of international efforts to combat tax havens.
- Chapter 9 presents the Commission's recommendations. These include both measures which Norway can implement unilaterally and others which Norway should seek to collabo-

rate on internationally. The Commission also provides recommendations which could be incorporated into the operational guidelines for Norfund.

1.3 Summary and the Commission's recommendations

1.3.1 Characteristic features of companies in tax havens

Scope. The number of companies and trusts being established in tax havens is much greater per capita than in most industrially and financially developed states. This is despite the fact that most tax havens are geographically remote both from the owners of companies registered there and from the business activities conducted by such companies. No less than 830 000 companies are registered in the British Virgin Islands which, for instance, have only about 19 000 inhabitants. In addition, there are an unknown number of trusts, banks and funds. The scope of such registrations is well illustrated by the fact that a single small office building at George Town in the Cayman Islands serves as the registered address for more than 18 000 companies.¹

Most of the companies registered in tax havens conduct no or very limited genuine local business activity. Legislation in these jurisdictions specify that such enterprises (often called exempted companies or international business companies (IBCs)) should not have local operations or activities over and above the formal activities associated with their registration. Typically, such companies cannot own or rent real property, etc., and their owners cannot reside locally or use the local currency in their business operations. Tax havens in general are characterised by a tax and regulatory regime which distinguishes between investments made by locals and foreigners, with the regulations giving favourable treatment to the latter in all ways. A tax and legal system of this kind is often described as "ring-fenced".

Exemption rules. Companies governed by ring-fenced legislation direct their activities toward foreigners. Companies operating within this regime can conceal or veil the identities of those who own or control the business, are partly or wholly exempted from paying taxes, have no real obligations relating to accounting or auditing, have no

duty to preserve important corporate documents, and are able to move the company to a different jurisdiction with a minimum of formalities.

The tax haven business model. Jurisdictions which offer exemptions like those described above derive their revenues from the registration and management fees paid by the companies. The total effect of these payments is insignificant for the companies, but they represent an important source of income for the tax havens, which are often very small jurisdictions. This makes it important for tax havens to attract many foreign registrations. These may amount to 95-98 per cent of the total number of registered companies in the jurisdiction; the remainder being ordinary companies with local activities.

Secrecy. The lack of access into tax relevant information and the absence of public registries in tax havens differ from corresponding regulatory regimes in states based on the rule of law because the actual purpose is to conceal activities which take place in *other* jurisdictions. The legal framework in tax havens has, unlike in other countries, no balance between the interests of the owners (the clients of tax havens) and the interests of the company's creditors, employees, or other social interests. Such aspects affect third countries because the companies and the owners of the registered companies are neither active nor domiciled in the tax haven. The geographical division between the formal domicile of the companies and the location of their economic activities means that those with legitimate claims against companies in tax havens have no or very limited opportunity to protect their interests. As a result of the secrecy rules, those affected by the operation and development of the companies or those who have claims against the owners have very few opportunities to discover what is actually happening in these companies or who operates and owns them. If the owners themselves wish to provide accurate information to the outside world, they are at liberty to do so. But they can also conceal their identity or present misleading or opaque information about ownership and the company's real position and operations.

Tax treaties. An unfortunate effect of tax treaties as they are normally drafted is that they reduce tax revenues in the country where the income is earned (the source country). Combined with the use of secrecy rules and fictional domiciles, this makes the access to tax-relevant information conferred by such treaties illusory. Paradoxically, tax treaties help to make tax havens a more favourable

¹ Uglund House in George Town, Cayman Islands, which takes its name from a Norwegian ship owning family.

location than if such agreements did not exist. The tax treaties will not affect the harmful structures that exist in tax havens. Accordingly, the Commission has noted that tax treaties can do more harm than good unless they are followed by measures that reduce the harmful structures identified by the Commission. It is important to ensure that in this connection the tax treaties do not constrain further action against tax havens.

1.3.2 Damaging effects of tax havens

Tax havens increase the risk premium in international financial markets. The financial crisis has revealed that many financial institutions carried off-balance-sheet liabilities where part of the liability was registered in tax havens and thereby protected from insight. Examples include underwriting structured investment vehicles and structured investment products registered in tax havens. Tax havens enhance counterparty risk and information asymmetry between different players, which undermines the working of the international financial market and contributes to higher borrowing costs and risk premiums for all countries.

Tax havens undermine the working of the tax system and public finances. Tax havens offer secrecy rules and fictional domiciles combined with “zero tax” regimes in order to attract capital and revenues that should have been taxed in other countries. This increases competition over mobile capital, but not tax-related competition in the normal sense since tax havens offer harmful legal structures which encroach heavily on the sovereignty of other countries. This has made it difficult for other countries to maintain their capital taxes, and has thereby contributed to lower taxes on capital. Developing countries have a narrower tax base than rich countries, and also obtain the largest portion of their tax receipts from capital. Accordingly, lower capital taxes mean either a decline in revenue and/or higher taxes on a narrower base. Moderate tax rates on a relatively broad base are preferable to high taxes on few tax objects, because tax efficiency declines more than proportionately with the tax rate. As a result, tax havens help to boost the socio-economic costs of taxation and weaken economic growth in developing countries.

Tax havens increase the inequitable distribution of tax revenues. The use of tax havens affects which country has the right to tax income from capital and can lead to a more inequitable distribution of tax revenues. This problem relates particu-

larly to taxation of capital gains by companies registered in tax havens. The normal approach in bilateral treaties regulating which country has the right to tax international revenues is to apply the domiciliary principle – in other words, the primary right to tax rests with the country in which the owner is domiciled or registered rather than the source country. This method of assigning the right to tax has traditionally been justified by reference to the strong link which typically exists between the country of domicile and the taxpayer. The justification for this principle of taxation disappears in cases where legal entities are merely registered in a jurisdiction, without pursuing real activity of any kind. A characteristic of tax havens is precisely that the link between the tax subject and the jurisdiction exists only at the formal level. In such cases, considerations of fairness suggest that the source country should have the right to tax.

Tax havens reduce the efficiency of resource allocation in developing countries. Tax havens make it more profitable to pursue tax evasion and planning through instruments which encroach on the sovereignty of other countries. These activities are not profitable for society as a whole because they make no contribution to value creation. Tax havens can also influence which investments are the most profitable after tax, and thereby increase the gap between private and socio-economic investment criteria. This can lead to a redistribution of resources by the private sector away from activities which yield the highest pre-tax return to ones which give the best return after tax. Such behaviour reduces overall value creation.

Tax havens make economic crime more profitable. A common feature of many developing countries is that they lack resources, expertise and capacity to build up and develop an efficient bureaucracy, and that the quality of the tax collection system is less well developed than in rich nations. The probability that economic crime will be discovered by the authorities is accordingly lower in developing countries. Secrecy legislation in tax havens provides a hiding place for players who want to conceal the proceeds of economic crime. Tax havens thereby lower the threshold for such criminal behaviour.

Tax havens can encourage rent-seeking and reduce private incomes in developing countries. Countries rich in natural resources have averaged lower growth than other nations over the past 40 years. This phenomenon is often termed the paradox of plenty. The most important lesson it teach-

es is that revenues which fall naturally into the lap of the political and economic players in a country can have unfavourable economic consequences in nations with weak institutions (such as a weak government bureaucracy and weakened democratic processes). This is because resources are wasted on redistributing existing revenues in one's own favour rather than on creating new income (known as rent-seeking).

Rent-seeking leads to the reorientation of society's resources away from productive value creation. A particularly important effect of this reorientation is that tax havens influence how some private entrepreneurs choose to use their talents. Tax havens make it relatively more profitable for them to devote their abilities to increasing the profitability of their own business through tax avoidance rather than through efficient operation. A private-sector distortion of talent along these lines is not balanced by a socio-economic gain, because the socio-economic calculation must reflect the fact that tax saved for the private entrepreneur represents a reduction in government revenue. Tax havens thereby enhance the profitability of being a rent-seeker, which prompts more people to opt for rent-seeking and fewer to choose productive activities. The more people who opt for rent-seeking, the fewer who participate in productive activity. In fact, rent-seeking activity can become so great that private income actually falls. Such a redirection of talent away from value creation is a particular problem in countries with a low level of expertise and technological development.

Tax havens damage institutional quality and growth in developing countries. Potentially the most serious consequences of tax havens are that they can contribute to weakening the quality of institutions and the political system in developing countries. This is because tax havens encourage the self-interest that politicians and bureaucrats in such countries have in weakening these institutions. The lack of effective enforcement organisations mean that politicians can to a greater extent exploit the opportunities which tax havens offer for concealing proceeds from economic crime and rent-seeking. These proceeds can be derived from corruption and other illegal activities, or be income which politicians have dishonestly obtained from development assistance, natural resources and the public purse. By making it easier to conceal the proceeds of economic crime, tax havens create political incentives to demolish rather than

build up institutions, and to weaken rather than strengthen democratic governance processes.

Over the past decade, it has become clear that institutional quality represents perhaps the most important driver for economic prosperity and growth. Acemoglu, Johnson and Robinson (2001) is the best-known study that looks at the impact of institutions on national income. It estimates that if countries which scored low for institutional quality could have improved their institutions, national income would have increased up to sevenfold. Few factors have such a strong influence on growth as improving institutions. This is precisely why the damaging effects of tax havens can be so substantial for developing countries – they contribute not only to preserving poor institutions but also to weakening them.

1.3.3 Capital flows and tax havens

The scale of illicit money flows from developing countries to tax havens cannot be determined precisely, but it unquestionably far exceeds development assistance, for instance, or direct investment in these countries. In 2006 the total registered money flows into these countries (including China and India) is estimated at USD 206 billion (IMF World Economic Outlook database). Total development assistance was USD 106 billion (OECD). Donor aid accounted for USD 70 billion of this figure. The most qualified estimate (Kar & Cartwright-Smith (2008)) for illegal money flows from developing countries indicates that illegal capital flows totalled USD 641-979 billion. The illegal outflow corresponds roughly to ten times donor aid given to developing countries.

Not all the illegal money flows go to tax havens, but it is well documented that placements in these jurisdictions are very large and that a substantial proportion of the capital placed there is not declared for tax. The Tax Justice Network has estimated (2005) that placements by high net-worth individuals in tax havens totalled USD 11-12 000 billion in 2004. Official statistics suggest that the scale of such placements increased sharply in subsequent years, while the financial crisis has led to a decline over the past year. Revelations in the USA and the UK indicate that only about five per cent of those placing assets in tax havens declare these for taxation in their home country (confer the UBS case in the USA, US Senate (2008) and Sullivan (2007) in the UK).

1.3.4 Other conditions

The Commission has determined that the problem related to the use of tax havens primarily represents a combination of (a) a ring-fenced tax system offered to players who do not pursue real business operations in these jurisdictions, but in other states, and (b) secrecy legislation which conceals the identity of the owner, the company's actual activity, transactions and so forth from the countries in which the business is actually conducted. These factors are reinforced by bilateral treaties to avoid double taxation, which often assign the right of taxation to tax havens. Many countries that in a number of areas are not perceived as tax havens possess elements of the types of structures typically found in tax havens. A case in point is the Norwegian international ship register. The Commission believes that the goal must be to eliminate such structures regardless of where they are established, but tax havens have gone much further than other countries in consistently developing such harmful structures.

The Commission has not demarcated tax havens in the form of a list, and believes that existing lists are inadequate for determining which jurisdictions possess harmful structures. Any list must be based on a detailed assessment of regulations and regulatory regimes in various jurisdictions. This has not been possible within the time allowed for the Commission's work.

A number of recommendations are made by the Commission, aimed partly at reducing the scope of the types of harmful structures described above and partly at reducing their damaging effect on developing countries. What Norway can achieve on its own is limited. Generally speaking, problems associated with tax havens must be combated through international collaboration. The most important of the Commission's recommendations are briefly presented below. The recommendations and the reasons for making them are described more fully in chapter 9.

1.4 Recommendations by the Commission

Development policy. The Commission has noted that the Norwegian authorities should increase their commitment to strengthening and improving tax regimes and anti-corruption efforts in developing countries. Working to strengthen democratic processes in developing countries is also

important, including support for organisations and institutions working for greater transparency, democratisation and accountable government (including freedom of the press and civil society). Norwegian industrial policies should also more strongly reflect the goals of Norwegian development assistance, so that the two conflict as little as possible.

Advisors and facilitators. The Commission wants the Norwegian actors who facilitate and establish operations in tax havens to record their activities in a dedicated Norwegian registry, where establishments from 2004 and onwards would be registered. A special domestic law Commission should be established in Norway to formulate the legal basis for such registration and the jurisdictions it should include. The Commission would also study a number of issues related to the tax status of companies that do not have local operations in tax havens.

Information duty and annual accounts. The Commission takes the view that the Norwegian authorities should study whether multinational companies in Norway could be required to present in their annual reports key figures relating to such aspects as taxable profit and tax payable as a proportion of taxable profit in each of the countries in which they have operations. Such information is important not only for investors but also for society, because most multinational companies have expressed support for corporate social responsibility.

Transfer pricing. The Commission takes the view that incorrect pricing of intra-group transactions with the aim of transferring profits to low-tax jurisdictions is a major problem for both rich and poor countries. Even in a country like Norway with relatively good tax controls, data from Norwegian enterprises indicate that multinational companies transfer a substantial share of their profits to low-tax jurisdictions. The loss of potential tax revenue from foreign multinational enterprises is estimated as being in the order of 30 per cent. On that basis, the Commission accordingly requests the Norwegian authorities to investigate a set of instruments which can be used to determine transfer pricing that are broader than those currently provided by Norway's domestic legislation, and that Norway also promotes such instruments in international fora.

National centre of expertise. The Commission has noted a lack of social investment related to transfer pricing and international constructions for avoiding tax. A general problem for all coun-

tries, but particularly for developing countries, is that expertise related to tax evasion techniques and transfer pricing exists primarily in the private sector. The public sector, including higher education institutions, have limited incentives for developing such expertise – partly because the financial incentives are not as strong and partly because this type of expertise is not concentrated in one place in the public sector. Accordingly, the Commission recommends the establishment of a centre of expertise which can conduct research into and support the Norwegian authorities on such issues, and which can simultaneously contribute to enhancing expertise on such issues in developing countries.

Cross-ministerial working group. The Commission recommends that the Ministry of Foreign Affairs appoint a cross-ministerial working group to develop networks with other countries which might cooperate with Norway to reduce and to eliminate harmful structures in tax havens. This group will also work to put tax havens on the agenda in international finance and development institutions.

Tax treaties. Tax treaties contain provisions on assigning taxation rights between two jurisdictions. They also provide for information exchange upon request. In the Commission's view, the use of tax treaties does not eliminate the damaging effects caused by tax havens. Signing a tax treaty with such jurisdictions does not lead to the establishment of official company and owner registries with a duty to keep accounting information, or the introduction of substantial genuine audit provisions. Nor will a tax treaty prompt a tax haven to change its practice of ring-fencing parts of its tax system so that foreigners secure better tax terms than nationals. Practice shows that issues related to re-domiciling of funds (in other words, transferring funds from one tax haven to another) will persist. Since none of these issues is affected by tax treaties, tax havens will have no incentive to exercise control over the extensive opportunities for misuse offered by the exemption system. The Commission accordingly recommends that Norway take both national and international initiatives to create new rules for (i) when a legal entity can be regarded as domiciled in a tax haven (including requirements for real economic activity in such jurisdictions) and (ii) assigning taxation rights between countries.

Convention on transparency in international economic activity. Norway should take the initiative to develop an international convention to pre-

vent states from developing secrecy structures which are likely to cause loss and damage to other jurisdictions. This initiative should be taken together with other countries that take the same view on such issues. The Commission would emphasise that, even though a number of countries are unlikely to sign to such a convention, experiences with other conventions which many countries have refused to sign are positive. Examples include the conventions banning the use of anti-personnel mines and cluster munitions. These have established norms, and even countries which have not signed up have applied them in various contexts and in a constructive manner. Such a convention should be general, apply to all countries and be directed against specific damaging structures rather than specific states or state systems.

Guidelines for Norfund. The Commission presents a number of detailed recommendations concerning Norfund, which include the preparation of ethical guidelines on the choice of investment location and how Norfund should report its operations. In the Commission's view, Norfund should gradually cease to make new fund investments via tax havens over a three-year period from the approval of the Commission's report. The Commission has noted that the consequence of this will probably be that Norfund increases its direct investments in companies in developing countries, without that necessarily having a negative effect on the profitability of the institution's investments. Furthermore, the Commission takes the view that, since Norfund has goals related to contributing to value creation and tax revenues in developing countries, the pre-tax return on its investments should be the most important investment parameter. Managing in accordance with the post-tax return means that Norfund would devote resources to minimising its tax payments in developing countries. This is not reconcilable with the institution's objective of contributing to development in poor countries. The Commission has not found it appropriate to recommend that the government ask Norfund to withdraw from funds existing in tax havens.

The Commission takes the view that risk capital is essential for sustainable development. Norfund's investment activities make an important contribution in that respect. When framing transitional arrangements, the owner must take into account the possibility that new rules could impose additional costs on Norfund and limit its investment opportunities.

On the other hand, account must be taken of the damaging effects of maintaining structures used to conceal illegal capital flows from developing countries. The Commission has established that tax havens represent an important hindrance to growth and development in poor countries, and that they make it opportune for the political and economic elites in developing countries to harm the development prospects of their own countries. Putting a stop to the damaging activities of tax havens is accordingly important. The Commission

takes the view that a short transitional period for Norfund will send an important signal as to the significance of not using tax havens. Against the background of ongoing processes in other countries, other actors are expected to adopt similar restrictions. Therefore, Norway has an opportunity to take a leading role in this work. In the longer term, the new guidelines for Norfund could also contribute to the creation of more venues for locating funds in African countries without harmful structures.

Chapter 2

Tax havens: categorisation and definitions

This chapter first discusses the concept of tax havens and how different institutions interpret the concept. It then provides a description of harmful structures in states that are not categorised or regarded as classic tax havens. The interaction between such structures within and beyond tax havens is important to understand how tax havens damage other states.

The Commission has not proposed a precise definition of the term “tax haven”, but takes the view that the combination of secrecy and virtually zero tax terms characterise such jurisdictions. Secrecy means both rules and systems that, for example, prevent insight into the ownership and operation of companies, trusts and similar entities, and the opportunity to register tax-free shell companies that actually conduct their business in other countries.

2.1 What is a tax haven?

“Tax haven” is not a precise term. No generally accepted criteria exist for determining the elements which should be given weight in classifying tax havens. The concept, therefore, finds no application in international law or national legal texts, but appears in certain legislative proposals which seek to authorise measures to counter harmful structures and the lack of information-exchange in tax cases.

Nevertheless, “tax haven” is a well-known and frequently used expression in the media and in everyday conversation. It is applied imprecisely to states characterised by the adoption of unusually low tax rates – either for their whole economy or for shell companies with foreign owners.

As a classification criterion, the tax base and level of taxation are complex to deal with. Countries which have traditionally levied high rates of tax have also introduced favourable tax arrangements in certain areas¹ – permanently or for defined periods – for certain taxpayers or taxable objects. Such solutions are generally a result of

strong pressure groups, specific political preferences or special governmental needs. The justification may be, for example, that the arrangement is required in order to attract capital or that other countries have similar systems. Over time, therefore, the tax base and tax rates may be transient values in many states.

“Tax haven” is often used as synonymous with or an alternative to “offshore financial centre” (OFC) and “secrecy jurisdiction”, which reinforces the lack of clarity. No consensus exists on which functions must be exercised for a state to be characterised as an OFC.

Tax havens wish to present themselves as professional “financial centres”. This term is in itself so imprecise that such a categorisation provides no meaning. A “financial centre”, for example, could be a place where companies and other legal entities are registered but where no decisions are made on the acquisition or sale of financial assets or transactions between various parties. It is important to point out that very little of the value creation in the financial industry occurs in classic tax havens, but takes place overwhelmingly in major financial centres such as London, New York and Frankfurt. Given the requirements set in international financial markets for size, location, level of education, general infrastructure and expertise, most of the classic tax havens have no capacity to provide advanced financial advice.

Tax havens are occasionally described as “offshore” states, with activity in the structures which earn them this designation termed the “offshore sector”. Use of the “offshore” expression can give

¹ See Zimmer (2009), *Internasjonal inntektsskatterett* (International income tax law), 3rd edition, pp 48-49. The Netherlands, Denmark, Sweden and Ireland, for example, have introduced special schemes to attract capital. Holding companies located in these countries can achieve reduced or zero tax on dividends from abroad or gain on foreign shares. In exchange, these countries attract international companies. The effect, which involves undermining the tax base in other states, can be short-lived. If all states do the same, the competitive advantage will be zeroed out while tax revenues are reduced for all states.

a false impression of tax havens as island states. This term reflects the fact that the operations which can earn them their tax-haven status observe their own rules, and not those applied for the rest of the country's economic activity. Viewed from that perspective, the legal rules which govern this business are an "island" in relation to the rest of the legal system.

The Commission's mandate uses the term "secrecy jurisdictions". This is applied to jurisdictions with strict secrecy regulations. All states have such rules to protect important private and public interests in the community. Tax havens distinguish themselves by the way the regulations are formulated and the strength of their protection. Many have special legal provisions to enhance the duty of confidentiality that applies to the employees of banks and other financial institutions in respect of their relationship with clients. Secrecy is often reinforced by the absence of public registries containing significant information about companies and other legal entities conducting economic activity. The registries are often particularly deficient for companies that intend to pursue operations exclusively in other states. In addition, the information which might be available is difficult to access, even through collaboration with other states based on legal assistance agreements. See chapter 3 below for further details.

Regardless of the definitions used, the principal objections remain the same. The regulatory regime is constructed in a way which caters to circumventing private and public interests in other states – in other words, those states where the owners of the companies are domiciled or have their obligations. The tax base in other states is particularly affected, but structures in tax havens are in many cases also suitable for concealing a number of other forms of criminal activity.

Depending on the definition chosen, the world currently has between 30 and 70 "tax havens". This implies that 15-30 percent of the world's states might be classified in one way or another as tax havens. The Commission has not found it appropriate to produce a list of tax havens. Relatively clear criteria for defining tax havens would be required, along with an extensive assessment of domestic law in a number of states. The Commission would nevertheless emphasise that it is hardly difficult to distinguish classic tax havens from states that regulate certain sectors in ways similar to the regulations found in classic tax havens. Secrecy rules and lack of transparency, in particular, represent the biggest differences.

The Commission has found it more appropriate to identify key systems which have been adopted in classic tax havens and which, in the Commission's view, are particularly damaging for other states. Furthermore, it describes how and why these are suitable for misuse and for causing loss and harm to public and private interests in other states. The main purpose is to demonstrate how these systems harm developing countries, but they can also be very damaging to developed countries.

The Commission's classification of tax havens has many features in common with the criteria presented in the OECD's 1998 report on *Harmful Tax Competition: An Emerging Global Issue*. This document discusses how a tax haven should be defined. The OECD identifies the following characteristics of these jurisdictions:

1. very low or no tax on capital income
2. a special tax regime for shell companies (ring-fencing)
3. a lack of transparency concerning ownership and/or lack of effective supervision
4. no effective exchange of information on tax issues with other countries and jurisdictions.

The second of these characteristics means, in reality, that tax havens create laws and systems through ring-fencing which primarily affect other states. This is a fundamental problem with tax havens. The first characteristic, concerning low or no tax on capital income, helps to make tax havens attractive, but it is the combination of this and the other distinguishing features which make them so damaging to other countries. What forms of taxation and levels of tax should apply to the state's own citizens and within its own jurisdiction must be a decision for each sovereign state alone. The problem is that the damaging systems in tax havens primarily have a direct effect on the taxation rights of other countries, with income which should have been taxed where the recipient is domiciled, for example, being concealed in the tax haven. The sovereignty principle does not extend to granting freedom from tax on income which is wholly or substantially liable to tax in other states, even though it might seem that only recognised legal principles are being applied.

The Commission would emphasise that the damaging structures in tax havens not only influence tax revenues in other states. These structures are also suitable for conducting and concealing a great many forms of criminal activity in which it is important to hide the identity of those

involved, where the crimes are being committed and what they involve. This includes such activities as the illegal sale of valuable goods, art, weapons and narcotics, human trafficking, terrorism, corruption, theft, fraud and other serious economic crimes. Generally speaking, the structures are suitable for laundering the proceeds of criminal activity. In Chapter 5, moreover, the Commission describes how the characteristics listed above collectively have major consequences in other countries, in particular for developing countries because they weaken the quality of institutions such as the legal system, the civil service in a broad sense and democratic processes.

2.2 Harmful structures in other states

The Commission would point out that the classic tax havens are not alone in promulgating systems that cause loss and harm to public and private interests in other states. Many countries possess elements of damaging structures, but they often do not have the full range of structures such as those found in fully-fledged tax havens.

Of particular significance are various pass-through arrangements. These undermine the tax base in both source and domiciliary states with the aid of intermediate companies (often a holding company) which have little or no commercial activity in the pass-through state. A case in point is the Netherlands. Data from the Dutch central bank reveal the scope of special financial institutions (SFIs). These are mainly shell companies suitable for undermining the tax base of other states. Their overall assets totalled EUR 4 146 billion as of 31 December 2008. Direct investments from the Netherlands accounted for just over EUR 2 200 billion, with the SFIs accounting for more than EUR 1 600 billion. That put the Netherlands in second place on the list of OECD countries with the largest direct investments, just behind the USA. Of the world's total direct investment, 13 percent is invested in Dutch SFIs.

The Netherlands is probably the largest and most popular pass-through state in the world today.² The precondition for the pass-through model to function is that the pass-through company can be seen as domiciled under the tax treaty in

the Netherlands and that the company is considered the beneficial owner, which means that it is the rightful owner of the income that passes through. This is often difficult to discover by states that are harmfully effected without access to information from the pass-through state. Since the Netherlands does not permit the same level of secrecy as tax havens, the Dutch holding company system is often combined with the use of companies in tax havens. The Netherlands is, therefore, a popular registration location because it confers legitimacy and also has an extensive network of tax treaties.

A number of other states not regarded as tax havens also permit pass-through companies which can damage the tax base in other countries by allowing artificial and commercially unnecessary companies to be inserted between the source and domiciliary state.

Some countries have introduced regulations which provide that foreigners who move there only pay tax on income earned locally, while revenue from other sources is regarded as tax-free – at least for a certain period. A significant difference nevertheless exists. This system applies to people who move to the jurisdiction, while the owners of international companies in tax havens are domiciled in other states.

There are also other examples of harmful structures outside of the tax havens. A number of countries have introduced types of companies which are exempt from audit requirements and/or charged little or no tax on specified tax bases.³ These often involve company structures suitable for engaging in activities with structures based in tax havens and with states which have established a large network of tax treaties.

Certain states permit very harmful secrecy rules, even though they cannot be regarded as classic tax havens.⁴ Examples include Switzerland and Luxembourg. These countries have recently agreed to establish tax treaties with information exchange also for suspicion of tax evasion, but traditional secrecy will continue for countries that do not have these treaties, including developing countries.

The same effect achieved by strict secrecy regulations is secured if lawyers (with an absolute duty of confidentiality) are permitted to act as

² When President Obama submitted proposals on new tax regulations and measures against tax havens on 4 May 2009, the press release noted that almost a third of all profit earned abroad by US companies came from “three small low-tax countries: Bermuda, the Netherlands and Ireland”.

³ See, for example, the coverage in Norwegian Official Report (NOU) 2009:4 of Norwegian-registered foreign companies (NUFs) which operate with parent companies in such countries as the UK.

⁴ Refer to OECD (2008).

nominee shareholders in limited liability companies. Generally speaking, the use of lawyers as advisors and facilitators for structures in tax havens reinforces the problems of uncovering criminal behaviour. This form of activity by lawyers falls outside the justification of their duty of confidentiality – in other words, the protection of communication with their clients in certain circumstances.

Taken together, a substantial number of states cause harm to other states by permitting arrangements which affect or undermine legal systems in the other states. These include the Netherlands, the USA (Delaware), the UK and Belgium.⁵

2.3 How different institutions define the tax haven concept

Certain organisations have formulated relatively precise criteria for what identifies tax havens, OFCs, secrecy jurisdictions and the like, and have compiled lists of jurisdictions based on these criteria. This section presents some examples of such lists.

2.3.1 The OECD

The OECD began to work seriously on the issue of tax havens in 1996 as part of its activity related to tax issues. A list of 40 jurisdictions characterised as tax havens was drawn up by the organisation in 2000.⁶ This list was based on the criteria in OECD (1998). The OECD changed its work in this area during 2001, and the 2000 list has not been used or updated. See table 2.1. A weakness of the list is that the OECD's member states are not included.

In recent years, the organisation has concentrated its efforts related to tax havens on “harmful tax systems” and agreements on information exchange related to taxation. By the end of April 2009, all jurisdictions had expanded their agreements regarding the exchange of information, and the OECD consequently no longer considers

any jurisdictions to be “non-cooperative tax havens”.

In connection with the G20 meeting in April 2009, the OECD compiled a list which divided countries and jurisdictions into four categories based on their declared willingness to enter into agreements on information exchange over tax issues as well as the actual establishment of such agreements. One of the four categories covers tax havens, as defined by the OECD in 2000, that have entered into many tax treaties. Jurisdictions which satisfy many of the criteria formulated by the OECD in 1998, but which have concluded many tax treaties, are grouped with the majority of OECD members (including Norway). Since the 2009 list is not based on an assessment of whether the jurisdictions are suitable for concealing assets and capital income or for money laundering, the list cannot be regarded as a categorisation of tax havens.

2.3.2 The IMF

The International Monetary Fund (IMF) has taken a completely different approach to secrecy jurisdictions from that taken by the OECD in recent years because it has a programme related to money laundering and financial monitoring in OFCs. The IMF has described the characteristics of OFCs in a number of contexts, and lists OFCs which have been invited to collaborate with the IMF. The organisation nevertheless lacks a clear definition or official list of OFC jurisdictions. A working document from the IMF (Errico and Musalem 1999) provides a list of 69 jurisdictions designated as OFCs. IMF (2008) contains a list of 46 jurisdictions that have been invited to collaborate on supervision and money laundering and to report data. The 2008 list is presented in table 2.1.

2.3.3 The US Senate Bill – Stop Tax Haven Abuse Act

A bill designated the “Stop Tax Haven Abuse Act” is before the US Senate. It was previously voted down, but it might now be re-introduced. The proposal includes provisions which give the tax authorities greater powers to pursue tax issues related to a specific list of secrecy jurisdictions. It also contains definitions of such jurisdictions, so that individual jurisdictions may be removed from the list or new ones added. The list of secrecy jurisdictions includes 35 countries. The principal criteria for being characterised as secret is that:

⁵ Refer to Van Dijk, M et. al (2006) regarding the Netherlands, and The Economist (2009) regarding the USA and the UK. Belgium's international coordination regime is due to be wound up next year after the European Commission found that its rules violated the EU's regulations on state aid. OECD (2008) refers to the strictness of banking secrecy in Belgium.

⁶ Refer to OECD (2000) Towards Global Tax Co-operation, report to the 2000 Ministerial Council meeting and recommendations by the Committee on Fiscal Affairs.

“(the jurisdiction) has corporate, business, bank, or tax secrecy rules and practices which, in the judgment of the Secretary, unreasonably restrict the ability of the United States to obtain information relevant to the enforcement of this title.”⁷

The wording “this title” in the quotation above must be understood as taxation related to the foreign capital income of American citizens.

The bill contains amplifications of the main criterion, but provides room for the exercise of judgement. However, certain specific criteria are also provided to define secrecy jurisdictions. These include the categorisation of jurisdictions with “regulations and informal government or business practices having the effect of inhibiting access of law enforcement and tax administration authorities to beneficial ownership and other financial information”⁸ as secrecy jurisdictions. One possible interpretation of this provision is that countries which establish forms of ownership without mandatory registration of beneficial ownership in registries to which the authorities can obtain access through a court order will be regarded as secrecy jurisdictions. Even countries with such systems which enter into an agreement on the exchange of tax information with the USA

⁷ Stop Tax Haven Abuse Act, p 6, lines 9-14.

⁸ Stop Tax Haven Abuse Act, p 6, lines 20 to p 7 line 2.

will continue to be regarded as secrecy jurisdictions if they do not establish registries of beneficial ownership.

The bill’s list of secrecy jurisdictions was not compiled by the direct application of its own criteria. The selected jurisdictions are identical to those which the US Internal Revenue Service (IRS) asked the courts to request access to with regard to credit cards use by Americans. The IRS had a justifiable suspicion that Americans were using these jurisdictions to avoid tax. As a result, the list does not include secrecy jurisdictions which are little used by Americans in this way. More jurisdictions would probably have been defined as secret if the bill’s criteria had been applied in a systematic manner. See table 2-1.

2.3.4 Tax Justice Network

The Tax Justice Network (TJN) is an organisation that works to promote understanding of the significance of taxation and the harmful effects of tax evasion, tax competition and tax havens.

Tax Justice Network (2007) *Identifying Tax Havens and Offshore Financial Centres* contains a list which includes all the jurisdictions on the OECD’s tax haven list as well as all those considered by the OECD to have a “potentially harmful tax regime”. It also incorporates countries which the TJN found were being recommended by websites involved in the marketing of tax planning.

2.3.5 Comparisons of various designations

Table 2.1 Tax havens and related terms – designations by various institutions

	OECD 2000	IMF 2008	US Senate	Tax Justice Network 2007
<i>The Caribbean and Americas</i>				
Anguilla	x	x	x	x
Antigua and Barbuda	x	x	x	x
Aruba	x	x	x	x
Bahamas	x	x	x	x
Barbados	x	x	x	x
Belize	x	x	x	x
Bermuda		x	x	x
British Virgin Islands	x	x	x	x
Cayman Islands	x	x	x	x
Costa Rica		x	x	x
Dominica	x	x	x	x
Grenada	x	x	x	x
Montserrat	x	x		x

Table 2.1 Tax havens and related terms – designations by various institutions

	OECD 2000	IMF 2008	US Senate	Tax Justice Network 2007
Netherland Antilles	x	x	x	x
New York				x
Panama	x	x	x	x
St Lucia	x	x	x	x
St Kitts & Nevis	x	x	x	x
St Vincent and the Grenadines	x	x	x	x
Turks and Caicos Islands	x	x	x	x
Uruguay				x
US Virgin Islands	x			x
<i>Africa</i>				
Liberia	x			x
Mauritius	x	x		x
Melilla (Spain)				x
Seychelles	x	x		x
São Tome é Principe				x
Somalia				x
South Africa				x
<i>Middle East and Asia</i>				
Bahrain	x	x		x
Dubai				x
Hong Kong		x	x	x
Malaysia (Labuan)		x		x
Lebanon		x		x
Macau		x		x
Singapore		x	x	x
Tel Aviv				x
Taipei				x
<i>Europe</i>				
Alderney	x		x	x
Andorra	x	x		x
Belgium				x
Campione d'Italia				x
London				x
Cyprus	x	x	x	x
Frankfurt				x
Gibraltar	x	x	x	x
Guernsey	x	x	x	x
Hungary				x
Iceland				x
Ireland		x		x
Ingushetia				x
Isle of Man	x	x	x	x
Jersey	x	x	x	x
Latvia			x	

Table 2.1 Tax havens and related terms – designations by various institutions

	OECD 2000	IMF 2008	US Senate	Tax Justice Network 2007
Liechtenstein	x	x	x	x
Luxembourg		x	x	x
Madeira (Portugal)				x
Malta	x	x	x	x
Monaco	x	x		x
Netherlands				x
San Marino				
Sark	x		x	x
Switzerland		x	x	x
Trieste				x
Turkish Republic of Northern Cyprus				x
<i>Indian and Pacific Oceans</i>				
Cook Islands	x	x		x
Maldives				x
Marianas				x
Marshall Islands	x	x		x
Nauru	x	x	x	x
Niue	x	x		x
Palau		x		
Samoa	x	x	x	x
Tonga	x			x
Vanuatu	x	x	x	x
Antall	40	46	35	72

Jurisdictions included on all four of the lists are fairly small countries or partly autonomous regions. On the other hand, the TJN list also includes relatively populous countries such as Switzerland, the Netherlands, South Africa and Singapore, as well as the world's largest financial centres – New York and London.⁹

2.3.6 Discussion of designations

As noted above, “tax haven” as a term is neither precise nor well-defined. Furthermore, the term is often used together with offshore financial centre and secrecy jurisdiction. The lack of precision in the use of concepts results in differing categorisations. In addition, actual categorisations by international organisations are affected by the desire of many states to prevent their designation as a tax haven. Designations by international organi-

sations are also partly the result of negotiation-like processes. As a result, for example, the OECD's 2000 list does not include any of its member countries.

The Commission takes the view that certain jurisdictions have regulatory regimes and systems that provide good opportunities for evading tax in other countries, for money laundering and for evading economic liability. It is countries and jurisdictions with such systems that the Commission would characterise as tax havens. A number of countries and jurisdictions have regulatory regimes which accord with all the general characteristics of tax havens cited above, but many more meet only one or a few of these criteria. The damaging effects for other countries can occur even though only some of the criteria are met. A few examples can illustrate this point.

- The Netherlands exchanges information both through an extensive network of tax treaties and through the EU's savings directive. The Netherlands imposes a 30 percent tax on inte-

⁹ Neither London nor New York is a jurisdiction with full self determination over tax rates, for example.

rest income and 25 percent on dividends from companies in which the taxpayer has a large equity holding. Consequently, the Netherlands fails to meet characteristics one and four in the above list. Nevertheless, the Netherlands can be regarded as a tax haven because it has regulations which allow companies to reduce their tax in other countries by establishing shell companies there (van Dijk et. al 2006). The Netherlands has amended some of its tax regulations and is in the process of phasing others out, so that the damaging effects can be reduced, but it could still be regarded as a tax haven for multinational groups.

- Individuals and companies that want to evade tax, launder money or evade economic liability find it attractive to be able to establish companies under false or concealed identities. Such companies become particularly attractive if it is also possible to open an associated bank account. In a test to determine how simple it was to establish companies under false names, Professor Jason Sharman found that it was easier to do this in countries such as the USA and the UK than in many countries normally regarded as tax havens.¹⁰ Generally speaking, a number

of countries not considered to be tax havens have regulations and practices which are well suited to committing various types of economic crime.

- Gordon (2009) reviews 21 cases involving economic crime committed by “politically exposed persons”. Many of these involve the creation of shell companies in order to conceal the criminal activity and its proceeds. In half of the cases, the companies are established in countries which Gordon does not regard as tax havens.

The Commission has not had the opportunity to review the laws and regulatory practices in all of the countries where these issues are relevant, and for that reason it cannot present all the nuances of these issues. Instead, the Commission will devote chapter 3 to presenting what it means by harmful structures and to demonstrating how these are constructed in many tax havens.

¹⁰The study is reproduced in the article “The G20 and tax – haven hypocrisy” in *The Economist*, 26 March 2009, and in Sharman, J (2009): *Behind the Corporate Veil: a Participant Study of Financial Anonymity and Crime* (unpublished).

Chapter 3

About tax havens and structures in tax havens

This chapter describes distinctive features of the legislation in tax havens. The aim is to give an account of the features that contribute to allowing tax havens to facilitate tax evasion and violations of the laws in other states. The main element is secrecy, i.e., severe restrictions on transparency, opaque company and trust structures, and a lack of public registers. The problem is that these structures invite crime, in the form of tax evasion, money laundering, and a series of other crimes.

The distinction between tax havens and other states and jurisdictions is not unequivocal.¹ This chapter deals with the rules and systems that make the establishment of harmful structures possible. Some countries that may be described as classical tax havens exhibit all these harmful structures. Other jurisdictions have only introduced some of these regulations and systems. This chapter refers to tax havens as a homogeneous group. This is a simplification in relation to the heterogeneity that actually exists among jurisdictions with harmful structures of these kinds.

3.1 Sources of law and questions of method

The formal basis for the regulation of the activities of companies and trusts² in tax havens lies in legislation. Of particular relevance to the interests

of the Commission is secrecy legislation and the legislation on companies and trusts, and how these define the rights and obligations of legal entities under the law – including the balancing of interests between the agents who are involved.

In a modern state governed by law, an approach based on legal dogmatics will generally provide a good basis for understanding the purpose of legislation and how the interests involved have been assessed and balanced. The language of the law and its legislative history will answer many questions of interpretation that may be raised in respect of the legislation. At the very least, it will be possible to clarify the nature of any unresolved issues. Where there is doubt, the issues will be decided through case law.

In a number of important areas, the legislation of tax havens has characteristics that differ substantially from the legislation in modern rule-of-law states. In well-regulated rule-of-law states, legislation balances the interests of all those who have a stake in companies with limited liability (owners, creditors, employees, public authorities, etc.). This contrasts with the legislation regarding corporate structures and trusts in tax havens. This legislation is mainly aimed at safeguarding the interests of *owners* and towards activities in other states. Other stakeholders – apart from owners – are nearly totally excluded from access to information about the entity.

It has not been possible for the Commission to analyze all aspects of corporate legislation in tax havens; it has chosen to focus on aspects that are particularly important for the victims of the damage inflicted by enterprises registered in tax havens.

The normal law source-based method is only partly helpful to understand how legislation in tax havens works in practice. Legislation is often voluminous and without elucidating preparatory material. Case law is also often non-existent, since the interests of owners are mainly safeguarded. Other stakeholders often do not have access to the information needed to file legal claims and secure their rights through the courts.

¹ A jurisdiction is a delimitation based on who has the judicial power in branches of law in the geographical area in question. In many cases, tax havens are established in limited geographical areas that do not have full sovereignty. Examples of this are Hong Kong (which is part of China) and the many British “overseas territories”, like the Cayman Islands, the Virgin Islands, etc.

² The concept of “trust” is explained further in section 3.4. In this report, trust is used in a broad sense to include trusts, the German language term *Stiftung* and other legal constructs that involve the establishment of an independent legal person (the trust, the *Stiftung* etc.) to manage assets, and where the person or persons who benefit from the allotment of funds (the beneficiaries) may be private persons involved in the establishment and/or management of those funds.

Important sources for understanding how tax havens work in practice are presentations given by those who facilitate the use of structures in tax havens (offshore promoters, service providers, lawyers, accountants, etc.). Some of the facilitators are located in the tax havens, but a great many work from other countries, and particularly from important financial centres like London, New York, Switzerland, etc. They offer their services on thousands of home pages on the Internet, where they advertise in detail the advantages of registering in tax havens. In spite of certain circumlocutions, like, for instance, the use of the term “privacy”, it is fairly explicitly understood that many facilitators offer to help companies and individuals evade taxes and financial responsibilities. The home pages may be inaccurate and contain errors, but they describe how facilitators believe these systems work in practice, and how the arrangements are carried out for clients.

It is evident from the web pages that the “classic” tax havens are fairly similar in terms of fundamental structures. They compete in the same market, and the competition parameters are minor variations in respect of strict rules of secrecy and a number of exemptions that apply only to companies and trusts active in other states.

3.2 Secrecy legislation

“Secrecy” is often used to describe the obligation to observe the confidentiality incumbent upon employees of various institutions, such as banks, tax administration, etc. This report uses the more comprehensive concept of secrecy frequently used by tax havens to prevent access to information on the ownership and assets of companies and trusts, and regarding the various forms of asset placement particularly adapted to foreign owners.

3.2.1 Confidentiality on activities in other states

Secrecy and confidentiality are different words with largely the same meaning. Privacy is protected in all societies that are considered rule-of-law states. At the same time, privacy can be abused. No one has the right to use private space to conceal or commit abuse, or to inflict damage or injury on other individuals or the public interest. The right to private freedom must therefore be balanced against the right of others to be free from

abuse, loss, and damage. The common interests of society must also enter into the equation, since a great number of people are affected.

Outwardly, the authorities of tax havens emphasize that their policy is to give special protection to the private sector, without taking into account the damage that may be caused to others. The rules of secrecy have two main elements. On the one hand, there is no, or very limited, publicly available information on the activities pursued and who is behind them. Furthermore, the possibility of accessing any information that may exist is severely limited by the terms of access, which may be gained only through a legal request.

The secrecy rules in closed jurisdictions differ from corresponding rules in traditional rule-of-law states in two ways. First, secrecy rules are applied primarily to activities that take place in *other* states, where the owners are domiciled and from which the enterprise is actually operated. This is unusual because most states enact legislation that regulates activity within their area of jurisdiction. Second, the rules hinder the application of normal rules of transparency in the states where the activities or operations actually take place.

Because of the secrecy rules, stakeholders located where the activities take place have, at the outset, very few opportunities to know what actually takes place within the companies, or who owns and operates them – unless the owners themselves choose to provide the outside world accurate information regarding this.

The secrecy rules do not, in fact, involve the exercise of domestic sovereignty, since local interests are not involved. The legislation is formulated so that it encroaches deeply on the sovereignty of other states, because the secrecy has no purpose other than concealing important information on activities taking place in other states.

3.2.2 The absence of publicly available information

In order to make good decisions, a decision maker must have as complete information as possible. Openness and transparency in commercial enterprises are important to ensure that markets function as well as possible. In addition, transparency is crucial for making agents accountable for their actions, and thus for the enforcement of a number of legal precepts.

It is very important to know who owns and operates companies and other economic entities. In order to know what happens in enterprises, it is

Box 3.1 Union Bank of Switzerland (UBS) – secrecy under pressure

In 2007, a former employee of UBS testified before a Senate committee in the USA. From the testimony, it transpired that UBS had for a number of years deliberately assisted American citizens evade taxes by placing assets in the Swiss branch of UBS without reporting this to American authorities.

The USA indicted employees of UBS and demanded the release of names and account information of Americans who held accounts in the bank. The case was resolved, in part, through a settlement requiring UBS to release 300 names and to pay USD 780 million in compensation to American authorities. However, the USA still demands (as of May 2009) the release of the names of 52,000 American clients of Swiss banks. It is estimated that they have deposited USD 14.8 billion in the banks. Swiss authorities have warned that if the banks release the names, this will constitute a violation of Swiss law, and the banks will, in all probability, be punished.

In this instance, the legality of bank secrecy in this type of case is brought to a head: As the

case now stands, the banks will be punished regardless – either by the USA or by Switzerland. In the future, however, there will be a solution to this type of case: The banks must make entering into a banking relationship conditional upon the client's reporting to the tax authorities. For relationships entered into previously, where a report has not been sent (this applies to about 95% of cases), it is unclear what the outcome will be.

Several cases show that most deposits in tax havens involve tax evasion. In 2005, the authorities in Great Britain gained access to data on 10,000 accounts held by British citizens in tax havens. Only 3,5 percent of these accounts had been reported to the tax authorities. In 2008, German tax authorities paid for lists of clients with deposits in LGT – a bank in Liechtenstein. These three cases have the common trait that they indicate that deposits in tax havens are rarely reported to tax authorities.

crucial that they present, and preferably publish, their accounts. Ideally, the accounts should follow a standardized format so that they are easier to interpret, and they should be relatively detailed. It is clearly advantageous if the accounts are controlled by an external auditor. Co-investors, creditors, employees, and a free press, etc., can thereby keep track and analyze the status and operations of companies.

The interests of those who need access must be balanced against the necessity of companies and owners for confidentiality about their activities, particularly regarding business secrets, but also about private matters that third parties have no legitimate need to access. Different countries have chosen to balance these concerns differently.

Tax havens have made rules for companies that are not intended to conduct activity in their jurisdiction, and that are frequently not subject to taxation there. Thus, the local authorities and other local agents have little need for information about them. Those who do need information about these enterprises are the authorities and agents in other countries. Tax havens do not take

into account the information needs of third parties, and have established systems that make the storage of information on ownership and activities voluntary for the owners and managers of these enterprises.³ Even tax havens that otherwise have a well-functioning public administration often lack public registers of companies that provide information on the ownership and accounts of “exempted companies”. For “exempted companies”, the Register of companies will generally include only the date of establishment, the name of the company, its nominal directors, and possibly an overview of owners, etc. This information is aimed at showing the existence of companies. The identity of the real owners can be kept secret. This also goes for the activities of the companies – if the owners so wish.

Trusts are frequently the ultimate owners of one or more subordinate companies. The trusts are not registered in any public register. This means that outsiders do not at the outset have ac-

³ In a number of tax havens, 95-98 percent of established companies are designed for activities that take place in other countries.

cess to any source that indicates which trusts exist, how the trust agreements are worded, or who the real beneficiaries of the trust funds are.

Consequently, a company or trust that is registered in a tax haven, but whose operational activities take place, for instance, in Norway (where the owners live or have commitments), can conceal who is behind it, as well as its activities, income, assets and debt. The same company, registered in Norway, would have been subject to very different requirements regarding access to this information.⁴

Although at the outset there is a strict obligation for confidentiality about all business activity, the owners can voluntarily provide any information sought by third parties. Such voluntary information may be complete and accurate and correspond to all legal requirements of the country in which the owners live or have commitments. The owners break the law of their home countries only if the reporting requirements are not followed, or if they selectively present information. However, the structures in tax havens are particularly suitable for distortions for those who wish to conceal information on their income, debt and assets from third parties.

3.2.3 Access through legal requests

In tax havens, access may be given if binding international agreements on the exchange of information have been entered into. Even if there are no binding agreements, access may be given after an individual assessment. This presupposes that the jurisdiction receiving the request has no legal prohibition, and that the request for access satisfies certain requirements. In both cases, a request for access is forwarded in the form of a legal request, which is considered administratively or by the judiciary.

Legal requests for access are a laborious, costly and time-consuming process, whose outcome is uncertain because the possibilities of access are often limited by a series of legal and practical obstacles. The grounds for the request must be stated in a manner that reasonably clearly declares the basis on which access is requested. In practice, important information regarding the circumstances that

give rise to the request are needed at the outset, including the identity of persons or companies, account numbers, clearly defined transactions, specific documents, etc. This is often difficult because the request is presented precisely because the necessary information is initially unknown.

Most tax havens have until now not granted access if the basis for the request is common tax evasion, i.e., cases where the taxpayer has given incorrect or incomplete information in tax returns and other statements. Legal requests have normally been granted only in cases involving the use of forged documents or the like. Most instances of tax evasion are, therefore, not among cases on which it is possible to collect information. There are still tax havens that cooperate only in cases of tax fraud, i.e., forged documents.

After pressure from the OECD, a number of tax havens entered into information-exchange agreements with countries that have normal tax rules. The extent to which these agreements will be useful is unclear as it will depend upon, among other things, the number of legal requests, how they are implemented in practice, and what resources are applied to meet the requests.

Even if access is granted, the value of such access may be limited, partly because in many jurisdictions there is no obligation to present and preserve accounts, and partly because the owners may quickly move the company and its documents to a different tax haven. The possibility of holding ownership through straw men (“nominees”) or bearer shares⁵ creates additional obstacles in cases where access to information on ownership is sought.

The usefulness of access may also be limited by the requesting state’s lack of qualified personnel to assist in the process, or by rules of notice that result in notice being given to the object of the request before documents and other evidence can be secured. In addition, the objects of the requests for access (the owners) have the option of using the legal system to prevent or obstruct the legal request, which can lead to the use of substantial resources and prolonged legal proceedings. If the company is moved (redomiciled), or the leads point to the use of other tax havens, the negative effects of time-consuming and costly process are further aggravated (cf. Box 3.2 on the *Jahre* case).

⁴ In this report Norway is used as an example. However, the same considerations would apply for any other country where tax haven-based enterprises conduct their operations – be they developing countries or industrialised countries. The damage to developing countries is nonetheless significantly greater, since generally, they have no people or institutions that monitor companies, and no free and critical press to analyse the market.

⁵ Whoever is in physical possession of the securities is regarded as owner. Tax havens normally have rules that imply that changes of ownership are not registered, and that the securities may be kept anywhere in the world.

Box 3.2 The Jahre case

The Jahre case shows how the structures of tax havens make it extremely difficult and costly to uncover economic crime. The case was investigated continuously for 35 years, and cost the Norwegian authorities NOK 500 million (not adjusted for inflation).

Anders Jahre was a well-known and successful Norwegian ship-owner (d. 1982), who operated extensive shipping activities in Norway and abroad. After the war, suspicions arose that he had concealed income from several ships he owned and operated abroad, controlled through complex companies and trusts in tax havens, with the assistance of, among others, the English bank Lazard Brothers Ltd. Investigations of the suspicions were stopped in exchange for a promise from Jahre that ships would be “bought home” from abroad. Through this transaction in 1955/56, Jahre actually increased the extent of his secret foreign assets by approximately 125 million NOK.

In 1973, suspicions were raised again when Jahre had problems explaining his role in the company Continental Trust Company (CTC), registered in Panama. A few years earlier, Jahre had, on behalf of CTC, pledged a gift of NOK 40 million to the municipality of Sandefjord to build a town hall. New investigations were set in motion and are continuing to this day. In 2008, the estate of Anders Jahre made the latest of a series of settlements on the return of concealed assets. The estate has used NOK 550 million in the search for the hidden assets. The counterparties, who have had access to the remaining part of the foreign assets, have used these to finance their resistance to the estate’s search. The estate assumes that the counterparties have spent at least as much as the estate itself. The estate has returned NOK 950 million. The hearing for the estate has been prolonged through obstruction and forced legal action, and this has led to substantial losses since Jahre’s death in 1982. At that time, his foreign assets were estimated to be in the order of USD 80-90 million.

One of the central questions of this case was who owned and controlled the (bearer) shares of Continental Trust Company, and who was the successor to the funds from this company. Thorleif Monsen was originally Jahre’s straw man, but he took control of the funds on Jahre’s death.

Because of, among other things, the secrecy rules of the tax havens, it was originally not possible to gain access to any information on the companies’ bank accounts, transfers between companies, or the ownership of the companies. Important information came to the estate in connection with a divorce settlement in the Monsen family. Further information came to light through police investigations, and not least through a series of legal steps from the estate in Norway, London, and the Cayman Islands – in all more than 20 suits before various legal authorities. Many of the suits have resulted in substantial settlements.

In the period 1994-2001, the activities of the estate were financed by the Ministry of Justice. This financing was decisive for the estate’s ability to continue its search. As a consequence of the state’s financing, the estate’s counterparties conducted an extensive process vis-à-vis the government and politicians in the Storting to stop further financing of grants to the estate.

The case is successful for Norway in the sense that the sums repatriated were higher than the cost of the process. However, this outcome was not certain, and there are always political costs and risks in granting means for uncertain processes like investigative steps to collect information and repatriate funds hidden in tax havens.

For developing countries, the costs of using the legal system to uncover facts and repatriate funds are significantly greater than for rich countries. The strain is greater relative to the cost of necessary legal proceedings and the political risks are greater. This can be used by third parties, who may, by effectively using supporters and media consultants, focus on the risks of the process. The Jahre case illustrates that time-consuming and very expensive judicial processes are frequently absolutely necessary when dealing with tax havens. Such processes will frequently have a small chance of success, but given the structures of the tax havens, there is no alternative if one wishes to repatriate funds and punish the guilty. For most developing countries, which often have less competence and a weaker financial capacity, it would be nearly unthinkable to initiate and carry through a process as extensive as the Jahre case.

3.2.4 The “know-your-customer” obligation

Normally, foreigners use local agents to establish companies, trusts, or similar entities in tax havens. In many cases, the use of an agent is compulsory. In principle, the company’s agent should have important company information. Information on the identity of the company’s owner at all times is particularly important, assuming that the agent has fulfilled the “know-your-customer” obligation⁶. However, such an obligation can be difficult for an agent to fulfil. If the company is owned by another company in another tax haven, or if the ownership chain ascends through several tiers, the agent must ascertain who is the real owner in the final or top tier – even if the owners are located in other closed jurisdictions. In practice, this demand is often impossible to satisfy because of the secrecy rules that apply in each individual jurisdiction. The problems are exacerbated by frequent changes of ownership in one or more of the higher tiers if the agent has not carried out the necessary “know-your-customer” investigations.

3.3 Further on the special treatment of companies and similar entities in tax havens

The secrecy rules are only one of the elements that contribute to giving the outside world little or no opportunity of gaining access to reliable and necessary information on companies registered in tax havens. The other element is evident from the design and regulation of company and trust structures. Companies in tax havens can be divided into two main groups: 1) local companies, intended to operate within the territorial jurisdiction where the company is registered, and 2) “international companies” intended to operate exclusively, or for the most part, in *other* states.

The first group is of lesser interest to this report, since it should have only local effects. Any state may freely choose how to balance the rela-

⁶ “Know your customer” is an important instrument in the fight against money laundering. The obligation states that a person or a company that receives, or acts as an intermediary for, payments, is under the obligation to assess whether the funds may derive from illegal activity. The obligation typically applies to banks and other financial institutions, real estate agents, managers, financial consultants and agents. If there is a suspicion that the funds derive from illegal activity, there is an obligation to report this to the relevant authorities.

tionship between its own citizens, or between the state and citizens.

The other group includes companies that have been given a number of exemptions or “freedoms”. These companies are intended to operate only in other states. Therefore, these exemptions in practice only have positive effects for the owners (who also operate under cover of the secrecy rules), but have only negative effects for the public and private interests in those states where they actually operate. (See the further assessment of the effects of tax havens in chapter 4.) This group of companies has a large degree of freedom to act outwardly through “nominees” or straw men who hold positions as directors (board members) or as “nominee shareholders”. In addition, a number of tax havens allow ownership to be held in the form of bearer shares. This means that whoever physically holds the shares is to be regarded as owner; changes of ownership can be accomplished without formalities and in seconds by the physical transfer of shares from one person to another.

3.3.1 IBC or “exempted companies” – the system of exemptions

Tax havens have rules for particular types of companies often referred to by the collective term as “offshore companies”. Offshore in this context does not refer to physical location, but indicates that these are companies that are registered in the jurisdiction in question, but do not have activity there. In the legislation of tax havens, these types of companies are called “International business company”, “Exempted company”, or “Global business company”, etc. These are companies that can operate legally only, or for the most part, in other states, and, as a rule, do not own or rent property locally.

International companies enjoy a number of freedoms or exemptions from obligations that are normally incumbent on limited liability companies. The most important exemptions or “freedoms” are listed and commented upon below.

3.3.2 Exemption from the obligation to pay taxes and duties

All sovereign states are free to decide which costs should be paid for by the government and how government expenditure should be financed – through levying taxes and duties (the sovereignty

principle). Tax policies will also be influenced by global competition for mobile capital. Outwardly, the main competition parameter that tax havens offer is tax-exemption for companies and individuals. Hence the name “tax haven”. Some tax havens have no, or very low, corporate income tax and no wealth tax. Others have relatively normal tax rates for their own citizens and companies with real production within the territory of the jurisdiction. Common to tax havens is that there is very low, or no, tax on international companies and on the capital income of foreigners.

The “tax exemptions” utilized by tax havens raise two fundamentally different problems relating to principles of tax law.

One derives from the secrecy rules, which make it possible to *conceal the identity and activities* of individuals who are liable for taxation in the state in which they live or belong. The information that can be concealed touches on one or several of the following elements relevant to the tax obligations: identity, place of residence, citizenship, source (the location of the source of income; income from work, profits from shares, etc.), location (real estate, etc.), the timing of income or costs, or family ties (inheritance tax).

At the outset, one cannot avoid tax liability by establishing a company abroad and registering assets and income there. According to the principal of global income – to which most states adhere – foreign assets and any returns on these assets must be reported and taxed in one form or another. Individuals domiciled, for instance, in Norway are consequently liable for tax to Norway for income derived from foreign sources, unless the income is exempt based on a tax agreement between Norway and the foreign state in which the income is derived. Registering companies in tax havens does not give grounds for tax exemption in the owner’s home county, but the lack of transparency in tax havens makes it easier to evade taxes by establishing companies there.

It is entirely legal for a citizen to own a company based in a tax haven, but accurate information regarding assets, income and debts must be given to the authorities of the country in which the owner is domiciled or has potential tax obligations. In the context of taxation, the owners are therefore obliged to provide information on tax haven-based assets in tax returns and related documents.

The second problem related to tax legislation touches on the use or abuse of tax agreements. A number of tax havens have entered into bilateral tax agreements with countries that are not tax ha-

vens. Transactions that result in income for companies registered in tax havens, which falls within such agreements, is not illegally concealed from either the source state or in the state of residence because the tax agreements authorise the exemption of this income in one or both of the states that are parties to the agreement. This is conditioned, however, on the provision of accurate and complete information regarding the transaction.

An important question is whether the conditions for exemption are fulfilled. Particular problems are raised by the concept of domicile and ownership in tax agreements, specifically, when the company in question is a holding company with no activity or is a shell company located between the source state and the state where the owner is domiciled. A condition for the exemption is that the company is domiciled in the tax haven in question, which is typically understood in such agreements in to mean that the company is the final owner of the income, asset, or debt at issue. Artificial pass-through solutions do not normally qualify for such exemptions.

It is characteristic of the “activities” of companies and trusts in tax havens that that there is little or no activity there. This is a consequence of the conditions for establishing “exempted companies”. Exempted companies are exempted from a number of obligations on the condition that all activity of any importance takes place in *other* jurisdictions, where assets are actually located, and where the owners are domiciled.⁷ Without access to correct information on underlying realities, it is difficult to ascertain the asset values of companies, and what activity actually takes place. Access to this information is often hampered by secrecy rules, in a broad sense.

3.3.3 Exemption from the obligation to prepare accounts

Companies with limited liability are independent legal objects with their own rights and obligations – independent of those of their owners. The right to establish limited liability companies is not without disadvantages, because the owners control the company, while this form of organization gives the owners protection against the company’s creditors. This gives substantial possibilities for abuse.

⁷ Share certificates and company documents have a different status. This is also the case for bank deposits, but such deposits can often be accessed onshore through various kinds of bank cards.

In order to reduce the dangers of abuse, limited liability companies typically have a statutory obligation to maintain accounting records. A company's accounts should give a complete, systematic and periodical overview of its status and operations. It is important to have access to correct and reliable accounts for the benefit of third parties, especially when other means of scrutinizing the company's finances are not available. This is particularly true for creditors, actors in the securities markets, employees, tax authorities, etc.

Accounts are important for the company's employees, and more generally for society and economic life. Accounts are also important for the owners because the accounts give an overview of the company's status and operations, in particular, for minority owners who do not have access to the corporate records as majority owners do.

To reduce the risk that accounts can be manipulated, it is useful to have them verified through an independent audit, and to provide the opportunity to review past accounting records. For this reason, it is also important that the accounting records and the material on which they are based are properly preserved.

"International" companies in tax havens are not normally required to prepare accounts.⁸ Consequently, there is no requirement for auditing accounts. If there are statutory obligations to prepare accounts, they are loosely worded. More detailed rules on application of accounting legislation as we know it from the accounting and book-keeping legislation in Norway, and most other developed rule-of-law states, rarely exists in tax havens – certainly not to a sufficient degree, or with the necessary controls and effective enforcement.

At the outset, the considerations that supply the rationale for the requirement for audited accounts should apply all over the world. Nonetheless, the reason that tax havens exempt companies from the obligation to prepare accounts seem reasonably obvious, cf. the discussion above. The obligation to present accounts involves a considerable amount of work for the legislative and administrative authorities responsible for preparing the rules for accounting and documentation, and for follow-up, monitoring and control.

Tax havens apparently do not take into consideration the effect that "exempted companies" have on other countries, and since these companies have no liabilities to agents in the tax havens,

these jurisdictions have no need for requiring "international" companies to present accounts. Since the companies pay little or no tax, local authorities have no need for the calculating taxable income which can be derived from correct financial accounts. In addition, no local creditors, investors or other private or public interests are affected by the operations of these companies.

In the legislation of tax havens, the accounting rules are described in different ways. Generally, they are, as mentioned above, rather loosely worded. Formally, the exemption applicable to keeping accounts is frequently expressed as a discretionary right of the company's directors to assess the need for presenting accounts (as "directors think fit to keep . . . [and] . . . considers necessary in order to reflect the financial position of the company").⁹

There are also examples that certain types of companies have an obligation to prepare accounts, but the obligation is limited, and there is normally no obligation to publish the account statements.¹⁰ Some jurisdictions also distinguish between "private" and "public" companies, or between categories of companies with differing accounting obligations.¹¹ "Public" companies must – where they exist – prepare and publish accounts, but there is often no accounting law to determine how accounts should be worked out. In some cases, there is reference to a few roundly worded general principles of accounting, and in others to the International Accounting Standards (IAS). The IAS are very comprehensive, and are not easily enforced without more precise rules on implementation. Sanctions for violating the rules are either very mild or completely non-existent in tax havens.

It is unclear whether accounting rules are enforced, and if they are, how they are enforced. This is the case partly because rules worded in the ways described above are difficult to enforce, and partly because local authorities generally have no interest in controlling and enforcing very extensive and complex rules since local interests are not involved. In the Cayman Islands, for example, the accounting rules state that, "directors

⁸ This is the case, for example, in the British Virgin Islands.

⁹ See for the Seychelles - International Business Companies Act, 1994, section 65 (1)

¹⁰ For example, in Gibraltar. See also Companies (Jersey) Law 1991, Part 16

¹¹ Mauritius distinguishes between Global Business Company 1 and 2. The latter group is not obliged to prepare accounts, but the former is, in an abbreviated form. See a more detailed discussion in chapter 7 below. See Companies Act 2003, Subpart C – Financial Statements, Section 210 ff.

shall cause proper books of accounts". This applies to "all sums of money received and expended by the company, and the matters in respect of which the receipt and expenditure takes place; and ... all sales and purchases of goods by the company and the assets and liabilities of the company."¹² Requirements relating to the assessment of values, for example, write-offs or depreciation, are not mentioned unless it is understood that these requirements lie within the expression "proper books".

The company legislation of Jersey states that the accounts should give a "true and fair view". What this implies is unclear; for instance, whether the wording refers to requirements in accordance with US GAAP, which also use this expression. When there is no obligation to conduct an audit, it will be up to chance as to whether the local financial authorities check that accounts are kept in accordance with certain standards.

The "Articles of Association" (AoA) of an "exempted company" may, for instance, describe the requirements for the company's presentation of accounts like this:

"The company shall keep such accounts and records *as the directors consider necessary or desirable* in order to reflect the financial position of the Company.

The Company shall keep minutes of all meetings of directors, members, committees of directors, committees of officers and committees of members, and copies of all resolutions consented to by directors, members, committees of directors, committees of officers and committees of members.

The books, records and minutes required by (the paragraphs above) shall be kept by the Registered Office of the Company or *at such place as the directors may determine, and shall be open to the inspection of the directors at all times.*"

The directors shall from time to time determine whether and to what extent and at what times and places and under what conditions or regulations the books, records and minutes of the Company or any of them shall be open to the inspection of members not being directors, and no member (not being a director) shall have any right of inspecting any book, record, minute or document of the Company except as conferred by Law or authorised by resolution of the directors". (Emphasis added)

In practice, it is up to the owners to decide whether accounts should be kept, and if they do, whether and how they should be preserved. The interests of third parties (here: the users of the accounts) are absent. That accounts *may* be kept if the management finds it necessary is, strictly speaking, not necessary to regulate. The opposite situation – a prohibition against keeping accounts – is hardly thinkable.

It is also somewhat unusual to include in the provisions that give directors the right to access and inspect the books. Theoretically, it is possible that the company's owners or its "Registered officer" refuses access and deprives management of the possibility of inspection. However, this would apply to decisions that the management not only has the right to scrutinize, but have actually made. Because of its position, the management will arrange for the preparation of accounts and minutes of what they have decided.

In companies where "management" is only a formality, such rules may be practical, but then to give the formal management access to the decisions that have actually been made.

It is alien to Norwegian legal culture to allow the management of a company to decide whether or not to keep accounting records. The obligation to keep accounting records is imposed in the interests of third parties who, in the case of limited liability companies, have a reasonable claim to information on the status and operation of the company to which they are connected. The company's owners have the possibility of deciding for themselves how to supervise and control the company. Tax havens take a different view when it comes to considering the need for protection of those who refer only to the company. Both formally and in practice, third parties have been deprived of any possibility for access.

In most countries, companies pay taxes on their profits. Company accounts are the basis for the calculation of income and assets. In most tax havens, "exempted companies" are exempt from paying taxes and other duties. The charges levied on the companies are not calculated on the basis of profits, and so there is no need to rely on the company accounts in order to calculate the correct charge. Although there is no statutory obligation to keep accounting records, it is obviously not forbidden to prepare accounts. The company and its management can have an interest in presenting accounts to the outside world and third parties in *other* jurisdictions.

¹² See Cayman Islands Companies Law (2004 Revision), Section 59.

There is no guarantee that accounts presented by companies registered in tax havens accurately reflect reality. Sometimes they include fictitious financial constructions created by the company's owners, but are nonetheless signed by the company's "directors". This does not include companies that are registered in tax havens but whose stocks are listed on the stock exchanges of other states. In such cases, accounts will be kept according to the requirements of the stock exchange on which they are listed, or in accordance of the rules of the country in which the stock exchange is located.

3.3.4 Exemption from the obligation to audit

Inasmuch as there is no obligation to keep accounts, there is also no obligation to audit, even when management decides that accounts should be prepared.¹³

Nonetheless, there are examples that auditing is mentioned in company laws, though in some cases without any clear meaning. The Cayman Islands Companies Law (2004 Revision), Section 101, states:

"The accounts relating to the company's affairs shall be audited in such manner as may be determined from time to time *by the company in general meeting* or, failing any such determination, by the *directors*." (Emphasis added).

The rules are difficult to understand. There is no obligation, but a freedom to audit the accounts, and the rules on the role of the auditor seem to be very limited. An owner in the company may be chosen as auditor, but a member of its management may not.

It is difficult to see that the provision contains any form of sensible commitment in which the outside world could have confidence. The owners or their representatives decide whether accounts should be audited. Little or nothing is said on who should carry out the audit, and on how it should, in such a case, be carried out. There are no sanctions for violations of the rules, which is natural since they have no binding content.

In well-organized rule-of-law states, the obligation to audit is imposed to guarantee third parties an independent verification of the accounting records. Given the strong and unchecked influence that the owners of an "exempted company" have on the decisions that are made, the provi-

sions that allow an owner-controlled audit seem rather meaningless.

The company's application of the auditing rules in the "Articles of Association" may for instance be worded as follows:

"The directors *may by resolution call for* the accounts of the company to be examined by an auditor or auditors to be appointed by them at such remuneration as may from time to time be agreed.

The auditor *may be a member of the company*, but no director or officer shall be eligible during his continuance in office". (Emphasis added).

3.3.5 Exemption from the obligation to register and publish ownership (register of shareholders)

In a variety of contexts, the parties to an agreement or a transaction may need to know the real identity and economic position of the opposite party. Furthermore, the legality of an action often depends upon who is behind the transaction. For instance, the parties to an agreement to buy or sell frequently require information on the economic position of the opposite party. If the opposite party is a company, it is necessary to know who manages and owns the company. Where are management and owners located? In what jurisdiction do they belong? Furthermore, investors of equity capital and loan capital need to know who their potential co-owners or debtors are. In trading of securities, the parties must be identifiable in order to determine whether insider trading is taking place. A register of shareholders or owners therefore contains particularly important information.

In well-regulated states, considerations like those described above have led to the obligation to maintain a reliably up-to-date register of shareholders, which is accessible for related public and private interests.

The same considerations should apply in tax havens, but there shareholder information is subject to strict confidentiality, and the obligation to keep a register of shareholders can be somewhat haphazard in "international" companies. In tax havens, it is nearly always the case that owners can be represented by straw men in the company register if such a register exists. The identity of the real owner is subject to strict secrecy rules. In cases where it is allowed to use lawyers as straw men, the lawyer's obligation of professional confidentiality will frequently be invoked if someone

¹³ There are exceptions for particular types of companies, see Companies (Jersey) Law 1991, section 110

wants to know who is behind the company, even though having the position of straw man in order to conceal actual ownership goes far beyond any defensible justification for lawyers' obligation of professional confidentiality.

Another factor is that in the company laws of tax havens the obligation to identify owners can be unclear and veiled. The British Virgin Islands Business Companies Act 2004, states in article 41 (1) that, "a company shall keep a register of members containing, as appropriate for the company ...". In addition, the specific data that may be contained in the register is listed: names of owners (members), forms of shares, classes of shares, ways of identification, changes in ownership, etc. Violating this provision may result in a fine of USD 1000.

What constitutes adequate ("appropriate") information from the company is unclear. The decision is made by the management, which represents the owners. This also applies to the obligation to preserve the register of shareholders, and how current ownership should be notarised and preserved. If a (albeit very limited) sanction is attached to the violation, the register should reasonably be available for scrutiny in the jurisdiction where the fine may be levied. In general, control is insignificant, and with a great number of companies in each jurisdiction, effective control would not be possible.

The same law in the British Virgin Islands states that the shareholder register must be "in such form as the directors may approve"¹⁴. However, this presumably refers only to the form. Whether the register is kept in paper or electronic form is less significant if electronic storage gives the necessary notoriety. If electronic storage is chosen, it must be done in a way that gives readable and reliable evidence.

Even when shareholder registers are kept, the information on ownership is confidential, and may be divulged to third parties only through a legal request. In reality, this presupposes that the third parties know the details of ownership at the outset, or have information that clearly indicates the identity of the real owners. If this is not the case, there is no basis for making a legal request.

"International" companies with concealed ownership registered in tax havens are unattractive as counterparties to independent parties. If ownership is unknown or unclear, transactions

carry great risks. Such companies are therefore best suited to entering into agreements with parties that are closely related to them, where they share interests in the agreement. In such cases, however, there is a great risk of abuse through the transfer of assets and debt to the detriment of third parties. This is particularly the case when funds are transferred across international borders, and between onshore and offshore companies.

3.3.6 Exemption from the obligation to preserve accounting documentation etc.

The obligation of companies to present accounts is closely related to the obligation to preserve such accounts. The accounts must be preserved to provide information on what takes place within the company. If a jurisdiction does not oblige companies to prepare accounts, it is hardly appropriate to oblige them to preserve such accounts.

In tax havens there is generally no obligation to *preserve* accounts or other documentation (records). The members of the company's board may decide whether and to what extent accounts should be preserved.¹⁵ If accounts or minutes from board meetings are kept, and there is a desire to preserve them, the preservation may take place anywhere in the world – as the owner wishes.

Most companies have no separate local management, but others require a locally domiciled individual in the management of the company. As a rule, a local employee of a "service provider", or a "Company Registrar" or "Registered Agent" is used to do the practical work of completing formal company documents that are necessary in connection with collecting fees at the company's establishment and to maintain its annual registration. The agent may also hold – if the client wishes – the position of "nominee" or "trustee" within the company.

Although the company has no obligation to preserve, the "Company Registrar" or "Registered Agent" has an obligation to preserve those documents he has contributed to preparing. This will typically be minutes from board meetings in which he has taken part.

¹⁴ See, for example, British Virgin Islands Business Companies Act 2004, article 41 (2)

¹⁵ For example, in Panama, British Virgin Islands, the Seychelles, Belize, Liberia, Cook Islands, Nevis, Vanuatu, Bermuda, Bahamas, Turks & Caicos, Lebuau.

In any case, it will be in the interest of the local representative to be able to document the instructions he has received from the client, and what action he has actually taken, in the event that there is a dispute regarding the management of the company's funds. Paradoxically, this can be important for local representatives so they can demonstrate that they have *not* taken any action at all, or that they have only acted on instructions from the owner. This is important in case of challenges or possible lawsuits filed by third parties.

3.3.7 Annual returns

Most tax havens require that every year an "exempted company" prepare an "annual return" to be sent to the company's agent or local representative (i.e., not to a public company register).¹⁶ In some cases, there is also a requirement that the annual return be sent to the *Companies Registry*, without containing information of great importance about the company.

The annual return is normally an attestation that consists of a simple form with limited information about the purpose of the company, the identity of board members (who may be straw men), shareholders (who may also be straw men), any changes in the memorandum of association, an attestation that activity takes place only outside the territory of the jurisdiction where the company is registered, etc.¹⁷ In some jurisdictions the annual returns should also contain information that bearer shares are deposited with a "custodian".¹⁸

3.3.8 Exemption from the obligation to hold board meetings locally

In most cases, the question of where board meetings are held is a purely practical one. The choice is made based on the whereabouts of the board members, and where there is access to the necessary facilities. In most cases, there is no doubt where companies belong. For companies without activities, this may be different. In certain instances, the place where board meetings are held may be of importance in determining the jurisdiction to which the company belongs, in a legal sense.

¹⁶ For example, the British Virgin Islands, which has more than 830,000 IBC, has no such requirement.

¹⁷ See Cayman Islands Companies Law (2004 Revision), section 187.

¹⁸ See Cayman Islands Companies Law (2004 Revision), section 187.

This question has great legal importance in most countries. According to the principle of global income, both companies and physical persons who are liable for taxes (for instance to Norway) will as a rule will be liable for taxes (to Norway) for all income, no matter where it is earned.¹⁹

According to the Tax law § 2-2, sub-section 1, for instance, joint stock companies are liable for taxes to Norway "provided they are domiciled in the realm". This means that the place where the company was founded (registered) is not necessarily decisive to determining where the company is regarded as "domiciled", but the place from where it is managed. An important consideration in the assessment is where the management of the company on the board level takes place.

In tax agreements, too, the place where board meetings are held is attributed importance. A condition for companies to benefit from exemptions in accordance with tax agreements is that they are regarded as "resident", in the sense of the tax agreement, in one of the states that is party to the agreement (cf. the OECD's model agreement, article 4). The place where the companies are effectively managed on the board level is given importance in this assessment. To the extent that companies based in tax havens should be regarded as "resident", the effective management of the company must be regarded as being in the tax haven in question.

It is unusual for company legislation to regulate where board meetings should be held. The company itself should decide this based on practical considerations. However, if board meetings are not held locally, this may have consequences for where the company will be regarded as domiciled, in terms both of company and tax law. Enterprises that are established in countries other than tax havens normally have an operational connection. The choice of where to establish a business is based on where one wishes to operate.

The legislation of tax havens differs from that of other countries in that it establishes that it is *not* necessary to hold board meetings within the territory of the jurisdiction.²⁰ This means that where an "international" company holds its board meetings is of no local legal importance for the tax havens.

Even though there is no requirement for local board meetings, the owners may, of course,

¹⁹ See Zimmer, loc. cit. p 23.

²⁰ See for instance BVI Business Companies Act 2004, section 126 (1).

choose to hold meetings there, even if it is often expensive and unpractical. The exemption for where a company holds its board meetings illustrates – in combination with the other exemptions treated above – that establishment in a tax haven is mainly a business of formal registration.²¹

In this connection, secrecy rules are important, because, among other things, the outside world does not have information on who owns the companies, where the board meetings take place, and from where the companies are actually managed. In promoting tax haven-based companies to the outside world, it is therefore useful to make explicit in the law that it is not necessary to hold board meetings locally – also given the costs involved. A requirement that board meetings should be held locally – for instance in a distant tax haven – would in many cases constitute a substantial barrier to the establishment of companies.

Tax haven-based companies are based on assumptions that are difficult to reconcile with the requirements for local ties demanded by the tax agreements. The absence of real activity and ties make it difficult to explain why “exempted companies” registered in tax havens should be regarded as domiciled in the tax haven in the sense of the tax agreement, apart from mere formalities. The condition for granting such companies exemptions is that they have no local activity. When there is not even a requirement that board meetings be held locally, or that there be local members of the boards, the local ties are, in practice, almost non-existent. As a rule, they are used only as a hiding place or for pass-through of funds of enterprises that operate in other jurisdictions, where the owners are also domiciled and reside.

3.3.9 The right to redomicile the company

For a variety of reasons, owners may wish to move a company and its activities to another jurisdiction (migration). In most cases, the decision to move is based on business considerations. The lack of profitability, weak markets, high costs, restructuring needs, political instability, etc. may make it necessary for management to take action – for instance by moving. Such considerations rarely apply to “exempted companies”, where there is no significant local activity.

If a company is to be liquidated in a jurisdiction, the interests of the company’s creditors and other third parties require that this be done in an orderly fashion. Among other things, the liquidation and move must be made public, and the interested parties must be invited to present their claims. Moving and/or liquidation should not be a simple way of discarding established commitments.

The legislation of tax havens is divergent in this respect, too. Many tax havens allow “exempted companies” to be moved to another jurisdiction without any liquidation procedures of importance. This is referred to as “redomiciliation” or “company relocation”. Most tax havens permit companies and other entities to move very quickly, with few effective procedures to guarantee the fulfilment of the company’s (actual and latent) commitments. The company is formally transferred to another jurisdiction and deleted from the company register in the jurisdiction from which it moves.

The company’s date of foundation, partnership agreement, bylaws, etc., are generally not changed by redomiciliation. Furthermore, the company as an independent legal object does not change identity, but it is domiciled in a different jurisdiction and subject to other authorities and courts. This may be particularly detrimental to interested third parties who are excluded at the outset from access to information about the company’s activities and ownership.

On redomiciliation, the company’s documents are transferred – to the extent that such documents exist – to the new jurisdiction. The move does not, however, imply that all information about the company is removed from the original jurisdiction. The company’s local registered agent or company agent will normally keep the documentation in his possession. Of particular importance is the information on the identity of the company’s “beneficial owner”, if “know-your-customer” requirements are followed.

In order to contest possible claims for compensation, etc., from a client, it is in the interest of the agent to know exactly which services he performed on behalf of that client. This also applies to banks, if the client moves accounts to another bank. Consequently, the extent of the information that remains depends upon, among other things, whether and to what extent the agent is informed about the company and its activities, and to what extent he has performed additional services for the client, for instance, by taking on the function of “nominee” or “director”.

²¹ Some tax havens require that at least one member of the board be local. This generates local income. However, local board members have positions in several hundred companies, and there is reason to question the reality of their position on the board in such cases.

Box 3.3 An example of the use of redomiciliation between tax havens

The system is vulnerable if agents and banks are willing to conceal evidence on the client's request. The LGT bank in Liechtenstein was aware that their client (the Lowy family) feared a tax claim from Australian tax authorities. Nonetheless, the bank agreed – at the client's request – to “remove evidence of old LGT accounts and transactions”. See Tax Haven Banks and U.S. Tax Compliance, United States Senate, Permanent Subcommittee on Investigations, page 51 (17 July 2008). Whether the bank removed all documents pertaining to the old account or whether it merely made the data untraceable by others is not evident from the report. The client moved the funds to other foundations and accounts within the bank. At the same time, this shows that the bank was willing to take part in a money-laundering operation to remove evidence in order to make detection difficult.

The bank suggested that the concealment should be carried out by transferring the funds via an account owned by a shell company, Sewell Services Ltd, registered in the British Virgin Islands for expressly for that purpose. The funds from the old account entered Sewell's account, and continued as a transaction within the bank to the account belonging to the newly founded Luperla Foundation, which was also controlled by the Lowy family. Because the funds were channelled via an internal transaction in the bank, the official link between the client's accounts was erased. This is extremely difficult to detect for the outside world, at least without access to the bank. The funds transferred to the Luperla Foundation were described as income from a complex securities transaction. (Infra page 52).

The consequences of the right to redomiciliation, and the ability to do so quickly, can be very great and inflict significant loss and damage on third parties. It contributes to reducing or obstructing the possibility for access and legal action from third parties or the authorities of other states.

When a company moves, those who want access to the company must relate to a new jurisdiction and to new legislation. A new legal request must be made in the jurisdiction to which the company moved, with new, and often time-consuming procedures. If the company is restructured in connection with the move, and is split into several legal objects located in different jurisdictions, the real possibilities for access are undermined even further. This is also the case if several companies in an ownership chain are moved to different jurisdictions.

It is significantly more time-consuming to gain access through legal requests (frequently several years) than to move the company to a different jurisdiction, which often also allows moving. Moving the company can therefore be an effective way to obstruct the claims of creditors, criminal liabilities, or the repatriation of illegally appropriated funds.

The right to redomiciliation must be seen in relation to the concept “exempted”. Tax havens

do not control the status and operations of companies. Their operations do not affect local interests, which are limited to collecting fees and those activities that flow from the various formal procedures that are connected to the company's activities. It is the wishes and needs of owners that are considered. For the authorities, the move can be beneficial. In many cases, they are rid of a client who is sought or under legal action from private interests or authorities in other states.

An “exempted company” may also be liquidated or dissolved in ways other than moving, or in combination with a real (as opposed to formal) move. The company may be established for a limited time period (Limited Duration Companies), so it is dissolved at a pre-defined point, determined by time or by an event. Examples of event-determined automatic dissolution or moving may be creditor action, payment difficulties, divorce, etc.

A company may also be liquidated or laps by omitting to pay the annual dues or fees to local directors or the company registrar/company agent. The fees are the income source of the tax havens for registration, and deregistration will follow from the non-fulfilment of the obligation to pay such fees. From the client's point of view, this is often not a threat, but an effective way of liquidating the company.

3.3.10 Further on the special treatment of companies and similar entities in tax havens

Companies in tax havens may, in principle, have any name. Some tax havens do not allow names that can lead to confusion with royalty, particular financial activities, etc., or names that are deemed inappropriate for other reasons.²²

As a rule, however, company names may be registered with suffixes or abbreviations in various languages (AS, Ltd, GmbH, Oy, Società per Azioni, AG, AB or the like).²³ At the same time, certain laws include extremely detailed rules on the form of abbreviations, or on which abbreviations should be used in particular situations.²⁴

All countries have the freedom to determine which letters of the alphabet a company suffix may or should contain, but the alternatives are probably not arbitrarily chosen. They correspond to suffixes used at the establishment of companies in other states. It is unclear what legitimate reasons justify why companies may, for instance in the British Virgin Islands or the Seychelles, be established with the Norwegian abbreviation for joint stock company, AS, as designation/suffix.

Trading partners and authorities in other states are often sceptical of carrying out transactions with companies registered in tax havens. This is caused, among other reasons, by the secrecy rules and the problems of gaining access to information on what takes place in the companies and who is behind them. Suffixes that conceal where the company is registered may, in such cases, draw attention away from the name of the company, and thus also to the company itself and to transactions with the company.

The consequence is that the company's name (logo) does not give information on where it is actually registered. On the contrary, an impression is created that the company is registered in a "respectable" country with normal company regulations. This is apt to create confusion – particularly

in cases, where Norwegian-registered and tax haven-registered companies have exactly the same name. There are examples of this.

Apart from having confusing names, the companies may also operate with "virtual addresses", usually in respectable onshore states. Outwardly, the jurisdiction in which the company is actually registered is effectively concealed. At the same time, the owners can claim that they are not acting illegally, since this is permitted by the local legislation. However, it contributes to misleading both contract partners and public authorities by encouraging them to believe that the company is registered in a jurisdiction different from the one in which it is actually registered.

3.3.11 The Commission's observations

The Commission would like to emphasize that it is entirely legal to establish enterprises in tax havens, and that there may be legitimate reasons for doing so. Those who establish companies in tax havens, but live in other states, must only comply with all legal or contractual requirements for disclosure where they live or have commitments.

At the same time, the secrecy rules – in a broad sense – ensure that the use of companies registered in tax havens provides great opportunities to act anonymously and to conceal the companies' income, debt and assets. On a number of points, the Commission has difficulty understanding the legitimate reasons that tax havens legislate exemptions for companies that are intended to operate only in other states, while the companies – their ownership and activities – are subject to strict obligations of secrecy. The legitimate reasons for using the services offered by tax havens demand neither rigorous rules of secrecy nor an extensive system of exemptions.

The Commission would stress that the lack of transparency is a major factor of uncertainty in the legislation of tax havens, and inflicts great damage on public and private interests in other states. Experience has shown – for instance through a series of criminal proceedings, public inquiries, etc. – that the structures allowed by tax havens have been instrumental in several serious forms of crime. This is particularly unacceptable because companies are only supposed to conduct activity in states where their owners are domiciled, where their activities take place, and from where the companies are actually managed.

Although the owners may, generally, refer to the legality of the arrangements in the jurisdiction

²² Examples of what is excluded are names that include designations like "Chamber of Commerce", "building society", "royal", "imperial", or "bank", "insurance", etc., unless this is consistent with the company's activity [and such activity requires consent]. See Cayman Islands Companies Law (2004 Revision), section 30.

²³ See, for instance, the Seychelles (International Business Companies Act, 1994, section 11 (1), which in an appendix to the act (Part III) lists about 40 company designations and abbreviations. See also BVI Business Companies Act 2004, section 17 (1) (d).

²⁴ See BVI Business Companies Act 2004, Division 3.

Box 3.4 Scandinavian Star and environment crime at sea – the use of closed jurisdictions to evade punishment and liabilities for damages

Ice Bay: On 17 October 2005 the Norwegian coast guard boarded the fishing vessel *Elektron* while it was illegally reloading fish onto the cargo ship “Ice Bay”. The case was well covered by the media, because *Elektron* set course for Murmansk with Norwegian fisheries inspectors on board. The captain of *Elektron* was later charged with deprivation of liberty by a Russian court, but was acquitted. Norwegian authorities found that the shipping company that owned *Elektron* was empty, i.e., the company had sold *Elektron* and was without property. Thus, it was impossible to actually charge anyone with illegal fishing or deprivation of liberty in a Norwegian court.

“Ice Bay” evaded the coast guard after *Elektron* had been boarded on 17 October 2005. On 11 October 2007, it was discovered that the ship “Ice Bay” was off Senegal – now under the name “Cliff”, and was on its way to the Gulf of Guinea. Norwegian authorities alerted Ghanaian authorities. When the vessel put in at the port of Tema in Ghana, the authorities seized the vessel. Ghanaian media reported that serious breaches of the country’s fisheries legislation had been uncovered. According to the articles, the ship had fished in Ghana’s territorial jurisdiction and then imported the fish to Ghana for sale on the local market. For this breach of law, the Ghanaian public prosecutor was in the process of issuing a fine of close to USD 2 million. The case took an unexpected turn when Ghana’s Minister of Fisheries, Gladys Asmah, on a visit to the port of Tema, discovered that the port authorities had released the ship without the fine having been paid. Ghanaian authorities reported that the vessel was, at that time, registered in Cambodia, a country with minimal controls on ships and owners who wish to register ships in the country’s shipping register. The vessel was owned by Nord Shipping Company Ltd, Belize. Ghanaian authorities have not pursued the case further. Today, the vessel is called *Aquamarin*, sails under the flag of St. Kitts Nevis and its ownership is located in the Ukraine. The vessel has some activity in Mauritania. Whether the owners are the same, or whether the vessel has actually been sold to a new firm is difficult to know.

Change of flag: On 29 June 2006, the Norwegian coast guard boarded a ship marked with the name “Joana” which flew the flag of the state of São Tome. However, the coast guard knew that the vessel had changed flags from the state of Togo to the state Guinea before sailing in to Aveiro in Portugal, on Saturday, 14 January 2006. After sailing from Aveiro, the vessel changed back to the flag of the state of Togo on 15 May 2006. And in international waters, the vessel changed flags from the state of Togo to the state of São Tome on 22 May 2006. At the last of these changes of flags, the vessel also changed names from ‘Kabou’ to ‘Joana’.

A ship may not change flags at sea or in a port of call, except in cases of real changes of ownership or real changes of registration. A ship that breaks this rule is given the status equal to that of a ship without nationality. The absence of nationality was the basis that allowed Norwegian authorities to force the ship to land.

The authorities identified a number of breaches of fisheries law, including illegal mesh width in the trawl and a lack of logs for the catch. The shipping company and the captain were fined NOK 300.000 and NOK 50.000 respectively. The authorities were never able to determine who owned the shipping company. There are, however, suspicions that the ship is actually owned by a consortium that also owns several boats that have broken fisheries legislation. If such ownership could have been established, sanctions could have been levied on the shipping company, and not merely on the individual boat. However, Norwegian authorities have not been able to establish actual ownership.

Scandinavian Star: On the night of 7 April 1990, a fire broke out on the ferry *Scandinavian Star*. The ship was on its way from Oslo to Fredrikshavn. The fire killed 158 people, and one person died two days later because of injuries sustained in the fire. It was later established that the ship had serious defects and that security regulations had not been followed. A Danish citizen presented himself as the ship-owner responsible for the ship. However, final ownership has not been established. The ship was registered in the Bahamas. There was reason to suspect that an American company (*SeaEscape Cruises Ltd.*) was the real owner of *Scandinavian Star*. If the bereaved had initiated legal proceedings in the USA, they might have been awarded substantially more in damages than they received from a Danish court. However, most of the bereaved accepted a settlement and legal proceedings were never initiated against *SeaEscape Cruises Ltd.*

These cases show how owners of shipping companies use closed jurisdictions to ensure that they are not held responsible for criminal acts connected to maritime transport and fisheries. In the maritime industries, it is also problematic that many flag states (i.e., countries where ships are registered) do not actually confirm that the data in their shipping registers are correct. Ships may be re-registered in a matter of hours without inspection by representatives of the flag state. Many flag states that offer registration without controls are not closed jurisdictions. To a certain extent, the same states appear repeatedly in connection with taxation, money laundering, and a lack of compliance with obligations as flag states.

in which the company is registered, the harmful effects occur in other states where the activity actually takes place. Particularly vulnerable are developing countries, which have only limited resources to pursue those who conceal funds in tax havens. There are a number of examples of dictators and heads of state in developing countries who have concealed large amounts of illegally appropriated funds in tax havens.

The Commission is aware that the secrecy rules are justified by referring to the need to protect wealthy individuals against extortion and the like. It is difficult to attach weight to such a justification. Wealth invites extortion because it is visible, and this concern cannot in any way compensate for the many and serious harmful effects brought about by the secrecy rules.

In the commission's opinion, some exemptions are particularly harmful. For example, the absence of informative registers of companies and accounts, the practice of rigorous rules of secrecy, the exemption from obligations to prepare and preserve accounts, and the right of rapid redomiciliation. In sum, such rules and arrangements make it very difficult – often impossible – to gain access to reliable information on the activities of companies and the identity of the real owners. This gives reason to question the seriousness and trustworthiness of substantial parts of the activity that takes place in tax havens. Conditions of near-exemption from all taxes contribute, in combination with the factors mentioned above, to inflicting great damage, particularly on developing countries (cf. chapters 5 and 6).

The Commission would further point out that the tax exemptions, which the tax havens present as a legitimate competition parameter, are, in reality, often exemptions on funds that should have been taxed in other states. It is not acceptable that companies be given resident status in relation to tax authorities in a jurisdiction where the company has no real activity. In the Commission's view, this is not an exercise of sovereignty, but an unacceptable infringement on the sovereignty of other states.

The Commission realizes that some tax havens have established certain regulations that oblige certain companies to prepare financial accounts, that establish limited tax liability, and that implement certain measures to counter money laundering (among other things the “know-your-customer” requirement). The cases studied by the Commission leave doubt as to whether some of these tax havens actually implement these reg-

ulations through supervision and controls that demand corporate compliance.

“International” companies in tax havens that have no obligation to preserve accounting records, or that can preserve their accounts wherever they choose, to the extent that they choose to keep accounts, are, in the Commission's opinion, unsuitable as counterparties in business since the transaction risks are great.²⁵ Such companies are therefore best suited to enter into agreements with closely related parties that know what actually transpires in the company, and to hold assets and debts that are located in, and subject to the legal conditions of other states. In both cases, there is a considerable danger of abuse.

The Commission would point out that the secrecy rules and the company/trust structures, considered together and separately, are extremely harmful to the global economy, particularly for developing countries. Effective countermeasures presuppose considerable changes both in structures and in secrecy rules.

It is difficult for the Commission to see legitimate reasons for any state to establish these types of exemptions, subject to secrecy, for companies whose activities exclusively, or primarily, involve the citizens and legal conditions of other states. A well-functioning global market depends on loyalty between states. In the opinion of the Commission, no state should profit from arrangements that inflict damage on other states and which ensure that a company's activity is concealed from public and private interests.

3.4 Trusts – What is a trust?

A *trust* is a collection of assets where the *formal and legal owner* of the assets (the “trustees” or managers) have agreed to undertake to manage the assets for the benefit of those who, according to the *basis for establishment* (the foundation agreement or the trust agreement/trust deed), are designated as beneficiaries of the trust (*beneficial owners*). It is commonly said that the trustees formally hold the ownership of the collec-

²⁵ At the outset, this case also involved large multinational corporations, which regularly have many affiliates in several tax havens. Such corporations are generally listed on stock exchanges and are subject to, among other things, the legislation on stock exchanges and accounting in the country in which the parent company is registered. Nonetheless, the use of affiliates in tax havens actually makes it impossible for any single country to gain a full view of the corporation's activities.

tion of assets on trust and for the benefit of the beneficiaries.

A limited liability company is different from a trust in important ways. The owners of a company control the company as beneficial owners. They have full control of the company through the company's bodies – on behalf of themselves. They have the company at their disposal for their own benefit, in accordance with the provisions of the applicable company law. For instance, they may sell or liquidate the company, and take out salaries, loans or dividends, to the extent that the finances of the company allows.

As legal instruments, trusts specifically distinguish between *formal ownership* “legal (title) ownership”, which is held by one or more managers (“trustees”), and those who are *entitled to benefit from its assets* (“equitable ownership”, “beneficial ownership” or “interests”). The managers exercise ownership not on their own behalf, but “on trust” – in accordance with the trust agreement – on behalf of the beneficiary. Those entitled to the funds of the trust are normally (but not always) different from those who have formal legal control over the assets.

In the rationale behind trusts, the concepts of trust and obligation are crucial elements. The relationship between trustees and beneficiaries is built on four elements:

1. it is fair and equitable
2. it gives the beneficiaries the rights to the assets
3. the trustees have obligations
4. the obligations are, by their nature, a relationship of trust

Compared to Norwegian legal entities, the trust structure is unfamiliar and somewhat difficult to understand. In particular, the relationship between legal and beneficial ownership seems alien and illogical, if the aim is to create clear and predictable lines of representation between actors in the trust, and in relation to third parties.

3.4.1 Legal characteristics of trusts

The beneficiaries may be identical to the founders of the trust, the settlors, or they may be individuals the settlors desire to favour. The trust may be funded by the settlor when the trust is established, or by subsequent transfers. Once the trust is established, funds may also be transferred and/or provided by others.

If the settlors wish, a “protector” or “enforcer” may be appointed as an intermediary between the

trustees and the beneficiaries. These are particularly trusted individuals who are charged with controlling whether the trustees act in accordance with the trust agreement and in the interest of the beneficiaries.

Even if the trustees *formally* own the funds of the trust, the funds do not form part of their personal wealth. They are not liable for taxes on the funds, nor can the funds be targeted by their creditors, or by their estate, if the trustees go personally bankrupt.

If the trust is properly constructed, the trust funds should not form part of the wealth of the beneficiaries before they formally receive distributions in accordance with the trust agreement and whatever stipulations were made at the establishment of the trust. They will be liable for taxes only on funds that they receive, which may also be targeted by their creditors.

This has importance in several contexts. The prospect of future distributions do not typically form part of the beneficiary's estate, provided the beneficiary does not control the trust. During the period after the valid transferral of funds to the trust, but before the funds are properly distributed to the beneficiaries, the trust funds live their own life with independent rights and obligations. Nonetheless, a trust is not an independent legal object, in contrast to, for instance, a Norwegian “stiftelse” (foundation), which owns itself.²⁶

The form of ownership held by trustees is similar to that of an owner, but limited by the contents of the trust agreement. They should, in the administration of the trust's funds “... *have all the same powers as a natural person acting as the beneficial owner of such property*”.²⁷ Depending upon the power granted to the trustee in the trust agreement, trustees may buy and sell the trust's property, mortgage it or provide surety, take loans on behalf of the trust or lend the trust's funds, and decide matters relating to distributions, etc. The trust agreement may, for instance, stipulate that the trustees must obtain the consent of others (for example a protector or enforcer), before they exercise their authority in general or in specific areas.²⁸

Outwardly, ownership of the trust funds is formalized in the name of the trustee in property

²⁶ See among others Hayton, Kortmann and Verhagen p. 30, which in the commentary to the Hague Trust Convention state that a trust “has no legal personality”, unlike companies and foundations.

²⁷ See Trusts (Jersey) Law 19884, Section 24 (1).

²⁸ Loc. cit. Section 24 (3).

registers (real property), in shareholder registers (shares), in respect of banks (bank accounts), etc.²⁹ Since the trust does not own itself, it can normally not be party to a law suit.³⁰ The trustees are the legal owners and may sue or be sued on behalf of the trust. This is the natural consequence of being granted legal ownership rights to the funds. If the trustees do not fulfil their responsibilities under the trust agreement, they are in breach of their obligations to the beneficiaries.

Even though the trustees act as the formal owners of the trust funds, they do not further their own interests, but act in the interests of the beneficiaries. The trustee shall "... *exercise the trustee's powers only in the interests of the beneficiaries and in accordance with the terms of the trust*".³¹

If the trustees file a lawsuit, the beneficiaries bear the risk of the suit, i.e., all the positive and negative consequences that may result. The beneficiaries also bear all commercial and market risks for any changes in the value of the trust brought about by changes in the economy or bad investment decisions made by the trustees. The trustees cannot authorize distributions to themselves, unless it is stipulated in the trust agreement, or they themselves become the beneficiaries.

Trusts are conditioned on the premise that beneficiaries in no way, directly or indirectly, control the disbursement of assets, i.e., that they neither directly nor indirectly influence whether, when and how much of the funds are distributed. In cases of abuse, this condition will not hold. Underlying realities, however, often show that the beneficiaries have actual control and authority in respect of the trust funds, even if formal documents shown to the outside world state otherwise.

If the settlor or a contributor to the trust is also a beneficiary, (be it together with his family) the trust must be regarded as self-imposed limitation on the disposal of the assets that are owned by him or his family. In this case, the trust funds will often be viewed as forming part of the beneficiary's property and estate, even though the trustees may have broad discretionary rights of disposal.

3.4.2 Use and abuse of trusts

Over time, trusts have become widely used in countries not founded on Anglo-Saxon legal tradi-

tions.³² Trusts may be used for many legal and useful purposes. However, abuses have sprung from the opportunities that present themselves. The formal distinction between trustees and beneficiaries is based on the premise that the beneficiaries do not control the trustees. If the beneficiaries control the trustees, either directly or indirectly, the beneficiary is regarded as the owner of the trust funds. This determination is fact specific and is made on a case-by-case basis.

Secrecy rules inevitably hamper the possibility of exposing the underlying realities. Those who have legal claims against beneficiaries are not generally aware of the trust funds or have any possibility to access information relating to the real circumstances of control. The means to access this information are obstructed by the secrecy rules of tax havens.

The settlors may have good and legitimate reasons for creating a trust, i.e., designating funds to be managed by trusted individuals without the influence of the settlor or beneficiaries and in the interests of the beneficiaries. The trust structure, among other things, ensures that the beneficiaries receive access to, and a fair share of, the trust funds through the management of an independent and impartial manager. It can prevent conflicts between the beneficiaries (heirs, for example) about management and distribution. It creates clarity and order. If the obligations for reporting imposed by each state are fulfilled, the exercise of disposal through trusts is unproblematic.

In cases of abuse, it is generally important to keep the *existence* of the trust secret. Should outsiders nonetheless gain knowledge of its existence, and wish to know who is behind and controls the trust's funds, it is also important to conceal who *in reality has the right to dispose of the funds*. Outwardly, the impression is given that the beneficiaries do not have the power to dispose the assets of the trust. This is important in order to claim that the trust funds are not owned and controlled by the beneficiaries, with the consequences that ensue for the obligation to report information on ownership and disposal. In actuality, the

²⁹ See Pearce and Stevens p 137.

³⁰ See the Lugano law § , and the Lugano convention art. 5 subsection 6.

³¹ See for instance Trusts (Jersey) Law 1984, Section 24 (2)

³² Three or four decades ago, the establishment of companies and trusts in tax havens was the prerogative of a few wealthy individuals – often ship-owners who were familiar with international trade and legal constructs. Today, tax havens are used by far greater numbers of both companies and individuals with extensive or limited assets. The number is increasing rapidly. The reason is increased globalization, more frequent travel, well-developed information and communication technology, and, not least, intense marketing efforts on the part of facilitators.

beneficiaries nonetheless have full control over the trust's funds. In such cases, the trustee acts only on instructions from the beneficiaries.

It is often very difficult for outsiders to ascertain how beneficiaries control the trust. This is particularly true if external formalities that regulate the trust differ from how the trust is actually controlled. Indications of discrepancies are, as a rule, not easily discernable.

It is difficult to suppose that anyone would entrust valuable assets to a legal construct in a closed tax haven, where trustees appear to have irrevocable and full legal control and may disclaim all responsibility for any mismanagement. The settlor and/or the beneficiaries can keep control in ways that are not evident to the outside world.

According to trust agreements, trustees should ostensibly be irremovable and should hold irrevocable, discretionary powers to manage the trust funds. In reality, the settlors and/or the beneficiaries may nonetheless keep full control. The trustees may, for instance, when they are appointed, sign an undated letter of resignation to be kept by the settlors and/or beneficiaries to be made effective (i.e., dated by the beneficiaries) if and when it is necessary to sack trustees who do not do as they are instructed.

Trustees who act within arrangements giving the beneficiaries or settlor actual control over the trust may, according to circumstances, be in breach of regulations on money laundering if the criminal elements are otherwise met.³³ Indications that trustees have little decisive influence, contrary to the language of the trust agreement, may be seen in the manner in which they perform their responsibilities. Irrevocable and unrestricted control indicates that the trustees are responsible for ensuring that the trust agreement is followed in the interests of the beneficiaries. If the trustees, in spite of their right of disposal, have disclaimed all responsibility for the dispositions they make, this clearly indicates that the trustees do not in reality exercise control.

Certain legal systems also provide solutions for such arrangements. The trustee may choose not ("shall not be required") to "interfere" in the management of the trust funds, or to seek information on subordinate companies, or to interfere in how the profits are distributed. This is common in trusts whose purposes is abuse.

³³ See for Norwegian law, the Norwegian Criminal Code, *Straffeloven* § 317.

Even if the resignation of the trustees is not formalized in writing, the beneficiaries' relationship with trustees in tax haven-based trusts is entirely dependent on trust. This will not be forthcoming if the trustees do not comply with the wishes of the client – although they may formally have the opportunity not to do so. The settlors and beneficiaries frequently prepare a "letter of wishes", which contains wishes for the trustees – as opposed to instructions. In practice, the letters of wishes are always complied with, if they are within the framework of the trust agreement. They are meant to be handy guidelines for the dispositions of the trustees, but are apparently not binding. They contain "suggestions" rather than "instructions".

The purpose may also be to create *apparent* transparency. In such cases, the existence of the trust is not concealed, but outsiders are *openly* given the erroneous impression that the beneficiaries do not control the trust funds.

3.4.3 The trust structure and obligations to inform in respect of private and public interests

Most states impose on their citizens a number of information obligations in private and public law. These include the obligation to provide information on income and assets to tax authorities, lenders, creditors, the securities markets in certain situations, etc.

The question is what obligation to inform is placed on trust beneficiaries. This depends on how the trust is designed.

Without a public registry of trusts and trust beneficiaries, it is normally difficult for tax authorities and third parties to obtain knowledge on or become aware of the assets located in trusts. In cases of abuse, a trust in a tax haven will normally not own assets directly in countries that are not tax havens. The trust will frequently be the top tier in a corporate chain of "exempted companies". Subordinate companies in tax havens may, in turn, own companies in countries that are not tax havens. If trusts are used in combination with one or more "exempted companies", it is necessary to penetrate several layers of complex structures to uncover the underlying situation of ownership and the power of disposal

In practice, the control held by beneficiaries or settlors will not appear openly to the outside world when a trust is established in a tax haven. The trust is based on a private agreement that is

not registered publicly, not including purely charitable foundations, which are irrelevant to this report. The trust is as anonymous as the settlor desires. If the trustee is a lawyer, it is generally claimed – often erroneously – that the management of the trust is subject to the lawyer’s obligation of professional confidentiality.

As a rule, trustees also desire anonymity. There are several disadvantages to being registered as an “owner” in public registers in states that are not tax havens, with the consequences that may arise in relation to third parties, or possible breaches of provisions against money laundering, etc. Frequently, trustees have little knowledge of how the underlying assets are actually managed, and what these assets truly consist of. This creates fear among trustees that funds may be managed in ways that create problems for the formal owners.

3.4.4 Discretionary trusts

With an eye to abuse, the so-called discretionary trusts are of particular interest. Under discretionary trusts, the trustees have the discretionary freedom – without instructions from the beneficiaries – to decide how the trust should be managed, within the framework of the foundation document (the trust agreement).³⁴

A central question is how a discretionary trust, and the distinction between the formal ownership of the trustees and the real ownership of the beneficiaries, should be regarded by the Norwegian legal system in respect of the obligation to provide information by Norwegian citizens who are beneficiaries of such a trust in a tax haven. The answer depends on, among other things, whether the *beneficiaries* have been deprived of management over the trust to the degree that they cannot be considered as owning or controlling the trust, and whether they do, in fact, benefit in a way that gives a reasonable assurance of access to the trust funds. The concealment of distributions or benefits made to a person domiciled in Norway will normally be regarded as an infringement of several provisions to provide information.

Distributions from discretionary trusts may, according to the trust agreement and all amendments, be constructed in many different ways. Even if the trustees have the discretion to exercise their power of disposal, this discretion is sub-

stantially limited by stipulations in written and unwritten agreements.

The basic provision inherent in the construct is that the trustees at the outset have only formal ownership disposal of the trust funds. The disposal is not exercised on their own behalf, but on the behalf of the beneficiaries (on trust) – within the framework of the trust agreement.

For the beneficiaries to be able to assert that they do not control the trust funds, the formal disposal (within the framework of the trust agreement) must be all but complete, unrestricted and irrevocable. Nonetheless, only the beneficiaries may claim distributions from the trust.

The most important written limitations on the mandate of the trustees lie in the trust agreement itself. Normally, the trustees are not beneficiaries and may not directly or indirectly distribute benefits from the trust funds to themselves. If the trust agreement, for instance, names individuals A, B and C as beneficiaries, this determines *who* the trustees may distribute funds to. The trustees then have no discretion in this important regard.

In addition to specified individuals or groups, a public service organization will frequently be named as a beneficiary. At the outset, the trustees would then be free to choose whether the distributions should go to charitable causes, or to one or more of the individuals A, B or C. In practice, this is not the case. It is common to name a charitable organization as a beneficiary. This gives the outward impression that the trust is established for a good cause, or that the purpose of establishing the trust is broader than merely to benefit one or more selected individuals. At the same time, there will still be beneficiaries to the trust in case the other beneficiaries fall away, for instance as the result of accidents or of unforeseen events.

In practice, in such cases, nothing, or very little, is distributed to charity. When the settlor (or later contributors of funds) and his family are named as beneficiaries, they receive the greatest share of the distributions. Naming a charitable organization as one of several beneficiaries does not lead to the trust being regarded as a charitable trust. Charitable trusts are established to further genuinely charitable causes, and are subject to quite different forms of public control, also in tax havens.

Discretionary tax haven-based trusts, in sum, create much ambiguity. This is partly because of the secrecy rules that prevent access to important information on the existence of the trust and its conditions of disposal. And partly because the le-

³⁴ See Thomas and Hudson (2004): *The Law of Trusts* p 28.

gal classification of the trust also raises significant problems in establishing how the beneficiaries have disposal, in fact and legally, in the state where they are domiciled or belong.

3.4.5 Other forms of trusts

There are several types of trusts³⁵ with names based on the purpose of the trust, or the obligations of the trustees, or who benefits, etc. The following can be mentioned as examples: “protective trusts”, “express trusts”, “implied trusts”, “resulting trusts”, “constructive trusts”, “private trusts”, “public trusts”, “purpose trusts”, “asset protection trusts”, “sham trusts”, “illegal trusts”, etc.

The various designations may seem confusing, and several of the designations are “popular forms” that give characteristic features of some trusts, without the names in themselves having any legal significance for purposes of classification. There does not seem to be any consensus on how trusts should be classified.

Some trust forms are, like discretionary trusts, particularly apt for abuse.

“Cayman Islands Star Trust” (STAR-trust) is a new and sophisticated form of trust which was established on the Cayman Islands in 2001 and is referred to in “Part VIII” of “the Trusts Law” of 1997 (2001 Revision).³⁶ The law allows for the establishment of both “non-charitable purpose trusts” and “asset protection trusts”. The purposes are not limiting, in fact, they seem to extend the scope compared to alternative forms of trusts. All forms of trusts may be established as a STAR-trust – to benefit individuals, or various causes, or combinations of these.³⁷

A STAR-trust involves both “trust of a power” and “trust of a property”.³⁸ “Trust of a power” involves a trust “... if granted or reserved subject to any duty, expressed or implied, qualified or unqualified, to exercise the power or to consider its exercise”.³⁹ The control of the trust funds lies in

the power. That power also includes powers of management and disposal.⁴⁰ A characteristic of this trust form is the special authority given to the trustees, who may make decisions on the management of the trust funds independently of the wishes of the beneficiaries. This has the consequence – or at least the appearance – of a trust that is not controlled by its beneficiaries.

“Virgin Islands Special Trust” (VISTA) 2004 is another newly developed form of trust that lends itself to abuse and to concealing the conditions of disposal. By placing a trust as the highest tier in a structure, the trustees have the formal authority to legally disposal of and control the shares of subordinate companies, and therefore their management and distributions. To create the necessary distance between trustees and beneficiaries, discretionary trusts are frequently employed. A precondition of such trusts is that the trustees have considerable freedom to dispose of the trust funds, with no other overriding control than that which derives from the trust agreement.

This may be a problem for beneficiaries who wish to keep control of subordinate companies while maintaining the advantages of having a discretionary trust as the top tier in the ownership chain. If the beneficiaries are not to be regarded as owners of the trust funds, the distinction between legal and beneficial ownership must be absolute. This means that the beneficiaries may not instruct the trustees.

The necessary distance is regarded as established through the discretionary element, i.e., the independent right of disposal given to trustees within the framework of the trust agreement. In the opposite case, the beneficiaries will be regarded as in control of the trust funds. If, however, the distinction is sufficiently clearly established, the trustees control also the subordinate companies.

In 2004, the British Virgin Islands introduced new legislation to solve the “problem” that control of the trust also implied control of the subordinate companies.⁴¹ The solution – described as the primary object of the law – consisted of establishing the right to create trusts where the trustees are deprived of authority over and influence in subordinate companies.⁴² Exceptions apply only in special cases where the beneficiaries decide other-

³⁵ On different types of trusts, see generally Hayton, D. and Marshall, C. (2005), *Commentary and Cases on the Law of Trusts and Equitable Remedies*, pg 36 f.; Pearce, R. and Stevens, J. (1996), *The Law of Trusts and Equitable Obligations*, pgs 92-94, 313 f., 625 f. etc.. See also Harry Veum in *Revisjon & Regnskap* (1997) no. 6 pgs 278-282 and no. 7 (pgs 350-355) that give a simple introduction to the trust form.

³⁶ Special Trusts (Alternative Regime) Law, 1997 (STAR). The references to sections below refer to those of the revision, and not to those used after the incorporation into PART VIII in the Trust Law of 1997.

³⁷ See Thomas and Hudson, p 1292.

³⁸ See STAR Section 2 (1) and Section 6.

³⁹ See STAR Section 2 (2).

⁴⁰ See STAR Section 2 (1).

⁴¹ See Virgin Islands Special Trusts Act, 2004 (VISTA) [Gasetted 6 Nov 2003].

⁴² VISTA 2004, Section 3.

wise or the trustees must intervene to protect the interests of the beneficiaries. This means that the trustees are formally regarded as owner of the trust, but they do not have disposal rights over the subordinate companies. Such an arrangement makes it relatively simple for those who have disposal of the subordinate companies to act as they want, without appearing outwardly as owners.

Certain trust constructs are designed in a way that is difficult to understand. Logical considerations of corporate law or business rationale suggest that clarity and transparency should be important elements in their design. Tax havens are open to the establishment of trusts that allow concealing structures, with modest regulations and obligations ("exempted trusts" of various kinds).⁴³ In these cases, it may be difficult or impossible for outsiders, who do not have access, to know the nature of the trust's funds, and who in reality controls or receives distributions from the trust. It is difficult to see legitimate reasons for tax havens to develop these types of structures, whose activity should take place only, or primarily, in other states.

3.4.6 Redomiciliation of trusts

A number of tax havens allow redomiciliation or migration of trusts (for instance, to a different tax haven) if it is regarded as expedient. This is achieved by transferring the position of trustee to a different jurisdiction. The assets of the trust are not moved. They are located in subordinate companies – that may, in principle, be scattered across the world. This is effective in cases of abuse, where the purpose is to conceal real ownership and the power of disposal.

Since trusts are not registered publicly anywhere, the position of trustee may be moved between various jurisdictions without formalities. But local agents who have fulfilled the function of trustee, or had other commissions for the trust, will still, as a rule, keep the documentation that shows what they have received in the form of wish-letters or instructions, as well as what dispositions they have made of trust funds, and what decisions they have made.

3.4.7 Exemptions

Trusts are normally exempted from tax liabilities, obligations to present accounts, obligations to pre-

serve accounts etc., in the same way as "exempted companies". The exemptions do not apply to charitable trusts.

3.4.8 The Commission's observations

The Commission would point out that it is problematic that trusts are often not registered anywhere, while at the same time they are frequently the top tier in a chain of subordinate companies. The opportunities for abusing trusts to conceal ownership and the authority to dispose of the trust funds are many and difficult to uncover. The possibilities for abuse lie in the trust structure itself, which, together with rules on secrecy, make it difficult to uncover both underlying facts and the true legal regulation of the trust.

Particularly problematic are trust structures which mask the fact that the beneficiaries actually control the trust, whereas the formal regulation (falsely) states that the trustees have full and unrestricted authority in accordance with the trust agreement. In the Commission's view, trusts that are granted the same exemptions as limited liability companies are at least as apt to be abused.

3.5 Cooperation between concealing structures in tax havens and other states

In cases of abuse, the concealed structures in tax havens will often work with concealing mechanisms in other states. In such cases, the purpose is to operate through tax haven-based structures without this being obvious to the outside world.

Companies and trusts in tax havens are frequently not trusted in other states, as a result of the broad secrecy rules. Links to companies in tax havens can be masked in a number of ways. We have seen above that many tax havens allow the use of company suffixes from other states.

It is also common to use virtual addresses and mail drop-services. Virtual addresses mean that a company may outwardly present itself with an official address in a financial centre in a country that is not a tax haven. Frequently, it is the address of an office building whose occupants specialize in this kind of service. Anyone who approaches the company will establish contact with a switchboard that presents itself with the virtual address. The stationary, etc., of the company uses this address, which also has references to e-mails, telephone numbers, etc., that do not identify the jurisdiction

⁴³ See among others. Cayman Islands Trusts Law (1998 Revision), Part IV.

in which the company is registered. Mail to and from the company is always sent via the virtual address in order to prevent third parties from discovering where the company is actually registered. When contacting the company by telephone, a prefix to the virtual company's jurisdiction appears on the display, and enquiries are conveyed to the company's real owners who are not domiciled or do not permanently reside in the tax haven in which the company is registered. The purpose is to conceal that the company is registered in a tax haven, and frequently also to conceal the identity and whereabouts of the real owners. This type of deceit is harmful when it is important that customers know the identity of the real owners and how to contact them.

Alternatively, a related conduit company may be established in a "respectable" country and used in order to conceal the underlying structures in tax havens.

This type of facade is possible, in part, because the real companies and their ownership are concealed in tax havens.

3.6 The secrecy rules of tax havens and fundamental human rights.

The European Convention on Human Rights of 4 November 1950 (ECHR), contains a number of articles to guarantee "all" or "anyone" protection against abuse, loss and injury. Material values, too, are protected, although their position is somewhat different from the protection of life and health. See, for example, the first amending protocol of 20 March 1952. Victims of a number of forms of economic crime are thus, in principle, protected by the catalogue of rights in the convention.

The tax haven secrecy rules, broadly speaking, often function as a denial of justice for those who experience loss and damage, regardless of whether these are public or private actors.⁴⁴ The consequence is that the existence of, reasons for, or extent of the loss is not disclosed, and illegally taken funds cannot be recovered.

The system of the European Convention of Human Rights implies that those who lodge com-

plaints against states for the European Human Rights Court in Strasbourg (EHRC), must first exhaust the national means of justice before the complaint is taken under consideration, cf. ECHR article 35 no 1. Law is developed through complaints, and the convention is dynamic and should be interpreted in the light of "present days conditions".

Primarily private individuals have the right to lodge complaints to the EHRC, but also enterprises are protected in several articles of the convention. States may lodge complaints according to the ECHR's article 33.

The Commission would point out that human rights give the opportunity for protection, so that those on whom damage is inflicted because of concealing structures in tax havens, may secure their rights. It has been shown repeatedly that state leaders in developing countries conceal very valuable assets in several jurisdictions for instance in Europe, where the ECHR applies. States against whom complaints are lodged must have acceded to the treaty. The convention was passed by the member state of the European Council, whereas the UN conventions of 16 December 1966 have a far wider geographic range.

Furthermore, it is known from a number of cases, that developing countries have had great difficulties in gaining access in several states that have acceded to the ECHR. Consequently, developing countries, too – because of the secrecy rules – have no realistic possibilities to repatriate stolen funds. The Commission would point out that the amounts concealed are enormous in absolute numbers, and even greater relative to the poverty in the states from which the funds have been stolen.

To the extent that formal and material conditions allow, developing countries should seek to bring states that hide illegal capital flows and stolen funds before the human rights organs.

The Commission would underline that many human rights questions remain untried. Those who suffer a denial of rights, or are denied access, or are denied repatriation because of rigorous secrecy rules, may only have a final answer to what rights they have by lodging complaints against the respective closed jurisdictions for the human rights organs.

The Commission would encourage developing countries to explore the possibilities human rights give for enforcing a right for access to and repatriation of stolen funds. Civil society is encouraged to assist developing countries in this

⁴⁴ A number of classical tax havens are subject to the UCHR: Jersey, Guernsey, Isle of Man, Gibraltar, Andorra, Liechtenstein, Monaco. However, also states that are not seen as classical tax havens have secrecy rules that create problems. This is the case with for instance Switzerland and Luxembourg.

work. The work must also include an exploration of the possibilities for complaints that are inherent in various UN conventions.⁴⁵

3.7 Particularly on the harmful structures outside tax havens.

The Commission would point out that there are a number of examples that the type of harmful structures that characterise pure tax havens also exist in countries that are not normally referred to as tax havens. This is particularly the case with company structures that are apt to cooperate with tax haven-based structures, and to cooperate with states that have built a large network of tax agreements. The tax agreements should safeguard against double taxation, but they can also be abused for so-called “treaty shopping” by the establishment of closely related companies that do not conduct any activities.

Several industrialised countries have established company forms that are exempt from the obligation to audit, and/or are liable for little or no tax in limited areas. There are provisions for pass-through solutions that work so the tax base in both the source state and the state of residence is undermined by recourse to an artificial intermediate company in a pass-through state.

⁴⁵ See for instance the International Convention on Civil and Political Rights of December 1966, with protocols.

The Netherlands is an example of this last case, but also other jurisdictions have established more or less activity-less structures that in the main only hurt other states.

Several states allow very harmful secrecy rules, even if they cannot be regarded as classical tax havens. Examples of this are Belgium, Switzerland, and Luxembourg. Company structures in Delaware (USA) also contain substantial harmful elements.

It is also an important point out that those who abuse tax havens actually live in countries that are not tax havens. Measures to combat the harmful effects of the legislation in tax havens must therefore also be enacted in other states.

The Commission would point out that it is important that developed rule-of-law states discontinue all arrangements that are apt to be harmful to other states. Tax havens often point to such arrangements as an argument for not enacting the necessary changes before other countries do the same. For instance, tax havens frequently point to the secrecy rules in Switzerland. As long as Switzerland does not change its rules, the tax havens see no reason to do so either.

The Commission would point out that the motive force for the development of harmful structures often derive from well-developed financial centres in large industrialised countries. Consultants in these countries contribute both with general counselling and with the organizing of structures that are apt for abuse.

Chapter 4

The effects of tax havens

In this chapter, the Commission presents and discusses arguments for and against the kind of structures which characterise tax havens. Issues related to the taxation of international companies and capital movements are central to this discussion. Also addressed are issues relating to the effects rising from access to information about financial institutions and markets.

4.1 Negative effects of tax havens

4.1.1 Damaging tax competition

Economic integration has made it easier to avoid taxation in one country by moving mobile taxable objects to other countries. In particular, increased capital mobility has made it possible for countries to attract capital by offering favourable tax terms. A welfare economics perspective indicates that, when countries compete to attract taxable objects, taxes will be set too low because each country will not take account of the fact that they harm other nations. Tax havens have contributed to reinforcing tax competition by offering secrecy rules and fictitious domiciliary positions combined with “zero tax” regimes. This is not tax competition in the normal sense, because low taxes are combined with legal structures which represent a major encroachment on the sovereignty of other countries.

The degree of harmful tax competition will largely depend on the mobility of the tax base.¹ It has normally been assumed, for example, that people are less mobile than capital and that tax competition accordingly presents a bigger problem for capital taxation. Governments can in principle reduce the problem of competition over capital taxation by assigning the right to tax capital gains to the country in which the owner of the capital is domiciled rather than the one in which the capital has been invested (the source coun-

try). Most OECD members have accordingly opted to apply the domiciliary principle to taxation, which means that taxpayers are taxable in their country of domicile on all their income regardless of where it has been earned. However, this principle has often proved difficult to enforce because it depends on the country of domicile obtaining information from the source country. Tax havens increase this problem because their secrecy legislation hinders insight by third parties.

Tax competition makes the national tax base more tax sensitive. Some people have feared that tax competition will lead to a “race to the bottom”, where tax rates become so low that countries with large public sectors must make dramatic cuts in their welfare systems. However, the impact of tax competition on the general level of taxation has proved more limited than had been feared. Generally speaking, tax competition has led to higher taxes on immobile tax objects and lower rates on mobile objects. A particular decline has been seen in taxes on capital income, which has been offset by higher taxes on other tax objects.

The change in the composition of the tax base has two secondary effects. First, it affects the way the tax burden is distributed between different groups in society, such as owners of capital and wage earners. Viewed in isolation, a reduction in capital taxes means that owners of capital pay a relatively smaller proportion of total taxes and wage earners pay a higher share.

Second, a change in tax composition could cause an increase in the social cost of taxation if reduced capital taxes are offset by higher taxes on other parts of the base. In that context, it is important to stress that an significant insight from economic research is that taxes direct resource allocation by both companies and employees away from what is socially optimal. A tax on earned income, for instance, could prompt wage earners to desire to work less than they would have done without the tax, which means a loss of efficiency in relation to the position in which earned income is not taxed. The effect on the supply of labour,

¹ The tax base is the sum of taxable activities, the collective value of real property and assets subject to tax in a community.

and thereby the efficiency loss from taxing earned income, will normally increase with the tax rate. Moreover, it is the case that the effect on resource allocation, and thereby on economic efficiency, differs between various types of taxes. Generally speaking, the loss of efficiency in tax financing is smaller the lower the tax rates and the broader the tax base. Tax havens increase the loss of taxation efficiency by reducing the tax base and thereby triggering the adoption of high taxes for the remaining base. It should also be stressed that competition over capital from tax havens is particularly harmful because of the use of secrecy by the tax havens, which interferes with the opportunities of other countries to gain access to information and thereby causes additional harm. In that sense, the tax havens do not compete over tax – they utilise legal structures which encroach on the sovereignty of other countries to attract capital.

The costs of tax competition affect all countries, but are higher for developing countries because they derive the larger part of their tax revenues from capital. This means that they face a greater threat of losing tax revenues and must accordingly reduce public sector investment, for example. Since poor countries have a different structure for their tax revenues and a far greater need for public sector investment than rich countries, they suffer more harm from tax competition. See chapter 5 for more details.

The damaging effects of tax competition have led to a recommendation that national taxes on mobile tax objects should be harmonised or coordinated.² This view was reflected, for instance, in multilateral initiatives undertaken by the OECD and the EU in the 1990s, where the intention was to limit competition over mobile tax bases.³ These initiatives also assumed that damaging mechanisms such as secrecy regulations in tax havens should be abolished.

4.1.2 Inefficient allocation of investment

To maximise the contribution to value creation, investment should be made where it obtains the

highest *pre-tax* return – in other words, where the socio-economic return is best. However, private investors are not concerned with the pre-tax return but with the *post-tax* return, which is the income they retain. Ideally, the tax system should be designed to ensure that private and socio-economic investment decisions coincide. That would yield the highest possible value creation. As mentioned above, however, taxes influence investor behaviour. The greater the difference between private and socio-economic returns, the more the tax system will impose an efficiency loss on the economy.

Tax havens can change investor behaviour and thereby increase the difference between socio-economic and private returns. This is because the profitability of some investments could be enhanced by routing them through tax havens. The existence of such jurisdictions and low/zero tax may mean that investments which would not have occurred if they were taxed under the usual rules are nevertheless made. This reduces the socio-economic return on the investments actually undertaken, so that tax havens have lowered overall value creation for society.

4.1.3 Effects of secrecy

The secrecy rules mean that tax havens can easily become pass-through locations where investors achieve anonymity from the tax authorities in their home country and from possible creditors. This is lucrative for these jurisdictions because, in exchange for zero or very low tax, they make money from fees or from the use of local representatives and administrators by foreign companies. The effect of such rules on other countries is that the cost of committing economic crimes is reduced, because both the criminal activity and its proceeds can be concealed. Furthermore, the tax base has become more sensitive to tax changes. Taken together, this imposes heavy costs on third parties.

As discussed in greater detail in chapter 3, the principal competitive parameter of tax havens is that they offer a combination of (a) tax affiliation without the investor or company needing to have real activity and (b) systems which hinder access to information. This cuts the link with real ownership and ensures anonymity, so that owners avoid having to pay tax in their own country of domicile. This is not tax competition in the traditional sense, but competition over offering the combination of low tax and tax evasion technology. Low

² Tax competition also has a distribution policy aspect, because capital earnings often form a larger proportion of revenue for high-income households than for low-income groups. As a result, tax competition means that low-income groups are harder hit than high-income ones when taxes on capital decline.

³ European Commission 1997 and OECD 1998 (OECD 1998: Harmful Tax Competition: an Emerging Global Issue. Paris: OECD).

tax serves as bait in order to charge for the sale of tax evasion technology. Income from these services is the real source of revenue for tax havens.

In reality, jurisdictions where no real activity occurs and where technology is provided to promote transfer pricing and tax evasion offer investors “weapons” for tax evasion in their country of domicile. This is not beneficial for the world economy because it has no effect other than to damage national and international welfare while simultaneously violating national rights to the tax base. Establishing “safe houses” to conceal criminal activity is not an acceptable competitive parameter.

4.1.4 Tax havens and the financial crisis

The Commission would furthermore emphasize that the international financial crisis which began in 2007 has been reinforced by the existence of tax havens because they impose various costs on the international capital market.

Among other factors, the financial crisis was driven by new types of financial instruments and derivatives (such as the transformation of mortgage debt into convertible financial instruments) which were placed in funds located in secrecy jurisdictions. The use of complex new financial instruments made it difficult for investors to understand the risk profile they were acquiring. Registering funds in secrecy jurisdictions also created uncertainty because third parties were denied information about the actual commitments of counterparties.

The financial crisis has led to the collapse of banks which were regarded as rock-solid, such as Carnegie and Lehman Brothers. Such bankruptcies have meant that the banks no longer have mutual confidence in each other’s financial strength. This uncertainty and lack of trust is reinforced in cases where the counterparty operates in jurisdictions characterised by a lack of transparency and regulation. Because confidence is lacking in the regulatory regime or in the ability of governments to regulate or support companies which might falter during a crisis, players will seek to mitigate counterparty risk with companies which transact substantial business using tax havens. This is well illustrated by the fact that the interest rate on four-week US Treasury bills was down to zero for part of 2008. The bills were much sought after because the buyers knew the risk involved. When uncertainty peaked, it was better to lend money free of charge to the US government for four weeks than entrust it to a bank which

might be doing business in opaque jurisdictions, where insight and legal processes were challenging, and where there was no confidence that governments could play the role they should in a modern financial system. This means that transactions and companies operating in tax havens pose an additional risk for the international financial market. That is well illustrated by the fact that many financial institutions in the run-up to the financial crisis had off-balance-sheet liabilities in their accounts – such as special-purposes vehicles (SPVs) and structured investment vehicles (SIVs) – which were registered in tax havens.

All in all, the various conditions described above have meant that tax havens have contributed to information asymmetry between various players in the financial markets. They have increased the risk premium on financial transactions in the international financial market.⁴ At the same time, they have contributed to bigger stock exchange fluctuations as players sought to eliminate counterparty risk.

4.1.5 Illegal transfer pricing

Much analysis has been conducted into the way multinational companies transfer corporate profits to low-tax countries through the pricing of intra-group transactions (see Appendix 3 for documentation). These studies show that national differences in nominal corporate taxes drive illegal price-setting of intra-group transactions.

Two principal methods are available to a multinational company for transferring profits from a high-tax to a low-tax country. The first method is to overprice transactions from low-tax to high-tax countries and under-price transactions in the opposite direction. Such a strategy reduces the taxable profit in the high-tax country and, conversely, increases it in the low-tax country. The second method is to structure the balance sheet of a company to minimise tax. One way of doing this is through debt financing of subsidiaries in high-tax countries in order to achieve large tax deductions there, while financing subsidiaries in low-tax countries by equity.⁵ An example is the extensive

⁴ This has been regarded as rational for individual investors who have carried out transactions in secrecy jurisdictions because the tax savings have more than offset the higher risk premium. As the financial crisis developed and investors shunned risk, the risk premium may also have outweighed the tax advantages for the individual investor.

⁵ The rules on thin capitalisation in Norway’s petroleum tax system were introduced to avoid such effects in a regime with a very high nominal tax rate.

Box 4.1 The banana trade – an example of transfer pricing

This case was reported by The Guardian newspaper in the UK on 6 November 2007.

Three US companies – Dole, Chiquita and Fresh Del Monte – dominate world trade in bananas. According to The Guardian, they pay a minimum of tax both in the Latin American producer countries and in the major consumer nations in North America and Europe. All three companies have their head offices in the USA. Over a five-year period, they paid USD 0.2 billion in tax on a total profit of USD 1.4 billion – or 14 per cent. The US tax rate on profits is 35 per cent. The companies all have a number of subsidiaries in classic tax havens and channel part of their profits to these companies. As long as the income is not repatriated to the USA, it is not liable to taxation.

The Guardian has estimated that, for every GBP 100 earned from banana sales, GBP 12 goes to the producer country and GBP 39 per cent to the sales organisation in the consumer

country. A profit of GBP 1 arises in both producer and consumer countries. The remaining GBP 47 is used for the following:

GBP 8 to financing costs delivered from Luxembourg

GBP 8 to purchasing procurement services from the Cayman Islands

GBP 4 to companies in Ireland for brand use

GBP 4 to a company in the Isle of Man for insurance

GBP 6 to a company in Jersey for management functions

GBP 17 to a company in Bermuda for distribution services.

The opportunities available to governments for checking that the above-mentioned services have been “correctly” priced are very limited. International companies can thereby channel income where they want, and it pays to transfer profit to where taxes are lowest.

use of internal banks by multinational companies. The banks are equity financed, and the internal bank then lends this capital to companies in the same group located in high-tax countries. The company thereby achieves tax deductions on its debt in the high-tax countries, while income earned by the internal bank often remains untaxed.⁶ It is precisely because tax havens have particularly favourable tax rules on capital directed solely at foreigners that such tax arbitrage is so profitable.

Multinational companies also use subsidiaries in tax havens as pure holding companies to achieve tax credits. Since capital income often goes untaxed in tax havens, tax on current profits

is avoided. This makes it particularly attractive to use companies in tax havens as holding companies.

Another strategy is to transfer the ownership of brand names to subsidiaries in tax havens. These companies then charge royalties for the use of the brand name, reducing taxable profit in high-cost countries. A multinational company may have transferred such brand names to subsidiaries in tax havens at a very low price or free of charge. Such transfers of brand names, for instance, can be legal pursuant to the tax regime in certain countries. The fact that tax havens apply tax rates for foreigners alone which are effectively zero or close to zero makes such transactions very attractive. But it also means that high-tax countries lose a tax object which they might have been entitled to tax, and that the loss of tax revenue would not necessarily have arisen if the tax havens had not set special rules for foreigners.

Insufficient data are currently available in developing countries to establish the share of company profits, and thereby of the tax base in these countries, which is transferred out through intra-group transactions. To obtain an indication of the scale of such transfers, the Commission has commissioned a research team at the Norwegian

⁶ The value of such transactions can be demonstrated in the following way: Assume that the parent company in a high-tax country with tax rate t borrows K units of capital at an interest rate of r . The post-tax cost of this loan to the group is: $-(1-t)rK$. The capital is applied as equity by the internal bank in a tax haven, which lends the money back to the parent company. The cost to the parent company is: $-(1-t)rK$. The parent company must pay interest to the internal bank, which earns: $(1-t^*)rK$, where t^* is the tax rate in the tax haven. The parent company has received K units of capital, which it can place in the financial market. The gain is $(1-t)rK$. Deducting the same costs and gains finds that the value of the transaction is a pure tax arbitrage, expressed as $((t-t^*)rK > 0$.

School of Economics and Business Administration/Institute for Research in Economics and Business Administration to produce a status report on the extent of transfer pricing in Norway. Since Norway has very strong tax controls compared to developing countries, the hypothesis is that if profits are transferred away on a large scale by multinational companies established in Norway, the problem will probably be considerably greater in developing countries.

The study is presented in Appendix 3. Utilising Norwegian enterprise data, the study has exposed links consistent with the movement of profits through the manipulation of internal transfer prices. The study found that multinational companies move profits both in and out of Norway, depending on the relative tax rates they face. The net flow is estimated to be out of Norway, and the revenue loss could be in the order of 30 per cent of the potential tax payable by foreign multinational enterprises. Furthermore, the study found that multinational enterprises in Norway have a profit margin which is 1.5 to four percentage points lower than in comparable national companies. The research team conducting the Norway study takes the view that more studies must be conducted in order to confirm the findings, and that research into multinational companies and tax is a neglected subject area in Norway. It nevertheless points out that large amounts of tax are *potentially* evaded through the transfer of profits abroad by multinational companies in Norway.

4.1.6 More unequal division of tax revenues

The use of tax havens also affects which countries have the right to tax capital income which can lead to a more unequal division of tax revenues. This problem is particularly associated with the taxation of capital gains by companies registered in a tax haven.

Under international tax law, both the country where an owner is domiciled (if a private individual) or registered (if a company) and the country where the company operates basically have the right to tax capital gains. A large network of bilateral tax treaties seeks to overcome the potential problem of double taxation which arises because more than one jurisdiction has the right to tax the same tax base. These treaties normally apply the domiciliary principle – in other words, the country in which the owner is domiciled or registered acquires the right to tax, rather than the source country where the income has been earned.

Traditionally, this way of assigning the right to tax has been justified with reference to the strong ties which typically exist between the country of domicile and the taxpayer. If a personal taxpayer pays tax in the country where they are domiciled, they will also benefit from the range of public services financed by the tax. This justification disappears in the case of legal entities merely registered in a jurisdiction. A characteristic of tax havens is precisely that a minimal link exists between the taxpayer and the jurisdiction. In such circumstances, principles of fairness suggest that the right to tax should rest with the source country.

Many tax treaties between OECD members and developing countries have taken account of the effect of the domiciliary principle on the distribution of taxes by giving the source country the right to impose a withholding tax up to a specified amount. This system ensures that the source country also receives a share of the tax revenues. Typically, tax treaties established between tax havens and other developing countries make no provision for such a withholding tax.

4.2 Positive effects of tax havens

The economic literature cites a number of positive aspects related to tax havens. In principle, tax havens could have a positive impact on prosperity in (a) countries which are not tax havens and (b) countries which are tax havens. The economic literature primarily cites effects which only affect the prosperity of tax havens. These are presented below.

4.2.1 Beneficial tax competition

Some commentators have maintained that a political system has an underlying tendency to set the level of taxation too high. This view is derived from the notion that politicians are not solely concerned to serve voter wishes, but that they have private interests related to a high level of taxes (see, for instance, Brennan and Buchanan, 1980). Such private motives could be the desire for power, which would be bolstered by a large public sector. In such circumstances, tax havens – with low or non-existent taxes – can help to keep taxes in other countries down. This is because other countries would lose part of their tax base to the tax havens if they set tax levels too high. In other words, the tax havens discipline politicians so that

they do not increase taxes beyond levels desirable for the voters.

4.2.2 Increased investment in high-tax countries

Tax havens can contribute to increased activity in high-tax countries, and so do not crowd out investment there. This argument is advanced by Desai, Foley and Hines (2006). They point out that tax havens can contribute positively to a high level of investment if investors can transfer taxable profits from a high-tax country to a tax haven. This will increase the effective return on investment in high-tax countries and thereby make them more attractive for further investment. Alternatively, the use of tax havens can be a source of tax credits which would also reduce the effective tax rate on investment in high-tax countries. Furthermore, it might be that economic activity takes place in tax havens which involves the sale of low-priced goods and services (low-priced because they are not taxed) to high-tax countries. Such activities would also increase the return on investment in high-tax countries.

The analysis by Desai, Foley and Hines (2006) builds on the assumption that an investor can make real investments with a real level of activity in a tax haven. In fact, foreigners who use the preferential tax regime are not permitted to invest locally, have local employees or use the country's currency. The Commission accordingly takes the view that the assumption underlying the analysis is based on ignorance of investor regulations in tax havens.

4.2.3 Economic development in the tax havens

Dhammika and Hines (2006) study which countries become tax havens. They find that these countries often display political stability, a well-functioning legal system, a democratic form of government, little corruption and a relatively well-qualified bureaucracy. One reason that countries become tax havens could be that low tax is not the only important attraction for mobile capital. Institutional conditions which assure the safety of investments and the conduct of financial transactions may also be important. The study shows that tax havens are well organised and that competition over capital sharpens the requirements for institutional quality and good politics. Since institutional quality is an important factor for economic

expansion, competition over capital between tax havens helps to improve their growth prospects (see Hines 2004). The extent to which such growth occurs at the expense of expansion by other countries is not an issue addressed in this literature.

The fact that a tax haven is able to develop strong institutions and that it must have these in place to be an attractive investment location is supported by Norfund's justification for investing in such jurisdictions. In correspondence with the Ministry of Foreign Affairs, the institution noted that Mauritius is attractive as a location for investment funds because it has predictable legislation and a well-run banking sector. Overall, this ensures cost-efficient handling of transactions and low risk for investors. See the discussion in chapter 7 below.

4.3 Tax treaties and tax havens

An important feature of the tax havens is their use of tax treaties. A network of bilateral tax treaties between the tax havens and other countries regulates which of them should have the right to tax different tax objects. These agreements regulate, amongst other matters, which country has the right to tax capital income where the owner of an enterprise is not domiciled in the country in which the business is conducted.

4.3.1 Background

A basic characteristic of a sovereign state is its ability and right to levy taxes.⁷ Without the opportunity to acquire financial resources, a state would not be able to offer collective benefits to or redistribute income between its citizens. Economic integration means that value creation occurs in part across national boundaries, and creates circumstances in which more than one country has the opportunity to tax the same tax object. In such circumstances, one needs to determine which country has the right to tax. International tax law regulates how that determination should be made. Its rules also influence the scope for effective national tax collection and the division of tax revenues between countries.

International tax law is based on international legal rules which restrict the right of states to levy

⁷ The analysis in this section builds to a great extent on Cappelletti (2001).

taxes. The principle rule is that a relevant connection must exist between a country and a tax object if the country is to have the right to tax a person, a transaction or a property. Under international tax law, the connections which give a country the right to tax a taxpayer can be both personal and economic. Two types of personal connection are recognised as a legal basis for the right to tax. First, a country has the right to tax all its citizens regardless of where they reside and where their income is earned. Second, a country has the right to tax all persons resident within its territory even if they are not citizens. International law also permits a country to levy taxes in the absence of a personal connection if an economic connection exists through the location of either economic activity or assets. Personal connection, both citizenship and residency, creates a general tax liability, while economic connection creates a limited tax liability. In other words, a country has the right to tax the “global” income of all its citizens and everyone resident within its borders, but can only tax income earned domestically in the absence of a personal connection. The practice in most countries, including Norway but with the USA as an important exception, is to exempt citizens from tax if they are domiciled and earn their income abroad.

A number of features of international tax law are worth noting. First, the characteristics of a country – whether it is poor, for instance – or the taxpayer – such as their ability to pay – provide no legal basis for taxation. Only the existence of specific connections between the country and the taxpayer give the country the right to tax. Second, only a limited set of such connections confer the right to tax. Historical connections, such as a person’s earlier residence in or citizenship of a country, do not give that country the right to tax. Third, tax liability varies between the different forms of connection. As mentioned above, an economic connection creates a limited liability, while a personal connection creates a general one. A final important feature is that international tax law regulates the division of the right to tax between sovereign states. Other groups or entities, such as international organisations, are not given a right to tax.

The mobility of individuals, production factors and goods between different countries creates circumstances in which the same taxpayer or tax object has connections with more than one jurisdiction. Economic integration has therefore meant that conditions which can be termed double tax-

tion have become more common. Such conditions typically cause international transactions to be taxed more than once. Double taxation worries economists and politicians because it means that income from international transactions is taxed more heavily than corresponding domestic income, which results in reduced trade and inefficient resource allocation. The most important measure for limiting double taxation is a network of bilateral tax treaties. These agreements normally build either on the domiciliary principle or on the source state principle. A tax treaty based on the first of these principles assigns the right to tax to the taxpayer’s country of domicile. The source principle, on the other hand, assigns this right to the country where the income is earned. These principles can be combined, and a particularly common way of achieving such a combination is to grant the source country a restricted right to impose a withholding tax. This divides the tax revenue between the two countries. The choice of international tax principles has different effects on the distribution of saving and investment between countries and on the cost of tax collection.

4.3.2 Dividing the tax base

An important ethical issue is how far these treaties lead to an inequitable division of the right to tax. The fundamental moral concept in international tax law is that an adequate connection must exist between a country and a tax object in order to justify taxation. However, a distinguishing feature of secrecy jurisdictions is that a minimal connection exists between the taxpayer and jurisdiction. Typically, very little of the economic activity actually takes place in the tax haven. In such circumstances, principles of fairness suggest that the right to tax should lie with the source country.

The way tax treaties assign the right to tax has little effect on the division of total tax revenues between two countries if their tax bases are fairly similar – with regard to exports and imports, for instance, or to foreign direct investment. In the case of tax treaties which regulate relations between rich and poor countries and between tax havens and other nations, however, big differences exist in tax-base composition. The choice made between source and domiciliary principles in such treaties will affect the division of tax revenues between the countries. A tax treaty based on the domiciliary principle will clearly give larger revenues to the country in which owners of capital are

domiciled and companies registered than to the source country.

Many tax treaties between OECD members and developing countries have taken account of the tax division effect by giving the source country the right to impose a withholding tax up to a specified amount. This system ensures that the source country also receives a share of the tax revenues.

An unfortunate effect of tax treaties as normally formulated is that they reduce tax revenues in the country where the income is earned (the source country). At the same time, the use of secrecy rules and fictitious domiciles make the access to tax-relevant information conferred by the treaty illusory. Paradoxically, tax treaties help to make tax havens more favourable as a location than would be the case without such agreements. Nor do they affect the harmful structures in the tax havens. Accordingly, the Commission finds that tax treaties can do more harm than good unless they are followed with measures that modify the harmful structures identified by the Commission. In that connection, it is important to ensure that tax treaties do not constrain further action against tax havens.

4.4 Overall effect

The Commission cannot see that the positive effects of tax havens outlined above are in any way sufficient to compensate for the damaging impact which has been identified. In fact, the position is that the positive impact of tax havens is largely confined to these jurisdictions alone, and thus

make no positive contribution in an overall perspective. The Commission's view is, accordingly, that tax havens impose losses on other countries because they weaken the ability of tax systems to yield tax revenues and encourage transfer pricing, economic crime and income transfers in general from high-tax to low-tax countries.

The Commission does not object to countries choosing their own tax rates and is not opposed to low taxes, but would stress that competition between high-tax and low-tax countries is not conducted on equal terms. Virtually all tax havens have a dual tax system, with extremely favourable rates for foreigners and more normal rates for residents. This type of discrimination does not occur to the same extent in other countries. In addition, tax havens combine low or no tax with legal structures which prevent access to information by other countries, and which cut the link with real ownership while providing anonymity which caters to tax evasion in the country of domicile. So tax havens are not involved in competition on equal terms, but in a type of competition which is directly aimed at harming the economies of other countries. The fact that very limited real economic activity is conducted by the companies in tax havens which are offered zero or very low tax rates further supports this view. The tax havens thereby serve as pass-through locations for capital rather than as places which lay a sound basis for value creation and in which capital is genuinely invested locally.

In the following, the Commission will analyse the particularly damaging effects of the tax havens on developing countries.

Chapter 5

Tax havens and developing countries

Tax havens harm both industrialised and developing countries, but the impact of the effects described in chapter 4 will be greatest in developing countries. This is partly because these countries are poor and thereby have a greater need to protect their national tax base, and partly because they generally have weaker institutions and thereby fewer opportunities for enforcing the laws and regulations they adopt. Tax treaties between tax havens and developing countries often contribute to a significant reduction in the tax base of the latter. In addition, certain effects of tax havens primarily make themselves felt in developing countries. While the existence of tax havens is likely to have had little impact on political institutions in rich nations, a number of indicators suggest that tax havens contribute to maintaining a vicious circle in developing countries whereby weak institutional capacity facilitates illegal capital flight, and tax evasion and capital flight in the next instance restrict the development of institutions. By the development of institutions, the Commission means all aspects from the legal system and law enforcement to the civil service and democratic governance in the broad sense.

5.1 Reduced tax revenues

Chapter 4 showed how tax havens increase opportunities for tax evasion. Tax evasion strategies which include the use of tax havens are difficult to identify, and competent and well-functioning tax authorities are required to prevent these opportunities from being exploited. A common feature of many developing countries is that they often lack resources, expertise and capacity for building up and developing an efficient civil service, so that the quality of the tax collection system is frequently found to be weaker in developing countries than in richer nations. As a result, developing countries often also have limited opportunities to pursue cross-border investigations, which demand both time and resources. The probability

that tax evasion will be discovered by the tax authorities is accordingly lower in developing countries. These states also have more extensive corruption, which weakens the quality of the legal system at every level. This means that the consequences for taxpayers found to be evading tax are smaller. The willingness of taxpayers to pay what they owe may also be lower in poor countries than in most rich nations. This is the result partly of historical, political or cultural factors (Lieberman 2003) and partly of a lack of trust in the authorities because of their persistent misuse of public funds (Rothstein 2000).

Opportunities to utilise tax havens for economic crime, such as tax evasion, are not the same for all tax objects. Multinational companies, for instance, have greater opportunities to use tax havens to evade taxes than ordinary wage earners. Moreover, the problem of tax evasion will increase with the amount of income concentrated in a few hands. In many developing countries, only a few hundred or perhaps a few thousand taxpayers contribute the bulk of tax revenues. Less than one per cent of the population of Bangladesh, for instance, is registered as taxpayers. Only four per cent of these (in other words, less than 0.04 per cent of the population) pay 40 per cent of the taxes, while 50 per cent of the taxpayers (less than 0.5 per cent of the population) pay less than one per cent (Sarker and Kitamura 2006). In Tanzania, a country where the population exceeds 35 million, 286 companies contribute about 70 per cent of domestic tax revenue (Fjeldstad and Moore 2008). According to Baer (2002), 0.4 per cent of taxpayers in Kenya and Colombia account for 61 and 57 per cent of total domestic tax revenues respectively. The concentration of the tax base in a few hands, which are often rich in resources, makes countries more vulnerable to tax evasion through tax havens, and thereby contributes to the possibility that developing countries will experience a greater relative reduction in their tax revenues as a result of tax havens.

5.2 Tax treaties between tax havens and developing countries

An important feature of tax havens is that they have established tax treaties which assign the right to tax capital to the country in which a company is registered or an individual is domiciled, while the source country's right to impose a withholding tax is sharply circumscribed or in some cases non-existent. Since developing countries are net recipients of investment from tax havens, these treaties lead to a reduction in their tax base.

One might ask why a number of developing countries voluntarily cede their right to tax in this way. The answer is probably that the tax havens occupy a very strong negotiating position in relation to the source countries. Secrecy legislation and low tax rates mean that tax havens attract mobile capital. A large proportion of foreign direct investment in developing countries is channelled through tax havens because the investors want to exploit the tax benefits and secrecy which such jurisdictions offer. Developing countries depend on the tax treaties to secure access to investment from the tax havens, direct investments which are sorely needed to generate domestic growth.

Although tax treaties with tax havens have been voluntarily entered into by two independent countries/jurisdictions, it is important to consider how far the unequal division of the tax base enshrined in these pacts can be defended.

Two conditions could potentially legitimise granting tax havens the right to tax companies registered there. One is that the companies are effectively managed from these countries, and the other is that a significant part of the value creation occurs there. However, neither of these conditions would appear to apply.

Typically, the tax regime for foreigners in tax havens requires that foreign companies do not use the local currency or have local employees other than local representatives at senior executive or boardroom level. See the detailed presentation in chapter 3 above. From a business management perspective, such rules make it impossible to conduct production or other types of operation on any scale in a tax haven if one also wants to obtain the tax benefits accorded to foreigners. It is therefore clear that very little of the value creation by companies registered in tax havens takes place there.

There is also every reason to believe that the companies are not generally run from the tax ha-

vens. Where business management is concerned, the importance of maintaining an overview of operations in a company through local knowledge of the markets in which it invests is well known. This means that chief executives in rich countries are located together with parts of the company's activities (either staff functions or staff and operational functions). In tax havens, it is common for a few people to be nominated as the chief executive for hundreds of companies. The same individuals also serve as directors of these companies. The companies they administer are located in different countries with different cultures and cover a very wide range of business activities. From that perspective, they demand different kinds of technical and economic expertise, and no single person covers such a variety of qualifications. Another indication that the effective management of the companies is not conducted from the tax havens is that full-scale board meetings are seldom held there, as is the case for companies and group in other countries. Such structures indicate that the local representatives are passive front persons. This can be illustrated by looking at direct investments from Mauritius to India. No less than 38 per cent of direct investment to India in 2006-08 came from Mauritius. This capital was primarily channelled through companies prohibited by Mauritian law from having local employees. This means that the capital in reality is administered by people who do not live in Mauritius.

Conditions such as those outlined above raise questions of principle about what requirements should be set for a company to be regarded as domiciled in a country. The Commission is aware that such requirements have been defined in the legal field. In its view, however, these cater for the establishment of harmful structures in tax havens. The Commission takes the view that the assignment of the right to tax should be based on the real economic substance.

The domiciliary state principle has traditionally been justified with reference to the strong ties which typically exist between the country of domicile and the taxpayer. If a personal taxpayer pays tax in the country where they are domiciled, they will also benefit from the range of public services financed by the tax. This justification disappears in the case of legal entities only registered in a jurisdiction. A characteristic of tax havens is precisely that a minimal connection exists between the taxpayer and the jurisdiction. In such circumstances, principles of fairness suggest that the right to tax should rest with the source country.

5.3 Effects of reduced tax revenues¹

The consequences of a decline in tax revenues for developing countries are more serious than for rich countries, in the sense that tax revenues in developing countries are already generally low. Weak public finances are one of the principal challenges in a number of developing countries. Tax revenues in low-income countries averaged about 13 per cent of GDP in 2000 (Baunsgaard and Keen 2005), or less than half the average of 36 per cent for OECD members (OECD 2007). The basis for the calculation is also smaller, since per capita GDP is much smaller than for the OECD countries. A substantial share of the operating budget in many developing countries is financed by development assistance, and this proportion can reach 40-50 per cent in certain African countries. These figures show that substantial weaknesses exist in the fiscal base for many developing countries. According to the IMF, tax revenues corresponding to 15 per cent of GDP represent a “reasonable” minimum level for low-income countries in order to ensure the funding of basic state functions such as law and order, health and education (IMF 2005). Many developing countries lie far below this level. A study by Fox and Gurley (2005) found that as many as 44 of the 168 countries covered had tax revenues lower than 15 per cent of GDP during the 1990s. Eighteen of these nations were in sub-Saharan Africa.

Rich countries have, by and large, responded to the tax-haven challenge by modifying their tax systems towards heavier taxation on less mobile tax objects and lighter on mobile tax objects. Compared with more developed states, however, developing countries would find it more difficult to collect alternative taxes – on wage earners, for example. Low economic activity also means that few alternative tax objects exist. Insufficient institutional capacity and extensive informal sectors reinforce the challenges related to effective tax collection. The potential for replacing the loss of tax objects is accordingly limited. Responses to the loss of income as a result of tax havens must therefore largely take the form of a reduction in economic activity by the public sector, which is already very low.

One might think that reduced government revenues resulting from the use of tax havens

would be partly offset by higher post-tax private incomes, and that the reduction in the tax level in developing countries might thereby encourage positive development of the business sector, with a consequent contribution to higher economic growth. As discussed in Appendix 1, however, tax havens are also likely to have a negative effect on private incomes. This is because tax havens make unproductive activity more attractive, which means that fewer resources are employed in productive operations. Viewed in isolation, that tends to reduce incomes and leads in the next instance to lower demand for productive entrepreneurs. This makes it even less profitable to pursue productive commercial activity. Overall, the decline in private economic activity is typically larger than the tax savings made by the private sector from the use of tax havens (this multiplier effect is considered in more detail in section 5.4). In other words, the effect of the tax havens on developing countries is not only lower revenues for the public sector but probably also a decline in private sector incomes. There is no contrast between private and public sectors here – the tax havens are a disadvantage for both.

5.4 The paradox of plenty: natural resources, rent-seeking and tax havens

On average, countries rich in natural resources have experienced lower growth than other states over the past 40 years. Often termed the paradox of plenty, this phenomenon is described in detail in Appendix 1. Two principal reasons explain why studying the paradox of plenty is important for analysing the impact of tax havens. One is that income from natural resources can give rise to many of the same mechanisms as tax havens – particularly to economic changes motivated by the desire to redistribute existing income to one’s own benefit rather than to create new income. The second is that tax havens make it easier for the power elite to conceal that income from resources is not being used in the best interests of the broad population. Tax havens are a contributory factor in making income from resources negative rather than positive for a country’s economy.

If, for example, a country’s resource wealth is measured by the proportion of GDP represented by the export of natural resources, a negative correlation exists between resource wealth and economic expansion. Natural riches accordingly ap-

¹ A more extensive presentation of this subject is provided in Appendix 2 on the importance of taxes for development.

pear to coincide with low economic growth – while resource poverty is correlated with high economic growth. Such a correlation does not necessarily mean that resource wealth is the true reason for low economic progress. A number of other explanations for such a correlation can be conceived. However, new research which seeks to take account of other possible reasons for the correlation shows that rich natural resources do actually appear to be a cause of poverty (Mehlum, Moene and Torvik, 2006a). The reason for this paradox is that a large proportion of society's resources in countries with a wealth of natural resources are devoted to activities which primarily seek to redistribute income to the individual's own benefit. Such activities are often termed "rent-seeking" in the economic literature, because players seek to obtain the economic rent² from natural resources.

However, rich natural resources are not a curse for all countries. Where societies have well-functioning political institutions, research shows that no negative correlation exists between resource wealth and poverty. Resource income appears to make a positive contribution to growth in countries with little corruption, well-functioning legal systems, good protection of property rights and a high probability that the public sector will fulfill its contractual obligations. Another interesting finding from recent research is that the paradox of plenty does not apply to democratic countries with a parliamentary system, while countries with a presidential form of government have a negative correlation between rich natural resources and economic growth. It is unclear why presidential government seems to have a less beneficial effect than parliamentarism when a country derives income from natural resources. Some commentators maintain that, viewed in isolation, a president in a presidential system has great power but that this is balanced by the fact that decisions in the popularly elected bodies are taken under a separation of powers. A central element in the US constitution, for example, establishes a division of power – often termed "checks and balances" – in the presidential system.

Recent research suggests that many other countries with a presidential form of government have not gone as far in implementing the necessary mechanisms which ensure a balance of power

(see Appendix 1). In a number of countries with substantial earnings from natural resources, particularly in Africa, the presidential mode of government gives one person or a small group of people great political might. Abuse of power can more easily occur in such countries, and resource income can be applied for purposes which benefit the power elite rather than the population.

The most important lesson to be drawn from the paradox of plenty is that revenues which fall to a great extent into the lap of the political and economic players in a country can have unfavourable economic consequences. That is because resources are wasted on securing this income through rent-seeking. As with some forms of natural resources, tax havens provide players in the economy with opportunities to obtain earnings without creating any supplementary value. Rent-seeking leads to the reorientation of society's resources away from productive value creation. A particularly important effect of this reorientation is that tax havens influence how some private entrepreneurs choose to use their talents. Tax havens make it relatively more profitable for them to devote their abilities to increasing the profitability of their own business through tax evasion rather than through efficient operation. A private-sector distortion of talent along these lines is not offset by other beneficial socio-economic effects, because the socio-economic calculation must take account of the fact that tax saved for the private entrepreneur represents a reduction in government revenue. Once again, the damaging effects can be stronger in developing countries because power is more concentrated there and because entrepreneurs and expertise are scarcer resources. Misuse of such talents will accordingly have greater consequences in developing countries.

Wealth obtained from natural resources has particularly damaging side effects for a society when economic and political players have opportunities to conceal the proceeds of rent-seeking. Tax havens provide a relatively easy opportunity for such players to conceal income from natural resources. These jurisdictions thereby make it profitable to be a rent-seeker, which encourages more people to opt for rent-seeking and fewer to prefer productive activity. More rent-seekers and fewer productive entrepreneurs lead in the next instance to a decline in income for each productive entrepreneur. But a relative fall in earnings from productive activities makes it even more attractive to pursue rent-seeking. That leads to a further contraction in the number of productive en-

² Economic rent means the extra return which can be obtained from owning land or possessing the right to exploit a scarce natural resource, in the form of an oil field, for example, or a mineral deposit.

trepreneurs and thereby to a decline in the income of those involved in productive business activities. In turn, this means fewer people wish to pursue productive operations and more want to turn to rent-seeking and the like. In other words, the existence of tax havens helps to unleash a negative multiplier process. The reason this does not continue *ad infinitum* is that the income of rent-seekers also falls as their number increases and the proportion of productive players declines.

In other words, tax havens reinforce the mechanisms which underlie the paradox of plenty – they make it easier for corrupt politicians and destructive entrepreneurs to enrich themselves at the expense of society. As mentioned above, recent research shows that it is precisely countries with weak institutions and political systems which are affected by the paradox of plenty (see Appendix 1). Private entrepreneurs and politicians in this type of country have private incentives which do not accord with the most beneficial behaviour for society as a whole. The combination of weak institutions and tax havens give corrupt politicians and destructive entrepreneurs good opportunities to conceal the resource income they arrogate to themselves.

5.5 Tax havens and institutional quality

Potentially the most serious consequence of tax havens is that they can contribute to weakening the quality of institutions and the political system in developing countries. This is because tax havens help to give politicians in these countries a self-interest in weakening the existing institutions. The lack of effective enforcement bodies means that politicians can make greater use of the opportunities offered by tax havens to conceal the proceeds of economic crime and rent-seeking.

Tax havens represent a problem for politicians in countries with strong institutions and well-functioning political systems – they cause economic damage and limit government revenues. However, institutional and political changes can restrict these harmful effects. In well-functioning countries, it will therefore be natural to respond to the challenges represented by tax havens with specific measures which reduce their damaging impact. The opposite responses may occur in developing countries. Secrecy jurisdictions could represent not only a problem to politicians in countries with weak institutions and political systems but also an

Box 5.1 The case against the Suharto family¹

President Suharto topped Transparency International's list of the world's most corrupt leaders (confer Transparency International Global Corruption Report 2004). It is estimated that he and his family misappropriated USD 15-35 billion. Time's issue of 24 May 1999 presented estimates that the Suharto family's collective assets totalled more than USD 70 billion.

Suharto resigned as president in 1998. He was placed under house arrest in 2000 while allegations of corruption were investigated. He was later charged, but the case did not come to trial because Suharto allegedly suffered from brain disease. He died in 2008.

The legal inquiry has largely focused on Suharto's family and particularly his son Tommy. The Guernsey branch of the BNP Paribas bank notified the regulators in 1998 that it suspected illegal behaviour associated with a deposit from Garnet Investments Ltd. This company was registered in the Virgin Islands. It has subsequently emerged that Tommy Suharto was behind the company. The authorities in Guernsey blocked

the payment from the BNP account. The Indonesian government charged Suharto with corruption and demanded the repayment of USD 400 million. The authorities lost this case in February 2009, and Suharto may recover control of the funds in Guernsey.

Former president Suharto sued Time over the article on corruption, and claimed USD 93 million in damages. The magazine won this case in April 2009 on the grounds that Suharto was given a right to respond.

All in all, this means that Suharto is suspected of having misappropriated more money than anyone else in history. However, nobody has been found guilty of these conditions and no money has been repaid.

Of the examples of large-scale corruption cited in this report, the Suharto case is the only one where the rules on money laundering appear to have played a role in initiating the investigation and the legal process.

¹ This presentation is based primarily on an unpublished paper by British lawyer Tim Daniel.

Box 5.2 The case against Arif Ali Zardari¹

Zardari is now the president of Pakistan. He was previously married to Benazir Bhutto, who was Pakistan's prime minister for two electoral periods. Zardari has been tried and found guilty of corruption in Pakistan and has been charged with money laundering in Switzerland and the Isle of Man. He has been found guilty of corruption by courts in both of these jurisdictions, but has appealed, and Pakistan has now dropped its charges against him.

The charges against Zardari alleged that he had exploited his position to secure payments from two companies in exchange for contracts related to the inspection of commodity imports to Pakistan. These payments were allegedly channelled partly via three companies in the Virgin Islands to an account in Dubai and then to Switzerland, and partly via a foundation in Liechtenstein which owned a trust in the Isle of Man. This trust owned three companies on the Isle of Man, which in turn owned a large property in the UK.

Pakistani investigators had strong indications that both the bank accounts in Switzerland and the UK property were actually controlled and owned by Zardari. According to Tim Daniel,

the lawyer who represented the Pakistani government in connection with the charges against Zardari in the UK, it would have been virtually impossible to trace ownership back through the chain from the property in Britain without the material provided from Pakistan. Despite extensive documentation concerning Zardari's ownership of the accounts and the property, the appeals process meant delays in securing a final judgement. Eventually, Bhutto and Zardari returned to a position of power, Pakistan dropped the case and the funds which had been frozen in Europe were released.

Some commentators claim that the roughly USD 100 million covered by the two cases named above represent only a small part of the funds illegally acquired by Zardari while his wife was prime minister. Estimates of the total amount vary widely, but USD 500 million is among the lowest (confer, for instance, Gordon 2009). It is suspected that proceeds from corruption were paid to shell companies established by Zardari in various tax havens.

¹ This presentation is based primarily on an unpublished paper by British lawyer Tim Daniel.

opportunity. Tax havens provide an opportunity to conceal the proceeds of corruption and illegal activities, or income which politicians have dishonestly acquired from development assistance, natural resources and the public purse. In this way, the growth of tax havens also provides political incentives to tear down rather than build up institutions and to weaken rather than strengthen the political system. Many examples exist of institutions supposed to prevent illegal money transfers being deliberately destroyed by governments,³ and of people associated with such institutions being pressured to neglect their duty or even being killed.

An example of the way resource wealth can lead to a weakening of democratic mechanisms is documented by Ross (2001a). Ross shows that the presence of extensive rain forests in the Philippines, Indonesia and Malaysia contributed to the conscious destruction of state institutions by politicians. The rain forest assets gave many players

big opportunities to enrich themselves – but, in order to do so, they had first to undermine the state institutions which were specifically intended to combat misuse and excessive exploitation. Rather than building institutions, the politicians were given incentives to destroy them. Ross (2001b) also finds that countries with large oil deposits become less democratic. In such nations, democracy can carry a cost for politicians because it prevents them from using large government revenues as they please. Income opportunities provided for politicians by tax havens weaken the incentives to introduce democratic reforms or even strengthen incentives to reduce democratic controls over those in power.

Collier and Hoeffler (2008) demonstrate how checks and balances (institutional rules which limit the abuse of and balance political power) promote growth. They find that countries where such rules are important – because of large government revenues from natural resources, for example – are precisely where the rules often get un-

³ See Ross (2001a).

Box 5.3 Oil money from Congo

In its report *Undue Diligence*, Global Witness presents the story of how Denis Christel Sassou-Nguesso – son of the president of Congo-Brazzaville – mixed up government and private financial interests. He did this through his role in state oil exports, and concealed it with the aid of companies registered in Anguilla and the Bank of East Asia in Hong Kong.

Global Witness demonstrates that Sassou-Nguesso has used government funds to pay his personal bills. The documented scope of these irregularities is modest compared with the Abacha case (see box 8.3 below) and a number of other known instances involving government leaders in developing countries. The case concerning Sassou-Nguesso is nevertheless interesting, in part because it is suitable for illustrating weaknesses in the systems intended to combat money laundering.

Global Witness documents that both the Bank of East Asia and the facilitators of the company structures in Anguilla have been in possession of information which clearly indicates that the relevant transactions could involve money laundering. However, there are no indications that anyone in these jurisdictions has initiated

any process to expose illegalities and to take possible further legal steps. Failing to act on reporting suspicious transactions is a crime. Nothing suggests that the private players with a duty to report suspicious transactions have been subject to any criminal investigation for possible breaches of their reporting duty.

The matter became known because a private player purchased claims on the government of Congo-Brazzaville in the secondary market. They then sought to obtain payment of the debt by securing the right to part of the country's oil revenues. Through the legal process following the private player's claim, information became known about Sassou-Nguesso's ownership of companies involved and his use of company funds to pay for his own private consumption. Global Witness raises the question in its report of whether the banks could have complied with the money laundering regulations in handling the funds from Congo. Questions can also be asked about whether the governments of the countries where the banks are located should have pursued a criminal investigation into breaches of the money laundering regulations.

dermined by both politicians and the commercial players who bribe them. The analogy with tax havens is once again obvious. The growth of tax havens can give dishonest politicians incentives to reduce institutional rules which promote growth. It becomes in the politicians' interest to invest in a social model where secrecy and opportunities for personal abuse of power are tolerated.

The impact which tax havens can have on institutional quality in poor countries may cause great damage. During the past decade, it has become clear that institutional quality is perhaps the most important driver for economic prosperity

and growth. Acemoglu, Johnson and Robinson (2001) provide the best-known analysis of the effect of institutions on national income. They estimate that, if a country located initially in the 25 per cent percentile for institutional quality could improve its institutions so that it moved into the 75 per cent percentile, national income would be increased sevenfold. Few factors have such a strong impact on growth as improved institutions. This is precisely why the damaging effects of tax havens can be so great for developing countries – the tax havens contribute not only to preserving weak institutions, but also to making them worse.

Chapter 6

The scale of tax havens and illegal money flows from developing countries

The Commission's mandate encompasses a discussion of both legal and illegal money flows from developing countries to tax havens. A number of estimates of such flows have been made. Since the illegal flows by definition embrace funds which either have been acquired through crime or represent breaches of the law *per se*, they will be largely channelled outside official systems or concealed in other ways. Partly because of rules on the burden of proof and limited investigatory resources, statistics of crime revealed through the justice system will only represent a small fraction of the actual level of criminal activity. Given this, therefore, no direct measurements of such flows exist.

Tax havens publish few statistics which help to estimate the scale of illegal money flows and the holdings of various forms of assets.

This chapter presents various data and analysis which can throw light on the scale of illegal money flows from developing countries and on the size and distinguishing features of tax haven economies.

Tax havens are characterised by the fact that a large part of their activity is pure pass-through – in other words, the operations are owned and managed in other countries. In addition, the financial industry often has a disproportionate significance. This is illustrated in this chapter through various statistical indicators.

6.1 Scale of illegal money flows

6.1.1 Methods – highlights

For natural reasons, the scale of illegal money flows cannot be measured precisely. Instead, they must be estimated by methods which involve a substantial degree of uncertainty. It is even more difficult to estimate illegal money flows from developing countries and how large a proportion of these go to or pass through tax havens.

The weaknesses of the various measurement methods mean that it is advantageous to avoid relying on any one method and, instead, compare estimates produced by different approaches in order to draw conclusions on the basis of a variety of indicators.

In the main, two methods are relevant:

1. combining an estimate of the scale of illegal transfer pricing with one covering other flows based on figures from national accounts
2. measuring the amount of capital placed in tax havens and calculating income from these holdings.

A number of the methods reviewed below are limited in their ability to identify opportunities for manipulation within multinational companies, variations between gross and net figures for foreign trade in the national accounts, and so forth. In the Commission's view, this suggests that these methods will often underestimate the scope of capital flight and illegal money flows. The following methods for estimating capital flight will be presented by the Commission:

1. direct estimates of proceeds from crime and tax evasion
2. use of national accounts data to estimate unregistered capital flight
3. methods for measuring manipulated transfer pricing
4. measuring the value of assets in tax havens and using the results to estimate unregistered income.

Below, the Commission refers to studies which use these methods to estimate either capital flight from developing countries or the scope of financial activity in developing countries.

A weakness with some of these methods in relation to the Commission's mandate is that they are unsuitable for estimating total illegal money flows. Direct estimates (item 1 above) aim to as-

sess income from all types of illegal activity. The methods in item 2 could be suitable for estimating all unregistered capital flows other than those which occur through manipulated transfer prices. As a result, the methods under item 2 are usually supplemented by separate estimates for transactions concealed through transfer pricing (item 3). The method in item 4 has been used to estimate concealed income through the return on the assets of individuals placed in tax havens. This can detect unregistered income from assets in tax havens and can be interpreted as an expression of accumulated illegal flows over a period, but not as an estimate of current income other than the return on holdings in tax havens or additions from other illegal activity.

6.1.2 Estimates – main points

Despite the uncertainties noted above, the Commission believes it can conclude that the scale of illegal money flows from developing countries to tax havens is very large, particularly viewed in relation to the size of developing country economies and tax bases. The most complete estimates indicate that the combined illegal capital flight from developing countries represents between six and 8.7 per cent of their GDP. By comparison, tax revenues for the poorest countries amount to about 13 per cent of GDP.

Income transfers through manipulated transfer prices probably account for the largest part of the illegal money flows from developing countries. Analyses carried out through the DOTS method (see section 6.1.6) on the basis of trade statistics indicate that the scale of manipulated transfer pricing in trade to and from developing countries amounted to roughly USD 500 billion in 2006. This corresponded to 6.5 per cent of foreign trade for these countries. Weaknesses in the method suggest that it yields an underestimate of the real scale.

Gross registered capital flows to developing countries totalled USD 571 billion in 2006 (World Bank 2007). Donor grants accounted for USD 70 billion of this. Estimates from Kar and Cartwright-Smith (2008) indicate that illegal money flows from these countries totalled USD 641-979 billion in 2006. Even the lowest estimate indicates that the illicit capital outflow is larger than the gross legal inflow. Illicit capital outflows correspond to about 10 times the total development assistance going to these countries.

The estimates above apply to all illegal money flows from developing countries. Not all of these

go to tax havens. No estimates are available for the proportion of illegal money flows from developing countries which go to tax havens specifically.

Nor are any estimates available for all illegal money flows to tax havens. However, it has been documented that placements by private individuals in such jurisdictions are very large, and that a big proportion of the capital placed there is not declared for tax. TJN (2005) estimates that placements by affluent individuals in tax havens amounted to NOK 10-12 000 billion in 2004. Official statistics indicate that the scale of such placements increased strongly in subsequent years, but the financial crisis has probably led to a reduction over the past year. Few data are available for estimating how large a share of these placements derive from developing countries. Cobham (2005) has assumed that 20 per cent of placements derive from developing countries. If so, this would mean that USD 2 200-2 400 billion has been transferred from developing countries to tax havens. This represents four years of gross capital inflow or more than 30 times the amount that the developing countries receive in the form of assistance. However, this estimate of illegal money flows does not include flows to tax havens from such activities as manipulation of transfer prices. These flows are probably significantly larger than the amount of income tax evaded on capital placements by private individuals.

6.1.3 More on different methods for estimating the scale of capital outflows

In this section, the Commission will discuss in greater detail the four methods mentioned in the introduction to this chapter for estimating the scale of illegal money flows between tax havens and other countries. The subsequent section sums up various efforts to quantify such money flows.

6.1.4 Direct estimates of proceeds from crime and tax evasion

Directly estimating the proceeds from crime and tax evasion is a simple method in principle, but one which involves considerable difficulties in practice relating to the identification of suitable data. The method involves using statistics and experience to answer the following questions:

- how extensive are various types of criminal activity in the economy?

- how large are the proceeds obtained by the criminals from this activity?
- how large a proportion of these proceeds is laundered?
- how is money laundering divided between the various countries/jurisdictions?

Statistics of charges, judgements and so forth can be found for certain types of criminal activity and in some countries. These can be used to support the estimates. In addition, substantial experience will be available through staff involved with law enforcement, customs service and the tax authorities. Figures from certain countries as well as research results on the relationship between other social conditions and the extent of criminal activity can be used to estimate the scale of crime where data or systematised police experience are not to be found. Similarly, selected individual cases related to money laundering can be used to identify the forces driving the choice of laundering locations.

The strength of this method lies in the fact that:

- it is intuitive
- it links criminal activity in one country with money laundering in another.

This method can also contribute to checking the consistency of other estimates based on completely different sources of information. The scope of money laundering in one jurisdiction, for example, can be either estimated directly or calculated with the help of estimates for the proceeds of crime and the proportion of these proceeds laundered in various forms and areas. In certain cases, a number of estimates can thereby be made of the same phenomenon. Such “triangulation” provides a basis for checking the consistency of different estimates.

The big drawback with this method is that it virtually assumes that the difficulty of finding suitable data has been overcome before one starts. It primarily comprises a summation of finalised estimates for various components of illegal capital flows. For examples of the application of the method, the Commission would refer to the website of Australian professor John Walker.¹

6.1.5 Using figures from national accounts

National accounts are built on the principles of double-entry bookkeeping, which means that the

same amounts can be generated in a number of ways. “Income”, for instance, can be calculated from the input side (income formation) or by measuring “use of income”. Stocks can also be calculated directly or from the original stock plus/minus net investment/disinvestment and possible revaluations.

However, national accounts contain errors and deficiencies. Calculating income from both input (earnings) and output (use of income plus/minus changes in assets) sides, for instance, will not yield exactly the same figures. This creates various types of “unexplained discrepancies”. In certain cases, it is reasonable to assume that these are due to systematic errors – which arise, for example, because certain activities or transactions are consciously under-reported. In other cases, it can reasonably be assumed that unexplained discrepancies are entirely due to various types of unintended and more accidental measurement errors.

In principle, a country’s income surplus with other countries (current account surplus) should correspond to changes in its net asset balance (net assets and liabilities and the net stock of direct investments) with other states. Countries with well-developed systems for national accounting register the current account balance, net capital inflows and outflows, and stocks of and changes in various forms of assets and liabilities. However, the change in net national wealth will not correspond exactly to the surplus/deficit on current account. An item for “net errors and omissions” is accordingly included to ensure that the national accounts add up.

If the national accounts for a number of countries are compared, discrepancies can also be found in amounts that should have been identical but actually differ. (Commodity exchange between two countries should be identical in both countries’ trade figures, for example.) It has been known for many years that, according to national accounts statistics, the world has run a deficit on current account with itself. What this means is that outgoings on current account to all the countries in the world are larger than the income. In theory, total income and outgoings for all countries should be identical. When an unexplained discrepancy recurs year after year, it is reasonable to assume that this reflects either a fundamental error in the methodology or a form of deliberate erroneous reporting by some groups. A number of analyses are based on the assumption that part of the statistical variation in the balance of pay-

¹ <http://www.johnwalkercrimetrendsanalysis.com.au/>

ments data can be attributed to capital movements which are not directly registered.

This provides the general foundation for three different methods which are all based on the use of national accounts to estimate illegal money flows. These three methods are presented in more detail below.

6.1.5.1 *The hot money method*

This approach has acquired its name because it focuses on capital considered to be particularly volatile.

It rests primarily on the assumption that the residual item of net errors and omissions in the balance of payments is an expression of capital flight. Transactions by governments and banks are excluded, on the assumption that these institutions are not involved in capital flight.

The balance of payments measures a country's income surplus and net wealth against other countries. In principle, changes in net wealth should roughly correspond to the income surplus. If the latter is larger than the registered growth in net wealth, the explanation *could* be that assets have been transferred out of the country and invested without having been recorded with the authorities.

Both positive and negative statistical variations can unquestionably arise in the balance of payments without illegal capital transactions being involved. The most important reason for a discrepancy is probably measurement errors which occur without the deliberate provision of deficient or erroneous information. To reduce the danger that measurement errors are interpreted as capital flight, variations of the hot money method have been developed which ensure that only large and stable discrepancies are interpreted as an effect of capital flight. Furthermore, variants exist which exclude various items in the balance of payments. These rest on an assumption that certain types of financial transactions are not used for illegal activity.

6.1.5.2 *The Dooley method*

This approach gets its name from its originator, Michael P Dooley.

It builds on an assumption that one can properly register income from legitimate foreign placements.² For the first year of the calculation period, net foreign liabilities are calculated either from stock figures in the national accounts or by esti-

imating liabilities from net financial expenditure abroad together with an assumption of the income yielded by various assets. Changes in net liabilities are then calculated with the aid of the balance of payments and the net errors and omissions item for each year ahead. Finally, an estimate for legal and registered positions is extracted with the aid of net capital income and expenditure and assumptions for the income from various assets. Placements which do not yield income are regarded as capital flight. For the method to provide good estimates, it is crucial that correct estimates can be produced for the rate of return on various types of international capital positions. This method does not appear to have been used in recent years.

6.1.5.3 *The residual method*

The name says it all. This method builds on an assumption that unexplained (residual) growth in net liabilities is due to capital flight. While its technical basis is largely the same as for the hot money method, the residual approach does not distinguish between which sectors are involved in the transactions or which instruments are used. All statistical discrepancies between the current and capital accounts in the national accounts are therefore regarded primarily as an expression of capital flight. However, some studies exclude certain observations which are believed to be highly likely the result of chance, measurement or similar errors as opposed to capital flight. This is done by eliminating figures which fail to show a certain level of systematic correspondence with the hypothesis concerning the direction of capital flight.

Balance of payment figures can be used to produce estimates with this method. Nevertheless, some studies use other sources where these are considered to provide better data quality.

6.1.6 **Methods for measuring manipulated transfer prices**

The transfer pricing term is used in two ways. One refers generally to all transactions within one and the same group. The other applies the term to the transfer of income between different group entities by pricing intragroup transactions differently from the normal market price or from the

² See Dooley, M. P. and Kletzer, K. M. (1994): Capital Flight, External Debt and Domestic Policies, Economic Review 1994 number 3, San Francisco Reserve Bank.

price which would have been paid by independent players.

Determining prices for transactions between different entities in a group is very necessary. Intragroup pricing can become open to criticism and/or illegal if prices are set in order to transfer income to reduce the group's overall tax obligation. Most countries prohibit concealed transfers of income between different parts of a group by setting artificially high or low prices for intragroup transactions. This violates both accounting principles and/or tax regulations.

The Commission has opted to use the term *manipulated transfer prices* for various forms of inaccurate pricing of intragroup transactions intended to move income between group entities.

Transfer pricing is a subject for both theoretical and empirical studies related to corporate behaviour and taxation. This research applies methods which cannot be used in practice to estimate the total scale of income transfers to low-tax countries through manipulated transfer prices. No dataset exists which could be used to produce a global estimate.

The three different methods based on figures from national accounts presented in the previous section are not suitable for detecting illegal income transfers through manipulated transfer prices. To establish an overall picture of money flows, these methods must be supplemented by calculations related to manipulated transfer prices.

At least three methods of transfer pricing take place:

1. income transfer with the help of intragroup pricing
2. income transfer to third companies by amending invoices
3. income transfer to third companies through supplementary invoices.

The first of these methods involves implementing a transaction between two entities within the same group at an artificial price so that profits are transferred from one entity to the other. Exposing such transfers, which are illegal under most countries' tax or accounting regulations, calls for an independent assessment of whether the price of the underlying delivery is reasonable in relation to the market price of corresponding deliveries or to production costs. Alternatively, one can use the level of profit in the various group companies as an indication of whether prices for transaction between them are unreasonable. It is not unusual for multinational groups to have companies in tax ha-

vens which are credited with income, for example, from the use of the group's name, patents and so forth. Issues related to such transfer pricing are very common in all multinational companies which have activities in different tax regimes, including those outside tax havens. In Norway, which has different rules and rates for ordinary income tax and for the taxation of such activities as shipping, power generation and petroleum operations on the Norwegian continental shelf, transfer pricing problems can also be encountered within the country as long as the company has operations in different areas of activity.

The second method of income transfer listed above involves the transaction passing via a company which is part of the same group as the seller (most commonly) or buyer of the delivery. The delivery is sold first to a shell company (located in a tax haven, for instance) and then from there at different (normally higher) price. That ensures an income transfer to the shell company from the rest of the group. This form of transfer pricing can be exposed by comparing the invoice price from the exporting country with the price charged to the importing country, or by making an assessment similar to that made under the first method for the first part of the transaction.

Income transfer under the third method means that the main delivery is made at a low price. In addition, an invoice showing an excessive price is sent to the importer from a shell company in the same group as the exporter. This will again transfer income to the shell company from the exporter. To expose this type of income transfer, one must normally use the first method – in other words, documenting that a delivery has been made at an unreasonable price or that the outcome in the enterprises is unreasonable.

In addition to the three above mentioned methods, it is common to transfer income between group entities by adjusting their financing costs. A multinational company, for example, can use an internal bank in a tax haven to secure deductions for interest payments made on debt by subsidiaries in high-tax countries, achieving a tax arbitrage gain from differences between nominal tax rates. Companies are also partly able to manipulate interest rates used in such transactions. In that case, the actual assessment of the interest rate must use the same method applied to assess illegal transfer pricing. Both debt-equity and net profit ratios can be used as indicators for this type of transfer pricing. Efforts to reduce incentives for making such adjustments in tax regimes with

high tax rates and the presence of branches and subsidiaries of international groups – as in the Norwegian oil industry, for example – include rules against thin capitalisation.

A number of methods exist for detecting and estimating income transfers through manipulated transfer prices. These approaches differ over the forms of manipulation they can detect. Most of them require very high data quality. As far as the Commission has been able to establish, no country can use data directly from public registries. Supplementary information is required in order to use the methods.³ The requirements for data quality mean that the methods used for research into manipulated transfer prices cannot be applied to produce global estimates of such income transfers. Appendix 3 presents part of the research in this field, including studies of manipulated transfer prices in developing countries.

Global estimates of income transfers through the manipulation of transfer prices are produced by using international trade statistics. This approach is termed the DOTS method by some.⁴ It builds on comparing trade statistics from import and export countries respectively. One often finds that data for imports by country A from country B do not coincide with the value of exports from country B to country A. In principle, these two amounts should be identical (assuming that transport and handling costs as well as customs duty have been eliminated).

In cases where data from two countries fail to match, the typical assumption is that trade statistics from industrial countries are correct while the figures from developing countries contain errors. Where they arise, differentials are interpreted as capital flight concealed by under-reporting of income in developing countries.

The assumption that statistics are mainly accurate in industrial countries and often erroneous in developing countries is supported to some extent

by Almendingen *et al* (2008). This study compares data on Norwegian trade with Jamaica and Iceland respectively. Detailed trade statistics are compared to see if each country's export data are consistent with the relevant trade partner's import figures. The study indicates that consistency is good between Norwegian and Icelandic data, but weak between Norwegian and Jamaican data. Jamaica's export figures are often lower than Norwegian data for imports from Jamaica.

As a result, the main trend supports an assumption that transfer prices for export deliveries from Jamaica to Norway are used to conceal income which would have been liable to Jamaican tax, but the findings are not statistically significant.

The DOTS method will only detect transactions where deliveries are repriced between the export and import location. Cases could also occur where the player or players do not need to show different prices at the two registration points. The specified value could then be the same at both points, but would diverge from the regular market price.

6.1.7 Estimating untaxed assets hidden in tax havens

This approach is used to estimate the scale of wealth placements by foreigners in tax havens and the return on these assets. One problem with the method is that tax havens often produce no statistics of assets placed with them by foreigners. The Tax Justice Network (TJN, 2005) has largely utilised estimates produced by international consultancy and audit companies. How these estimates are produced has not been made public, but the companies can be assumed to possess information through their role as advisors to financial institutions and investors. The TJN has also produced other estimates from official data (BIS), supplemented by estimates for other types of placements.

No information is available on the return achieved by investors on their placements in tax havens, nor on the proportion of this income declared to the relevant tax authorities. The TJN assumes that investors achieve normal market returns on these assets and that the bulk of the income is untaxed. Both these assumptions appear to be reasonable.

American data for direct investment suggest that the return on investment in tax havens is rather higher than for investment in other coun-

³ A method also exists which utilises detailed data from the customs authorities to identify manipulated transfer prices through big variations from average unit prices for the individual commodity. This approach does not depend on additional information. It is uncertain whether it primarily detects manipulated transfer prices rather than price variations which reflect differences in dates, quality and so forth. An example of the use of the method can be found in Boyrie, M. E., Pak, S., and Zdanowicz, J. S. (2005): "Estimating the magnitude of capital flight due to abnormal pricing in international trade: the Russia-USA case", *Accounting Forum*, 20, 2005, pp 249-270.

⁴ DOTS stands for direction of trade statistics. These figures are produced by the IMF and are normally used as the basis for analyses which utilise this method.

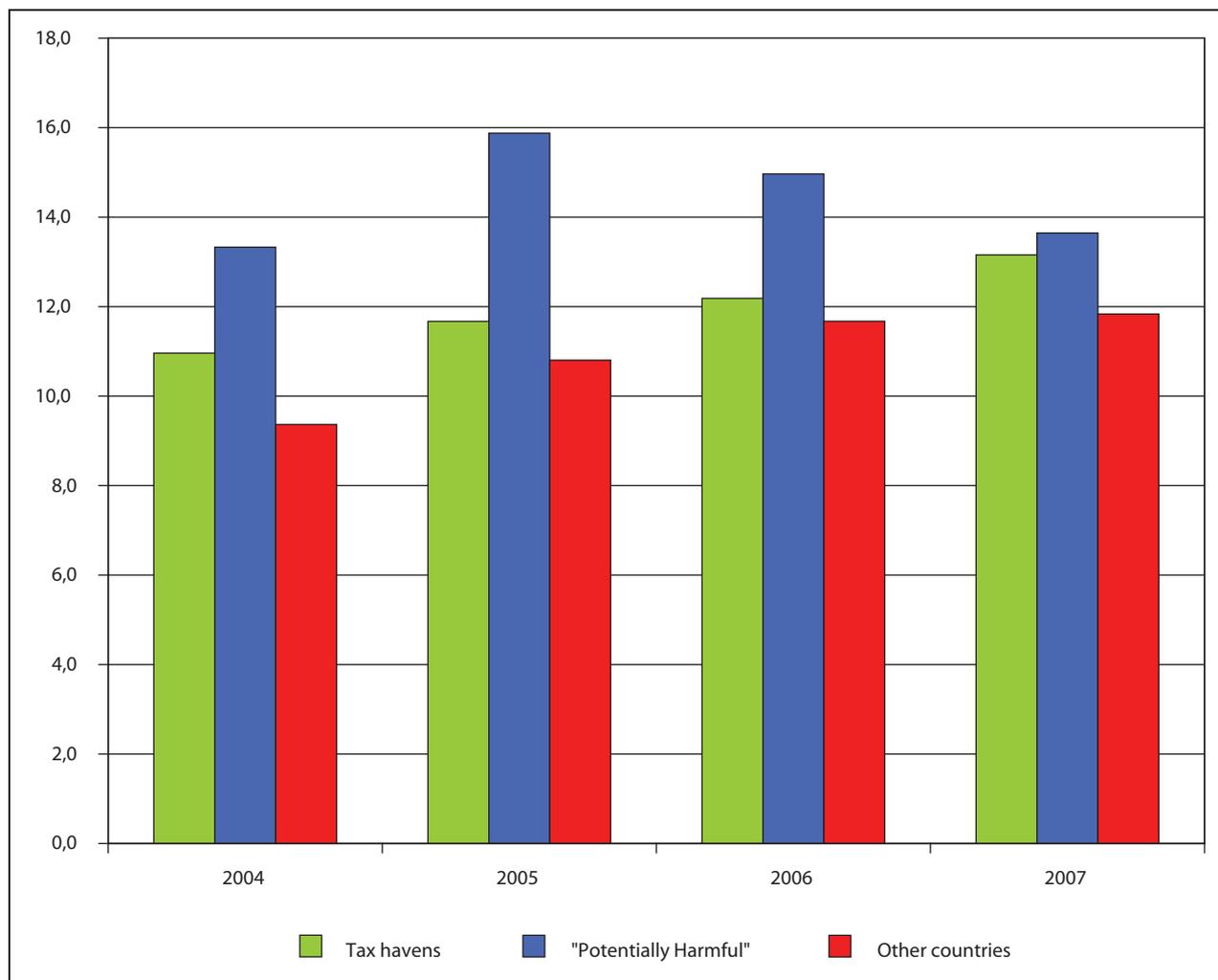


Figure 6.1 Rate of return¹ on direct investments from the US into tax havens and other countries.

¹ Rate of return is calculated as income in percent of the stock of direct investments measured at historical cost. Country grouping is based on OECD (2000)

Source: The Commission's calculations based on U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data, The Bureau of Economic Analysis (BEA)

tries (see Figure 6.1). It is reasonable to suppose that the high return on investment in tax havens reflects the manipulation of transfer prices, so that the tax base is higher where taxes are at their lowest – in other words, in the tax havens.

The assumption that assets placed by private individuals in tax havens are not declared for tax in their country of domicile is supported by a number of recent cases. These have provided insights into how large a proportion of the wealth of private individuals is reported to the tax authorities in their country of domicile. The report from the investigation into the UBS case in the US (see US Senate, 2008) shows that 95 per cent of the UBS clients who opened an account in a tax haven failed to declare the existence of this account to the tax authorities. The UK tax authorities gained access in 2006

to a list of depositors with the tax-haven branches of a major bank. Of the almost 10 000 British depositors, only 3.5 per cent had provided account information to the tax authorities (see Sullivan, Martin A. (2007): *Keeping Score on Offshore: UK 60 000, US 1 300*, *Tax Notes*, 7 July 2007).

6.1.8 Statistics and actual calculation results for the various methods

The Commission is not aware of any written publication of calculations based on direct estimates of proceeds from crime (see section 6.1.4) or of relatively new estimates based on the Dooley method (section 6.1.5.2).

The only estimates which are reasonably up-to-date and suitable for identifying capital flight

from developing countries in particular combine the residual and DOTS methods (see sections 6.1.5.3 and 6.1.6 respectively).

In relation to the Commission's mandate, these studies have the weakness that they cannot identify the extent to which tax havens are used to conceal capital flight. The scope of tax haven use has been clarified to some extent through data on financial balances in these jurisdictions. These data are far from complete, however, and the lack of information on the proportion of the assets deriving from developing countries is, accordingly, a weakness from the Commission's perspective.

6.1.9 Capitalism's Achilles Heel

The heading for this section is the title of a 2005 book by Raymond Baker, based on data for 2004 and earlier. This volume presents a number of estimates of capital flight from developing countries.

Baker carried out an interview-based survey to identify tax evasion through transfer pricing in multinational companies. The management of 550 companies was interviewed on the use of manipulated transfer pricing in cross-border trade.⁵ Baker concludes that 45-60 per cent of all international transactions related to the sale of goods and services take place at manipulated prices. Erroneous pricing in these transactions account for 10 to 11 per cent of the value. On this basis, Baker concludes that transfer pricing accounts for five to seven per cent of world trade.

Baker also concludes that capital flight from developing countries amounts to USD 539 to 778 million per year, corresponding to six to 8.7 per cent of GDP in all developing countries during 2004. His estimates are not based on a single method, but on an overall assessment of a number of different studies and methods.

6.1.10 Ndikumana and Boyce – estimate of capital flight from Africa

Ndikumana and Boyce (N&B, 2008) have estimated capital flight from Africa. They emphasise that these estimates are confined to capital movements related to breaches of law, but assume that the bulk of the flows relate to criminal activity. The estimates embrace unregistered capital movements and erroneous invoicing of trade

flows. N&B use what Kar and Cartwright-Smith (2008) describe as the residual method combined with the DOTS approach. Their study presents estimates for individual countries from 1970 to 2004. In addition to estimating capital flight, they analyse the link between the foreign debt of the countries and capital flight as well as the connection between structural features of national economies and economic policies on the one hand and the scale of capital flight on the other.

The scale of capital flight is estimated as the sum of unexplained increases in net foreign debt and assumed erroneous pricing in foreign trade. Estimates for erroneous pricing build on the normal assumption that trade data for the industrial countries are accurate. Generally speaking, the method is based on interpreting the difference between industrial states' imports from Africa (in accordance with statistics from industrial nations) and Africa's exports to the industrial states (as specified in statistics from the African countries) as an expression of capital flight. An identical approach is used for African imports from developed countries.

The results indicate that capital flight varies sharply from year to year and between countries. Accumulated over the 1970-2004 period, capital flight is estimated at USD 420 billion (converted to 2004 prices). With calculated interest accumulation, capital flight is assumed to total USD 600 billion over the same period. This corresponds to almost three times the total foreign debt of the countries concerned.

According to the analyses, a positive statistical correlation clearly exists between capital flight and debt. N&B believe that 62 per cent of the debt accumulated by African countries during the period flowed straight out in the form of capital flight. Furthermore, according to N&B, it seems that capital flight is self-reinforcing: high capital flight in one year appears to stimulate capital flight the following year. High economic growth and low inflation seem for their part to reduce capital flight. The real rate of interest (relative to the international level) does not appear to have any effect. Nor does the development of the financial market in the countries (measured as lending by financial institutions relative to GDP). The study finds no correlation between the size of exports of petroleum and other non-renewable resources and capital flight – in other words, the problem of capital flight is not confined to nations which would be characterised in other contexts as suffering from the "resource curse".

⁵ As far as the Commission has been able to ascertain, nobody else has conducted similar interviews. To verify the method, several independent studies would have been a clear strength.

6.1.11 Kar and Cartwright-Smith (2008)

Kar and Cartwright-Smith (2008) discuss various methods, and estimate capital flight from developing countries from 2002 to 2006. They also use various filters to exclude arbitrary effects. These include eliminating estimated capital flight from a country if the calculation does not yield positive figures for such flight in three out of five years and if average capital flight amounts to less than 10 per cent of the country's exports.

The authors apply both the hot money method and two variants of the residual method. These approaches give an estimate for capital flight from the developing countries in 2006 of USD 337 to 939 billion. The hot money method provides a substantially lower estimate than the residual approach. According to the authors, data problems make the hot money method unsuitable for such calculations in many developing countries. The variants of the residual method yield estimates of USD 641 to 939 billion for 2006.

Calculations for each year in the 2002 – 2006 period are also presented in the study. The conclusion is that capital flight increased by about 150 per cent from 2002 to 2006. These calculations indicate that the growth was fairly steady, but particularly strong in 2002-2003 and 2005-2006.

No complete country-by-country breakdown is provided by the report, but figures are presented for regions and for the 10 countries with the biggest capital flight. Not surprisingly, given their income from international trade, China and Saudi Arabia top the list for capital flight. Capital flight from China is about four times larger than the figure for Saudi Arabia. Sub-Saharan Africa accounted for three to four per cent of total capital flight. This corresponds well with the calculations of N&B (see the previous section), which reflects the fact that the methods employed in the two studies are closely related and that they use many of the same data sources.

6.1.12 The Price of Offshore

This heading is the title of a report from the TJN in 2005. The report is based on a number of sources for assets held in tax havens, including annual surveys of the assets of wealthy private individuals (*Global Wealth Report* from Boston Consulting Group and *World Wealth Report* from Merrill Lynch/Cap Gemini). Use is also made of banking statistics from the Bank for International Settlements

to support the view that financial assets of wealthy private individuals in OFCs total USD 9-10 000 billion. Other claims (including the ownership of companies in OFCs) are roughly estimated to total about USD 2 000 billion. Furthermore, the annual return on these assets is assumed to be seven to eight per cent. That makes income from these assets about USD 860 billion. Assuming that such earnings would normally have been liable to tax at 30 per cent, assets placed by wealthy private individuals in tax havens represent an estimated annual loss of roughly USD 255 billion in tax revenues.

A. Cobham (2005) uses part of the same data. He assumes that the proportion of assets in tax havens belonging to residents of developing countries is similar to the share of these countries in world GDP (20 per cent). Based on the estimates and assumptions in *The Price of Offshore*, he then calculates that the developing countries as a whole lose about USD 50 billion per annum from the use of tax havens by wealthy individuals to evade tax.

The method used in *The Price of Offshore* – estimating the return on assets placed in tax havens – can only be used to estimate one type of illegal money flow. This is the failure to pay tax on income from assets transferred to a tax haven which should have been taxed in the owner's country of domicile. Based on the results of the other methods mentioned above, income transfer through the use of transfer pricing is the dominant form of illegal money flow. The method used in *The Price of Offshore* would not register this at all. That is because the method only detects the estimated return on holdings and not additions to these holdings through transfer pricing. Moreover, the method is partly based on data which relate exclusively to the assets of individuals rather than companies. One could also well imagine that companies have financial income which they do not declare for tax. Nor is the growth in assets through transfer pricing the only aspect which fails to be detected. The method in *The Price of Offshore* will generally be unsuitable for detecting gross flows to and from holdings in tax havens. One must assume that drawings are often made on these holdings in the form of consumption, or where the owner completes a money laundering process by transferring assets to locations where their ownership is no longer concealed behind the secrecy rules of a tax haven.

6.2 The economies of tax havens

6.2.1 Market share for banks in tax havens

As mentioned above, official data on the scale of placements in and from tax havens are very limited, and such information is not in itself an estimate of illegal behaviour but illustrates the size of financial activity in tax havens.

In a report from 2000 (IMF, 2000), the IMF estimated that 50 per cent of international positions in the world's banks are held by banks in OFCs. See the discussion of the various definitions of tax havens in chapter 2. The IMF utilises a broad definition of OFCs in the report, which includes London, Dublin, the Netherlands, Singapore and Switzerland.

Data from the Bank for International Settlements (BIS) can be used to illustrate how the position of tax havens as financial centres has changed over time. These statistics are based on bank balances in countries which report to BIS, but only includes the international positions of the banks. Over time, BIS has persuaded a growing

number of countries – and particularly tax havens – to report data.

As noted earlier in the Commission's report, no unambiguous definition exists for which countries and jurisdictions should be regarded as tax havens. Whether the major financial centres, such as London, Singapore, Luxembourg, Dublin, Hong Kong and the Netherlands, are included is particularly important when assessing the scale of international banking operations in tax havens. These centres are regarded as tax havens (or secrecy jurisdictions or OFCs) by some but not by others. The figures below show data for tax havens based on both narrow and broad definitions of these jurisdictions.

Figure 6.2 shows that positions in tax havens expanded strongly until the financial crisis contributed to a contraction in 2008. The BIS banks have net debt with tax havens – liabilities exceed assets. This probably reflects the fact that many placements in tax havens involve the establishment of shell companies, trusts, foundations and so forth, and that some of the assets in such entities are deposited in banks.

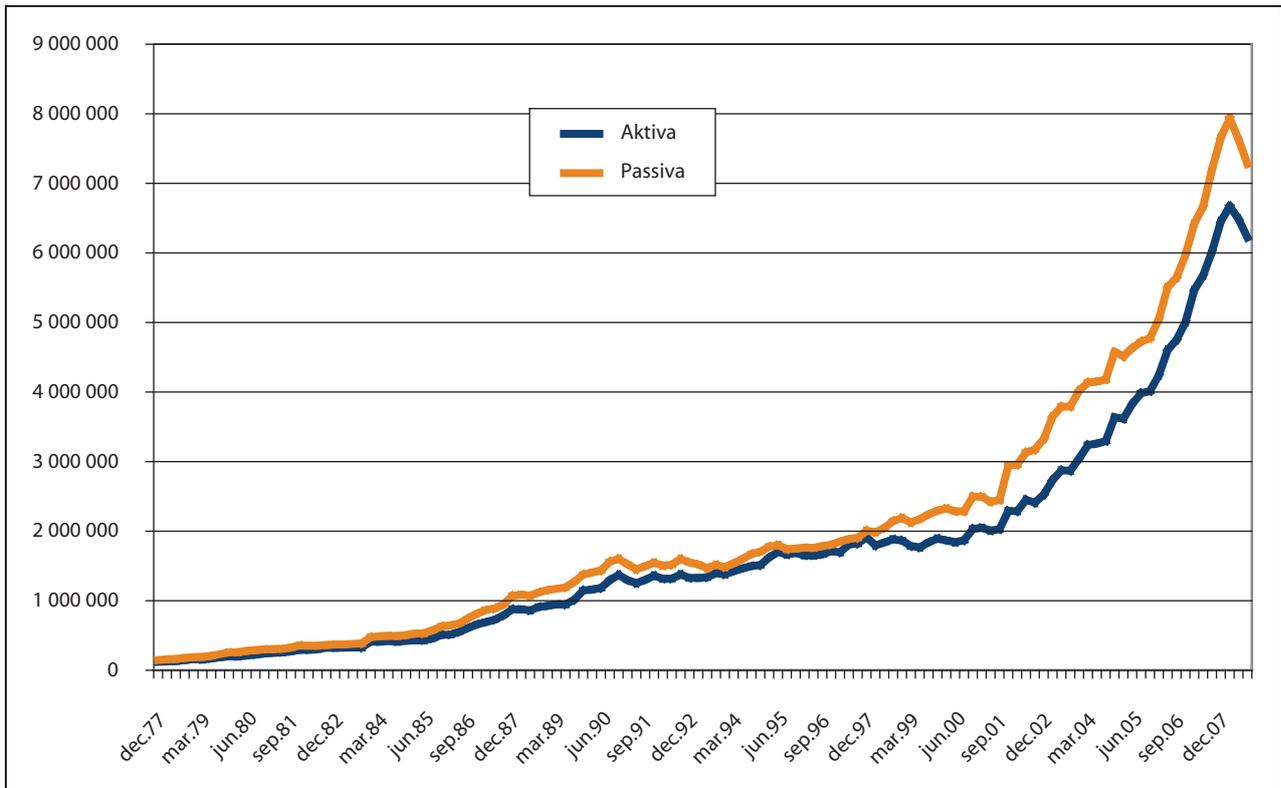


Figure 6.2 The position of banks in BIS' countries towards tax havens. Narrow definition.¹ Million USD

¹ Aruba, Bahamas, Bahrain, Barbados, Belize, Bermuda, British Overseas Territories, Cayman Islands, Cyprus, Dominica, Gibraltar, Grenada, Guernsey, Hong Kong, Isle of Man, Jersey, Lebanon, Liechtenstein, Luxembourg, Macao, Malta, Mauritius, Netherlands Antilles.

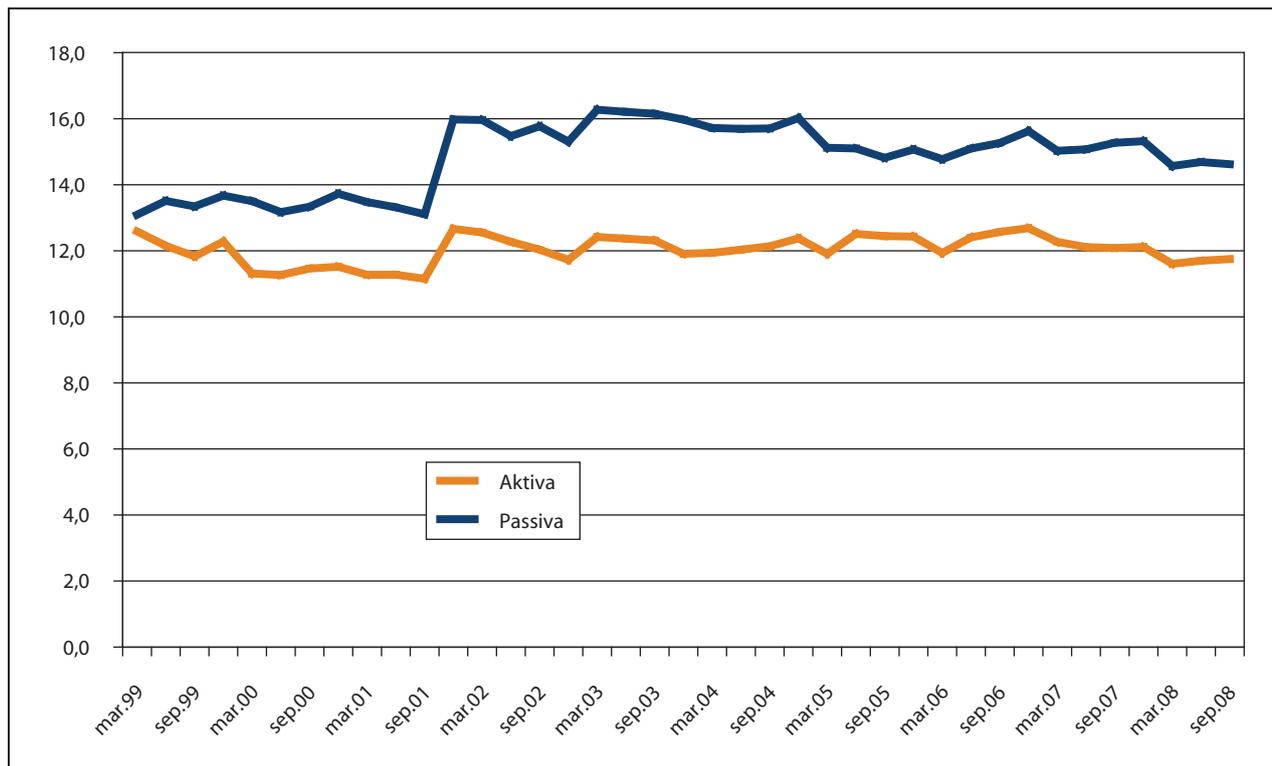


Figure 6.3 The position towards tax havens as a share of total international positions of banks reporting to the BIS (narrow definition). In percent

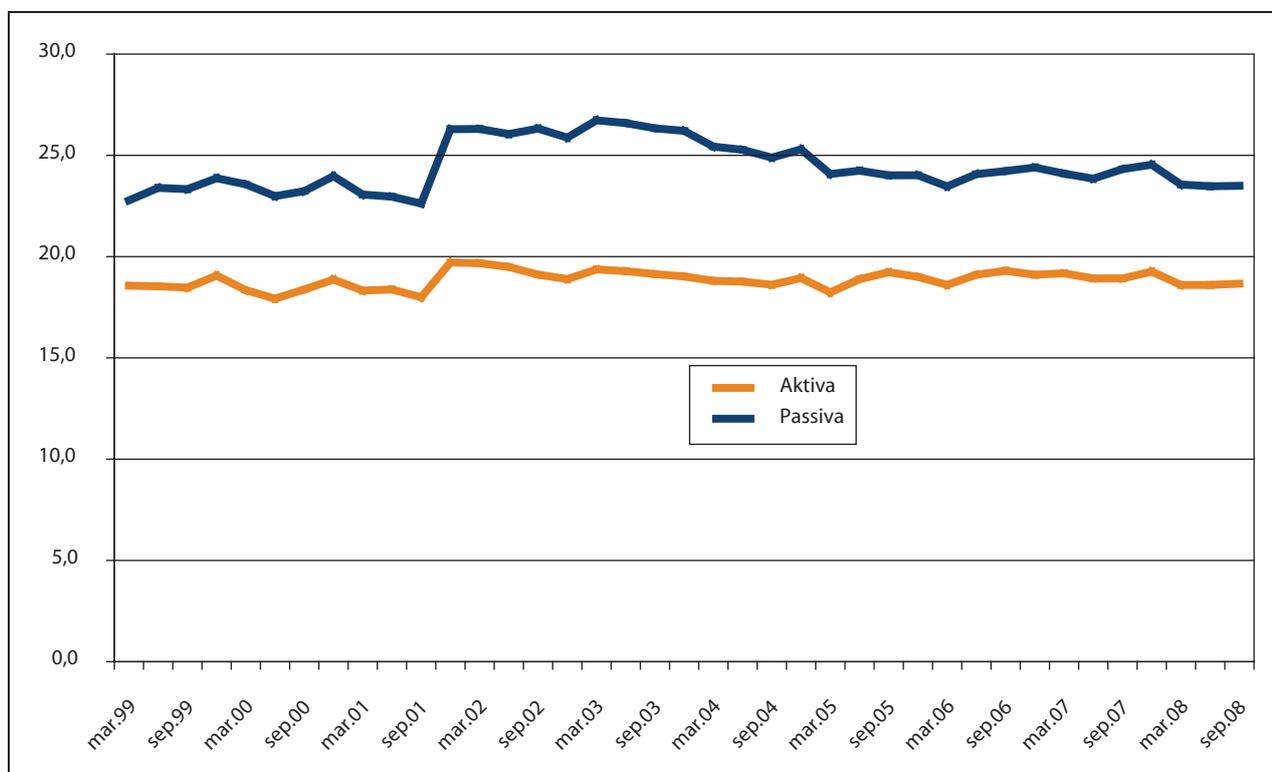


Figure 6.4 The position towards tax havens as a share of total international positions of banks reporting to the BIS (broad definition). In percent¹

¹ Aruba, Bahamas, Bahrain, Barbados, Belize, Bermuda, British Overseas Territories, Cayman Islands, Cyprus, Dominica, Gibraltar, Grenada, Guernsey, Hong Kong, Isle of Man, Jersey, Lebanon, Liechtenstein, Luxembourg, Macao, Malta, Mauritius, Netherland Antilles. Panama, Samoa, Singapore, St. Lucia, St. Vincent, Switzerland, Turks and Caicos Islands, Vanuatu, West Indies Great Britain, Netherlands and Ireland

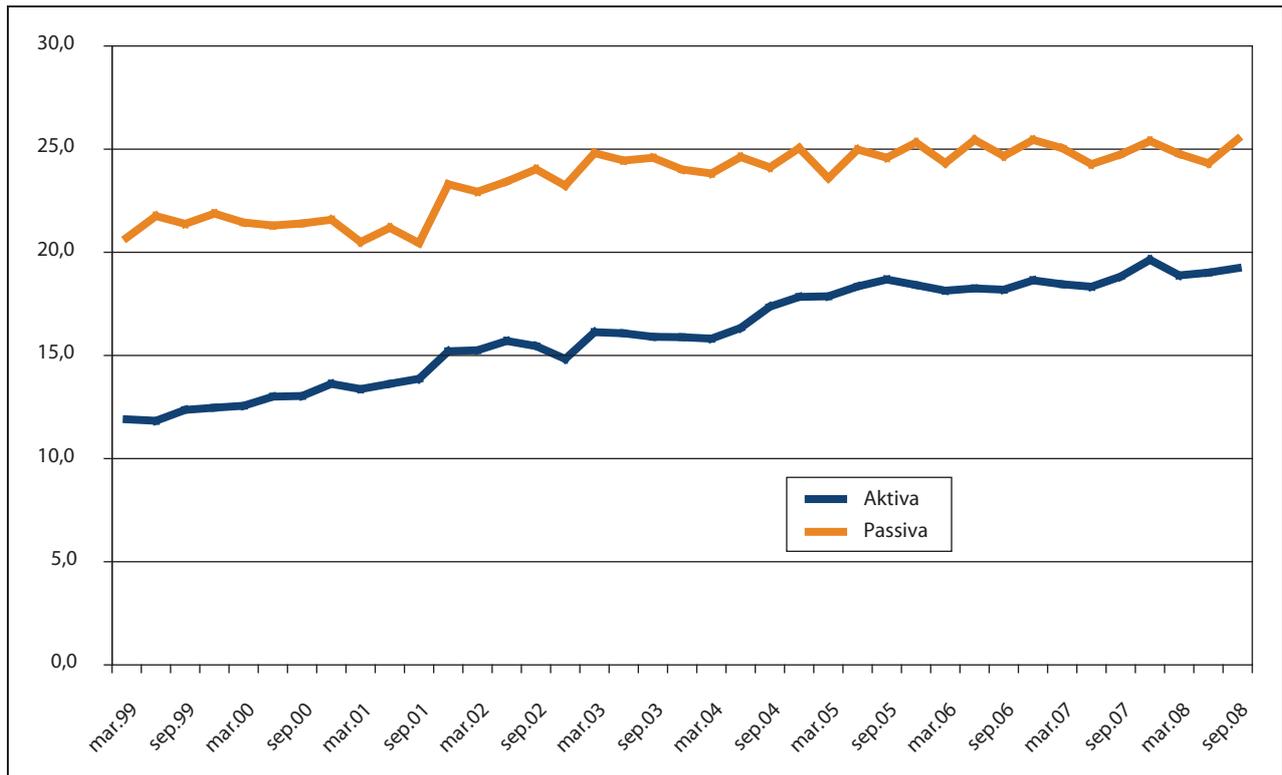


Figure 6.5 The international positions of banks reporting to the BIS. Positions towards tax havens in percent of total.

Although there has been strong growth in the absolute level of positions between tax havens and BIS banks, the tax havens' share of the total positions of the BIS banks has not actually increased. See also Figure 6.4, which shows the proportions for a narrow and broad definition of tax havens respectively.

If the UK, the Netherlands and Ireland are included in a broader definition of "tax haven", a higher proportion of positions are naturally found with tax havens. But the pattern is otherwise the same since the end of the 1990s. See Figure 6.4.

Figure 6.3 shows that the proportion of assets in the BIS banks placed in or lent to tax havens as narrowly defined has been at a stable level of about 12 per cent since the end of the 1990s. The share of international deposits and borrowings deriving from the same tax havens has been 15-16 per cent since 2002.

Excluding inter-bank positions, placements from tax havens account for just over 25 per cent of liabilities in the BIS banks (deposits and borrowings). See Figure 6.5. The tax haven share showed a rising trend until 2003, but has since been relatively stable. The proportion of the BIS banks' assets (loans, securities, etc) in tax havens

has tended to rise over time, but has never exceeded 20 per cent of total assets.

The BIS figures could be used as an indication of which tax havens are the largest and how the extent of tax haven use has developed over time. As mentioned above, however, these data do not measure the scale of capital flight associated with illegal activities.

- First, illegal money flows do not necessarily find expression in a loan or deposit between a tax haven and a bank in another country. The funds could, for instance, be injected into a company or a trust which in turn buys shares or other securities in an open jurisdiction.
- Second, it is important to note that not all positions related to tax havens are associated with illegal behaviour. This applies particularly when using a broad definition of tax havens. The broad definition used above embraces financial centres which are also among the most competitive for activities which do not require particular secrecy. Even the narrow definition includes centres fairly certain to encompass substantial international activity which is not attracted by the secrecy on offer.

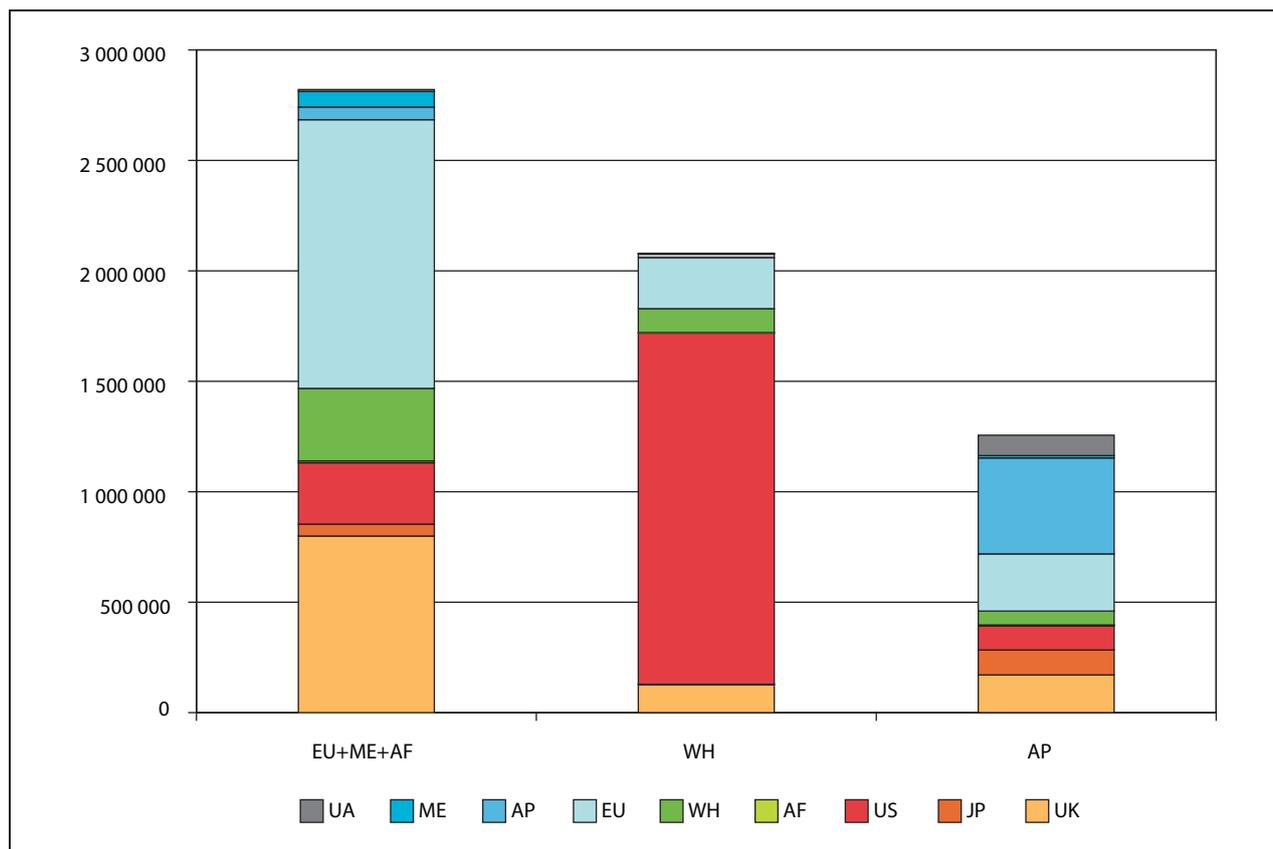


Figure 6.6 Claims on banks in different groups of tax havens. Geographical break down by source¹. Million USD 2006

¹ The specified countries and country groups are: The United Kingdom (UK) Japan (JP), USA, Africa (AF), America except USA (WH), Europe (EU), Asia and Oceania (AP), Middle East (ME) and unallocated (UA). The tax havens are grouped in (1) Europe, Middle East and Africa (EU+ME+AF), (2) America (WH) and (3) Asia (except Middle East) and Oceania (AP)

Source: IMF (2008)

6.2.2 Where does the capital in tax havens originate?

The IMF shows in a 2008 report (IMF, 2008) how international assets and liabilities held by the banks in groups of OFCs break down by continent. These figures are reproduced in Figure 6.6. A key feature is that this market is characterised by regional segments. Europeans primarily use European OFCs, Americans use those in the Americas, and so forth. Nor does this survey pick up all use of tax havens to conceal illegal activity. Funds deposited in trusts and then in a bank in the same country would not be included, for example.

6.2.3 Direct investments to and from tax havens

A number of different types of legal constructions can be relevant when placements are made in or

from tax havens. In many cases, it will be appropriate to establish a company in a tax haven. The value of this company will be regarded as a direct investment regardless of whether it pursues production or is simply a shell entity.

UNCTAD produces statistics for direct investment over national boundaries. All the major tax havens report data to UNCTAD. Countries such as the UK, Hong Kong, Switzerland and Luxembourg place high on the list for the size of both inward and outward direct investment. However, it is only when the investment figures are compared with the size of the various economies that a number of the tax havens really stand out.

Figure 6.7 shows that Iceland is the only one of the 11 jurisdictions with the largest inward direct investment which could not be regarded as a tax haven. All the others would be defined as tax havens.⁶ Inward direct investment to the British Virgin Islands equals USD 2.7 million (almost NOK 18 million) per capita. While the Cayman Is-

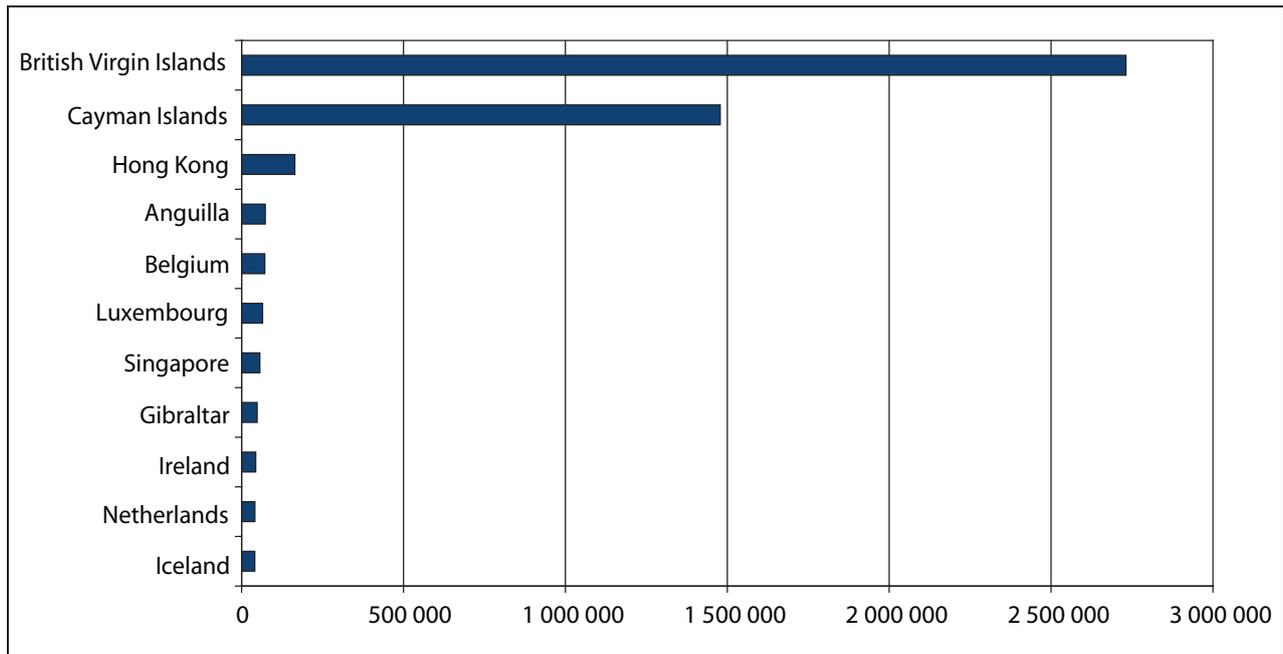


Figure 6.7 The stock of inward direct investment. In USD thousands per capita. The 11 countries with the highest direct investment per capita.

Source: UNCTAD.

lands and Hong Kong also stand out from all the others, they are nevertheless far behind the Virgin Islands.

Direct investment to and from offshore companies, exempted companies, trusts and the like will probably be substantially under-reported. Governments in tax havens normally lack good information about activities in these structures. Section 7.5.5 on the pass-through of capital in Mauritius shows, for example, that while outward direct investment from this country totalled USD 285 million as of 31 December 2007, data from India indicate that direct investment from Mauritius to India alone can be estimated at more than USD 38 billion at the same date.

The scale of direct investment in the Virgin and Cayman Islands must primarily reflect purely financial operations rather than production activities. It is fairly inconceivable that capital per job in a whole economy should amount to several million kroner. Another way of illustrating the scale of direct investment is to view it in relation to the size of the economy. This is presented in Figure

6.8. Inward investment to Vanuatu equaled to 102 per cent of GDP. The comparable proportion for Norway is about 20 per cent.

Most of those who establish a company in such jurisdictions channel its capital in the form of financial claims or direct investments in other countries. As a result, tax havens have large direct investments not only inward but also outward. Figure 6.9 shows that tax havens also dominate among countries with the highest direct outward investment per capita.

Where outward direct investment is concerned, Iceland and Sweden as well as eight areas which can be defined as tax havens have the largest per capita holdings. The Virgin Islands stand out even more markedly here, with outward direct investment corresponding to almost USD 7 million or NOK 45 million per capita.

When inward and outward investment in the Virgin Islands are compared, the latter can be seen to be much larger than the former. It seems inconceivable that the population of these islands and the companies they own should have assets which can explain the difference between inward and outward direct investment. Moreover, it will emerge below that the Virgin Islands does not have a particularly large banking sector. The Commission takes the view that a possible explanation could be that a great deal of capital enters

⁶ The Netherlands falls outside a number of definitions of tax havens and related terms. However, this country has established a form of shell company with virtual freedom from tax, which has contributed to a number of companies registering their head offices there – often without having employees in the Netherlands.

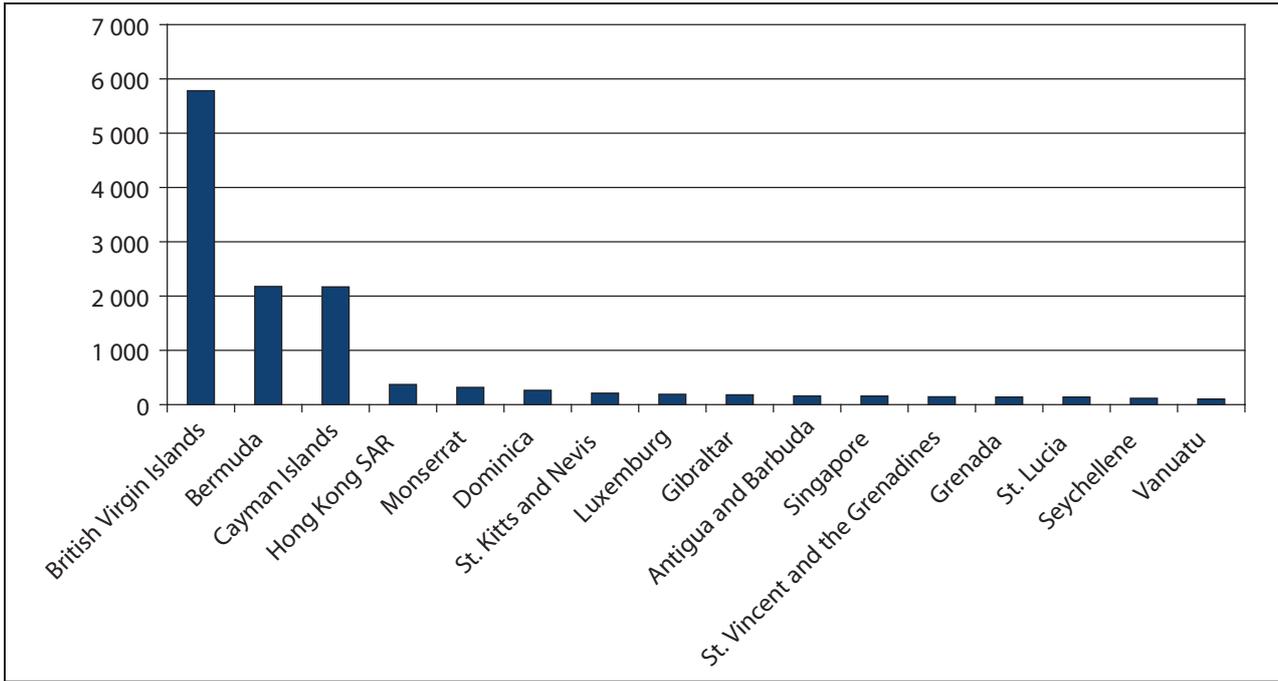


Figure 6.8 The stock of inward direct investments in percent of GDP. All countries and jurisdictions where the stock exceeds GDP.

Source: UNCTAD

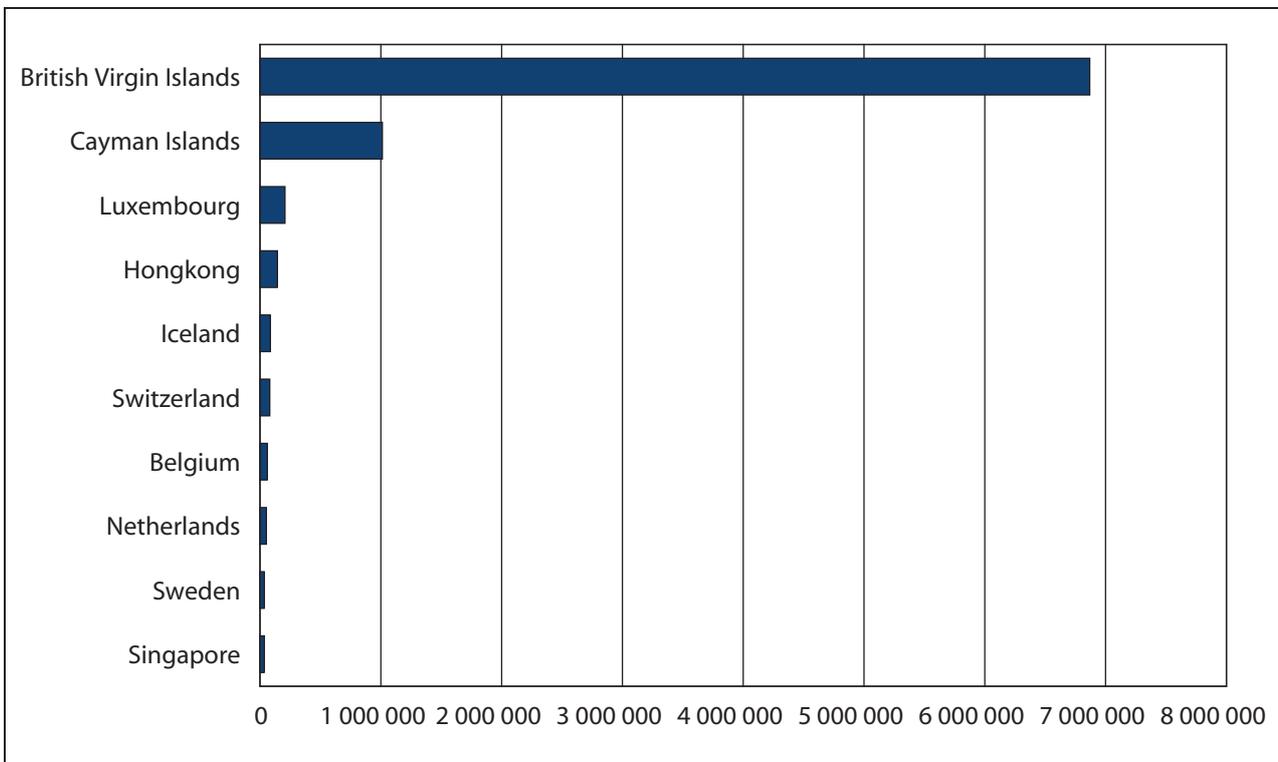


Figure 6.9 The stock of outbound direct investments. USD thousands per capita. End 2007.

Source: UNCTAD

the Virgin Islands through trusts and the like, and that much of it flows out again in the form of direct investment.

Figures for the Netherlands do not include special financial institutions (SFIs). These are special structures suitable for tax planning. Dutch tax regulations and an extensive network of tax treaties make this country attractive as the location of holding companies. The majority of these are shell companies, even though they formally have an address and management in the Netherlands. However, the management can often be regarded as front persons. The real leadership is located in other countries. Nonetheless, the Dutch tax rules have also contributed to attracting a number of genuine head offices – in other words, ones where the company management sits. Excluding the SFIs, the Netherlands had direct investments abroad totalling EUR 606 billion as of 31 December 2008. When the SFIs are included, this figure rises to EUR 2 227 billion or almost USD 200 000 per capita. Including the SFIs, the Netherlands comes a close second to the US as the country with the largest outward direct investments.⁷

Figures for direct investment can also be put in perspective by looking at the number of companies registered in the various jurisdictions. No international statistics are available through a standardised methodology, and many companies do not publish figures. However, the Commission is not aware of any national figures for the three jurisdictions with the largest inward direct investment in relation to GDP (see Figure 6.8). The number of companies per 1 000 inhabitants in these countries were:

- Virgin Islands: 17 917
- Cayman Islands: 1 815
- Bermuda: 213.

By comparison, Norway had 40 enterprises with limited liability per 1 000 residents. Including sole proprietorships would more than double this figure.

6.2.4 Significance of the financial sector in tax havens

Capital flows to secrecy jurisdictions in many different forms. Some of it enters as deposits in or other types of claims on banks. More of it goes to

companies, trusts and similar entities in these jurisdictions, and then is placed in banks or other financial claims in secrecy jurisdictions before being channelled to countries with an activity which can take advantage of the capital and thereby provide a return on it.

Although direct investments to and from tax havens are substantial, capital from the financial sectors in these countries is far greater. Among the pure tax havens (small economies with large financial balances), the Cayman Islands with USD 1 672 billion had the highest international bank claims. By comparison, direct investments from the Virgin Islands were just over USD 150 billion. A number of tax havens (including Hong Kong, the Netherlands and Switzerland) had larger direct investments than the Virgin Islands, but these countries also have substantial economic activity which is not particularly associated with secrecy. As a result, it cannot simply be assumed that direct investments abroad from these countries represent the reinvestment of funds which

Table 6.1 International bank assets in selected tax havens. 2006.

	International bank assets. Percent of BNP	International bank assets. Billion. USD
Cayman Islands	724,09	1 671 922
Jersey	66,68	444 064
Guernsey	56,54	182 970
Bahamas, The	52,24	343 250
Isle of Man	22,45	77 039
Monaco	22,32	21 780
Gibraltar	15,47	16 486
Bahrain	11,93	159 674
Netherlands		
Antilles	7,37	20 647
Andorra	5,89	16 324
Singapore	4,57	603 565
Cyprus	3,21	51 307
Ireland	3,14	819 137
Hong Kong SAR	3,00	621 332
Anguilla	2,91	317
Switzerland	2,63	1 122 005
Bermuda	2,29	10 313
Vanuatu	2,16	1 069
Macau	1,59	22 653
Panama	1,31	22 176

Source: (1) BIS, International Banking Statistics, IMF WEO database, IMF (2008)

⁷ See Weyzig, F. and Van Dijk, M. (2008): Tax Haven and Development Partner: Incoherence in Dutch Government Policies. SOMO (Centre for Research on Multinational Corporations).

Table 6.2 Indikatorer for finansnæringens¹ betydning i utvalgte jurisdiksjoner. Siste tilgjengelige data i perioden 2004-2006.

	The financial sector's share in GDP	The financial sector's share in employment	"Value creation" per employee in the financial sector. USD thousands
Jersey	50,0	22,0	303
Bermuda	32,5	17,9	209
Isle of Man	28,6	20,9	109
Guernsey	25,5	22,6	118
Bahrain	18,4	2,4	308
British Virgin Islands	18,1	6,3	176
Dominica	12,9	2,0	44
Cayman Islands	11,9	17,1	46
Seychelles	10,2	2,9	79
Singapore	9,5	5,0	108
Mauritius	8,0	2,7	69
Panama	7,8	1,2	88
USA	7,8	5,9	139
Bahamas	6,4	2,2	105
The United Kingdom		11,8	
Norway	2,4	2,0	164

¹ There may be national differences both in the definition of "financial sector" and in method for measuring value creation (contribution to GDP).

Source: IMF (2008), Ecwin (for USA), National Statistics (Great Britain) and SSB (Norway).

they have received because of their secrecy and facilitation of pass-through activities.

Table 6.1 shows the size of bank assets in selected tax havens. The Cayman Islands are distinguished by an extremely large bank sector, with international assets totalling more than 700 times their GDP. By comparison, assets (national and international) equal 1.3 times GDP in Norwegian banks and 2.5 for the eurozone. The table ranks countries by the size of their international bank assets in relation to GDP. Switzerland, which is regarded as a major financial centre, lies in 17th place. Calculated by the absolute size of international bank assets, Switzerland ranks second among the countries in the table.

Table 6.2 illustrates the financial sector's significance for secrecy jurisdictions. It presents indicators for all the countries and jurisdictions which report the relevant figures to the IMF (2008). For comparative purposes, it also shows figures for the UK, the USA and Norway. The UK and the USA embrace the world's two largest financial centres, and the significance of the financial sec-

tor – particularly in Britain – is far greater than is normally the case.

The financial sector accounts for 50 per cent of GDP in Jersey. In five of the jurisdictions, it accounts for more than 17 per cent of employment. Value creation (in other words, the contribution of the industry to GDP) per employee is extremely high in a number of these countries.

Much of the financial industry in tax havens is run from abroad, and particularly from the major financial centres such as London and New York. An indication that activity in the banks registered in secrecy jurisdictions is partly run from other locations can be obtained by calculating the size of bank assets per financial-sector employee in the tax havens. This figure comes to more than USD 250 million in the Cayman Islands. Although almost 75 per cent of bank assets represent inter-bank positions, it seems entirely unreasonable to suppose that each bank employee actually manages such large positions. One must also take into account that the financial industry embraces many activities other than managing bank assets.

Chapter 7

Norfund's use of tax havens

This chapter describes and discusses Norfund's investments in funds and its choice of location for these investments. As a supplement to this discussion, the Commission has incorporated a detailed description of rules and practice in Mauritius as part of its description below of Norfund's use of tax havens. Mauritius is a tax haven with considerable activity, and is one of the jurisdictions of this kind that Norfund uses most frequently for its investment funds. Part of the presentation of Mauritius includes rules and elements of the country's practices that are not relevant for Norfund, but which nevertheless need to be presented in order to provide a complete picture of the way tax havens operate and are perceived as locations.

7.1 Norfund's investment in funds

Norfund is a state-owned institution with the following mandate:

“The object of the Norwegian Investment Fund for Developing Countries (Norfund) is to contribute equity and other risk capital, and to make loans and provide guarantees, for the development of sustainable business activity in developing countries. The aim is to create viable, profitable enterprises which would not otherwise be established because of high risk.”

It invests both directly in companies in developing countries and via funds. At 31 December 2008, Norfund had invested or committed itself to invest just over NOK 1.7 billion in fund holdings. These interests totalled almost half its total investments and commitments. In addition, Norfund has provided equity and loans to both funds and other financial institutions. The last of these financing forms also involves the use of intermediaries. The target group for this financing is non-financial companies. At 31 December 2008, Norfund's investments and undisbursed commitments totalled about NOK 4.8 billion.

Norfund has advanced a number of arguments for investing via funds rather than directly.

- The funds are managed geographically near the companies being invested in. This ensures that the investors have access to local knowledge when making investment decisions.
- Local management strengthens owner follow-up of the underlying companies in the fund compared with direct investment by Norfund from Norway. Through owner follow-up, one can contribute to better management of the business and of other areas where companies in developing countries are often weak, including HSE, standardisation/certification and so forth.
- Following up each company involves fixed costs. Were all Norfund's investments to be managed directly from Norway, it would have to concentrate on large companies to secure the profitability of its operations.
- The existence of funds can lower the threshold for investment by other investors in the relevant areas, and thereby increase the supply of capital to these areas.
- The existence of funds contributes to the development of local management clusters, and thereby to the build-up of expertise where the funds are managed.

In order to limit the cost of following up direct investments, Norfund's strategy is that such placements will only be made in selected countries and in areas where the institution has a regional office. Investing through funds can thereby also be regarded as a means of expanding Norfund's geographic range. The institution currently has three offices outside Norway, in Costa Rica, South Africa and Kenya.

Norfund has invested in 35 different funds. It has a 50 percent equity holding in three of these, while its maximum interest in the remainder is one-third. A large number of players are co-owners of the various funds in which Norfund has holdings. Almost all of these funds have at least

one other development finance institution (DFI)¹ among their owners. The exceptions are two microfunds which have only Norwegian ownership. Private commercial players participate in almost half the funds. Moreover, some of the funds include participation by private players with non-commercial objectives (Oxfam, the Shell Foundation, ethical funds and so forth).

Twenty-nine of the 35 funds are located in tax havens (Delaware in the USA is regarded as tax haven in this context). Mauritius is clearly the most popular jurisdiction, with 15 of the funds located there. Table 7.2 below lists 35 of the funds in which Norfund is involved and shows where they are registered.

Each fund is an independent legal entity. This entity can also incorporate a management organisation. In many cases, however, all management services are purchased from third parties. In both cases, management can be exercised in a different location from the one in which the fund is registered. This is the most common arrangement. The picture is complicated by the fact that management-related work can be spread over a number of offices. Typically, the fund (if it has its own management capacity) or the management company will have employees in countries in which the funds invest relatively heavily. Both the direct employment and the expertise built-up in fund management will thereby often occur in countries other than the ones in which the funds are registered.

7.2 Norfund's justification for using tax havens

Norfund has explained, in part in a written submission to the Commission (see Norfund, 2009) why the funds in which it invests are often located in tax havens. The submission argues that it is not secrecy which makes tax havens attractive locations for the funds, but the fact that these jurisdictions often offer the following:

- secure and cost-effective handling of transactions between the home countries of the inves-

tors and the companies in which the funds invest

- a good and stable legal framework specially tailored to the requirements of the financial sector
- arrangements which avoid unnecessary taxation in third countries
- political stability.

According to Norfund, the tax havens in which the funds are located often have well-developed systems for cross-border payments. Norfund notes, for example, that the funds in Mauritius in which it participates benefit from the fact that the banks they use have branch networks on the African mainland.

Norfund says that tax havens often have regulations which are well suited to investment funds. As an example, Norfund has pointed to certain funds in which it participates that would not be permitted under Norwegian rules for financial institutions and funds.

Investors do not wish to take risks unless they receive compensation in the form of higher returns. Norfund points out that the tax havens often have stronger legal traditions than other countries in the same region and that the level of corruption is often lower. Locating in a tax haven thereby reduces political risk and the danger of governments abusing their power.

With regard to the third justification, on taxation, Norfund notes that tax havens levy low or no taxes on the fund company's profit and that they also have a relatively well-developed network of tax treaties. Such agreements ensure that double taxation is avoided. According to Norfund, location in a tax haven will not reduce tax revenues in the countries in which the funds invest. The institution has moreover declared to the Commission that it is certain the funds are not being used for money laundering.

Norfund maintains that it cannot determine on its own where the funds are to be located. These always have several owners, and Norfund normally has a minority holding. In its experience, its sister organisations in other countries and corresponding funds affiliated with international organisations prefer tax havens. Norfund has also pointed out that the mandate for the African Development Bank prohibits it from investing in funds located outside Africa.

¹ These are institutions which have development effect as part of their object, and not solely commercial return. They are moreover wholly or partly owned by governments or multilateral development institutions (the IFC, for instance, is owned by the World Bank). Norfund itself is a DFI.

Table 7.1 Norfund's Investments and undisbursed commitments in the core business. End 2008 in NOK thousands.

Instrument	Investments and undisbursed commitments
Equity (direct investments)	2 595
Shares in funds	1 662
Loans (including hybrid)	541
Total	4 798

Source: Norfund

7.3 Norfund's portfolio and payment of tax

Norfund's core business is to finance commercial activity in developing countries. Table 7.1 provides an overview of the portfolio for the core business. In addition, Norfund has liquid assets as well as a portfolio of loans taken over from Norad in order to be wound up.

Generally speaking, companies pay income tax when they operate at a profit. National differences in the definition of the tax base mean that a company can have a taxable profit even if the financial statements show a loss. Companies established relatively recently will often be able to offset profits against losses carried forward from earlier years, so that they do not become immediately liable to tax. Norfund often finances relatively newly established companies or ones in a growth phase. Such companies frequently have no taxable profits.

The data submitted by Norfund to the Commission include figures on operating profit and tax paid for 14 of 19 direct investments and for 33 of the 35 funds in which the institution participates. By and large, accounts are lacking only for companies which have just been established.

Of the 14 companies with complete data, eight had an operating profit in 2008. Six of these paid tax.

Eight of the 33 funds providing complete data made an operating profit in the same year. Two paid tax – one in Luxembourg and the other in Mauritius. The latter paid withholding tax to Kenya rather than tax to Mauritius. Adding together the tax paid by companies financed directly by Norfund, funds in which Norfund participates, and companies financed by these funds, and then

weighting these payments by Norfund's equity interest in the companies, yields a tax payment of NOK 66 million. This figure is an estimate made by Norfund. The institution does not have data from all the companies on tax paid, and the estimate would be higher were complete information available. The press release on Norfund's website concerning the annual results for 2008 states: "Another important factor with regards to the development impact is the generation of tax income to national governments, a crucial factor in order to develop public services. Along with partners, companies in which Norfund had invested contributed NOK 3.2 billion in tax income in our markets."

Of the 35 funds, only six are located in places not regarded as tax havens by the Commission (one each in India and Tanzania, two in Norway and two in South Africa). All the other locations have at least some structures or regulations which suggest that they should be regarded as tax havens, but they do not necessarily function as tax havens for the funds in which Norfund participates. The table also shows that there are a number of examples of funds located in tax havens although they only have one country as their target zone. For example, of the four funds in the Cayman Islands, one is directed at China, one at Thailand and two at Vietnam, while the three funds in Mauritius are focused on Madagascar, Sri Lanka and Costa Rica respectively. Where these choices of location are concerned, the Commission fails to see the relevance of Norfund's argument that location in a tax haven contributes to avoiding unnecessary tax payments in third countries. In cases where funds invest in only one country, no third country need be involved. One could have established these funds in the country at which they are directed, and only two countries would then have been involved in the activity – Norway and the country where the funds are located. In its argument for using funds, Norfund has maintained that these are often located close to the investment country and that this gives the managers better local knowledge than if the institution had invested directly. This argument does not ring true for all the above-mentioned funds directed at single countries.

7.4 Assessment of Norfund's use of tax havens

Chapter 3 reviews typical structures in tax havens. Many countries and tax havens possess a

Table 7.2 Funds in which Norfund participates. Localisation/Place of registration and target area for investments. Norfund's share of profits and tax liable in percent of profits

Name	Place of registration	Target area	Weighted profil ¹ (NOK thousand)	Tax in percent of profits
CASEIF		Regional		
	Bahamas	Central America	-7 825	0
CASEIF II	Bahamas	Nicaragua	-4 641	0
Horizonte BiH Enterprise Fund		Bosnia and Herzegovina		
	The Netherlands		-2 358	0
CAIF	British Virgin Islands	Regional Central America		
China Environment Fund 2004	Cayman Islands	China		
SEAF Blue Waters Growth Fund	Cayman Islands	Vietnam	-5 146	0
Siam Investment Fund II	Cayman Islands	Thailand	-24 431	0
Vietnam Equity Fund	Cayman Islands	Vietnam	-30 753	0
LOCFUND		Regional Latin America		
	Delaware		462	0
SEAF Sichuan Small Investment Fund	Delaware	China	1 026	0
SEAF Trans-Balkan Fund	Delaware	Regional Balkan	-1 087	0
APIDC Biotech Fund	India	India	-4 557	0
European Financing Partners SA*	Luxembourg	Regional Africa	103	25
AfriCap Microfinance Investment C (print)	Mauritius	Regional Africa	-9 556	0
ACAF		Regional Central America		
	Mauritius		-8 314	0
African Infrastructure Fund	Mauritius	Regional Africa	-21 515	0
Aureos Africa Fund	Mauritius	Regional Africa	-28 841	0
Aureos CA Growth Fund (EMERGE)		Regional Central America		
	Mauritius		-3 449	0
Aureos East Africa Fund		Regional East Africa		
	Mauritius		16 575	5,2
Aureos South Asia Fund (Holdings)		Regional South Asia		
	Mauritius		-6 551	0
Aureos South Asia Fund 1	Mauritius	Sri Lanka	-2 121	0
Aureos South East Asia Fund		Regional South East Asia		
	Mauritius		-21 179	0
Aureos Southern Africa Fund		Regional Southern Africa		
	Mauritius		54 229	0
Aureos West Africa Fund		Regional West Africa		
	Mauritius		190 765	0
Business Partners Madagascar SME Fund	Mauritius	Madagascar	-175	0
GroFin Africa Fund	Mauritius	Regional Africa	-27 653	0
I&P Capital II	Mauritius	Madagascar	-10 150	0
The Currency Exchange (TCX) *	Nederland	Global	-454 217	0
NMI Frontier Fund	Norway	Global		
NMI Global Fund	Norway	Global		
Aureos Latin America Fund (ALAF)		Regional Latin America		
	Ontario, Canada		-4 129	0
Solidus Investment Fund S.A.		Regional Latin America		
	Panama		16 139	0
Horizon Equity Partners Fund III	South Africa	South Africa	-20 049	0
Horizon TechVentures	South Africa	South Africa	3 425	0
FEDHA Fund	Tanzania	Tanzania	-86	0

¹ Weighted with Norfund's share

* These two funds have a different profile than the others and do not invest directly in developing countries

number, but not all, of the distinctive features described in that chapter.

Put briefly, tax havens often fulfil the following. They have a dual tax system which favours foreigners through a virtually zero-tax regime, combined with secrecy and the absence of publicly accessible registries. The foreign companies which take advantage of this tax regime must not conduct local activities nor have local employees other than local representatives at senior executive and boardroom level. These local representatives with executive or director functions are often so few in number and spread over so many different companies that the latter could not be run from the tax havens if their purpose was to provide the owners with the best possible return on capital.

The Commission therefore takes the view that the use of the residency concept – in other words, that the company has its main seat and is domiciled in the tax haven – is often artificial. Such tax havens are made attractive to foreign companies and investors through the combination of affiliation in a tax sense, virtually zero tax and the benefit of tax treaties which reduce the tax burden on investments in third countries.

The tax planning aspect which the use of tax havens involves runs counter to Norfund's goal of paying full tax on its investments in Africa. The Commission also takes the view that the use of tax havens in general conflicts with the overall goals of Norway's development and assistance policy, including opposition to corruption and economic crime and contribution to economic development.

The Commission has identified the following possible detrimental effects of Norfund's use of tax havens:

1. Contributes to the loss of tax revenues by developing countries.
2. Contributes to maintaining tax havens by providing them with income and legitimacy which, in turn, contributes to lower growth in poor countries.
3. Contribute to money laundering and tax evasion.

1. Contributes to the loss of tax revenues by developing countries

A goal for Norfund is to contribute to development in the countries where the institution or the funds in which it participates invest capital. This implies that tax revenues should be secured for the host country.

One question is whether Norfund, given its goal, should focus to a greater extent on investing where the highest pre-tax return can be obtained in the developing country, and ignore opportunities for reducing overall tax on these investments through tax treaties and havens, given that reduced tax in such cases could mean a transfer of income from the relevant developing country to the owners of the investment fund – including Norfund.

Placing assets in tax havens can run counter to the goal of contributing to securing tax revenues for the host country. This is because the tax treaties between the host country and the jurisdictions where the investment funds are registered eliminate or reduce the right of the former to levy tax. This can be illustrated by Mauritius, which has tax treaties with a number of African countries. These reduce the withholding taxes which can be levied by the latter. Such treaties are agreed in part because poor countries lack capital and therefore occupy a weak negotiating position in circumstances where the tax havens can offer capital.

Tax treaties of the kind mentioned above are not unusual, but the Commission would make it clear that they are formulated on the basis of the domiciliary principle – in other words, the country given the right to tax is the one in which the taxpayer is domiciled. In cases involving legal entities that are merely registered in a jurisdiction and that cannot engage in meaningful activity there (confer GBC1 and GBC2 in Mauritius, see below), no justification exists for such tax treaties on legal, economic and fairness grounds. No justification accordingly exists for giving Mauritius the right to tax GBC1s, as the tax treaties do.

Norfund has as one of its goals that tax revenues should accrue to the countries in which it invests. However, the use of a secrecy jurisdiction as an intermediary means, for instance, that some types of capital income are not taxed anywhere. This helps to rob the source country of tax revenues, and the investors rather than the developing country obtain the benefit of the tax saved. The countries which thereby lose tax revenues are those with the greatest need for government income.

2. Contribute to maintaining tax havens by providing them with income and legitimacy

Norfund's use of tax havens helps to finance the harmful structures in these jurisdictions through the administration and registration fees it pays. It

could also be argued that Norfund, as a public Norwegian fund, contributes to legitimising tax-haven activity if it makes use of their services. Norfund thereby contributes to maintaining the harmful impact of tax havens on developing countries.

This effect would be present even if Norfund did not directly contribute, through its use of tax havens, to tax evasion or money laundering. In chapter 5 and in Appendix 1, the Commission has outlined the way in which tax havens provide a sanctuary where the power elites in developing countries can conceal assets. The fact that such hiding places exist makes it attractive for the power elite to demolish the institutions intended to prevent the plundering of community assets. By legitimising tax havens, such mechanisms will persist and thereby weaken the ability of poor countries to achieve growth.

3. Contribute to money laundering and tax evasion

Given Norfund's mandate to promote growth and development in the countries in which it invests, investment by the institution in funds must be considered unacceptable if such activities pose a significant risk of Norfund contributing to the concealment of illegal money flows or to tax evasion. Generally speaking, investment in funds registered in tax havens will present a threat of this kind because the secrecy rules make it impossible for outsiders to know who the owners are and what is taking place. However, most of the investors in the funds in which Norfund has invested are state-owned or international financial institutions and/or local pension funds required to invest in their own country. The danger that these investment funds will be used to channel illegal money flows is therefore limited. Nevertheless, private investors also participate in these projects and may have a different agenda. The Commission has noted that the EDFI, to which Norfund belongs, recommends that its members make an assessment of private co-investors to assure themselves that the funds are not being exploited for money laundering. Norfund has supported this recommendation.

The funds in which Norfund invests are normally likely to represent a very small proportion of financial activity in the relevant tax havens, and the direct investment effect for the tax haven will also be fairly insignificant. On the other hand, the signal conveyed if Norfund ceases to use tax havens could be a strong one.

7.5 Example of a tax haven – Mauritius

The Commission has wished to describe in relative detail the effects arising from the use of tax havens by Norfund and other investors. Mauritius is clearly the most popular location for funds in which Norfund participates. The Commission has accordingly chosen to look more closely at the structures in this jurisdiction in particular, and the effects of locating funds there. It has no reason to believe that the Mauritian structures are more or less harmful than would normally be the case for tax havens. The Commission's purpose has been to identify how arrangements in Mauritius function in relation to taxation and to registration of and transparency over ownership and the financial value of various types of assets and activities. The assessment looks only at those structures which are particularly suitable for capital pass-through. It must be emphasised that a number of the arrangements and structures found in Mauritius and discussed below are not necessarily relevant for Norfund as the institution operates today.

During its visit to Mauritius, the Commission held short meetings with a number of institutions and was given access to a number of annual reports prepared by these as well as to relevant legislation. The Mauritian authorities and institutions were most accommodating and open in relation to the Commission's work.

7.5.1 Company types in Mauritius

Mauritius has special regulations for companies which are going to operate solely in other states – known as “foreign companies” (non-local or non-resident). Both local and foreign companies are covered by the Companies Act – Act No 15 of 2001 – but differences exist in crucial areas of the regulation of these two company types. Foreign companies are given a number of exemptions from obligations which otherwise apply to companies with limited liability.

A foreign company can be registered as a global business company, either 1 (GBC1) or 2 (GBC2). GBCs cannot have employees in Mauritius, and their business must be conducted in foreign currencies. The differences between these two types include a larger number of exemptions for GBC2s than for GBC1s.² The funds in which Norfund invests are GBC1s. Both types enjoy a long list of exemptions which distinguish them from local companies. Providing an exhaustive list

of the various exemptions given to the two categories would be too inclusive, but examples which apply to both types are listed below:

- Exemption from using the designation "Limited" for companies with limited liability. Abbreviations used in other states can be employed, such as AS, OY, GmbH and so forth. See section 32.
- No obligation to publish any reduction in stated capital. Section 62 (2).
- A subsidiary can own shares in a holding company which owns the subsidiary. Section 83.
- Exemption from restrictions related to loans and other benefits for directors and senior executives. Section 159.
- Exemption from the requirement to have a local senior executive or director in the company who can serve as company secretary. Section 164 (1) a.
- Exemption from the duty of redemption, obligation to indemnify and so forth. Sections 178 and 179.
- Exemption from the requirement to prepare an annual report. Sections 218-222.
- Exemption from the requirement to prepare an annual return. Section 223.
- Exemption from official inspection of the company and corporate documents. Sections 225 and 228.

The following exemptions apply only to GBC2 companies:

- Exemption from paying in share capital (in cash). Section 57.
- Exemption from the requirement to use a local company secretary. Sections 163-167.
- Exemption from accounting obligations, the duty to preserve important corporate documents and the obligation to use an auditor. Sections 193-195 and 210-217. This means that a GBC1 does have an obligation to keep.
- Exemptions from a number of local registration obligations and requirements to provide documents: to use a local agent, to provide key documents (articles of association and so forth), and to submit the names of directors, changes to the articles or to the officers of the company, and possible voluntarily prepared accounts, etc, to the registrar. Section 273.

Broad opportunities are provided to move a company fairly simply into and out of Mauritius. A GBC1 has some obligation to prepare accounts. These must be compiled in accordance with the International Accounting Standards (IAS) as defined in section 2. The Commission has little information about how these accounting requirements are enforced in practice, and what real enforcement opportunities exist. It is also questionable how appropriate they are for enforcement without other provisions. Nor do the accounts have any significant local interest, since GBC1s and GBC2s are by definition unable to pursue local operations (see above) and corporation tax is insignificant. The accounts are only submitted to the Financial Services Commission, and are not accessible to the public (users of the accounts).

Few provisions in the Companies Act are accompanied by any sanctions, particularly for GBC1s and GBC2s. In those cases where a sanction exists, the maximum penalty is low and limited to fines (see sections 329, 330). The exception is cases which fall under section 332 (false statements), where the penalty is five years imprisonment.

In the event of breaches of the accounting legislation, the Commission takes the view that the secrecy rules will also pose a considerable problem. A company's contractual partners, creditors and so forth basically have no opportunity for insight into the company's operations. As a result, they will not be in a position to report violations or to demand explanations for uncertainties affecting the accounts.

The tax regulations are of particular significance. Mauritius has a dual tax regime – one for nationals and the other for foreigners. The tax regime for foreigners is substantially more favourable than the one for citizens, with lower tax rates and reduced reporting requirements. Foreigners pay no tax on capital gains, wealth, inheritance or royalties. Nor does Mauritius charge a withholding tax when foreigners transfer income from there to their country of domicile. The regulations described above mean that the type of fund in which Norfund invests in Mauritius has a fairly narrow tax base in that country.

GBC1-type companies have a nominal corporation tax rate of 15 percent, but can credit tax paid abroad against their liability in Mauritius. Even if they cannot produce documentary evidence of tax paid abroad, they receive an automatic discount for such payments which corresponds to 80 percent of the nominal tax rate. This means that the

² See the Companies Act 2001, Thirteenth Schedule (paragraph 343) Part I and Part II. Part I details exemptions for both categories, while further exemptions apply only to the GBC2.

real rate of corporation tax for such companies is three percent. Various facilitators in Mauritius advertise on the internet that exemption from Mauritian tax can be granted on application to the government. GBCs on Mauritius accordingly appear to have a zero-tax regime.

GBC1 companies can take advantage of the tax treaties Mauritius has signed with other countries. Most African countries which tax capital gains, for example, apply a rate in the 30-35 percent range. However, the tax treaties assign the right to tax capital gains to the country in which the investor (company) is domiciled. This means that, if a GBC1-type company realises capital gains in an African country (or in India³), the right to tax is assigned to the country of domicile (Mauritius) and not to the source country. The tax treaties also contribute to reducing withholding taxes on dividends. Nearly all African countries levy such withholding taxes on dividends, with the rates varying between 10 and 20 percent. The tax treaties reduce this type of tax to 0.5 or 10 percent respectively, depending on the country concerned.

Corporation tax for GBC2-type companies is zero, and no other types of taxes are levied either. Such companies cannot take advantage of the Mauritian tax treaties. They have no obligation to produce accounts and do not need to meet requirements for local representation through front persons of any kind. GBC2 companies can be established in the space of 48 hours. The sum total of all the liberal provisions applied to this type of company makes it very difficult, even after a request for access, to obtain any information. Since their investors cannot take advantage of tax treaties, but are covered by secrecy and a zero-tax regime, GBC2-type companies are very suitable hiding places for money and other types of tax evasion.

Protected cell companies (PCCs). Such companies can divide their assets and liabilities into different cells, each of which has its own name and represents a single asset (or asset class). The total number of cells thereby comprises the whole company. The most important reason for permitting such companies is that they provide very good protection against creditors and third-country governments. Moreover, Mauritius derives an income from the registration of each cell, and requests for access to information from each cell also incurs charges.

PCCs are often used by insurance companies and various types of funds (for pensions or investment, for example). They are covered by the same tax regime as GBC1 companies, and can credit tax paid abroad even if it is hypothetical. A company which invests in a tax-favoured object can, for instance, credit tax paid abroad as if the investment were made in a non-favoured object by calculating what the tax would have been for such an object. Favourable arrangements of this type mean that the tax burden in practice is probably zero for PCCs. Such companies can take advantage of Mauritian tax treaties. No open registry of PCCs exists, and they are thereby also covered by the secrecy regime.

Companies which take advantage of the tax regime for foreigners cannot operate locally, use the local currency or employ locals on any scale other than through nominees. The latter can be appointed as senior executives or directors for hundreds of companies. The Commission has explained in chapter 3 that the number of companies represented by each nominee is so large that, if they actually managed the companies in which they are employed – or participated, for that matter, in any substantial activity at company or board level – the operation of these enterprises would not have been rational in business management terms.

The lack of real activity in these companies makes the use of the domiciliary principle as the basis for the tax treaties extremely dubious.⁴ In reality, these are shell companies and funds to which Mauritius offers a location for a nominal fee to the government and for very low taxes protected through tax treaties. This is an example of a harmful structure, whereby Mauritius offers investors the opportunity to establish an additional domicile which allows the investor to exploit what amounts in practice to a virtually zero-tax regime. In reality, the source country is robbed of tax on capital income through this type of structure, while the tax-related outcome for the investor is very favourable.

The differences between GBC1 and GBC2 companies are very important in practice, and they are directed at different target groups. GBC1 is aimed at owners who want to take advantage of the tax treaties with transactions into and out of Mauritius. The requirement is that the company is regarded as resident in Mauritius and can be

³ Mauritius has tax treaties with 16 African nations and India, among others. Norfund has located funds in Mauritius aimed at Sri Lanka and Costa Rica. Mauritius has a tax treaty with the first of these, but not with the second.

⁴ It is conceivable that the front persons have outgoings in connection with managing a company, but such expenditure cannot be regarded as real activity.

considered the beneficial owner of the relevant income stream within the provisions of the tax treaty. How far these terms are fulfilled is often uncertain. That rests on the facts in each case, which cannot be established because of the secrecy rules without access to the company's accounts and other documentation.

The next question is whether the exemptions applied to GBC1 companies are of such a character that it would not be natural to conclude that the company has the necessary local connection, both under the tax rules of other countries and under the tax treaties. Particularly problematic is the concept of special arrangements and exemptions for companies which are only going to operate in other states, which can only be owned by foreigners and which cannot own real property locally. This means that those affected by the company's operations are exclusively resident in other jurisdictions, without the right to access tax documentation from the company except through a rogatory letter to the courts. It is also uncertain whether any documents of significance for the company are held locally. Taken together, this contributes to giving foreign companies a limited local connection. The Commission would point to this aspect without expressing any further view on the legal and other questions it raises.

In the Commission's view, the characteristic features of GBC1 and GBC2 companies are not significantly different from company structures in other tax havens.

7.5.2 Trusts

Trusts are regulated by the Trusts Act of 22 May 2001. Trust legislation in Mauritius differs little from the general description of trust law in tax havens provided in chapter 3. The misuse of trusts to conceal that it is, in reality, the beneficiary rather than the trustee(s) – as required by the law – who controls the trust can be difficult to detect. In any event, it is impossible to identify underlying realities if the existence of the trust is unknown to the outside world, and secrecy rules hinder access to information by those who need it. Trusts pay no form of tax in Mauritius, and no obligation exists to register them in any open registry.

7.5.3 Measures against money laundering

The Registrar of Companies has a duty to report to the Financial Services Commission if reasonable grounds exist for believing that the legal re-

quirements of the Companies Act 2001 are not being observed, or if a company is being used as an instrument for illegal trade in narcotics or arms, economic crime or money laundering. This reporting duty also applies if the registrar discovers that an agent of a company is not discharging his or her responsibilities as an administrator of the GBC in a satisfactory manner (see Companies Act 2001, section 345, Part I no 2).

Since GBC2 companies, in particular, do not have obligations to produce accounts or retain documents and so forth, abuse is very unlikely to be detected – particularly when both GBC1 and GBC2 companies are also exempted from inspection under sections 225 and 228.

Companies based in tax havens which have a GBC2 structure could be well suited for laundering funds which relate exclusively to other states and citizens in other states. The 2007 annual report from the Financial Intelligence Unit (FIU) states that about 120 suspicious transaction reports (STRs) were filed in that year. Of these, just under 100 came from banks and a little less than 20 from offshore management companies. The great majority of the reports related to local companies. These are very low figures regardless of the method of assessment. The number of reports must be viewed in relation, for instance, to the fact that assets placed from Mauritius in other countries total more than USD 184 billion. The great bulk of this has passed through from other countries. Viewed in relation to this activity, the number of STRs is low (see box 8.2 on money laundering).

7.5.4 Access to information through rogatory letter

Rogatory letters are handled by the Office of the Solicitor General, which seems to follow up such requests in an acceptable manner. At the moment, the process can take three years if available legal barriers to accessing information are utilised. The goal is said to be to reduce the time taken by the procedure to one year.

7.5.5 Mauritius – principal features of capital movements

According to the figures presented in section 6.2.3, Mauritius does not have especially large direct investments or a particularly big proportion of its labour force employed in the financial sector. The financial sector's share of GDP is unusually

high, to be sure, but figures for this industry in the national accounts must always be treated with caution because of major methodological problems.

Statistics for the balance of payments from the Bank of Mauritius show that its international assets totalled MUR 359 billion as of 31 December 2007, while its liabilities were MUR 291 billion. These figures include direct investments to and from Mauritius, and represent 164 and 133 percent of GDP respectively. The assets and liabilities cannot be described as extraordinarily large in relation to the size of the economy.

The IMF conducts an annual coordinated portfolio investment survey (CPIS) covering a number of countries broken down by debtor nation. Mauritius participated in 2007 along with 76 other countries and jurisdictions. Important countries which did not participate were China and Saudi Arabia. All the other largest economies and international financial centres took part, including the tax havens. According to this survey, portfolio investments in Mauritius as of 31 December 2007 totalled USD 155 billion. This is far above the figure from the Bank of Mauritius, which was just over USD 13 billion at the exchange rate prevailing at 31 December 2007. The difference can probably be explained by the fact that the central bank's figures do not embrace all the assets in the GBC1 and GBC2 companies mentioned above.

Since GBC1 companies placing assets abroad must use a bank in Mauritius as an intermediary, its assets will be included in the figures for the bank's assets. This does not apply for a GBC2 company, and the assets of such companies are accordingly excluded from the central bank's statistics.

In its annual report for fiscal 2006-2007, the Bank of Mauritius refers to the CPIS for 2005. The bank notes that the percentage of response from non-banks and GBCs to the data-gathering process has improved. This explains part of the strong growth in the overall portfolio and the fact that the percentage of the portfolio held by GBCs rose from 98.1 percent in 2004 to 98.5 percent in 2005.

The CPIS otherwise shows that Mauritius has a clear majority of its activities directed at Asia. Almost 72 percent of the Mauritian portfolio is placed in India. Singapore, Hong Kong and China, and South Africa occupy the next places (with two-six percent respectively) in the list of the largest investment recipients.

The IMF also presents estimates for capital *inflows* to different nations and jurisdictions, bro-

ken down by country. This division is based on registrations in the creditor country. It is striking that Mauritius has total identifiable claims of only USD 6 billion. Since the central bank has reported that more than 98 percent of the portfolio is linked to GBCs, the ownership of this portfolio should either have emerged in the CPIS (assuming that the portfolio was financed by loans) or in the stock of inward direct investments to Mauritius. However, this is not the case. According to UNCTAD, the stock of direct investments to Mauritius was about USD 1.3 billion as of 31 December 2007. It is thereby unclear how the extensive assets placed from Mauritius are financed.

According to UNCTAD, direct investments made from Mauritius in other countries totalled USD 0.3 billion as of 31 December 2007. However, India's balance of payments showed that the flow of direct investment from Mauritius to India amounted to just over USD 11 billion during 2007 alone.⁵ The Indian data show that net direct investment from Mauritius totalled USD 29 billion in the 1991-2007 period. This figure accords poorly with the UNCTAD statistics for direct Mauritian investment. The explanation could be that UNCTAD's figures do not include investment by the GBCs, and that the great bulk of investment from Mauritius to India is pure pass-through from third countries. Mauritian regulations prohibit round-tripping with India (Indian assets placed in Mauritius and then returned to India).

The methods used for the CPIS and direct investment statistics mean that no overlap should exist between the two statistics with regard to which positions and assets they include. One may thus add the Indian figure for direct investment from Mauritius to the overall Mauritian portfolio of investments as recorded in CPIS, making the total portfolio USD 184 billion. In addition, there are direct investments in other countries, but we have no figures for these.

Statistics from Mauritius provide no data concerning the return on investment by the GBCs. If these are assumed to yield an annual return of 10 percent, the figure should be USD 18 billion in 2007-08. The Mauritian GDP for 2007 was just under USD 7 billion.

The data presented here show that the role played by Mauritius as a pass-through country for capital is very extensive, particularly by comparison to the size of its economy. The tax regulations

⁵ See the website for the department of industrial policy and promotion, Ministry of Commerce and Industry.

in Mauritius mean that this pass-through generates little tax revenue for the country. Data presented in section 6.2.4 indicate that this activity contributes to a relatively extensive financial sector, but the Mauritian economy is primarily based

on other activities. It is striking that the bulk of the financing of the pass-through business in Mauritius does not appear to be recorded in the statistics of other countries.

Chapter 8

International work on tax havens

8.1 Introduction

A number of international organisations work on issues related to the harmful effects of tax havens and similar damaging structures in other countries. None of these organisations have a mandate directed specifically at tax havens, which is one of the reasons why they view such jurisdictions from different perspectives. International collaboration in this area is aimed primarily at money laundering and at establishing tax treaties that include the right to obtain information from other states on specific tax matters.

From the perspective of developing countries, the Commission takes the view that work at the international level suffers from the following fundamental weaknesses:

- Developing countries are excluded from a number of the initiatives. For example, the work of the OECD and FATF.
- None of the initiatives are suited to overcoming the principal problems related to illicit financial flows – the lack of registration, automatic exchange of information on ownership, and insight into transfer pricing within companies.
- Full participation in the various fora and initiatives often calls for a level of expertise and

Box 8.1 Tax treaties and efforts to combat tax evasion

Norway, and many other countries, have recently entered into treaties on double taxation or on information exchange with tax havens. Whether such treaties make a substantial contribution to the fight against tax evasion is a contentious issue. In any event, opportunities for concealing the true ownership of companies, trusts and similar entities undoubtedly continue to exist, which makes it difficult to expose tax evasion. The value of information exchange pursuant to the tax treaties is, accordingly, controversial, and securing appropriate data under such agreements in all relevant cases raises a number of problems. This can be illustrated by the following examples:

A number of jurisdictions refuse to release data about matters that relate “only” to tax evasion and not to fraud (falsification of documents).

Many jurisdictions only provide access to very limited data, and only if strong grounds exist for specific and well-documented suspicions related to the relevant data. Adequate documentation of suspicions can be very difficult to obtain.

Information will be of limited value if the owner of the assets is a company in another jurisdiction which practices secrecy.

The authorities will in many cases lack access to relevant information from financial institutions and providers of money transfer services.

It can take considerable time in many jurisdictions to secure access to information, and, in the meantime, the owners of the assets about which information is sought can transfer the assets without leaving records or historical documents which provide a basis for legal action.

Many jurisdictions do not make it obligatory to hold data about the real owner of any form of asset.

These weaknesses mean that great opportunities exist for concealing taxable income from the authorities in home countries by using the structures offered by tax havens. This also applies to many jurisdictions which have entered into tax treaties or agreements on tax-related information exchange.

capacity which many developing countries do not possess.

The declaration from the G20 meeting in April 2009 stated that proposals will be developed by the end of 2009 “to make it easier for developing countries to secure the benefits of a new cooperative tax environment”. While it is important *per se* that account was taken of the requirements that developing country have in this area, practical action to ensure that the goal of information access is met has yet to be seen.

Moreover, work at the international level depends on the voluntary participation of tax havens. By and large, the only pressure from other countries has involved categorising and criticising the tax havens. Such pressure has yielded certain results, including the establishment of rules and systems by the tax havens to regulate financial stability and money laundering and the establishment of treaties which provide for access to tax-related information. Additionally, some jurisdictions have chosen to levy taxes or to provide other countries with information through the work on the EU’s savings directive.

Nevertheless, this does nothing to alter the basic harmful structures in tax havens: the lack of registries where governments and beneficial owners can identify the owners of different forms of assets, and the lack of corporate accounting records which can be automatically accessed by the tax authorities of other countries. One can hardly claim that the progress achieved thus far has made it significantly more difficult to use tax havens to conceal funds or evade tax than has been the case in the past.

8.2 The IMF

The goal of the IMF is to promote monetary and financial stability through, in part, international cooperation. This has been the starting point for the organisation’s work in relation to tax havens.

The IMF uses the term “offshore financial centres” (OFCs). Its current work related to OFCs is primarily a continuation of a programme launched in 2000. At that time, the IMF’s executive board resolved that the organisation would invite the OFCs to an individual assessment of their rules and systems for financial regulation and stability, and for reporting statistics. This initiative was named the Offshore Financial Centre Assessment Programme. All 42 jurisdictions invited to

participate accepted. Seventeen were not members of the IMF. A 2001 note to the IMF’s executive board¹ stated that the programme had contributed to many of the jurisdictions launching extensive work to upgrade their rules and systems since they had been invited to join the programme. These were the rules and systems which would be assessed later in the programme. Measures against money laundering were also included in the assessment in 2003. The assessment of systems in the jurisdictions was based on international standards developed by BIS² (banking inspection), IOSCO (securities trading), the IAIS (insurance regulation) and FATF (money laundering and financing of terrorism).

The OFC programme was incorporated in 2008 into the Financial Sector Assessment Programme (FSAP), which involves all IMF member countries. In that sense, it can be said that the IMF no longer has a programme directed specifically at tax havens. However, many OFCs are not members of the IMF, and it is unusual for the organisation to have programmes which includes non-members. Evaluations of the countries’ regulatory systems, measures to counter money laundering, etc., will continue to be made through the FSAP.

The IMF recently established the AML/CFT Trust Fund as a project to combat money laundering and the financing of terrorism, which includes reform efforts, training, support for implementation and research.

8.3 The World Bank

The World Bank has no special programme for combating the negative effects of tax havens.

However, it is pursuing the FSAP in partnership with the IMF. This programme is directed at all member countries plus OFCs.

The World Bank conducts the StAR initiative³ together with the UNODC. See section 8.7 below.

Through the World Bank, Norway finances a research programme which will produce 15-20 special studies on various aspects of illicit financial flight flows.

¹ Confer <http://www.imf.org/external/np/mae/oshore/2001/eng/062901.htm>

² BIS stands for the Bank for International Settlements, IOSCO for the International Organisation of Securities Commissions, IAIS for the International Association of Insurance Supervisors and FATF for the Financial Action Task Force.

³ StAR stands for stolen asset recovery.

8.4 The Financial Action Task Force (FATF)

FATF is an international organisation that was established by the G7 countries in 1989 to advise on policies for combating money laundering. It has produced the “40+9” recommendations for such action, which have become an international standard in the area. The recommendations have been revised over time. Nine related to financing terrorism were added to the original 40 in 2001. Thirty-two countries and two organisations (the European Commission and the Gulf Cooperation Council) are members. In addition, two countries have observer status.

As the name indicates, FATF is not intended to be a permanent organisation. Its present mandate expires in 2012.

FATF evaluates the implementation of its recommendations through its members. Reports from these assessments are publicly available providing the country concerned does not object. No country has fulfilled all 40+9 recommendations.

An initiative was launched by FATF in 1998 to identify countries which represented problem areas in the fight against money laundering. During 2000-01, 23 countries and jurisdictions were defined as “non-cooperative”. These countries were notified that certain measures would be taken against those which did not begin to cooperate by taking specified actions against money laundering. The proposed punitive measures involved intensified monitoring and reporting of transactions related to countries that continued to be non-cooperative. The countries categorised as non-cooperative have all strengthened their efforts against money laundering, and the last of them was removed from the list in 2006.

A particular problem is that FATF – because of opposition from tax havens and others – does not regard tax evasion as an illicit act which could form the basis for criminal charges of money laundering.

In its declaration after the London meeting in April 2009, the G20 stated that FATF should revise and strengthen its process for evaluating implementation of the recommendations by the jurisdictions, and report back to the G20 whether each country accepts and is implementing the recommendations.

8.5 The Financial Stability Forum (FSF)

The FSF was established by the G7 countries in 1999 to strengthen financial stability through international collaboration on information exchange and the regulation of financial markets. Australia, Hong Kong, the Netherlands, Singapore and Switzerland are also members. FSF meetings are attended by the finance ministries, central banks and regulators in the member countries. In addition, a number of international institutions and organisations working on financial stability participate.

The FSF uses the same OFC term as the IMF. Its attention has focused on weak information exchange and regulatory functions in the OFCs. In this context, the FSF has concentrated largely on work performed by the OECD, the IMF and IOSCO. At its meeting of September 2007, the FSF described the status of international collaboration related to OFCs and financial stability. It noted that big strides had been made, but that problems related to information exchange remained.

A meeting was held by the FSF in November 2008 on the international financial crisis. The declaration from this meeting emphasized the lack of transparency in the markets as one cause of the crisis, and an increase in transparency as a countermeasure. In that context, the declaration also contained formulations which can be interpreted as a demand that the tax havens must become more transparent.⁴ The declaration from the G20 meeting in London during April 2009 stated that the FSF is to be replaced by a new institution, the FSB (see section 8.9).

8.6 The OECD

The OECD has worked since 1996 to improve transparency in tax havens and to prevent harmful tax practices. It published a report in 1998 entitled *Harmful Tax Competition: an Emerging Global Issue*. This defined the problem and what was regarded as harmful tax competition. The *Towards*

⁴ “Promoting integrity in financial markets: We commit to protect the integrity of the world’s financial markets by bolstering investor and consumer protection, avoiding conflicts of interest, preventing illegal market manipulation, fraudulent activities and abuse, and protecting against illicit finance risks arising from non-cooperative jurisdictions. We will also promote information sharing, including with respect to jurisdictions that have yet to commit to international standards with respect to bank secrecy and transparency.”

Box 8.2 Efforts to combat money laundering – participation by tax havens

International collaboration against money laundering is pursued through a number of different bodies, including FATF, the IMF and The Egmont Group. A number of tax havens participate in some or all of these fora. In many cases, they have also implemented recommendations from FATF and others on regulations and systems to combat money laundering. The Commission takes the view that tax havens nevertheless represent one of the principle obstacles to combating money laundering.

When criminals receive the proceeds of a crime, they will eventually want to use this money for consumption or investment. Perhaps the most crucial stage in the fight against money laundering is the first persons to receive such funds, either as payment for a product, a service or a capital object, or in the form of a management assignment on behalf of the owners. One of the key elements in fighting money laundering is an obligation to report suspicious transactions. This obligation rests in most countries on bank staff as well as on employees in the rest of the financial industry and in a number of other sectors.

In practice, reporting a transaction which proves to involve money laundering means that the reporter loses a customer. Ignoring the reporter's moral views, the choice between reporting or not will depend on balancing the risk of being caught for failing to report and the penalties that follow against the cost of losing the customer and other possible customers involved in money laundering. If one has systems well suited for concealing funds, they will attract money laundering. At the same time, such systems will often also make it difficult for the country's own authorities to expose the money laundering and any breaches of the reporting obligation. The business people who manage such systems have, of course, weak economic incentives to report suspicious transactions.

Data on the number of reports concerning suspicious transactions submitted to the rele-

vant authorities have been published in a number of jurisdictions. The number of these reports correlates to the number of inhabitants, but it should also reflect whether the country is a financial centre which manages substantial funds from abroad. In addition, it seems reasonable to assume that general attitudes towards and the quality of law enforcement should be significant in respect of the number of reports.

The figure below shows the number of reports per USD 1 billion in assets under management in the banking system. Such assets are intended to provide an indicator of the scale of financing activity registered in the jurisdiction. It might perhaps have been more appropriate to compare the number of reports with the number of customers and include the whole financial sector (including trusts and the like), but such data are not available.

The figure shows very substantial differences in reporting frequency between the various jurisdictions. There is a tendency for this frequency to be low in tax havens. Of the jurisdictions in the figure, the Commission regards the Cayman Islands, Switzerland, the Bahamas, Malta, Liechtenstein, Jersey, Guernsey, Mauritius, Bermuda and Panama as secrecy jurisdictions. The first eight of these have the lowest reporting frequency. Bermuda and Panama have reporting frequencies on a par with or higher than some of the open jurisdictions (India and Norway). A number of tax havens have fairly extensive inward direct investment, international insurance business, and/or trusts and the like (see chapter 6). Had it been possible to take the size of the whole financial industry into account, the differences between the secrecy and open jurisdictions would probably have been even more striking.

Jurisdictions included in the figure have been selected from the participants in the Egmont Group, which is the international organisation for national institutions responsible for efforts to combat money laundering.

Box 8.2 (cont.)

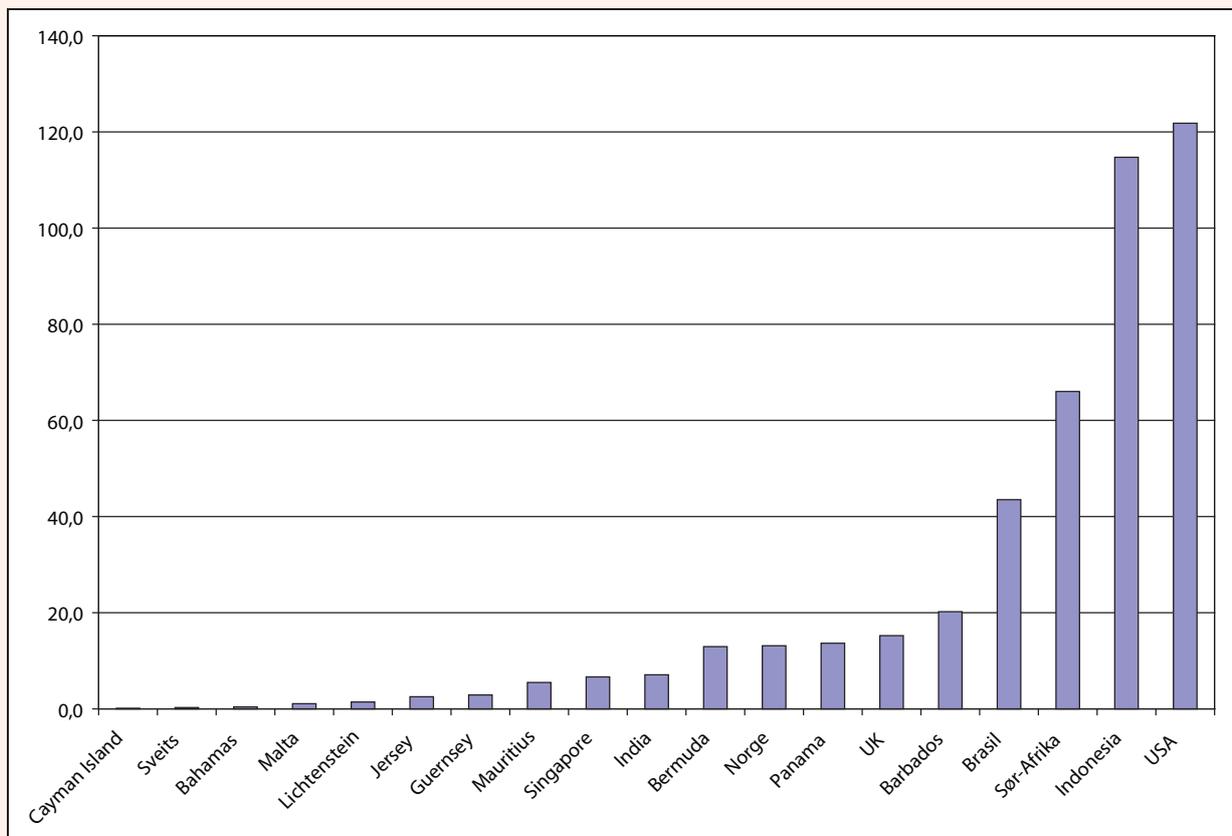


Figure 8.1 Number of "Suspicious transaction reports" sent to the authorities per USD 1 billion of bank assets in the economy. Most recent year for selected countries and jurisdictions.

The great majority of the reports on suspicious transactions are shelved without investigation. Only a small number lead to charges and a court judgement. Numerous tax havens conduct exceptionally many international transactions relative to the size of their populations and economies. In a number of instances, it is virtually inconceivable that these jurisdictions have the capacity to control money laundering, and not least to pursue cases through investigation and trial. No systematic studies are available which compare the number of cases related to money laundering which are investigated and brought before the courts in different countries. Where data do exist, they suggest that the tax havens conduct little investigation hold few trials regarding such cases. The National Audit Office (2007) report shows that only two judgements

were delivered with regard to money laundering during 2006 in the British Overseas Territories. Both were in the Cayman Islands. No judgements were recorded for money laundering in the other territories (Bermuda, the Virgin Islands, Gibraltar, the Turks and Caicos Islands, Anguilla and Montserrat), but four cases were awaiting trial. Almost 800 reports in all were submitted on suspicious transactions. A number of the jurisdictions have been criticised by the IMF and FATF for poor capacity to deal with economic crime, but these jurisdictions have a total of 57 employees working in this area. Viewed in relation to that, two judgements might seem to be a low number. However, investigators working on economic crime are not only concerned with money laundering.

Global Tax Cooperation report in 2000 included a longer list of possibly harmful tax regulations in member countries, as well as a list of 35 jurisdictions characterised as tax havens. A number of tax rules in certain OECD member countries were amended after the report appeared. Moreover, a number of countries that were characterised and listed as tax havens made changes that resulted in their removal from the list.

This list shortened rapidly in subsequent years. However, this reduction is unlikely to have solely reflected changes to national regulations. It was also a consequence of reduced support for this work in the OECD following the US election in 2000.⁵

The 2000 list has not been updated and is no longer used by the OECD. A list of non-cooperative jurisdictions existed for a time, but jurisdictions which showed a willingness to enter into agreements on tax-related information exchange were regarded as cooperative. None of the jurisdictions are now regarded as non-cooperative. In connection with the G20 meeting in April 2009, the OECD drew up a list which categorised countries and jurisdictions on the basis of their progress in implementing international tax standards. The principal criterion for this categorisation was whether the country had actually concluded agreements on tax-related information exchange or declared its willingness to enter into such agreements. Four of the countries (Costa Rica, Malaysia, the Philippines and Uruguay) had not declared their willingness to do so, but quickly reversed their positions. By the end of April, the OECD declared that all the countries initially on the list had now expressed their willingness to conclude such agreements.

In 1998, the OECD identified a number of potentially harmful tax rules in member countries. However, after closer investigation, a number of these were declared to be not harmful. Other countries changed their rules. Only one rule relating to the taxation of holding companies in Luxembourg was characterised as harmful by the OECD in 2006. The European Commission had also concluded that this rule involved illegal state aid. Luxembourg decided to amend the rule in 2007.

⁵ Sharman, J. C. (2005): *Havens in a Storm – the Struggle for Global Tax Regulation* includes an analysis of the OECD's work in this area. The author indicates that the organisation's decision-making structure makes it poorly suited to acting as an arena for exerting strong pressure on member countries.

The OECD plays a central roll in the effort to establish tax treaties (partly in order to avoid double taxation) and agreements on exchanging information relevant to the tax authorities. Recommendations from the OECD on the formulation of agreements in this area have been used as models for treaties and agreements not only between members of the organisation, but also between non-member states. Furthermore, OECD collaboration with the UN means that its recommendations have also strongly influenced the UN's recommendations, and thereby agreements between countries outside the OECD. The tax treaties are intended to contribute to correct taxation. This means avoiding both double taxation and tax evasion. The treaties contain provisions on the way the tax base should be delineated between countries and on the exchange of information intended to help ensure that countries can achieve an overview both of taxable income and assets held in other countries and of tax paid in other countries.

The OECD has also formulated standard agreements particularly on information exchange. In addition, it has carried out extensive work related to tax evasion through the use of manipulated transfer pricing. Outcomes of these efforts include recommended formulations for prohibiting the manipulation of transfer prices as well as measures against such forms of tax evasion.

Relatively few treaties on double taxation have been signed between a tax haven and a developing country. Viewed in relation to the Commission's mandate, the failure to secure access to data for developing countries represents a weakness of these agreements.

8.7 The UN

The UN has no programmes that focus specifically on tax havens or their misuse, but does have programmes aimed at various forms of economic crime and at strengthening tax administration and cooperation on tax matters.

The UN operates the International Money Laundering Information Network (IMOLIN) to support collaboration in this area. Its Office on Drugs and Crime (UNODC) works primarily to combat international crime, including terrorism.

In cooperation with the World Bank, the UN runs the StAR initiative to identify and recover funds acquired through large-scale corruption in developing countries. Norway provides financial support for the StAR initiative.

Box 8.3 The case against the Abacha family¹

The Abacha affair is an example of extreme greed. Compared with other major corruption cases, it must be considered a success with regard to the repatriation of funds. Sani Abacha was the de facto head of state in Nigeria during 1993-98. After his death in 1998, the Nigerian police discovered that he had misappropriated at least USD 2 billion from the country's currency reserves. Transfers to other countries had been made in cooperation with Nigerian and foreign companies. The transfers identified by the police included USD 80 million to Swiss banks. On behalf of the Nigerian authorities, charges were brought in 1999 and a claim submitted for sequestration of the Abacha family's assets in Switzerland. In addition, assistance was requested from the Swiss authorities. Both claim and request were accepted by Switzerland. However, it eventually transpired that the relevant Swiss accounts had been closed and the money transferred to other jurisdictions, including Luxembourg, Liechtenstein, the UK and Jersey.

The lawyers conducting the case for the Nigerian authorities in Switzerland have maintained that, if Nigeria had simply requested assistance in the investigation from the Swiss authorities rather than pressing charges, it would have taken several years before the country was in a position to demand the sequestration of the assets and that no assets would have remained in Switzerland. Nigeria would then have had to continue following the evidence, with new rounds of requests, transfers of funds and so forth.

Thanks to the approach adopted and effective collaboration with the Swiss authorities, assets valued at USD 700 million were frozen in Swiss banks. Swiss investigators also discovered materials which indicated that assets corresponding to USD 1.3 billion had been transferred to Luxembourg, Liechtenstein, the UK and Jersey.

Local investigations were rapidly set in motion in Liechtenstein and Jersey, and assets in addition to those identified by the Swiss investigators and covered by the Nigerian request for legal assistance were identified and frozen. The authorities in Luxembourg did not launch an investigation, and only the assets named in the request from Nigeria were frozen.

Switzerland was initially reluctant to begin legal proceedings against Abacha's family, on the grounds that the legal hearing should take place in Nigeria. Because the Nigerian trial was so protracted, however, the Swiss reversed their position and initiated legal proceedings which led to the gradual return of

USD 500 million to Nigeria. Because of a number of appeals from the Abacha family, the trial in Nigeria has yet to take place.

A number of intermediaries were identified during the investigation of the Abacha family. These individuals have not been charged.

Liechtenstein was unable to bring a case to trial without the accused being present. Abacha's son has refused to appear in court, which has created legal problems related to the repatriation of the assets. They are likely to be repatriated in the near future.

Britain proved to be the most difficult place to secure the repatriation of assets. The investigation was lengthy, and evidence was first sent to Nigeria only four years after the investigation began. In the meantime, assets were moved out of the country.

Abacha's right-hand man, Abubakaren Bugudu, was charged by the authorities in Jersey. The case ended in an out-of-court settlement which allowed Bugudu to retain USD 40 million in exchange for returning USD 140 million.

The Abacha family had transferred part of the assets to other well-known tax havens, such as the Virgin Islands and the Isle of Man, in the name of various front persons. Tim Daniel, who was Nigeria's lawyer in the UK, has declared that it would have been virtually impossible – on the basis of the material found in Britain – to prove that these assets were actually owned by the Abacha family. However, the material originally identified in Switzerland proved sufficient to secure the return of the assets to Nigeria.

The Abacha case is probably the most successful in terms of securing the return of assets misappropriated by leading politicians. Up to USD 3 billion could be repatriated. The key to this success was the vigour and efficiency of the Swiss authorities, and an element of luck in that a good deal of revealing information proved to be available in Switzerland. Without the original swift investigation and general freezing of assets which took place in and from Switzerland, a much smaller proportion of the assets would have been identified and eventually returned. On the other hand, it is surprising that so little constructive action was taken by the UK in this affair. The same can be said of Luxembourg. It is also surprising that not a single money laundering report appears to have been submitted by any of the actors involved, and that none of them has been charged with complicity in money laundering.

¹ This presentation is largely based on an unpublished paper by British lawyer Tim Daniel.

The UN has developed and negotiated a convention against corruption, which was adopted in 2003 and came into force in 2005.

Furthermore, the UN has developed a model tax treaty intended to be suitable for developing countries. This model has much in common with, and is tailored to, the OECD model for such treaties. The Committee of Experts on International Cooperation in Tax Matters is mandated to provide advice on tax treaties (see the point above), strengthen international cooperation on tax, and advise on international efforts to promote the interests of developing countries on tax matters. The committee is also working on alternative standards for transfer pricing, without so far having arrived at a better system than today's arms-length principle⁶ which can command sufficient support.

8.8 The EU

Cooperation within the EU provides a number of points where the work touches on tax havens. These include collaboration on fighting crime. Moreover, the EU places great emphasis on strengthening competition by ensuring a level playing field for all players offering the same product or service.

The EU has adopted a savings directive.⁷ This specifies that countries and other jurisdictions in the European Economic Area (EEA) must automatically exchange data on interest income received by individuals. The goal is primarily to reduce tax evasion, but the directive also contributes to reducing differences in competitive terms between institutions offering savings products. Each country will be able to receive data on the income of its own taxpayers. Unlike the provisions of normal tax treaties, the exchange of information under the directive is automatic – in other words, it does not require a specific request from the country where the taxpayer concerned is domiciled.

Several countries have refused to implement the duty to provide information pursuant to the savings directive. Foreign recipients of interest

payments in these jurisdictions face the choice of paying a modest withholding tax or allowing data about their interest income to be sent to the tax authorities in their country of domicile. The following countries have adopted this approach:

- Austria
- Belgium
- Luxembourg.

Similar rules also apply in the following jurisdictions outside the EU:

- Guernsey
- Jersey
- Isle of Man.

Receipts from the withholding tax are divided between the country collecting it and the taxpayer's country of domicile.

The EU has also reached agreement with a number of countries and jurisdictions on similar information exchange or withholding tax arrangements. Switzerland, Liechtenstein, Andorra and a number of Caribbean tax havens are among the countries covered by such agreements.

The savings directive covers deposits in and interest income from interest-bearing securities. Interest income earned by trusts and the like, as well as capital income earned in investment funds, are among the many exceptions from the fundamental rule that interest income must be reported.

The savings directive applies only to interest income earned by individuals. Capital income from sources other than interest are excluded. So are interest payments to companies, trusts and a number of other legal entities. This means that a taxpayer with assets concealed in a country with an automatic reporting obligation pursuant to the savings directive could avoid such reporting by taking such steps as:

- transferring interest-bearing assets to a jurisdiction not covered by the directive
- establishing a legal entity (company, trust, etc.,) to own the interest-bearing assets.

The European Commission has reviewed the savings directive (see European Commission, 2008) and concluded, in part, that it cannot be demonstrated that the directive has led to changes in the pattern of savings. However, amendments to the directive have been proposed to reduce opportunities for avoiding its provisions.

The amounts received in income from jurisdictions which have opted to offer depositors the opportunity to pay withholding tax rather than being

⁶ This principle means that each company must treat its corporate entities as if they were external trading partners. Checking that this actually happens is extremely complicated, and transfer pricing is likely to be used extensively to transfer income and profits to tax havens and low-tax jurisdictions.

⁷ Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments.

reported to the authorities in their country of domicile seem modest compared with estimates of deposits and other assets in these jurisdictions.⁸

The European Commission has called for reporting under the savings directive to be extended to other forms of placement (trusts and the like) as well as to financial income other than pure interest payments.

The EU formulated a code of conduct in 1997 for constructing tax regimes. Furthermore, the European Commission investigated the tax systems of member companies and identified breaches of the norm. These largely concerned tax rules which primarily had their effect in other states. The member countries were given a transitional period until 2006 to eliminate departures from the norm, but some exceptions were granted with longer transitional periods.

8.9 The G20

The G20 is a forum for discussing issues of international economic policy. Participants are governments and central banks from the world's largest economies, plus the EU, the IMF and the World Bank. It was established in 1999.

At the G20 meeting in London during April 2009, issues related to tax havens and OFCs were raised. The declaration from the meeting noted that such jurisdictions create problems for both financial stability and government finances.

The G20 meeting yielded little that was specific to combating the harmful effects of tax havens. Much of the media coverage focused on a list compiled by the OECD of various jurisdictions and their willingness to be open on international tax matters. This list was largely based on whether the jurisdictions in question had concluded agreements on tax-related information exchange. The declaration states in part that sanctions could be imposed on countries which fail to comply with international standards for transparency over tax matters. "International standards" probably mean the recommended UN and OECD agreements on information exchange in tax treaties. The Commission has pointed out in chapters 1 and 9 that such agreements on access to tax-relevant infor-

mation do not affect the harmful structures in tax havens.

The appendix to the declaration states that developing countries will share the benefits offered by greater access to information. Proposals on how this is to be achieved are due to be presented during 2009.

The G20 simultaneously appointed the Financial Stability Board (FSB) to serve as an important forum for developing a common policy on tax matters, transparency and financial stability. The FSB will be an expansion of the FSF (see section 8.5). The appendix also emphasises evaluations of compliance by different countries with international standards. Assessments by both the IMF and FATF are mentioned in this context.

8.10 Other organisations, collaborations and initiatives

A number of other international initiatives organisations are working in various arenas on topics relevant both to combating crime and to taxation.

Germany has taken the initiative on the International Tax Compact. The Tax Compact aims to establish a common platform among like-minded countries towards international tax issues that are relevant to developing countries. A stronger effort to deal with tax havens forms part of the initiative. It also includes strengthening tax administration in developing countries through assistance and sharing best practices.

A G8 meeting took place in Germany during February 2009. In this context, German chancellor Angela Merkel and the heads of the OECD, the ILO, the IMF and the World Bank issued a joint press release which stated that they wanted basic principles for a cleaner world economy.⁹ This work has so far produced a catalogue of existing international agreements in the area.

A forum called the International Tax Dialogue has been established, with the OECD, the World Bank and the IMF among its participants. The goal is to exchange views, transfer knowledge and strengthen collaboration between these institutions and between states. The forum is purely technical and takes no decisions which are binding on the participating institutions.

⁸ Confer the article in the Financial Times of 7 July 2006 at <http://www.ft.com/cms/s/2/ae51ab84-0d9f-11db-a385-0000779e2340.html>.

⁹ The G8 is a forum for seven of the largest wealthy countries plus Russia and the European Commission. It brings together heads of government and finance ministers to discuss various issues in international politics.

Greater attention has been focused in recent years on corruption in connection with the exploitation of non-renewable natural resources, particularly petroleum. The transparency of money flows between companies and governments was identified as a problem, and formed the background for establishing the Extractive Industries Transparency Initiative (EITI). This includes standards for openness over money flows related to the exploitation of natural resources, and procedures for evaluating whether these standards are observed by those states which have declared that they will comply with this norm.

The Kimberley process is a forum for states, the mining industry and non-governmental organisations which aims to prevent the use of diamond mining to finance armed conflict. Its instruments include a form of certification for diamonds by their place of origin to prevent sales from areas controlled by groups using violence against legitimate regimes.

Many voluntary organisations contribute to focusing attention on conditions related to developing countries and illicit financial flows. Many of these bodies see raising awareness of such issues as their principal task. Global Witness, Transparency International, Global Financial Integrity and

the Tax Justice Network can be mentioned as particularly important organisations in this area.

A number of initiatives in the US could lead to American citizens and companies making less use of tax havens than before. These include a set of proposals from President Obama which will limit opportunities for US companies to make legal use of tax protection through tax havens. These opportunities have been broader under the American tax system than in the Norwegian, for example. In addition, the proposals embrace measures to ensure that a bank wishing to operate in the US submits reports to the US tax authorities about accounts which it holds for American citizens. In addition, there are several proposals from members of Congress. One of these, the Stop Tax Havens Abuse Act, includes provisions to permit the US to adopt sanctions against jurisdictions with regimes which make it unreasonably difficult for the US to enforce its tax regulations. These measures will not have a direct impact on third countries, but could have substantial indirect effects both by making it less attractive to maintain harmful structures like those found in tax havens and by strengthening the arguments for adopting similar measures in other countries.

Chapter 9

Recommendations of the Commission

Tax havens make it more expensive for developing countries to collect taxes, lead to inefficient use of resources, undermine the workings of the tax system and make it possible for power elites to enrich themselves at the expense of the community. The most important damaging effect is perhaps that tax havens help to give power elites incentives to weaken public institutions, institutional quality and governance in their own country. Economic research has shown that institutional quality in the broad sense is an extremely important factor for economic growth. The negative impact of tax havens on a country's institutions accordingly contributes to ensuring that growth in poor countries is substantially lower than it could have been. The secrecy practised in tax havens has also created information asymmetry between investors and consequently reduced the efficiency of international financial markets. That has led to higher risk premiums and thereby increased borrowing costs for both rich and poor countries.

The Commission has been asked to recommend measures which could contribute to a greater extent to identifying capital flows to and from developing countries via tax havens, and to make recommendations which could help to limit the illegal flight of capital and laundering of money from developing countries via tax havens. In this chapter, the Commission presents measures which could be adopted to limit such harmful effects. Recommendations are also made on Norfund's use of tax havens. See the discussion in chapter 7.

9.1 National initiatives

9.1.1 Development policy

The Commission recommends that:

a) The Norwegian development assistance authorities should increase their commitment to strengthening initiatives which aim to improve tax systems in developing countries and official registries. Norway has substantial exper-

tise in such matters. The commitment in this field should be broad-based and deal with conditions related to tax administration, utilisation of various tax bases and the formulation of contracts between multinational companies and developing countries on resource exploitation issues. Norway should contribute to and strengthen the African Tax Administrative Forum (ATAF), which was established in 2009 at the initiative of a number of African tax administrators in cooperation with the OECD. The ATAF aims to be a prime mover in the work of strengthening tax systems in its member countries.

- b) The Norwegian development assistance authorities should continue to give weight to the work of strengthening democratic processes in developing countries. Strong democratic institutions are an important factor in the fight for sustainable economic development.
- c) Norwegian development assistance should continue to support organisations and institutions working for greater transparency, democratisation and accountable government. This should be pursued both through economic support and by demands from Norway in its dialogue with governments that civil society should have a place and that the press should be free to do its work. A stronger commitment should also be made to improving the quality of the economic and financial press in selected developing countries, particularly in Africa.
- d) The Norwegian development assistance authorities should strengthen the anti-corruption network financed by Norway.
- e) The Norwegian government must ensure, across ministry structures, that industrial policy and the exercise of Norwegian state ownership do not undermine development policy goals. This is particularly important in respect of large Norwegian multinational companies with high levels of state ownership and for an investment institution such as Norfund, be-

cause their behaviour can contribute to setting good examples for developing countries.

A number of considerations underlie these recommendations, which coincide in important areas with the government's proposals in Report no. 13 (2008-2009) to the Storting: Climate, conflict and capital. The existence of tax havens makes it simpler for power elites in developing countries to conceal the proceeds of corruption and other economic crime, and weakens tax revenues to the detriment of public investment and collective benefits. Chapters 4 and 5 have also shown that strengthening the tax system is one of the principal challenges faced by developing countries.

Both research and individual cases show that the political and economic elite in countries with weak institutional and democratic control mechanisms can easily enrich itself at the expense of the popular majority with little fear of being discovered and brought to justice. These experiences show that the power elite in countries with high levels of corruption consciously seek to weaken control mechanisms, in part by avoiding or undermining legal provisions, cutting back or inadequately financing public institutions, and working against those seeking to combat corruption.

Strong institutional and democratic control mechanisms are crucial for combating economic crime. The fight against the use of tax havens to conceal the theft of resources from developing countries must also be pursued by developing countries through a purposeful commitment to strengthening and building up such institutions as the tax authorities, the judiciary and anti-corruption agencies. At the same time, it is important that developed states combat bribery committed by companies domiciled in their own jurisdictions but which have operations in developing countries.

Norwegian development assistance has contributed for many years to strengthening the institutional capacity of and anti-corruption efforts in the countries with which Norway collaborates. However, the results have been mixed. In a number of cases, the authorities in the relevant countries have been unwilling to adopt the necessary measures. This does not mean that Norway should give up, but rather indicates that, in the Commission's view, the work should be reinforced. At the same time, countries receiving government-to-government aid must be required to increase their commitment to combating economic crime.

9.1.2 National legislation, advisors and facilitators

The Commission recommends that the government consider the opportunities for taking the following actions.

- a) All Norwegian companies and individuals who facilitate or establish companies and accounts *in tax havens* should report this to a separate register linked, for instance, to the Norwegian Register of Business Enterprise in Brønnøysund. The Commission recommends that such a register should be open to public inspection. The duty to register would also apply to companies which act as intermediaries for facilitators located outside Norway. The Commission would specify in connection with this proposal that a list must be compiled of countries to which the duty of registration would apply. In formulating the regulations, it will be important to ensure that both sides – in other words, both the owner and the facilitator – have an independent responsibility for ensuring that the correct details are recorded in the register. The registration must contain the name of the person or company with their personal identity/organisation number. This reporting and registration duty should extend from 2004.
- b) The recommendations in section (a) call for changes to the law. The Commission accordingly recommends the establishment of a domestic law commission to study the details of the registration requirement recommended in section (a). This commission should also consider the following:
 - The fundamental problem with companies registered in tax havens is the opportunities for misuse offered by the legislation, and the damage this misuse causes to other states. As a result of their registration, these companies are subject to the jurisdiction of the tax haven in crucial areas such as accounting and tax even though the companies do not generally pursue any real commercial activity there. The consequence is that companies/owners avoid legislation in the countries where their real activities take place, and where their business is pursued and the owners reside. At the same time, public and private interests in these states are denied access to information in the country in which the company is registered. The law commission

- should consider measures directed against companies with no activities in tax havens in order to prevent owners from using pure registration exercises to circumvent important interests and legislation where the services are provided or production is carried out.
- Enterprises established in tax havens are often holding or sub-holding companies with limited or no local activity. Among other considerations, experience shows that holding companies are often misused to conduct transactions through chains of tax treaties, both because the requirements for activity are limited and because the activities are subject to strict secrecy rules which make it impossible to know what is actually happening. The law commission should consider whether special reporting obligations should be imposed for such holding companies in those states where the services are actually provided and production is carried out.
 - The concept of domiciliary or home state are key classification criteria for determining where enterprises should be taxed under both domestic law and tax treaties. The law commission should investigate possibilities for formulating simpler and more easily enforceable criteria than those which apply today.
 - Experience shows that transactions are also conducted in group structures for purposes of misuse (in practice between related companies onshore and offshore). Most multinational companies have established a large number of subsidiaries in tax havens. In practice, each state affected by the group's operations currently has no opportunity to secure an overall view of intragroup transactions, in part because of tax haven secrecy rules – in the broadest sense. The law commission should study how greater transparency can be secured in order to reveal the substance in the transactions carried out.
 - Artificial and sham transactions, both circuitous and circular, are often used to conceal the connection between their beginning and end, and thereby to circumvent important third-party interests. The law commission should consider the imposition of information duties which ensure that affected third-parties can obtain an over-

view of the whole transaction chain, in order to prevent legitimate public and private interests from being thwarted by the lack of opportunities for accessing information.

- Advisors are often instrumental in organising the use and misuse of tax havens. The law commission should consider whether special duties or sanctions should be imposed on advisors who facilitate harmful structures.
- The introduction of special compensation rules and/or sanctions should be considered, including rules on the burden of proof related to the misuse of tax havens.

The Commission has shown earlier in this report that an overview of the amount of capital hidden in tax havens and of the identities of companies that make use of such jurisdictions is difficult to obtain. The recommendations above will help to highlight the activities of Norwegian companies and facilitators related to tax havens. This could encourage other countries, including developing countries, to follow Norway's example and adopt similar regulations.

9.1.3 Norwegian accounting legislation

The Ministry of Finance introduced new regulations in December 2007 on the documentation of transfer pricing. As an extension of these rules, the Commission recommends that the government consider whether it would be possible to require that Norwegian multinational companies specify in their annual accounts:

- the countries in which they have legal equity interests in companies and other entities
- the size of this equity interest
- the number of employees in the company
- the gross income and taxable profit of each company in each country
- how much tax is paid by each company in each country as a percentage of the taxable profit

The Commission would point out that multinational companies, in their reporting and on their websites, often claim to have ethical guidelines and broad corporate social responsibility. In line with such goals, the Commission believes that it would be appropriate for multinational companies to document publicly, to a greater extent than they do today, where they have operations and what they contribute to the community in the form of tax

payments. The recommended reporting would have a double function in that variations between expressed goals and realities would attract negative attention. It would also make incorrect pricing of intragroup transactions a less profitable activity for a company. In addition, such reporting standards could influence other countries to adopt similar measures.

9.1.4 Transfer pricing

The Commission has established in various parts of its report and in Appendix 3 that incorrect pricing of intragroup transactions with the intention of transferring profits to low-tax countries is a major problem for both rich and poor countries. Accordingly, the Commission makes the following recommendations:

- a) The government takes the initiative on and supports work in Norway aimed at improving the rules of domestic Norwegian law so that the arm's-length standard is supplemented with a broader set of instruments for determining when internal prices are being manipulated. In this context, the US rules on determining internal price manipulation should be considered.
- b) The government should work to ensure that the OECD, the UN and the World Trade Organisation (WTO) consider the desirability of a broader set of indicators to determine manipulation of transfer pricing than those currently in use.

The Commission takes the view that the transfer pricing issue provides guidelines for the shaping of corporate taxation, leads to extensive competitive distortions between national and multinational companies, and can cause a substantial loss of tax revenues. All these considerations are very important in developing countries, both for government tax receipts and for the ability to develop national commercial activity.

To document how big a problem transfer pricing might be for developing countries, the Commission has commissioned a research team at the Norwegian School of Economics and Business Administration/Institute for Research in Economics and Business Administration to study the behaviour of multinational companies in Norway. See Appendix 3. The hypothesis is that if the problem is substantial for a country with such good tax controls as Norway, it will be considerably greater in developing countries. The research team dem-

onstrates on the basis of Norwegian enterprise data, that multinational companies transfer profits to low-tax jurisdictions. Estimates suggest the tax loss could be on the order of 30 percent of the potential revenue from foreign multinational enterprises. The study also finds that multinational companies in Norway have a profit margin one and a half to four percentage points lower than comparable national enterprises.

As mentioned above, new regulations on the documentation of intragroup transactions and transfer pricing were introduced by Norway in 2007. These mean that the OECD's guidelines on transfer pricing by multinational enterprises have been given a more formalised status as a source of law in the Norwegian legal system. The arm's-length principle is the basis for transfer pricing in the OECD's guidelines. In the Commission's view, the opportunities to utilise a broader set of methods than those enshrined in the OECD's model tax agreement and Norwegian domestic law need to be studied. The Commission finds that the US tax authorities have made considerable progress in utilising various sets of regulations to determine incorrect pricing of transactions. Among other things, the US has applied the "comparable profits method", whereby profits are compared between companies in the same industry. If a subsidiary of a multinational company reports profits which are significantly lower over time than the average for the industry, this could provide evidence of transfer pricing. Under specified conditions, the company will have its taxable profits adjusted to a normal level. The Commission takes the view that it could be useful to consider the adoption of this and other methods for determining whether intragroup transactions are incorrectly priced.

The Commission also takes the view that the need to reform the legal regime must be carefully considered, including changes to company law, accounting law and legislation related to securities and key rules of civil law. Large Norwegian multinational companies, some with a considerable proportion of state ownership, have substantial operations in developing countries. Norwegian legislation in this area is accordingly important for developing countries.

9.1.5 National centre of expertise

The Commission has found that the public sector knows too little about research related to internal prices and tax evasion. Such knowledge is also as-

sociated with a general understanding of tax systems and has great social value. The Commission accordingly recommends the following:

- a) The establishment of a national centre of expertise to draw on the disciplines of economics, law and social sciences. Such a facility could secure leading-edge expertise for Norway on international tax questions, transfer pricing, tax havens and capital flight, and will be able to support the Ministry of Finance, the Ministry of Foreign Affairs and Norad on such issues.
- b) A centre of expertise of this kind should have strong links to the tax authorities, the National Authority for Investigation and Prosecution of Economic and Environmental Crime in Norway, and the Ministries of Finance, Justice and Foreign Affairs in order to exploit the experience gained by these institutions on various tax issues and to contribute to a mutual build-up of expertise through their networking function.
- c) The centre should collaborate with researchers and research institutions in developing countries.
- d) The centre should possess or forge links with institutional expertise on developing countries, and have general empirical knowledge.
- e) The centre should contribute to the education of people from developing countries.
- f) A facility of this kind should be closely affiliated with or form part of a productive research milieu in order to ensure that existing expertise is utilised by the specialist institutions and to lay the basis for further expertise development and innovative research.

A general problem for all nations, but particularly for developing countries, is that expertise related to tax evasion techniques and transfer pricing primarily exists in the private sector, where the willingness to pay for such knowledge is great. The public sector, including higher education institutions, have weak incentives to develop such expertise, and public-sector pay levels – particularly in developing countries – are very low. That helps to draw specialist expertise to the private sector in attractive areas such as taxation and law. A Norwegian centre of expertise could contribute to alleviating this problem by helping to educate people from developing countries in these areas. The Commission would emphasise that the desire and need for a long-term approach means that funding for a centre of this kind must be secured through an annual basic appropriation independent of the

programmes pursued by the Research Council of Norway.

9.2 International measures

The Commission has been asked to recommend measures which invite other development partners to adopt a common approach to the use of tax havens in connection with investment in developing countries. The various recommendations are outlined below.

9.2.1 Cross-ministry working group

The Commission proposes that:

- a) the Ministry of Foreign Affairs appoints a cross-ministry working group to develop networks with similarly minded countries on reducing and eliminating the harmful structures found in tax havens
- b) this working group should aim to influence international development and financial institutions dedicated to helping poor countries, such as the World Bank Group (including the International Finance Corporation) and the African Development Bank

The Commission considers it important to promote an understanding of the effects that tax havens have on development in poor countries among the countries with which Norway has traditionally had a good dialogue on development issues. Norway is an important contributor to a number of international development and financial institutions dedicated to helping poor nations, and it is important that these partners understand the damaging impact of tax havens and that they contribute through constructive measures.

9.2.2 Tax treaties

The Commission has pointed out that tax treaties can make it more profitable for foreign investors to use tax havens, while such agreements can also contribute to reducing tax revenues for poor countries. In the Commission's view, the recommendation of tax treaties by the G20 countries can meet some of the requirements of the industrialised states for accessing information in tax havens, but the strong focus on such agreements diverts attention from the economic forces which make tax havens damaging for rich and poor countries alike. Accordingly, the Commission recommends:

- a) that the requirements for a legal entity to be regarded as domiciled in a tax haven must reflect activity of real economic significance to a greater extent than the present rules require
- b) such activity requirements, and their scope, should be expressed in international tax conventions and treaties
- c) Norway should take an international initiative on new rules for assigning the right to tax

Tax treaties contain provisions on assigning the right to tax between two jurisdictions. They also provide for information exchange upon request. The Commission nevertheless takes the view that the use of tax treaties does not eliminate the harmful structures in tax havens. Signing a tax treaty with such jurisdictions does not lead to the establishment of official company and owner registries with a duty to keep accounting information, or to the introduction of substantial genuine audit provisions. Nor will a tax treaty lead a tax haven to change its practice of ring-fencing parts of its tax system so that foreigners secure better tax terms than nationals. Re-domiciling, or moving funds between tax havens once tax-relevant information has been requested about them, will persist. So will exemption schemes for companies and trusts which are made available because these structures will only have effect in other states. Since none of these issues is affected by tax treaties, the tax havens will have no incentives to exercise control over the extensive opportunities for abuse inherent in the exemption system.

Although tax treaties increase opportunities for accessing tax-relevant information, they are only effective if the requesting state has relatively precise knowledge that specific persons are concealing specific assets in a specific company in a tax haven. Such precise knowledge is difficult to obtain because secrecy rules often prevent third parties from gaining access to the necessary paper trail. (A case in point is Switzerland's UBS bank, which concealed income and assets for more than 50 000 US taxpayers.)

Tax treaties between tax havens and poor countries show that the latter are in a weak negotiating position when such agreements are formulated. Poor countries want the capital which tax havens can offer and are willing to forego tax revenues in exchange by reducing their tax rates for many of the income categories which a tax treaty covers. Paradoxically, tax treaties contribute to making tax havens a more favourable location than would be the case without such agreements.

Tax treaties can cause more harm than good unless they are followed by measures to reduce the harmful structures identified by the Commission. In that connection, it is important to ensure that tax treaties do not constrain further action against tax havens.

Formal legal considerations applied in tax treaties mean that a foreign investor can in reality have a company which is regarded as domiciled in the tax haven even though the company conducts no meaningful activity there. A good example is provided by locally appointed representatives at the vice president and director levels in the tax haven who give an impression of activity. These front persons often represent hundreds (in some cases thousands) of companies which are engaged in widely differing operations and which therefore have very different requirements for expertise. Such expertise requirements cannot be covered by a single executive officer who spreads their time across hundreds of companies. This shows that locally appointed representatives do not have a real function in the companies they represent other than to give an appearance of local affiliation. Had they possessed influence, it would have meant lower profits and inefficient operation of companies located in tax havens and reduced the attraction of company registration in such jurisdictions.

In conclusion, the Commission would point out that tax treaties could nevertheless be important for authorising access to tax-relevant information. They are also a necessary component in establishing fund structures in fund and investment companies which bring together a number of owners from other jurisdictions. However, this requires that tax treaties also exist between the countries in which the fund is placed and those in which the investors are located.

9.2.3 Convention for transparency in international economic activity

The Commission makes the following recommendations:

- a) Together with a group of like-minded nations, Norway takes the initiative on preparing an international convention which will prevent states from developing secrecy structures likely to cause loss and damage to other jurisdictions. Such a convention should define unacceptable practice.
- b) Work on a transparency convention should be incorporated in Norwegian foreign policy and

be coordinated by the Ministry of Foreign Affairs.

- c) A working group is appointed under the auspices of the Ministry of Foreign Affairs to work on drawing up the convention.

The Commission would emphasise that, even though a number of countries are unlikely to accede to such a convention, experience with other conventions which many countries have refused to sign is promising. Examples include the conventions banning the use of anti-personnel mines and cluster munitions. These have established norms, and even countries which have not signed up have applied them in various contexts and in a constructive manner. The Commission takes the view that it is important to attract and maintain international attention related to the problems posed by tax havens. A convention would create a dynamic which would persist and, hopefully, contribute to the elimination of harmful tax structures.

A convention should be general, apply to all countries and be directed against specific harmful structures. It should include at least two principal components. First, it must bind states not to introduce legal structures that, together with more specifically defined instruments, are particularly likely to undermine the rule of law in other states. Second, states which suffer loss and damage from such structure must have the right and duty to adopt effective countermeasures which will prevent structures in tax havens from causing loss and damage to public and private interests both within and outside of their own jurisdiction.

The Commission would emphasise that the right of state self-determination (the sovereignty principle) must be fully respected. Fiscal or other regulations adopted by a state within its own jurisdiction for its own citizens and sources of tax revenue must be determined by relevant bodies in the jurisdiction concerned. The introduction of legislation which exclusively or primarily will have effects in other states is not the exercise of sovereignty, but a major encroachment on the sovereignty of others.

9.2.4 OECD outreach programme

The Commission takes the view that:

- The Norwegian authorities should secure increased financial support for the OECD's taxation outreach programme for non-OECD economies.

This programme aims to promote international collaboration on tax policy and administration. It represents an important element in the global dialogue on taxation by functioning as a meeting place where the tax authorities from different countries can share experience and lay the basis for a new tax policy. The programme is also a potentially important forum for promoting the development of international standards for good tax practice through multilateral and bilateral collaboration.

The programme's strength lies in its focus on practical tax policy and current challenges. Relevant issues discussed at meetings under the programme's auspices include transfer pricing, auditing of multinational companies, exchange of information between tax authorities, and the negotiation, formulation and interpretation of tax treaties between countries. These meetings are attended by experts with special knowledge of relevant tax policy and administrative areas. The object of the meetings is to contribute to illuminating issues of particular relevance for countries which do not belong to the OECD. In the Commission's view, the outreach programme represents an important measure for professionalising tax administrations in developing countries by contributing to an international tax dialogue through the sharing of information and experience with counterparts from OECD countries.

9.3 Guidelines for Norfund

The Commission has been asked to make recommendations which can be incorporated as elements in the operational guidelines for investment activities by the Norwegian Investment Fund for Developing Countries (Norfund). It has also been asked to assess the extent to which transparent investments via tax havens contribute to maintaining the structures used to hide illicit capital flows from developing countries. The Commission accounts below for its conclusions on these issues and provides recommendations concerning Norfund's operational guidelines.

9.3.1 The Commission's recommendations on Norfund's investment activities

1. Guidelines and reporting
 - a) In dialogue with its owner, Norfund should develop and publish ethical guidelines for its choice of investment location.

- b) Norfund's operations divide naturally into two components: (i) fund investments in which the institution joins forces with other investors to establish a fund which acquires shares in or lends money to companies, and (ii) direct investment in companies in developing countries in the form of loans or share purchases (often in combination – in other words, loans to and shares in the same company). The Commission believes that Norfund should report the following:
- the proportion of Norfund's capital invested in funds and direct investments respectively, and the return on these two categories as well as on the sub-categories of loans and shares before and after tax
 - where the funds are registered
 - a breakdown by country of the investments made by the funds in which Norfund invests (overview of how much goes to each country and continent)
 - co-owners of the funds
 - for both funds and direct investment, how the investments break down proportionately between loans and shares
 - for fund investments, Norfund's share of tax paid as a proportion of its share of the capital in the fund.
- c) Norfund should work to ensure that the funds in which it invests have publicly accessible accounts.

Most of the type of information which the Commission believes Norfund should present under section (b) is easily available and very useful for owners, investors and the financial market in general. Some of the data are also available today, either on Norfund's website or in its report on operations. In the Commission's view, this type of information should be brought together in one place and positioned centrally so that stakeholders can readily identify the principal features of Norfund's investment strategy.

Norfund has previously reported that it contributed NOK 3.2 billion in tax revenues to developing countries in 2008 (Norfund's website, see also chapter 7 above). If, on the other hand, that figure is weighted by Norfund's share of the risk capital, tax payments come to only NOK 66 million in the same year. The Commission takes the view that Norfund should report in the future on its weighted contribution to tax paid by the companies as a proportion of the total risk capital. In

addition, Norfund should report what it has paid in tax deducted at source as a proportion of its own share of the investments.

2. Analysis of investment locations

The Association of European Development Finance Institutions (EDFI) adopted a recommendation in May 2009 on guidelines for the use of offshore financial centres by its member institutions. Norfund and other state-owned funds which invest in developing countries belong to the EDFI. The main thrust of the guidelines is that members of the association should avoid investing in or via jurisdictions which fail to satisfy certain minimum standards. These requirements relate mainly to systems for combating money laundering (the FATF's recommendations) and information sharing on tax issues (OECD agreements). The guidelines also include requirements related to involvement in capital flight from developing countries, but these have no specific content. As a result, the Commission recommends that:

- a) Norfund should conduct country analyses of the jurisdictions it utilises
- b) such analyses should include a detailed assessment of the relevant legal system, including legislation on tax, company and enterprise registration, banking and finance, money laundering and anti-corruption
- c) Norfund should assess whether African countries can be found which do not have the harmful structures associated with tax havens and which can function as investment locations.

3. Choice of commercial jurisdiction

The Commission would make the following recommendations concerning Norfund's choice of commercial jurisdictions:

- a) The institution's goal should be that the investment funds in which it is a partner will be registered in the country, or one of the countries, where the companies in receipt of the investments are located. This will ensure a better tax base for the developing countries and will send an important signal globally that a genuine desire exists to eliminate the damaging effects created by tax havens, regardless of the costs this might be incurred in the short term. Such investment could moreover make a positive contribution to improving relevant legislation and to developing the banking/financial sector in the investment country.
- b) The Commission takes the view that Norfund can choose to participate in funds based out-

side the countries in which the companies receiving the investments are located when good reasons exist for so doing. In that context, Norfund should make proposals on investment countries which are considered and approved by the owner. It follows from the Commission's discussion in chapters 2 and 3 that such jurisdictions should as far as possible possess credible public company and owner registries, no secrecy regulations, and legal structures which create as little asymmetry as possible and which are directed at undermining the rule of law in other states as little as possible. When choosing investment jurisdictions, Norfund should endeavour to find at least one African country. It is also anticipated that Norfund will involve its sister organisations in this work.

- c) Norfund is one of many investors in various funds, and often has a relatively small holding. The Commission has discussed what view to take on this, and has decided that it would be desirable in the long term for Norfund to invest together with investors who do not wish to use tax havens. However, the Commission is aware that it could be difficult to find such partners in the short term. It accordingly recommends a transitional arrangement whereby Norfund gradually reduces new investment via tax havens to zero over a three-year period after the Commission's recommendation take effect. That length of time will give Norfund and the Norwegian authorities time to work on the investors with whom Norfund invests so that these give their support to the work of combating harmful tax regimes.
- d) The Commission takes the view that no purpose would be served by requiring Norfund to withdraw from *existing* investment funds currently registered in tax havens. This is partly because the institution would lose money on such a withdrawal, particularly in those cases where the lifetime of the funds is relatively short, and also because such sales would reduce the size of Norwegian development assistance funds.

4. Cooperation with Norfund's sister organisations

The Commission takes a positive view of the fact that the EDFI, through its guidelines on the use of offshore financial centres, demonstrates a view that its members should take account of the role of tax havens in relation to developing countries. However, it also believes that these guidelines are

not suitable for excluding locations with harmful structures, and accordingly recommends that:

- Norfund works for a revision of the criteria for selecting investment locations to bring them into line with the criteria specified in sections 1 and 2 above.

9.3.2 Consequences

The Commission has also assessed the consequences of the recommendations outlined above. As mentioned, Norfund's activities divide naturally into two components:

- fund investments where the institution, together with other investors, establishes funds which acquire shares in companies or lend money directly to enterprises
- direct investments in companies in developing countries in the form of loans or share purchases.

About 81 percent of Norfund's total NOK 4.8 billion investment portfolio was invested (directly or indirectly) via tax havens in 2008. The consequences of reducing Norfund's new investment through such jurisdictions over three years will probably be that it invests a larger amount directly in companies in developing countries. This assumes that Norfund's co-investors continue to use tax havens to a certain extent, so that fewer relevant funds will be available for Norfund participation. An increase in Norfund's direct investment does not necessarily mean that the institution is prevented from investing in the same companies as the funds in which it is currently a co-investor. One possibility would be to use the same advisors as the funds, and another would be to make parallel investments.

It is unclear how direct investments affect Norfund's profitability because good profitability calculations are not available from the institutions for its fund and direct investments. The Office of the Auditor-General has moreover called attention in its audit report to deficiencies both in profitability reporting and in the way tax revenues for host countries are reported. The Commission cannot see that Norfund has taken adequate account of these comments.¹ It would particularly emphasise that Norfund's profitability reporting by the various investment categories should be improved,

¹ Investigations of Norfund's operations and management by the Office of the Auditor-General. Document no 3:13 (2006-2007), page 77.

and that the goal here should be to achieve the same standard as commercial funds.

Furthermore, the Commission takes the view that, since Norfund has goals related to contributing to value creation and tax revenues in developing countries, the pre-tax return on its investments should be the most important investment parameter. Managing in accordance with the post-tax return means that Norfund would devote resources to minimising its tax payments in developing countries. This is not reconcilable with the institution's object of contributing to development in poor countries.

The Commission takes the view that risk capital is essential for sustainable development. Norfund's investment activities make an important contribution in that respect. When determining transitional arrangements, the owner must take account of the possibility that new rules could impose additional costs on Norfund and limit its investment opportunities.

On the other hand, account must be taken of the damaging effects of maintaining structures used to conceal illicit capital flows from developing countries. The Commission has established that tax havens represent an important hindrance to growth and development in poor countries, and that they make it opportune for the political and economic elites in developing countries to harm the development prospects of their own states. Accordingly, putting a stop to the damaging activities of tax havens is important. The Commission takes the view that a short transitional period for Norfund will send an important signal on the significance of not utilising tax havens. Against the background of current processes in other countries, other actors are expected to adopt similar restrictions. Norway accordingly has an opportunity to take a leading role in this work. In the longer term, the new guidelines for Norfund could also contribute to the creation of more venues for locating funds in African countries without harmful structures.

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Appendix 1

Why are tax havens more harmful to developing countries than to other countries?¹

Memorandum written for the Commission to the Government Commission on Tax Havens
Date: 15th May 2009 by Ragnar Torvik, Department of Economics, NTNU, ragnar.torvik@svt.ntnu.no

Summary

This memorandum provides a survey and a discussion of why tax havens are more harmful to developing countries than to industrialised countries. Many of the effects of tax havens are common to both groups of countries. There is a discussion of why the negative consequences are nonetheless greater for developing countries. Lower government income has the greatest social cost in countries that have the greatest need for public spending at the outset. However, the memorandum argues that the damaging effects *over and above* the mechanisms seen in industrialised countries are more dramatic. It demonstrates why and how the opportunities for private income represented by tax havens in reality contribute to lower, not higher, private income in developing countries. There is no conflict between the public and the private sector – tax havens are damaging to both. There is a discussion of why and how institutions have a decisive importance for growth and development. The damaging effects of tax havens are particularly great in countries with weak public institutions, in countries with a presidential system of government, and in countries with unstable democracies. At the same time, institutions cannot be regarded as given by nature. Tax havens give the agents in the economy incentives to change institutions – for the worse rather than for the better. It becomes more attractive for political agents to weaken public institutions, to establish a presidential form of government, and to undermine democracy. For developing countries, the growth effects of putting a stop to the use of tax havens are great.¹

1 Introduction – The effect of tax havens

Tax havens provide an economic opportunity to enrich oneself at the expense of society. When this opportunity is used, it lowers the public income of the countries where taxable income or wealth is withheld. In jurisdictions that are themselves tax havens, however, the effect will possibly be opposite – here the tax revenue could increase since some of the income or wealth will be taxed here. It is, however, obvious that the net effect of tax havens is a reduction in the total amount of tax paid – if this were not the case, the taxpayer would have no incentive to conceal income or wealth in tax havens.

This appendix studies the effects of the existence of tax havens on countries that are not themselves tax havens. A different question, which is not studied here, is the effects of *being* a tax haven. There is reason to believe that these effects are positive – it is in the interest of the Cayman Islands to be a tax haven. However, that is of little interest to the problems studied in this appendix – an analogy clarifies that the policy conclusion is not to stimulate tax havens: If a thief becomes richer by stealing this is no argument to allow theft. We must distinguish between created income and income derived by taking from others.

For countries that are not themselves tax havens, the effect is that tax income is lower than it would otherwise have been. The sign, then, is clearly negative. The magnitude is an empirical question. As the discussion in the Commission's Chapter 5 shows, it seems that the sums withheld from taxation are substantial. For industrialised countries, there is reason to believe that the funds withheld from taxation are mainly private income. In developing countries, there are many examples of the great extent to which public funds, too, are

¹ I am grateful for comments from Poul Engberg-Pedersen, Stein Ove Erikstad, Helge Mjølnerød and the members of the Commission on Tax havens. The views presented in this appendix are those of the author.

concealed in tax havens, to enrich corrupt bureaucrats and politicians. DRC (Democratic Republic of Congo, Zaire), where Mobutu Sese Seko held power from 1965 to 1997, is a well-known example. Tax havens helped Mobutu conceal the great wealth his political position enabled him to steal. Acemoglu, Robinson and Verdier (2006, page 169) assert: "There is no doubt that the aim of Mobutu was to use the state as enrichment for himself and his family. He was a true kleptocrat." The authors show that the consequences were catastrophic. The country's natural resources and economy were plundered by the political elite. Income per capita in 1992 was half of what it was at independence in 1960.

The example of Mobutu shows that tax havens give the political elite in developing countries an instrument for concealing the wealth they plunder. The example also shows the key role played by a country's resource wealth. For corrupt politicians, natural resources are a possibility for personal enrichment, and tax havens represent a means to achieve this end. The example also shows that the types of institutions that serve the interests of politicians are not necessarily those that serve the interests of the general population. Weak public institutions, corrupt bureaucracy, and little democracy were preconditions that made it possible to conceal such substantial sums in tax havens. The institutions that served Mobutu's interests had different characteristics from institutions that would have served the interests of the general population – and he changed the institutions and undermined democracy to serve his own narrow self-interest. The halving of domestic income per capita cannot be explained by the direct effect of Mobutu's plundering alone: "In the 1970s, 15-20% of the operating budget of the state went directly to Mobutu." (Acemoglu, Robinson and Verdier 2006, side 169). In order to explain why per capita income was halved, we have to take into account the *indirect* damage the regime inflicted on the economy. By all accounts, this indirect damage was far greater than the sums that went directly to the private enrichment of the regime and its supporters. To understand the effect of tax havens on developing countries we should not confine ourselves to a traditional analysis that assesses damage only in terms of what is withheld or lost in public tax income.

In the following, least space will be devoted to the traditional effects of tax havens and most space to the effects specific to developing countries, effects that have been less analysed in the

past. This is not because of a conviction that the traditional analyses are less important. The background for these priorities is rather that the effects that are common to industrialised countries and developing countries are so well documented in previous literature that we are here on firmer ground. In this case, there is less reason to enter into details. The effects that are specific to developing countries have been less analysed. Here, then, we will enter more into details, and contribute some new, and hopefully original, analysis. At the same time, this will mean that chapter 3 of this appendix may seem more speculative than the survey of well-established knowledge.

In 1.1 and 1.2, we briefly treat the effect of tax havens on public and private income. In chapter 2, we first discuss theory for the effect of tax havens on developing countries. We show why and how the increased opportunities for private income represented by tax havens can in reality serve to reduce private income. It is a challenge that it is difficult to find data for an empirical investigation of whether tax havens contribute to a reduction in private income. Tax havens and secrecy go hand in hand. Instead, the effect of other income that can give rise to similar mechanisms as tax havens are studied. Central here is the study of the paradox of plenty – the fact that countries rich in natural resources seem to have had lower growth rates than other countries during the past 40 years. The paradox of plenty is relevant for the study of tax havens because the effects of resource income can give rise to many of the same mechanisms as tax havens – in particular, they give rise to economic adaptations whose motive is the reallocation of existing income in favour of oneself, rather than the creation of new income. There is, however, reason to believe that the income opportunities provided by natural resources have a *more benign* effect than do tax havens – the extraction of natural resources also contributes to value creation. Tax havens give rise to adaptations that increase personal income, not by increasing the total value creation, but by changing the allocation of resources with the aim of paying less tax. Drawing conclusions on the effects of tax havens based on the effects of resource income will give skewed results – the effects of tax havens will by all accounts be *less benign*.

The paradox of plenty is central to the study of tax havens for another reason as well: Tax havens help corrupt politicians and destructive entrepreneurs to plunder a country. Recent research shows that countries with bad institutions and po-

litical systems are hardest hit by the paradox of plenty. Private entrepreneurs and politicians in such countries are faced with private incentives that are not compatible with the best interests of society as a whole: The combination of bad institutions and tax havens gives corrupt politicians and destructive entrepreneurs good possibilities to stash away the resource income they plunder.

Chapter 3 treats the effect of tax havens on institutions and democracy. While the general population may have an interest in stable democracy and good public institutions, tax havens will contribute to giving politicians an interest in the opposite. There are many examples that institutions aimed at stemming illegal flows of money are deliberately destroyed by the authorities, that people working in such institutions are pressured not to do their jobs, or even killed.

Incentives to change institutions so they correspond better to personal motives can also cast a light on important changes to the political systems in many developing countries. One such change is the increased incidence of presidential rule in many developing countries, particularly in Africa. Most African countries started off with a parliamentary system at independence. Today, nearly all the countries have changed their constitutions to a presidential system. This massive change may seem counter-intuitive, as research indicates that presidential rule in Africa gives policies that are less responsive to the interests of the general population than a parliamentary system does. Why has it been so tempting for the political elite in Africa to introduce presidential rule? One possible hypothesis is that in some countries presidential rule is established not because it serves the general population, but because it concentrates power with an economic and political elite.

Further in chapter 3, there is a discussion of how tax havens may influence the degree of democracy. Much recent research indicates that important economic motives may lie behind conflicts – it may be in the narrow economic self-interest of opportunistic agents to weaken democracy. Again, tax havens play a major part – they provide an opportunity to stash away the income plundered through the undermining of democracy, and make such a strategy more tempting.

If tax havens contribute to making a country's institutions worse and to destabilizing democracy, the effects for the general population may be disastrous. Not only do tax havens contribute to lower incomes – they also contribute to undermining the basis of future growth and welfare.

While the contents of chapter 2 are based mainly on previously published research, part of what is presented in chapter 3 is based on research which has not yet found its way into scholarly journals, and which therefore exists only as unpublished notes. This means that what is presented here is to a lesser extent established knowledge, and must to a greater extent be regarded as speculation. However, the fact that the field of research is new is no argument for omitting it. The reader should nonetheless keep in mind that much of what is presented in chapter 3 is yet unpublished, and has therefore not undergone the quality control that underpins published research.

1.1 Tax havens – Reduced Public Income

When private agents take advantage of tax havens, tax revenue will be reduced. Lower public income will consequently lead to a combination of reduced public activity, and higher taxes on other activity. Compared to more developed countries, however, developing countries will find it more difficult to levy alternative taxes. A low level of economic activity means that there are few alternative tax bases. Deficiencies in institutional capacity and large informal sectors make tax collecting difficult. There is therefore a limited potential for alternative tax revenue. The loss of income caused by tax havens must mainly be compensated through a reduction in public economic activity.

At the same time, the need for public services and public investment is great in developing countries. Poverty, disease, and a limited level of education produce strong pressures and a great need for public services. Poor infrastructure makes public investment very necessary. Tax havens therefore contribute to reducing public activity in the countries where it is most needed. Tax havens reduce public income both in industrialised countries and in developing countries – but the negative effects of lower public income are greater for developing countries.

Tax havens make it relatively more profitable to apply talent to increasing the profitability of undertakings through tax evasion, than to apply talent to increasing profitability through operating more efficiently. Such skewing in the application of talent in the private economic sphere does not profit society, because society's economic calculations must take into account that saved tax for the private entrepreneur is equal to a reduction in

public income. Again the harm may be greater in developing countries, because entrepreneurs here are more of a scarce resource than in industrialised countries, and the misuse of such talent therefore has greater consequences.

In many developing countries, the quality of the legal system is lower, corruption is higher, and the public bureaucracy is less competent. This makes the probability of getting away with tax evasion high, and the cost of not getting away with it low. Since the use of tax havens is a greater temptation and carries a lower cost in developing countries, this, too, will ensure that the negative effects will be greater than in countries with a better legal system, less corruption and a more competent public bureaucracy.

1.2 Tax havens – Increased opportunities for private income

One potential argument against the assumption that there are costs connected with tax havens is that when the profitability of economic activity increases, economic activity will increase. One positive side effect of tax havens is thus that they can give rise to the development of industry and thus contribute to economic growth. Note, however, that this reasoning does not hold water. If tax havens lead to economic resources being used differently than would otherwise have been the case, the reason for this would be to save tax. Otherwise, resources would have been moved into this alternative activity even if there were no tax savings. Tax motivated movement of resources will therefore typically lead to an increase in private income smaller than the amount saved in taxes. Consequently, moving resources into other activity as a consequence of the existence of tax havens will reduce total value creation, not increase it: Total value creation is the sum of public and private income – and this has gone down.

2 Tax havens and developing countries

So far, we have seen that tax havens influence developing countries and well developed countries through the same mechanisms, but that the negative consequences are stronger for developing countries. In developing countries, however, mechanisms other than those relevant to more developed countries also make themselves felt. These mechanisms have their basis in, and are made worse by, the poor quality of public institu-

tions and the weakness of the political systems of these countries. In their turn, tax havens will make the institutions even worse and the political systems even weaker. In this way, institutions and political systems are, on the one hand, a cause of the strong negative effects of tax havens on developing countries, and, on the other hand, tax havens are a cause for the declining quality of institutions and political systems. Such a negative spiral has grave consequences for economic and political development.

2.1 Economic opportunities and economic outcomes

Although the argument that tax havens give increased possibilities for income has the wrong sign, it may be the case that the greater income opportunities provided by tax havens can *dampen* their negative effect. If the increased opportunities for private income represented by tax havens result in higher private income, their effect will be less dramatic than the impression given by measuring the total loss in tax income. The economically relevant measure for society is the loss of tax income *minus* the increase in private income. If tax havens give increased private income, they would represent a cost, but this cost would be lower than one might first believe.

2.2 Theory: Tax havens in developing countries

Let us assume a country with a high crime rate, widespread corruption, a poor quality of public bureaucracy and a weak political system. In such a society, it will be relatively attractive for people to engage in destructive banditry, corruption, rent seeking, tax evasion etc., rather than to establish and operate productive enterprises. For such an economy, a decisive point is how tax havens influence the incentives for talented entrepreneurs, and what effect this will have on the economy as a whole. The theory presented in the following is based on Torvik (2002).

It is clear that the higher the number of entrepreneurs who choose to engage in productive activity, the higher the income of each entrepreneur will be. There are many reasons for this. More entrepreneurs engaged in productive activity means fewer in destructive activity, and thus less crime and corruption. In its turn, a reduction in crime and corruption makes it more profitable to engage in honest economic activity. A higher

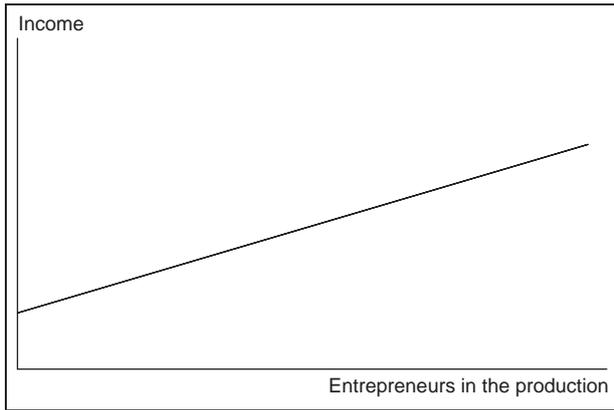


Figure 1.1 Income and production

number of entrepreneurs in productive activity gives higher production, income and thus greater demand. Greater demand in its turn increases sales and profitability. A higher number of entrepreneurs in productive activity gives higher tax income, greater public income, and thus better public services and infrastructure. Good public services and infrastructure in their turn increase the profitability of private industrial activity. Figure 1.1 shows this relation. We measure the number of entrepreneurs in productive activity along the horizontal axis and the income of each entrepreneur along the vertical axis. The rising curve shows that the income for each entrepreneur increases with the increase in the number of other entrepreneurs engaged in productive activity. Figure 1.2 shows how the number of entrepreneurs who choose to engage in unproductive or destructive activity influences the income for each and every one of them. We measure the number of entrepreneurs in such activity from left to right, and the income for each of them on the vertical axis. An increase in the number of entrepreneurs

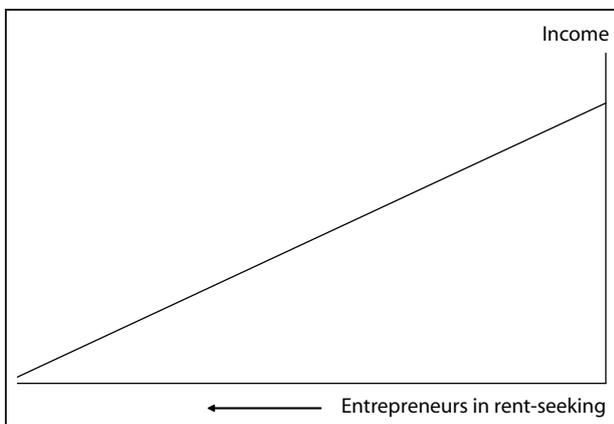


Figure 1.2 Income and rent seeking

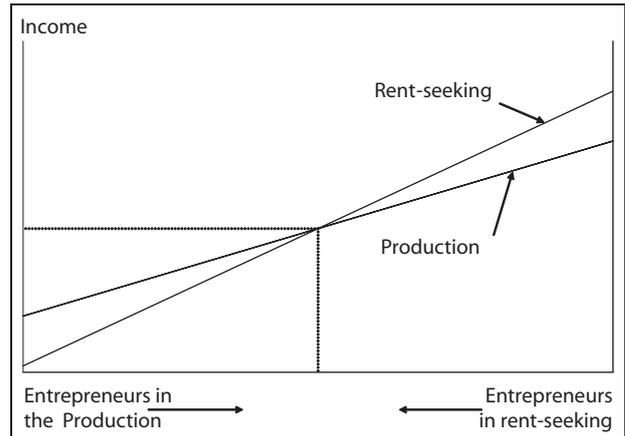


Figure 1.3 Equilibrium

in unproductive activity, i.e., a movement from right to left in the figure, implies a lower income for each and every one of the unproductive entrepreneurs. There are several reasons for this. A large number of criminal competitors reduces the income of each single criminal. A great number of entrepreneurs in destructive activities implies that there will be fewer entrepreneurs in productive activity. Then, there will be less production, less to steal and lower income for each criminal. Figure 1.3 shows how the country's entrepreneurs are distributed between productive and unproductive activity. Where the curves intersect, the income for entrepreneurs in productive activity and in unproductive activity is equal, and no entrepreneur has an incentive to switch between productive and unproductive activities. If the distribution of entrepreneurs is not at the intersection in the figure, but to left if it, income from productive activity will be higher than income from unproductive activity. In that case, entrepreneurs will have an incentive to switch from unproductive to productive activity. The number of entrepreneurs in productive activity will then rise, and the number in unproductive activity will decline, until we are back at the intersection. If we are in a situation to the right of the intersection, we will see the opposite movement. Here, the income of the unproductive entrepreneur is higher than the income of the productive one, and entrepreneurs will switch from productive to unproductive activity until we are back in the intersection, where the income of an entrepreneur is equal in unproductive and in productive activity. The intersection and the distribution of entrepreneurs between productive and unproductive it implies, therefore represents a situation of stable equilibrium.

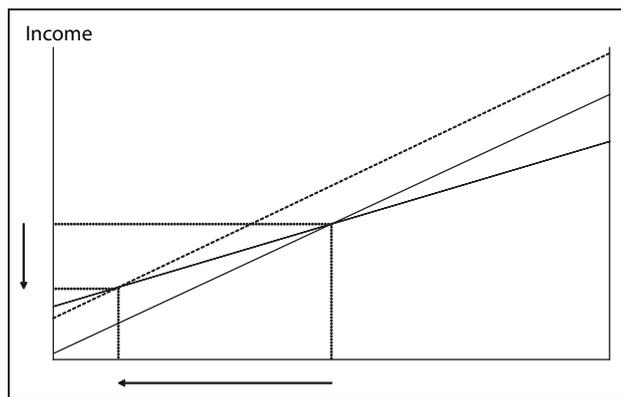


Figure 1.4 The effect of tax havens

The question is now how tax havens influence this equilibrium in the economy. This is shown in Figure 1.4. Tax havens represent improved income opportunities for those who are engaged in destructive banditry, corruption, rent seeking, tax evasion etc. When the possibilities for evading taxes improve, it becomes relatively more attractive to be a rent seeker. The curve that represents income opportunities in rent seeking thus shifts upward in the figure, as shown with the stippled curve in Figure 1.4. The conclusion is surprising: Better income opportunities for every entrepreneur cause the income of every entrepreneur to fall!

The intuition behind this result is as follows: Tax havens make it more profitable to be a rent seeker, and thus more people choose rent seeking and fewer choose productive activity. A greater number of rent-seekers and a smaller number of productive entrepreneurs reduce the income of every productive entrepreneur. However, lower income from productive activity makes it relatively even more attractive to engage in rent seeking. This leads to a further fall in the number of productive entrepreneurs, a further fall in the income for those who are engaged in productive activity, an even greater reduction in the number of productive people and an increase in the number of rent seekers, and so on. Tax havens thus provoke a multiplicative process – but the multiplier is negative. The reason this process will not continue indefinitely is that the income of rent seekers, too, falls when there are more rent-seekers and fewer productive agents.

In the new economic equilibrium it must be the case that what at first seemed like a better income opportunity for private entrepreneurs is a disadvantage for each and every one of them: Tax havens make the income of every entrepreneur

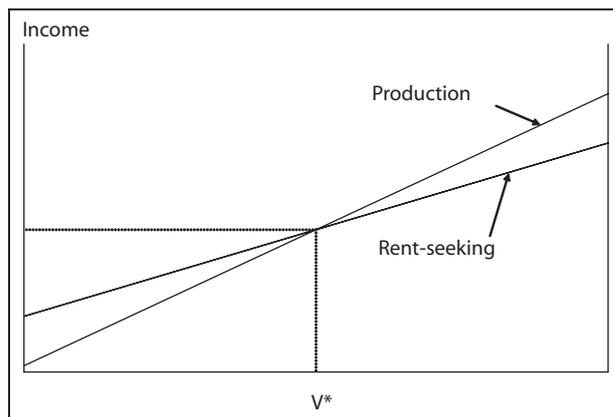


Figure 1.5 Two stable equilibria

go down – not up, as one might believe at first glance.

In developing countries, then, tax havens not only lead to lower public income – there is also reason to believe that they lead to a fall in private incomes. There is no conflict between private and public sector – tax havens are a disadvantage for both.

2.3 Theory: Tax havens and poverty traps

In the figures studied above, the income curve for rent seeking was steeper than the income curve for production. Now assume that the opposite is the case, as shown in Figure 1.5. Here the advantages for other entrepreneurs that there are many productive entrepreneurs are relatively great, while the disadvantages for rent-seekers of many other rent-seekers are relatively small.

At first sight one could believe that this figure gave the opposite conclusion of Figure 1.4: If we now make rent-seeking more advantageous and shift the curve upwards, Figure 1.6 shows that the curves

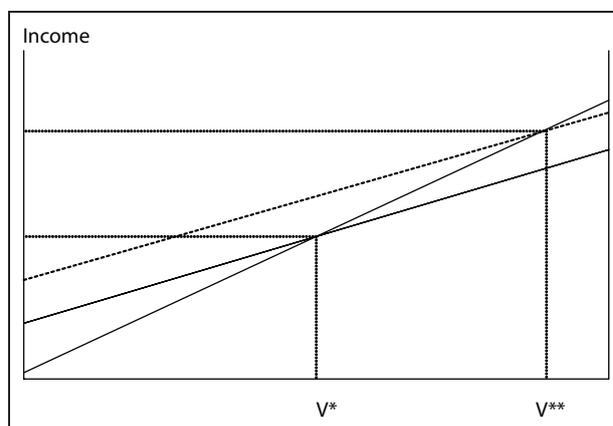


Figure 1.6 The effect of tax havens

will intersect at a higher level of income. Tax havens thus seem to give higher private income.

However, this is a logical fallacy. To see this, study Figure 1.5 again. If, in this figure, there are more productive entrepreneurs and fewer rent-seekers than at the intersection – i.e., if we are to the right of V^* – then the income of productive entrepreneurs is higher than the income of rent seekers. This leads to a switch from rent seeking to productive entrepreneurship. If we start out to the right of V^* , we will over time move further to the right in the figure – until we are in a situation where all entrepreneurs in the economy are engaged in productive activity. If we start out to the left of V^* , the income of productive entrepreneurs is lower than the income of rent seekers. Since it is more profitable to be a rent seeker than to be productive, the number of entrepreneurs will decrease, and the number of rent seekers will increase. If we start to the left of V^* in the figure, we will over time move further to the left in the figure – until we are in a situation where no entrepreneurs find it profitable to engage in productive activity:

V^* is not a stable equilibrium point – but a tipping point. There are two stable equilibrium points in the figure – either all are rent seekers, or all are productive entrepreneurs. The equilibrium where all are rent seekers is a poverty trap. Precisely because all are rent-seeker and no one a productive entrepreneur, it will be more profitable for each individual to be a rent-seeker rather than a productive entrepreneur. The situation is therefore stable – but not inevitable. If all chose to be productive entrepreneurs, then every individual would be better off as an entrepreneur than as a rent seeker. In this equilibrium, everybody's income would have been greater.

It is therefore clear that what Figure 1.6 really shows is that the critical mass of entrepreneurs needed for the outcome to be the good equilibrium increases from V^* to V^{**} . Tax havens make it more difficult to reach the good equilibrium, and make it easier to end in the poverty trap. If tax havens contribute to turning an economy that would otherwise have ended in a good equilibrium into a poverty trap, the growth effects of tax havens are worse – and not better – than indicated in the analysis above, where we had a unique equilibrium.

2.4 Empirical study: Do increased income opportunities reduce income?

We have seen that economic theory suggests that in developing countries the increased in-

come opportunities represented by tax havens reduce rather than increase income. This may seem counter-intuitive – it would seem more reasonable if the profitable economic opportunities available to agents in a society materialized as good economic outcomes. However, the “income opportunities” tax havens represent are in reality income acquired by agents without their creating any value. There is reason to believe that the effect of this type of income opportunity in developing countries is negative rather than positive. However, it is difficult to conduct empirical research on the effect of tax havens – secrecy lies in their nature. Because of this, it is difficult to find out whether countries where the population makes widespread use of tax havens have a lower income than other countries. Even if the investigation of the negative influence of tax havens on income is difficult, however, some light can be shed on the problem indirectly in a different way: One may find other income opportunities that represent income appropriated by agents in the economy without value-creation – and investigate whether these lead to reductions or increases in income.

One such income opportunity is natural resources, like for instance oil and diamonds. This type of income accrues largely because of the accident that countries have natural deposits – and to a lesser degree because the agents of these countries are particularly good at conducting industrial activity. This does *not* mean that it is not an advantage to have entrepreneurs who are good at converting such income opportunities to actual income. On the contrary – such countries may draw greater benefits from naturally given income opportunities than other countries.

Income from natural resources represents a greater value for society than “the income” derived from tax havens – this last income comes in its totality from a reduction in public income. Consequently, there is reason to believe that income opportunities from natural resources will have a more beneficial effect than income from tax havens. If we use income from natural resources to investigate the effect of increased income opportunities, we will therefore *underestimate* possible negative effect of tax havens.

There is also another reason that the following discussion on how resource income affects an economy will be fairly detailed: Tax havens are part of the explanation why income from natural resources can be harmful to a country.

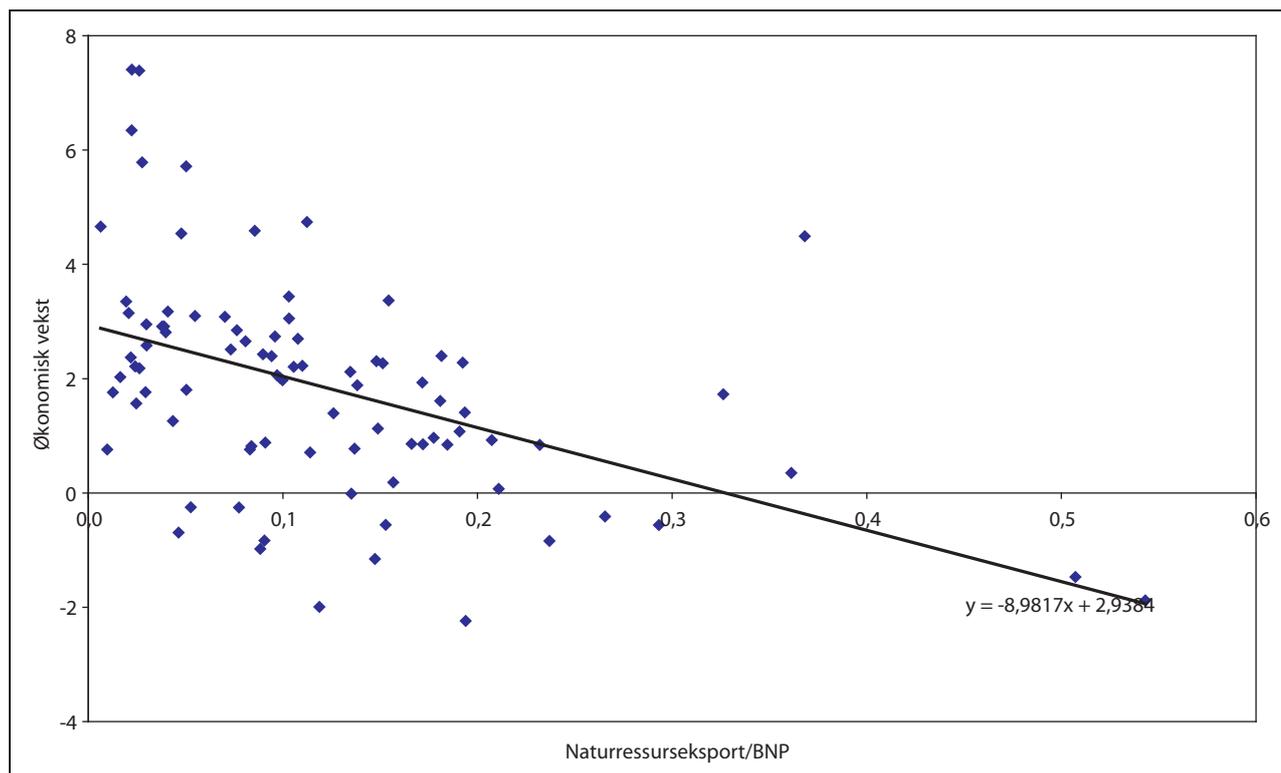


Figure 1.7 Natural resource abundance and economic growth

Source: Data source: Mehlum, Moene and Torvik (2006a).

2.5 The paradox of plenty

The last decade has seen the appearance of an extensive international research literature that argues that countries with much income from natural resources end up at a lower income level. This phenomenon is often called "The resource curse" or "The paradox of plenty".²

It is important to note that this literature is relevant to the effect of tax havens in two ways. Firstly, this literature will, as argued above, represent an indirect test on how income opportunities that give rise to rent seeking can affect an economy. Secondly and maybe more importantly: Tax havens are a natural part of the paradox of plenty. As we will see, it is precisely when economic and political agents have the opportunity to conceal income from natural resources that natural resources are harmful. In the opposite case, it is not harmful for an economy to gain income from natural resources.

Figure 1.7 illustrates the paradox of plenty. Each point in the figure represents a country – in

total 87 countries are represented, and they are all the countries for which we have the necessary data. All data used in this empirical analysis are taken from Mehlum, Moene and Torvik (2006a), and the data for all the countries are reproduced in the Appendix at the end of this memorandum.

The horizontal axis in Figure 1.7 shows the countries' exports of natural resources as a share of total production (GDP) in 1970. Countries far to the right in the figure, then, largely specialize in the export of natural resources, whereas countries far to the left in the figure have little export of natural resources.

The vertical axis shows average annual economic growth since 1965. Countries high up in the figure thus have high growth, whereas countries low down in the figure have low growth.

The solid line in the figure is a regression line that shows the connection that best represents the relation between exports of natural resources and growth – countries with much export of natural resources have lower growth than countries with little export of natural resources. Natural wealth is accompanied by poor economic growth – and poverty from nature's part is accompanied by good economic growth.

² The discussion of the paradox of plenty in the following is based on Torvik (2007) and Torvik (2009).

2.5.1 Correlation and causality

The correlation shown in Figure 1.7 has proven quite robust – can it then be said that exports of natural resources *cause* lower growth? No, and as we shall see, there are several reasons for this. The figure nonetheless represents a useful point of departure. However, to uncover the possible effect of the export of natural resources we must dig deeper. We must check whether the correlation holds water when we take into account that there may be other factors that affect *both* the export of natural resources and growth.

Assume that countries with substantial natural resources protect their markets from foreign competition in order to build up their own industry. Assume also that such protection does not in reality contribute to growth, but to inefficiency. In that case, we cannot based on Figure 1.7 argue that the export of natural resources *leads to* lower growth. Natural resources *per se* are not the problem for growth – but the fact that countries with substantial natural resources pursue policies that give inefficiency and low growth. Had these policies not been pursued, growth might have been as high as in countries with few natural resources. In other words, we lay the blame for low growth on the abundance of natural resources, when the blame should have been laid on the policies.

Another example: Some countries are poor and others are rich – in poor countries, production is low and in rich countries, production is high. If rich and poor countries have an equal amount of natural resources, it will represent a large share of production in poor countries and a small share of production in rich countries. When we measure natural resource exports as a share of total production, poor countries will, all other things being equal, present themselves as rich in natural resources – and rich countries as poor in natural resources. If poor countries grow more slowly than rich countries, Figure 1.7 only shows that poverty begets poverty – whereas wealth begets wealth. Export of natural resources may be completely irrelevant as an explanation of differences in economic growth. Figure 1.7 confuses the effect of natural resources with the effect of low income.

A third example: In poor countries the establishment of industrial activity will often give little profit – the only activity that gives economic yield is the cutting down of forests, the excavation of diamonds, or the pumping up of oil. In this case, Figure 1.7 does not show that the export of natu-

ral resources gives poverty – but that poverty gives specialization in the export of natural resources.

The examples illustrate a general point – there is a difference between correlation and causality. From Figure 1.7 we do not know whether it is low growth that leads to high exports of natural resources, or whether it is high exports of natural resources that lead to low growth, or whether there is a third factor (for instance politics) that co-varies with both exports of natural resources and growth. To investigate the effect of natural resources on economic growth it is not enough to look at these two variables in isolation – we must also include other factors.

Table 1.1 seeks to take this into account by including more variables. The table shows different variables that affect economic growth in the 87 countries with available data for the variables used. When a variable in the table has a positive sign, it means that a higher value of this variable increases growth in the countries, whereas a negative value means that the variable reduces growth. When a variable is marked with *, it means that it is reasonably probable that the variable's co-variation with growth is not caused by pure coincidence (in the sense that the estimate is significant on a 5% level). Adjusted R² shows how great a part of the variation in countries' growth rates is explained by the variables in the analysis.

If the analysis in Figure 1.7 confuses the effects of being poor with the effects of high exports of natural resources, we can control for this by including the level of income in our analysis. In Regression 1 in Table 1.1, this is done by including a measure for income level in the various countries at the beginning of the period under investigation. We see that this variable has a negative sign – the countries that had a high income in 1965 have had a lower average growth after 1965 than the countries that had a low income. Thus, it seems not to be the case that rich countries on average grow more quickly than poor countries – rather, it is opposite – poor countries grow faster than rich countries.

In the light of the discussion above, we must also control for whether the countries have pursued economic policies that have largely sheltered them from foreign competition. In Regression 1 in Table 1.1, this is done by including a variable for countries' freedom of trade in the period. We see that this variable has a positive sign – the countries that have largely pursued free-trade policies have, on average, grown faster than the

Table 1.1 Economic growth and resource wealth Dependent variable: Average GDP-growth

	Regression 1	Regression 2	Regression 3
Initial income level	-0.79*	-1.02*	-1.28*
Openness in trade	3.06*	2.49*	1.45*
Resource abundance	-6.16*	-5.74*	-6.69*
Institutional quality		2.20*	0.60
Investments			0.15*
Number of observations	87	87	87
Adjusted R2	0.50	0.52	0.69

Source: Mehlum, Moene and Torvik (2006a)

countries that have to a greater extent sheltered themselves from foreign competition. Openness has contributed to faster growth. Countries that have shut themselves off from the outside world have had lower growth.

The most interesting point of Regression 1 in Table 1.1 is, however, that the tendency from Figure 1.7 is still present – countries with high exports of natural resources have grown more slowly than countries with low exports of natural resources. If a country increases its exports of natural resources as a share of GDP by 10 percentage points, the estimate indicates that its annual growth will decrease by 0.62 percentage points. This is a powerful effect – the difference between a growth of one percent and a growth of two percent is not one percent, but one hundred percent. If the effect is relevant for Norway, it indicates for instance that the export of oil and gas of 26% of GDP in 2008 reduces growth by 1.6 percentage points. That is more than half of a “normal” Norwegian growth rate.³

Even if we have controlled for initial income and trade policies, the estimate may still not reflect how the export of natural resources influences growth. It is reasonable to assume that many of the countries that export natural resources have a weak protection of private property rights, much corruption, and a low-quality government bureaucracy. If we do not control for this, the weak economic development will be ascribed to the export of natural resources, while the real problem is poor public institutions. Regression 2 in Table 1.1 shows the effect of controlling for institutional

quality. As we see, an improvement in institutional quality has a positive effect on economic development. For example, the analysis predicts that a country like Mexico – which has institutions of medium quality, with a score of 0.54 on a scale where 1 is the highest, would have had an annual economic growth 0.9 percent higher if its institutions were as good as Norway’s, with a score of 0.96 of 1. This accounts for the entire difference in growth between Mexico (2.2 percent annually) and Norway (3.1 percent annually) in the decades after 1965.

But again – the effect of an abundance of natural resources is present even if we control for institutional quality – from Regression 2 in Table 1.1 we see that it is significant and approximately as strong as in Regression 1. Even when we take into account the possibility that countries rich in natural resources may have institutions of poorer quality, growth is still lower in these countries.

Another possibility is that that countries rich in natural resources have a poorer investment climate than other countries – an abundance of natural resources can for example give rise to a feeling that it is not so important to stimulate investment because “we have enough to live on anyway”. If we not control for investment climate, weak growth could be ascribed to natural resources – even though the investment climate is the real problem. Regression 3 in Table 1.1 shows the effect of controlling for investment as a share of GDP. As expected, there is a close correspondence between investment and growth – higher investment gives higher growth. If Turkey, which had investments equivalent to 22,5 % of GDP in the period, had invested as great a part of its income as Norway, which invested 32,5 % of GDP, the analysis indicates that annual growth in Turkey would have increased from 2,9 percent to 4,4 percent.

³ Note that this number is meant only as an illustration of the strength of the estimated effect, and not as a prediction of the effect of oil exports on Norway’s economic growth. Torvik (2007) discusses how the export of natural resources influences the Norwegian economy, and argues that the effect is positive and not negative.

However, we see in Regression 3 in Table 1.1 that the export of natural resources still has a negative effect on growth – the effect is significant and somewhat stronger than in the two previous Regressions. Even when we control for possible differences in investment climate, countries with abundant natural resources grow more slowly than countries with scarce natural resources.

It is also thinkable that there are other variables associated with an abundance of natural resources that affect growth – and which should therefore be controlled for. The reader who wants to study these effects more in depth is referred to Sachs and Warner (1995,1997) and Mehlum, Moene and Torvik (2006a,b). These analyses study the effect of controlling for variables like for instance level of education, income distribution, ethnic fractionalization, unstable terms of trade, and the size of the agricultural sector. These studies conclude that the negative effect of natural resources on growth is robust also when these factors are controlled for.⁴

We see, then, that on average an abundance of natural resources leads to lower economic growth in a country. Income that agents in the economy to a large extent appropriate although they do not create much of value can have unfortunate effects on the economy. Domestic income may be reduced and not increased. Tax havens, too, give agents in the economy income opportunities even though they do not create anything. Taken in isolation, then, there is reason to believe that the net effect of tax havens are negative, particularly if we take into account that the income opportunities represented by tax havens in all probability have a less benign effect than income from natural resources.

Nonetheless what may be the most important question remains: Are there systematic differences between those countries where unproductive income opportunities are particularly damaging and those countries where they are less damaging? The empirical literature on the paradox of plenty has until recently focussed on the *average* effects of resource income on growth. This is interesting enough in itself. But for every Nigeria or

Venezuela there is a Botswana or Norway – what is most interesting is not that natural resources on average can give lower growth – but that the differences between different resource-rich countries are so great. In order to understand the problem of tax havens and design policies we must study the variance rather than the average effects. When do unproductive income opportunities lead to economic failure and when do they not?

2.5.2 Institutional quality

Mehlum, Moene and Torvik (2006a) argue that natural resources will give different incentives in different countries depending on the quality of their public institutions. In countries where government effectively supports property rights, and where there is little corruption in the public bureaucracy, natural resources will contribute positively to growth. Natural resources in such countries will give private agents incentives to invest in exploiting this wealth – more natural resources therefore stimulate value creation and growth. However, in countries where property rights are poorly protected and there is much corruption, more natural resources will make it more tempting for entrepreneurs to purloin resource income rather than build up enterprises. Here, an abundance of natural resources will undermine investment, value creation and growth.

How can one then study whether natural resources have opposite effects on growth in countries with good and poor public institutions? The regressions in Table 1.1 estimate only the average effect of resources – to find out whether resources have different effects in different countries depending on institutional quality, one must include an interaction term, i.e., a term where resource wealth is multiplied by institutional quality:

(Resource exports • Institutional quality)

Regression 4 in Table 1.2 is the regression from Table 1.1 expanded by such an interaction term. The effect of an increase in resource abundance is now from Table 1.2 given by:

– 14,34 + 15.40 • (Institutional Quality)

This result strongly supports that the effect of resource abundance is opposite in countries with good and poor institutions. In countries with the worst imaginable institutions, the index for institutional quality has a value of zero – in that case the cross term is eliminated, and the effect of natural resources on growth is given by -14.34. In such countries, then, unproductive income opportunities are very detrimental to growth. In countries

⁴ Note however that at the present stage of research, there are still important unresolved questions in the study of how resource abundance affects growth. We cannot know for sure that all other variables that affect both (the measures for) resource wealth and growth are controlled for. Further, it may be that a county's borders, and therefore what we define as units in the empirical analysis, is itself dependent on resource wealth, because this has an influence on the number of states, and on where borders are drawn.

Table 1.2 Economic growth and resource abundance Dependent variable: Average GDP growth

	Regression 4	Regression 5	Regression 6
Initial level of income	-1.26*	-1.88*	-1.33*
Openness in trade	1.66*	1.34*	1.87*
Resource abundance	-14.34*	-10.92*	
Institutional quality	-1.30	1.83	-0.20
Investments	0.16*	0.11*	0.15*
(Resource abundance • Institutional quality	15.40*	11.01	29.43*
Oil and mineral wealth			-17.71*
Africa excluded	No	Yes	Yes
Number of observations	87	59	87
Adjusted R2	0.71	0.79	0.63

Source: Mehlum, Moene and Torvik (2006a)

with the best imaginable institutions, the index for institutional quality has a value of 1 – in this case, the effect of more natural resources on growth is given by $-14.34 + 15.40 = 1.06$. In such countries, then, natural resources have a positive effect on growth. The growth effect of natural resources has opposite signs in countries with good and poor institutions. In countries with good institutions the paradox of plenty does not exist – here resource abundance becomes an advantage for economic growth.

From Table 1.2 we can also find *how* good the institutions need to be in order for the paradox of plenty no longer to be relevant. The positive and negative effects of natural resources on growth even out when:

$$-14.34 + 15.40 \cdot (\text{Institutional Quality}) = 0$$

This means that for countries whose institutional quality is greater than $14.34/15.40 = 0.93$, natural resources do not have a negative influence on growth. Of the 87 countries included in the analysis, 15 have a value higher than 0.93 on the index for institutional quality. For this fifth of the countries with best institutional quality – among them Norway – resource wealth does not give lower growth.

A potential problem with regression analyses that include many countries is that there are other differences between Norway and Sierra Leone than those connected with institutional quality. More generally, it can be argued that the paradox of plenty may be relevant for Africa as the least developed continent, but not for the rest of the world. Regression 5 in Table 1.2 therefore excludes Africa from the analysis. However, we still see that the main results come through also if we

study only countries outside Africa – the paradox of plenty is not a specifically African phenomenon.

Since one of the most marked characteristics of developing countries is low institutional quality, it is precisely in such countries that the income opportunities represented by tax havens inflict the greatest economic damage. The analysis above therefore supports the view that tax havens are far more damaging to developing countries than to industrialised countries.

As discussed above, the question of whether natural resources underestimate the problem of tax havens can still be raised. An abundance of natural resources has more positive effects on the economy than there is reason to believe that tax havens have. It is difficult to argue that agricultural production represents the same type of unproductive income opportunities as tax havens do. In this respect, the income provided by tax havens has more in common with diamonds and oil than with grain and vegetables. However, the data for resource wealth used in the analyses lump all natural resources together to a general measure of resource wealth. It should therefore be investigated whether this has any significance for the results – and more importantly – is it the case that those natural resources that can most be associated with unproductive income opportunities have the most detrimental effects on economic growth and development in developing countries?

Regression 6 in Table 1.2 gives an alternative measure for resource abundance – it only includes minerals and oil as a share of GDP. There are two interesting results to note. Firstly, the term that shows the negative effect of natural resources when institutional quality is low is strong-

er than before (-17.71 in column 3 against -14.34 in column 1). Secondly, the positive interaction term between natural resources and institutional quality is also stronger than before (29.43 in column 3 against 15.40 in column 1). These results imply that relative to natural resources in general, minerals/oil have a stronger negative effect on growth in countries with poor institutions and a stronger positive effect on growth in countries with good institutions. In oil economies, the difference between failure and success is greater than in countries that base their economy on other natural resources.

Boschini, Pettersson and Roine (2007) is the most thorough empirical analysis to date of how different types of natural resources influence growth – and how this depends on institutional quality. They use four different measures of resources, and show that the decisive factor for the effect on growth is the combination of institutional quality and the ease with which various natural resources can be seized. The worst thinkable effect of natural resources we see with diamonds in countries with poor institutions.

On this background it is reasonable to assume that the effects of tax havens on growth in countries with weak institutions are substantially

worse than what one would believe by comparing with the effects of unproductive income opportunities in general. The types of incentive to which tax havens give rise are particularly damaging to growth precisely in those countries that most need growth.

2.5.3 *Presidential rule versus parliamentary rule*

In a new and very interesting contribution, Andersen and Aslaksen (2008) show the following: The paradox of plenty is relevant for democracies with presidential rule – but not for those with parliamentary rule. A simple way to show the result is Figure 1.8 and 1.9, taken from Andersen and Aslaksen (2008).

Figure 1.8 shows the link between resource wealth and economic growth for countries classified as democracies with presidential regimes. Here we see that there is a clear connection like the one in Figure 1.7 – countries with high exports of natural resources have low growth. The paradox of plenty is relevant for countries with presidential rule.

Figure 1.9 shows the link between exports of natural resources and growth for democratic countries with parliamentary systems. We see

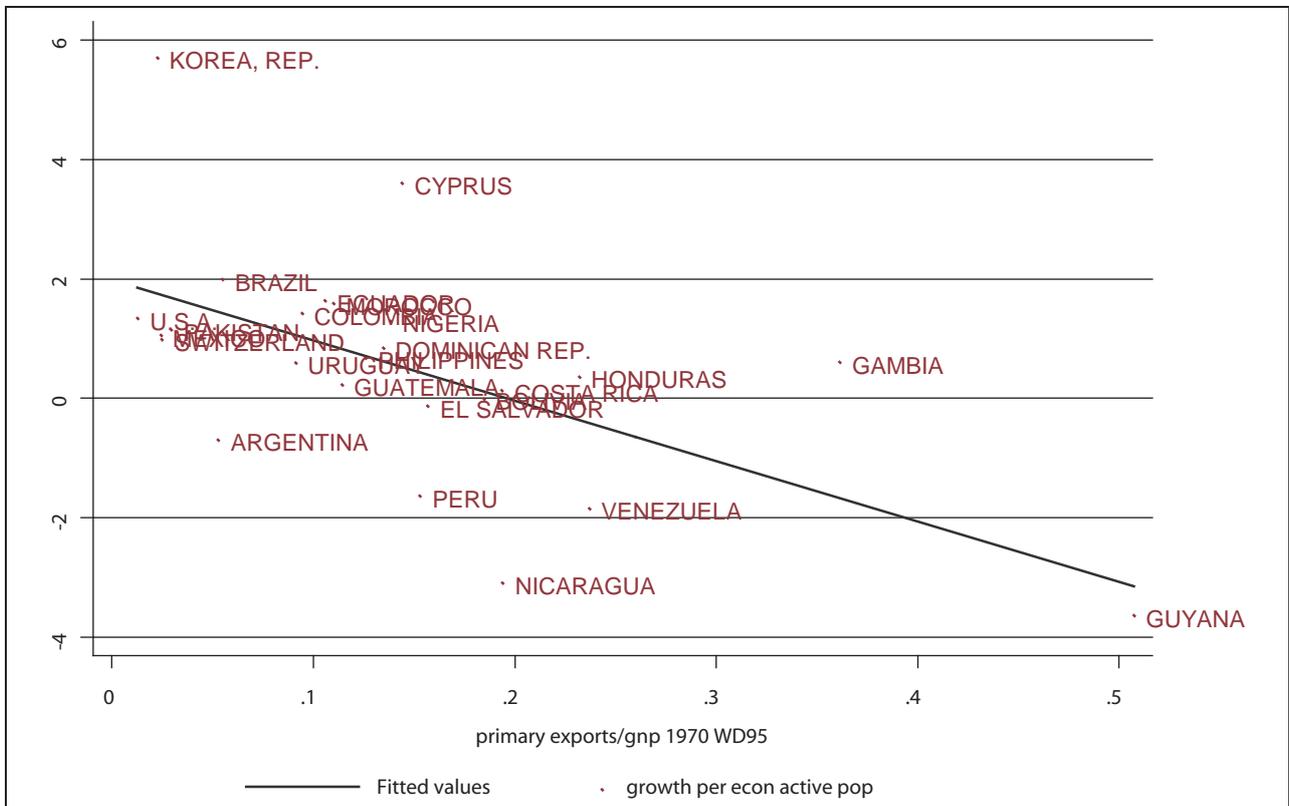


Figure 1.8 Democratic countries with presidential systems of government

Source: Andersen and Aslaksen (2008)

power is concentrated in the hands of the president. Such political systems seem very vulnerable to the damaging effects of the type of income opportunities represented by tax havens.

In sum, the argument that tax havens also represent income opportunities does not seem valid for developing countries. The “income opportunities” represented by tax havens contribute to exacerbate rather than alleviate their problems.

3 Tax havens and changes in institutions and political systems

In most countries, the negative effects of tax havens will set in motion institutional and political changes adapted to limiting the problems. In well-functioning countries, this will be a natural response, which will reduce the damaging effects of tax havens. Again, however, it may be the case that developing countries have the opposite response – responses that contribute to exacerbating the damaging effects of tax havens.

For politicians in countries with strong institutions and political systems tax havens represent a problem – they hurt the economy and reduce public income. Institutional and political changes can, however, limit this damage. For politicians in countries with weak institutions and political systems, on the other hand, tax havens do not necessarily represent a problem – they can also represent a solution. Tax havens provide opportunities for concealing income derived from corruption and illegal activity, or income politicians have dishonestly appropriated from development aid, natural resources and public budgets. In short, tax havens improve the feasibility of regarding the country’s economy as one’s personal purse. In this way, the appearance of tax havens also gives rise to political incentives to dismantle rather than build institutions, and to weaken rather than strengthen the political system. There are many examples that institutions designed to work against corruption and tax evasion are deliberately weakened. It seems obvious that the reason for this is that certain agents see their self-interest served by making such institutions weak.

Ross (2001a) shows that in countries like the Philippines, Indonesia, and Malaysia the existence of rich tracts of rain forest contributed to the deliberate dismantling of state institutions by politicians. The rain forests provided the basis for opportunities to pocket large sums of money through ruthless exploitation of the forest – but

for this to be possible, the state institutions established to counteract abuses and overexploitation had to be undermined. Politicians had incentives for dismantling institutions rather than building them – and the reason was the abundance of natural resources.

Ross (2001b) finds that countries with large oil deposits become less democratic. In such countries, democracy can represent a cost for politicians because it hinders them in using the large public income as they please. Large income from resources can therefore give political incentives for weakening democracy. In the same way, income opportunities provided by tax havens give politicians weaker incentives to enact democratic reforms, or can even give them stronger incentives to reduce the democratic control on those in power.

Collier and Hoeffler (2009) show how “checks and balances” – institutional rules that limit the political abuse of power and balance political power – enhance growth. However, they find that particularly in countries where such rules are important – for example because the country has substantial public income from natural resources – the rules are undermined by politicians. Again, the analogy to tax havens is obvious. It becomes in the interest of politicians to invest in a model of society where secrecy and opportunities for personal abuse of power are tolerated.

3.1 Presidential rule versus parliamentary rule

We have seen that there is a tendency that the political systems in countries with presidential rule are less able to use increased economic opportunities to achieve better political outcomes. There is reason to believe that tax havens do greater damage in such countries. This raises the question of why some countries have presidential rule whereas other countries have parliamentary rule. Until recently, the consensus was that this is largely determined by history, and is stable over time. Latin American countries have presidential rule. The most common understanding is that this was a political choice made when these countries became independent about 200 years ago, and that the political systems have since endured. In the same way, the fact that the majority of European countries are parliamentary is explained in terms of historical choices that have endured. Although this understanding may have its merits, it also raises some questions. For example – given

Table 1.3 Changes in constitution

Country	Independence	Constitution	Constitution today
Botswana	1966	Parliamentary	Parliamentary
Burkina Faso	1960	<i>Presidential</i>	<i>Presidential</i>
Burundi	1962	Parliamentary	<i>Presidential</i>
Cameroon	1960	Parliamentary	<i>Presidential</i>
Central African Republic	1960	<i>Presidential</i>	<i>Presidential</i>
Chad	1960	Parliamentary	<i>Presidential</i>
Cote d'Ivoire	1960	<i>Presidential</i>	<i>Presidential</i>
Gabon	1960	Parliamentary	<i>Presidential</i>
Gambia	1965	Parliamentary	<i>Presidential</i>
Ghana	1957	Parliamentary	<i>Presidential</i>
Guinea	1958	<i>Presidential</i>	<i>Presidential</i>
Guinea-Bissau	1973	Parliamentary	<i>Presidential</i>
Kenya	1963	Parliamentary	<i>Presidential</i>
Malawi	1964	Parliamentary	<i>Presidential</i>
Mali	1960	Parliamentary	<i>Presidential</i>
Mauritius	1968	Parliamentary	Parliamentary
Niger	1960	<i>Presidential</i>	<i>Presidential</i>
Nigeria	1960	Parliamentary	<i>Presidential</i>
Rwanda	1962	<i>Presidential</i>	<i>Presidential</i>
Senegal	1960	Parliamentary	<i>Presidential</i>
Sierra Leone	1961	Parliamentary	<i>Presidential</i>
South Africa	1910	Parliamentary	Parliamentary
Sudan	1956	Parliamentary	<i>Presidential</i>
Tanzania	1964	Parliamentary	<i>Presidential</i>
Zaire	1960	Parliamentary	<i>Presidential</i>
Zambia	1964	Parliamentary	<i>Presidential</i>
Zimbabwe	1980	Parliamentary	<i>Presidential</i>

Source: Robinson and Torvik (2009)

that certain forms of presidential rule are economically and politically damaging – why do not countries with this form of government switch to another form? One hypothesis could be that in some of the countries with presidential rule this serves the members of the political and economic elite, consequently they do not see their self-interest served in a switch to another form of government, even though a switch would have been advantageous for the country as a whole.

The explanation that the political system is formed by historical choices and is therefore stable over time is inadequate. This can easily be seen if one concentrates on African countries. Here we find a remarkable pattern. When African countries gained independence, most of them had parliamentary constitutions. If we look at African

countries south of the Sahara, we see from Table 1.3 that at independence, there were four times as many countries with parliamentary constitutions as with presidential rule. However, in country after country, constitutions were changed – and today only three of the 21 the countries that started out with parliamentary systems retain them. None of the countries that started out with presidential rule has changed to a parliamentary system. It is also remarkable that two of the three countries that still have parliamentary systems – Botswana and Mauritius – are the countries that have done best after independence.

Why have these countries chosen forms of government that seem to give worse economic outcomes? Why did Mobutu want to change his role from prime minister to president in Zaire in

1967? The same question can be asked of Mugabe in Zimbabwe in 1987, Stevens in Sierra Leone in 1978, Banda in Malawi in 1966 and Nkrumah in Ghana in 1960. There is little doubt that the transition to presidential rule in Africa represents a transition to a less democratic system, and to a system where the president personally has acquired substantial political power at the expense both of parliament and of the general population. In short, the transition in Africa is a transition that gives a narrower power elite greater political power – a power that can extensively be misused for personal gain. For opportunistic politicians it is therefore not difficult to understand that such a transition can serve their personal self-interest – even though it does not serve the interests of the country. The discrepancy between what serves the individual politician and what serves society is determined by the degree to which politicians are able to pursue policies that are not subjected to controls by the population. For opportunistic politicians tax havens represent a useful tool – they make it easier to adapt policies towards personal gain. The gains from switching to a system where the power of the general population is reduced and that of the political elite is increased is therefore greater for politicians the better their access to tax havens. Presidential rule with its concentration of power goes hand in hand with tax havens. The political system is not determined by the interests of the county – but by the interests of its political power elite.

The rise of tax havens increases the possibilities for personal enrichment through a political career, and at the same time makes it more tempting for opportunistic politicians to change institutions and political systems. In its turn, this can have an effect on what kind of people choose to be active in the political system. Not only do tax havens make it easier and more tempting for corrupt and dishonest politicians to further their own interests at the expense of the interests of society – tax havens may also have the side effect that the proportion of corrupt and dishonest politicians will be greater than it would otherwise have been.

3.2 Tax havens, natural resources and conflict

In the last few years, it has become clear that many civil wars can largely be explained by economic motives. Collier and Hoeffler (2004) find that higher income in the form of more natural resources increases the danger of civil war, whereas higher income in the form of higher productivity

reduces the danger of conflict. One weakness of the first empirical studies of conflict is nonetheless that the causality is unclear: Do more natural resources lead to more conflict – or are countries with more conflicts typically in a situation where the only viable economic activity is the extraction of natural resources, whereas other industrial activity will not develop? Does poverty lead to conflict – or does conflict lead to poverty?

The more recent empirical literature seeks to clarify these causal relations. The most path-breaking contribution is Miguel, Satyanath and Sergenti (2004). How can one know whether it is poverty that leads to conflict or conflict that leads to poverty? If one can find a variation in income that is certainly not caused by conflict, then one may next find the causal link *from* poverty *to* conflict. Miguel, Satyanath and Sergenti (2004) use meteorological data for this. In Africa it is clear that the amount of rain has a strong influence on the income from year to year – at the same time, it is clear that civil wars cannot have an effect on the amount of rainfall! The variations in income caused by changes in rainfall can therefore be used to establish how changes in income affect conflict. The result is unambiguous: Poverty engenders conflict.

Besley and Persson (2009) study the causality between income from natural resources and conflict by exploiting the fact that all countries are too small to influence prices on the world market. Thus, changes in these prices cannot be caused by changes in conflicts within single countries. At the same time, Besley and Persson (2009) use time series data that enable them to control for any unobserved characteristics for each country. Again, the result is unequivocal: Wealth in natural resources engenders conflict.

But *why* does income in the form of natural resources give more conflict – while income due to higher productivity gives less conflict? Tax havens can partly explain this relation. Aslaksen and Torvik (2006) develop theory for this. Natural resources are beneficial to politicians whether there is democracy or not. In a democracy, public income from natural resources will, wholly or partially, be transferred to the population in the form of income transfers or expanded public services. Since politicians are accountable to the electorate, they will have relatively limited opportunities for using much of the resource income to enrich themselves, or for projects preferred by politicians, but not by the electorate. Nonetheless, it is reasonable for politicians to regard resource in-

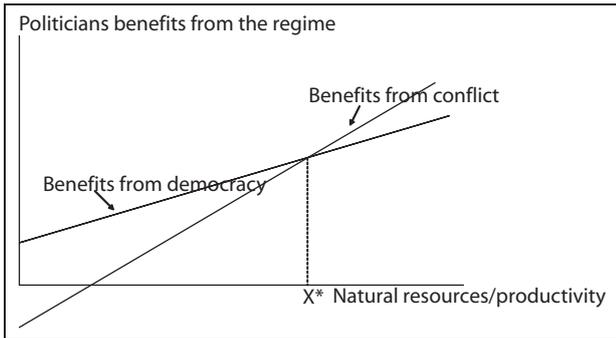


Figure 1.10 Democracy and conflict

come as beneficial – either because they care about what is beneficial to the population or because they, even in under democracy, will to a certain extent be free to use some of the resource income at their discretion. Figure 1.10 shows this connection. The greater the resource income, the greater will be the utility to politicians in a democracy.

One alternative to democracy is to decide the struggle for political power through armed conflict. Armed conflict is expensive – an army must be established, equipment must be acquired, soldiers must be paid, and at the same time, a conflict will damage the means of production and the infrastructure. The cost of conflict is higher the higher the productivity of a country – high productivity gives high costs – and high costs makes the establishment of an army expensive. High productivity raises the cost of destruction – there is more to destroy. On the other side – if productivity is low, pay is low, and it is cheap to establish an army. At the same time, there is not much to destroy – so destruction represents less of a cost than when productivity is high.

However, for the kind of politician who is more concerned about his own good than that of the general population, there can also be advantages in winning power through armed conflict rather than through democratic elections. Where in a democracy you are accountable to the voters, and this limits the political freedom of action, with no democracy, you will to a greater extent be able to control the nation's resources at will. For this reason, the utility of conflict for such politicians is higher the greater the resource income in relation to productivity. Moreover, since politicians have fewer barriers on their use of state funds than in a democracy, the utility to politicians of resource income grows *faster* under a non-democratic regime. The curve for the utility to politicians in Fig-

ure 1.10 therefore has two properties. Firstly, the expected utility of conflict will be negative if you have nothing to win – the conflict curve in 1.10 therefore begins below the utility to politicians under democracy. Secondly, the slope of the curve for utility to politicians under conflict will be steeper than the slope of the curve under democracy – in Figure 1.10 the conflict curve is steeper.

Figure 1.10 now clarifies that for the type of politician who primarily has personal economic motives, the choice between democracy and conflict will *not* be determined by how natural resources affect profitability under conflict, as many seem to argue. The central question is how profitability under conflict develops *relative* to profitability under democracy. Figure 1.10 shows the point at which politicians will see it in their interest to have democratic institutions – and when they will not see it in their interest, and instead resort to armed conflict. If natural resources in relation to productivity is lower than X^* , then it is in the self-interest of politicians to support democratic institutions. There will therefore be a tendency for democracies to be more stable in countries with little resource income and high productivity. If natural resources in relation to productivity is higher than X^* then it is in the self-interest of politicians to undermine democratic institutions and resort to armed conflict. In such cases, both parties in a conflict may have an interest in keeping the conflict alive!

A central factor in economically motivated conflict is that the wealth stolen by politicians can be safely channelled out of the country, so the funds are not lost if one loses political power. Easier access to tax havens will therefore shift the curve for the utility under conflict upwards, as is drawn with the stippled line in Figure 1.11.

We see from Figure 1.11 that tax havens make it relatively more attractive to undermine democracy and choose conflict instead – the critical level of resources relative to productivity needed for

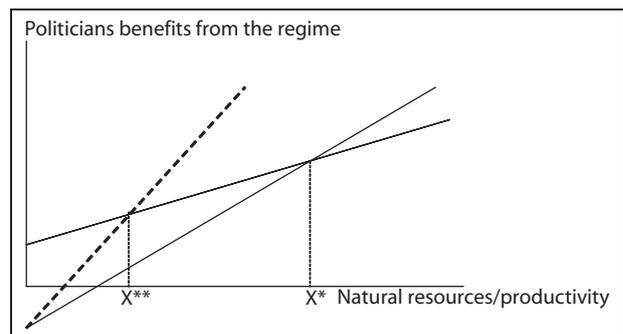


Figure 1.11 Tax havens, democracy and conflict

stable democracy goes down from X^* to X^{**} . Tax havens contribute to destabilizing democracies because the type of political agents who do not think of the best interests of the general population find it relatively more profitable to engage in conflict.

3.3 Theory: Tax havens, institutional change and income

Tax havens undermine the quality of countries' institutions and political systems. This in its turn has a negative effect on income, an effect over and above the negative effects of tax havens on income studied above. This is shown in Figure 1.12. For those entrepreneurs who are engaged in productive industrial activity, weaker institutions and political systems represent a cost. More corruption, a weaker legal system, contracts awarded on the basis of political friendships rather than profitability, poor government bureaucracy, and so on, make economic activity less profitable than it would otherwise have been. The curve that indicates the income of entrepreneurs in productive activity in Figure 1.12 therefore shifts downward to the stippled curve.

It is not surprising that the deterioration in opportunities for productive entrepreneurs reduces the income of all entrepreneurs. It is more surprising that the income is reduced *by more* than the initial deterioration in income opportunities would indicate: The fall in income is *greater* than the vertical shift in the curve for the income of entrepreneurs in productive activity.

The intuition is that weaker institutions and political systems spark off a multiplicative process that exacerbates the initial problems. When the profitability of industrial activity is weakened by deteriorating institutions, this leads to fewer en-

trepreneurs engaged in productive activity, and more engaged in unproductive activity. This, in its turn, reduces the profitability of productive activity even further, the fall in productive activity accelerates, income falls even more, and so on. Income falls, then, not only as a direct result of institutional change – but also as an indirect result of the negative multiplicative processes set in motion by the institutional changes. The effect of poorer institutions and weaker political systems on income is therefore greater than one would expect based only on the reduced profitability of economic activity caused by weakened institutions.

3.4 Empirical studies: Tax havens, institutional change, and income

To all appearances, stopping such a process will have a great effect on economic growth. In the last decade, it has become clear that institutional quality may be the most important driving force of economic prosperity and growth. Acemoglu, Johnson and Robinson (2001) is the best-known study of the effect of institutions on domestic income. They estimate that if a country whose institutional quality at the outset lies on the 25th percentile could improve its institutional quality to place it on the 75th percentile, domestic income would increase 7-fold. Few factors have as strong an effect on growth as improved institutions. Precisely for this reason, the damaging effects of tax havens are so disastrous for developing countries – tax havens contribute not only to conserving poor institutions – but also to making them worse.

If tax havens not only affect institutional quality, but also have an effect on the choices political agents make between conflict and democracy, the growth effects become still more dramatic. Nothing is as damaging for development and growth as war.

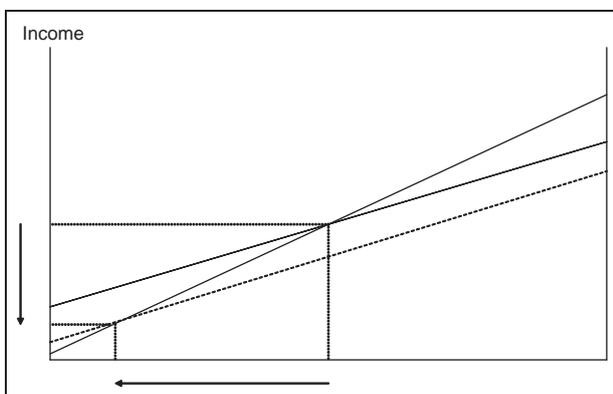


Figure 1.12 The effect of institutional change on income

4 Conclusion

The negative effects of tax havens are greater for developing countries than for other countries. There are many reasons for this. Reduced government income will have a greater social cost for developing countries than for industrialised countries. In addition, other mechanisms make themselves felt in countries with weak institutions and political systems. In such countries, “income opportunities” represented by tax havens for the pri-

vate sector in reality contribute to the reduction of private income. Tax havens are central to the explanation of the paradox of plenty – and give resources that normally contribute to economic growth and development the opposite effect. The damage is particularly great in countries with weak public institutions, in countries with presidential rule, and in countries with unstable democracies. At the same time, institutions cannot be regarded as natural givens. Tax havens give

the agents in the economy incentives to change institutions – but for the worse rather than for the better. Political agents are given incentives to weaken public institutions, to establish a type of presidential rule where much power is concentrated in the president's hands, and to undermine democracy. For developing countries, the growth effects of putting a stop to the use of tax havens are great.

Table 1.4 Appendix: Data used in the analyses

Country	iq	sxp	growth	gdp65	open	inv	snr	afr	pres	parl
Zambia	0.414	0.5431	-1.88	7.66	0.00	15.98	0.38	1	0	0
Guyana	0.284	0.5072	-1.47	8.06	0.12	20.23	0.19	0	1	0
Malaysia	0.690	0.3681	4.49	8.10	1.00	26.16	0.09	0	0	1
Gambia	0.563	0.3612	0.35	7.17	0.19	6.05	0.00	1	1	0
Gabon	0.538	0.3263	1.73	8.35	0.00	28.18	0.55	1	0	0
Ivory Coast	0.670	0.2932	-0.56	7.89	0.00	10.06	0.02	1	0	0
Uganda	0.297	0.2655	-0.41	7.10	0.12	2.52	0.01	1	0	0
Venezuela	0.556	0.2370	-0.84	9.60	0.08	22.16	0.35	0	1	0
Honduras	0.339	0.2320	0.84	7.71	0.00	13.40	0.02	0	1	0
Ghana	0.370	0.2109	0.07	7.45	0.23	5.05	0.12	1	0	0
Malawi	0.447	0.2073	0.92	6.68	0.00	11.29	0.00	1	0	0
Nicaragua	0.300	0.1939	-2.24	8.45	0.00	12.19	0.01	0	1	0
Costa Rica	0.547	0.1935	1.41	8.52	0.15	17.26	0.00	0	1	0
Algeria	0.436	0.1924	2.28	8.05	0.00	27.14	0.22	1	0	0
Togo	0.435	0.1907	1.07	6.82	0.00	18.35	0.21	1	0	0
Bolivia	0.227	0.1845	0.85	7.82	0.77	15.34	0.17	0	1	0
Cameroon	0.566	0.1815	2.40	7.10	0.00	10.59	0.00	1	0	0
Kenya	0.556	0.1808	1.61	7.14	0.12	14.52	0.00	1	0	0
New Zealand	0.965	0.1775	0.97	9.63	0.19	23.79	0.01	0	0	1
South Africa	0.692	0.1720	0.85	8.48	0.00	18.53	0.19	1	0	0
Tanzania	0.464	0.1716	1.93	6.58	0.00	11.60	0.06	1	0	0
Zimbabwe	0.444	0.1661	0.86	7.58	0.00	14.87	0.05	1	0	0
El Salvador	0.258	0.1567	0.19	8.15	0.04	8.19	0.00	0	1	0
Ireland	0.832	0.1543	3.37	8.84	0.96	25.94	0.01	0	0	1
Peru	0.323	0.1528	-0.56	8.48	0.12	17.49	0.07	0	1	0
Netherlands	0.981	0.1513	2.27	9.38	1.00	23.32	0.01	0	0	1
Chile	0.633	0.1488	1.13	8.69	0.58	18.18	0.10	0	0	0
Sri Lanka	0.433	0.1480	2.30	7.67	0.23	10.93	0.00	0	0	1
Zaire	0.298	0.1473	-1.15	6.93	0.00	5.20	0.32	1	0	0
Nigeria	0.308	0.1382	1.89	7.09	0.00	15.06	0.13	1	1	0
Jamaica	0.470	0.1368	0.78	8.32	0.38	18.85	0.11	0	0	1
Senegal	0.475	0.1352	-0.01	7.69	0.00	5.11	0.06	0	0	1
Dominican Rep.	0.452	0.1346	2.12	7.85	0.00	17.75	0.01	0	1	0
Philippines	0.297	0.1260	1.39	7.78	0.12	16.50	0.03	0	1	0
Madagascar	0.467	0.1187	-1.99	7.63	0.00	1.39	0.00	1	0	0

Table 1.4 Appendix: Data used in the analyses

Country	iq	sxp	growth	gdp65	open	inv	snr	afr	pres	parl
Guatemala	0.284	0.1140	0.71	8.16	0.12	9.19	0.00	0	1	0
Indonesia	0.367	0.1124	4.74	6.99	0.81	21.57	0.12	0	0	0
Morocco	0.430	0.1100	2.22	7.80	0.23	11.22	0.10	1	1	0
Belgium	0.971	0.1077	2.70	9.27	1.00	22.26	0.01	0	0	1
Ecuador	0.542	0.1056	2.21	8.05	0.69	22.91	0.00	0	1	0
Norway	0.960	0.1032	3.05	9.30	1.00	32.50	0.01	0	0	1
Tunisia	0.459	0.1030	3.44	7.81	0.08	14.54	0.14	1	0	0
Australia	0.943	0.0998	1.97	9.57	1.00	27.44	0.07	0	0	1
Denmark	0.968	0.0986	2.01	9.47	1.00	24.42	0.00	0	0	1
Paraguay	0.440	0.0971	2.06	7.88	0.08	15.53	0.00	0	0	0
Canada	0.967	0.0959	2.74	9.60	1.00	24.26	0.06	0	0	1
Colombia	0.530	0.0942	2.39	8.19	0.19	15.66	0.04	0	1	0
Uruguay	0.512	0.0910	0.88	8.67	0.04	14.34	0.00	0	1	0
Sierra Leone	0.542	0.0906	-0.83	7.60	0.00	1.37	0.51	1	0	0
Jordan	0.408	0.0898	2.43	8.04	1.00	16.80	0.01	0	0	0
Somalia	0.373	0.0884	-0.98	7.51	0.00	9.85	0.00	1	0	0
Thailand	0.626	0.0856	4.59	7.71	1.00	17.56	0.01	0	0	1
Mali	0.300	0.0838	0.82	6.71	0.12	5.89	0.00	1	0	0
Trinidad&tobago	0.609	0.0831	0.76	9.39	0.00	13.10	0.21	0	0	1
Syria	0.308	0.0808	2.65	8.37	0.04	15.31	0.05	1	0	0
Haiti	0.258	0.0774	-0.25	7.40	0.00	6.64	0.03	0	0	0
Congo	0.369	0.0763	2.85	7.60	0.00	9.24	0.08	1	0	0
Egypt	0.435	0.0732	2.51	7.58	0.00	5.13	0.05	1	0	1
Finland	0.968	0.0702	3.08	9.21	1.00	33.81	0.01	0	0	1
Brazil	0.636	0.0549	3.10	8.16	0.00	19.72	0.02	0	1	0
Argentina	0.428	0.0526	-0.25	8.97	0.00	16.87	0.02	0	1	0
Sweden	0.965	0.0504	1.80	9.56	1.00	22.38	0.01	0	0	1
Botswana	0.700	0.0503	5.71	7.10	0.42	24.61	0.05	1	0	1
Portugal	0.774	0.0478	4.54	8.25	1.00	22.99	0.00	0	0	1
Niger	0.583	0.0464	-0.69	7.12	0.00	9.37	0.01	1	0	0
Burkina Faso	0.475	0.0435	1.26	6.52	0.00	9.49	0.00	1	0	0
Greece	0.550	0.0409	3.17	8.45	1.00	24.57	0.01	0	0	1
Israel	0.609	0.0399	2.81	8.95	0.23	24.50	0.03	0	0	1
Austria	0.945	0.0389	2.91	9.18	1.00	25.89	0.01	0	0	1
Turkey	0.526	0.0380	2.92	8.12	0.08	22.52	0.02	0	0	1
France	0.926	0.0300	2.58	9.37	1.00	26.72	0.01	0	0	1
Spain	0.764	0.0299	2.95	8.87	1.00	25.05	0.01	0	0	1
Pakistan	0.411	0.0294	1.76	7.49	0.00	9.57	0.01	0	1	0
Hong Kong	0.802	0.0277	5.78	8.73	1.00	20.79	0.00	0	0	0
U.k.	0.934	0.0263	2.18	9.38	1.00	18.12	0.02	0	0	1
Singapore	0.856	0.0262	7.39	8.15	1.00	36.01	0.00	0	0	1
Switzerland	0.998	0.0247	1.57	9.74	1.00	28.88	0.00	0	1	0
Mexico	0.541	0.0241	2.22	8.82	0.19	17.09	0.02	0	1	0
Korea. Rep.	0.636	0.0224	7.41	7.58	0.88	26.97	0.02	0	1	0
Taiwan	0.824	0.0223	6.35	8.05	1.00	24.44	0.01	0	0	0

Table 1.4 Appendix: Data used in the analyses

Country	iq	sxp	growth	gdp65	open	inv	snr	afr	pres	parl
Germany. West	0.959	0.0218	2.37	9.41	1.00	25.71	0.02	0	0	1
Italy	0.820	0.0208	3.15	9.07	1.00	25.90	0.00	0	0	1
China	0.569	0.0195	3.35	6.94	0.00	20.48	0.04	0	0	0
India	0.576	0.0165	2.03	7.21	0.00	14.19	0.03	0	0	1
U.s.a.	0.980	0.0126	1.76	9.87	1.00	22.83	0.03	0	1	0
Bangladesh	0.274	0.0098	0.76	7.68	0.00	3.13	0.00	0	0	1
Japan	0.937	0.0064	4.66	8.79	1.00	34.36	0.00	0	0	1

Explanation of variables:

IQ – Institutional Quality. This is an index based on data from Political Risk Services. The index consists of an unweighted average of five part-indices: (i) the degree to which the population of a country accept its law-enforcement institutions, (ii) bureaucratic quality, (iii) corruption in government, (iv) risk of expropriation and (v) probability that government will honour contractual obligations. The index goes from zero to one, with zero as den worst institutional quality and one as the best.

SXP – Resource wealth: Primary exports as share of domestic income in 1970.

GROWTH: A country's average annual growth rate in GDP per capita in the period 1965 – 1990.

GDP65 – Initial level of income: Logarithm of GDP per capita in 1965.

OPEN – Openness for trade: An index that measures the proportion of years in the period when a country is characterised by openness for international trade.

INV – Investments: Average percentage share of real investments of GDP.

AFR – Africa: Coded as 1 if a country lies in Africa and zero otherwise.

PRES – Democratic countries with presidential rule: Coded as 1 if the country is classified as et democracy in the period and if its political system is presidential, 0 otherwise.

PARL – Democratic countries with parliamentary regime: Coded as 1 if the country is classified as a democracy in the period and if it has a parliamentary political system, 0 otherwise.

Sources for data: Sachs and Warner (1995, 1997), Mehlum, Moene and Torvik (2006a), Andersen and Aslaksen (2008). For some of the countries, these works do not include data for all the countries. In such cases, the data sources re-

ferred to in these works are used to complete the data sets. For Hong Kong, there are no data for the political variable. Hong Kong is therefore classified neither as a democratic presidential regime nor as a democratic parliamentary regime.

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Appendix 2

The importance of taxes for development

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Summary:

Improving the tax system is one of the main challenges in many developing countries. This appendix focuses on three interconnected topics: (1) weak state finances and low tax revenue; (2) characteristics of the tax base in poor countries; and (3) the connection between taxation and good governance. A series of factors contribute to explaining the low tax base in poor countries, among them a large informal sector, widespread corruption, and tax evasion. Capital flight also undermines the tax base, and thus the domestic resources available for financing the development of public institutions, social services, and investment in infrastructure. This appendix demonstrates that the political impact of taxation goes far beyond obtaining funds for financing the public sector, investment, and the basic needs of the population. Bad governance is often correlated with the state not depending on revenue from taxation of its citizens and businesses. Experience shows that taxation has contributed to more representative and accountable government by stimulating dialog between state and civil society about taxation. Developing an effective tax administration has stimulated the development of institutions also in other parts of the public sector. Systems for recruitment, competence building, and management in the tax administration have been models for developing other parts of the public administration. In this perspective, the challenge for poor countries is not necessarily to tax more, but to tax a greater part of their population and businesses. Income from aid and natural resources may substitute non-existent tax revenue, and ensure that important development goals are reached. Financing state expenditure through these sources, however, contributes little to developing the institutional capacity of the state.

1 Weak state finances

Average tax revenue in low-income countries was approximately 13 percent of GDP in 2000 (Baungsgaard & Keen 2005), i.e., less than half of the OECD average of 36 percent (OECD 2007). In the past few years, overall government income from domestic sources in sub-Saharan Africa has risen from an average of less than 15 percent in 1980 to a little more than 18 percent in 2005 (Gupta & Tareq 2008). The greater part of this increase comes from higher income from natural resources, and not through the tax system. Domestic revenue from sources not related to natural resources has risen by less than 1 percent of GDP in the last 25 years. In developing countries with abundant natural resources, too, state income from sources other than natural resources has remained more or less unchanged (Keen & Mansour 2008).

In many low-income countries that are net importers of oil, domestic revenue generation has not kept up with the increase in public spending. Consequently, a growing share of their operating budgets are financed through foreign aid. In Ghana, for instance, the share of the operating budget (including debt relief) financed through aid increased from 16 percent of GDP in the period 1997-1999 to 36 percent in 2004-2006 (Gupta & Tareq 2008). The corresponding figures for Tanzania show an increase from 22 percent to 40 percent, and in Uganda from 60 percent to 70 percent. Estimates from the OECD show that the dependence on aid will probably increase in the future, particularly in Africa and some countries in Asia.¹

These numbers show that there are considerable weaknesses in the fiscal base of many low-in-

¹ In 2004, official foreign aid in Burundi constituted about 55 percent of GDI and 88 percent of gross government spending. Corresponding figures for Cambodia are 11 percent and 67 percent; for Ethiopia respectively 23 percent and 79 percent; Mozambique 24 percent and 88 percent; and for Sierra Leone 34 percent and 128 percent (OECD-DAC 2006).

come countries. According to the International Monetary Fund, tax revenue equivalent to 15 percent of GDP is a “reasonable” minimum level for low-income countries to secure the financing of basic government tasks such as law and order, health, and education (IMF 2005). Many countries do not reach this level. A study by Fox & Gurley (2005) found that as many as 44 of the 168 countries included in the study had tax revenues lower than 15 percent of GDP in the 1990s. Eighteen of these countries are in sub-Saharan Africa. Income from natural resources and aid substitute non-existent tax income, and might ensure that important development goals are reached. However, financing state spending through such sources contributes little to developing the institutional capacity of the state (Moore 2004; Ross 2001). Revenue from aid and natural resources is also generally more unpredictable than tax revenue (Bulír & Hamann 2007).

2 Explanations for the low tax base in poor countries

Several factors contribute to explaining the low tax base in developing countries.

1. Corruption and tax evasion are widespread. Studies from various developing countries show that it is not unusual that half or more of due taxes never reach the state coffers because of corruption and tax evasion (Christian Aid 2008; Fjeldstad & Tungodden 2003; Mookherjee 1997). Multinational corporations play a central part for instance through manipulating transfer prices to avoid taxation (see chapter 3 in this report). Tax evasion by domestic taxpayers is also widespread in poor countries (Chand & Moene 1999; Fjeldstad 2006). The willingness of the taxpayers to pay taxes can be low for historical, political, or cultural reasons (Lieberman 2003), but their reluctance can

also be attributed to a lack of trust in authorities that consistently misuse public funds. (Rothstein 2000). Tax evasion in poor countries is probably one of the factors that contributes most to corruption in the public sector.

2. The political and economic elite in many developing countries is often not part of the tax base because of tax exemptions and/or evasion (Stotsky & WoldeMariam 1997). In addition, the tax base often does not include people in liberal professions like lawyers, doctors and private consultants (Bird & Wallace 2004).
3. The problems with mobilizing domestic resources are made worse because the liberalization of foreign trade the last 20 years has led to a fall in customs revenue for developing countries. This has been a particularly serious problem for low-income countries. Research from the IMF shows that while rich countries have succeeded in compensating for the fall in customs revenue through other sources of income, mainly value added tax, the poorest countries have only succeeded in replacing about 30 percent of lost customs revenue through other tax bases (Baunsgaard & Keen 2005).
4. It is difficult to collect taxes in poor, agricultural economies. The tax bases are often small, and the cost of collecting large; personal income is seasonal and unstable (Fjeldstad & Semboja 2001; Bernstein & Lü 2008). Where personal income tax generates around 7 percent of GDP in developed countries – and is paid by about 45 percent of the population, the corresponding number for developing countries is only 2 percent of GDP – paid by less than 5 percent of the population (Bird & Zolt 2005).
5. The informal sector, or the unregistered part of the economy, is large, particularly in towns, and this makes tax collecting difficult (see Table 2.1).

Table 2.1 Informal sector (unregistered) as percentage of GDP (2000)

Region	Value creation in % of official GDP
AFRICA	41
CENTRAL and South AMERICA	41
Asia	29
Post-Communist Transition Economies	35
European OECD-Countries	18
North AMERICA and OECD countries bordering on the Pacific	13.5

Source: FIAS (2009) based on The World Bank (2007)

Table 2.2 Concentration of tax collecting in selected countries (2000)

	Number of large Tax-Payers	% of Total Number of TaxPayers	% of Tax revenue
Argentina	3 665	0,1	49,1
Benin	812	1,0	90,0
Bulgaria	842	0,1	51,4
Hungary	369	0,1	42,1
Kenya	600	0,4	61,0
Peru	2 430	0,9	64,9
The Philippines	833	0,2	36,0

Source: Bodin (2003), referred to in FIAS (2009)

6. Poor countries often lack the resources and capacity for building effective tax collection systems. Given the scarce administrative resources, it is rational for tax collectors to concentrate their efforts on the relatively small number of available taxpayers who have the ability to pay, but lack the political contacts that can “protect” them against taxation (Dasgupta & Mookherjee 1998; Svensson 2003).
7. In many developing countries a few hundred, or maybe a few thousand, taxpayers contribute the greater part of tax revenue (see Table 2.2). In Bangladesh, for instance, less than 1 percent of the population are registered as taxpayers, and 4 percent of these (i.e., less than 0.4 percent of the population) pay 40 percent of the tax take, whereas 50 percent of taxpayers (less than 0.5 percent of the population) pay less than 1 percent of the tax take (Sarker & Kitamura 2006). In Tanzania, with a population of more than 40 million people, 286 companies contribute about 70 percent of domestic tax revenue (Fjeldstad & Moore 2008). According to Baer (2002), 0.4 percent of taxpayers in Kenya and Colombia pay respectively 61 percent and 57 percent of the total domestic tax revenue.
8. In the last few years, many developing countries have to a greater extent than before been able to finance their spending from other sources than taxation, for instance through commercial loans, income from oil and mineral resources, and foreign aid. A number of studies show that extensive aid can have negative effects on the recipient countries’ incentives to generate revenue through domestic resources (Bräutigam & Knack 2004; Remmer 2004). Research conducted by the World Bank finds that aid to African countries reduces tax income by an average of 10 percent (Devarajan, Rajcooner & Swaroop 1999).²
9. Capital flight and tax havens contribute to entrenching existing tax structures in developing countries. In many countries, particularly in sub-Saharan Africa and Latin America, capital flight is accompanied by increased foreign borrowing. This borrowing is not used to finance investment or consumption, but to finance the capital flight itself (Rodríguez 1987; Boyce & Ndikumana 2005). The ensuing debt burden will probably hurt the poor most, since public spending on the social sectors and on investment in infrastructure must be cut to service the debt. This also affects the development of institutions in the public sector through a falling level of real earnings and increased corruption.
10. Capital flight is a global phenomenon, but there are great regional differences between developing countries (see Table 2.3).
11. Collier *et al* (2004) estimate that capital flight as a share of private assets was about two times higher in Latin America than in East Asia in the 1980s and 1990s. For sub-Saharan Africa, i.e., in the region with the greatest scarcity of capital, capital flight as a share of private assets was on average six times higher than in East Asia in the 1980s, and more than ten times higher in the 1990s.³ It is probable that capital flight has not only caused, but is also caused by, lower

² These studies stress two aspects of aid dependency: (1) aid gives the authorities more financial autonomy with respect to citizens, since the long-term dependency on external resources requires neither dialogue or “negotiation” with tax payers, nor the development of the administrative capacity of tax authorities; (2) the aid system, with many uncoordinated donors and independent units for project administration, can contribute to overextending already weak state institutions.

³ There are also large variations within the regions, variations not reflected in these estimates.

Table 2.3 Capital flight as share of private assets in Latin America and East Asia

	(percent)			
	1980-9 (a)	1990-8 (a)	1980-9 (b)	1990-8 (b)
Sub-Saharan Africa	27.6%	30.1	27.4	30.3
Latin America & Caribbean	8.5%	9.0	7.5	7.9
East Asia and the Pacific region	4.5	5.0	2.0	2.7

Note: (a) all observations; (b) only full data points

Source: Collier *et al.* (2004, Table 1A, p.22)

economic growth, macroeconomic instability, and political instability in Latin America and sub-Saharan Africa. However, no matter which mechanisms have been active, capital flight from these regions has probably contributed strongly to the erosion of the tax base, and thereby also to the reduction in resources available for financing the development of public institutions, social services, and infrastructure investment. Capital flight may also have reduced the interest of the political elite in local economic growth and development.

3 Tax and governance

The political importance of taxation goes far beyond providing income to finance the public sector, investments, and the basic needs of the population. Historically, state building has been closely connected to the development of the tax system (Tilly 1992; Webber & Wildavsky 1986).⁴ However, the tax system has not only contributed to establishing states, but also to promoting the state's legitimacy and strengthening democracy, as well as to creating economic well-being for the general population.⁵ The concept 'fiscal social contract' is central to explaining the development of representative states and democracies in western countries. The experiences of Western Europe and North America show that taxation has contributed

to making the authorities more representative and accountable by furthering a dialog between the state and civil society on taxation. Mobilizing interest groups (business organizations, trade unions, and consumer organizations) to support, oppose, and propose tax reforms, has been central in this connection. The development of an effective tax administration also stimulated the development of institutions in other parts of the public sector. Systems for recruitment, competence building, and management in the tax administration have been models for the development of other parts of the public administration (Bräutigam *et al* 2008).

Although countries in East Asia followed a development path different from that of western countries, the tax system was an important component in the development strategy of this region, too. In South Korea and Taiwan, taxation contributed to supporting economic policies that furthered development and the building up of public institutions in general (Shafer 1997). The tax system in Taiwan required the authorities to develop extensive databases for a wide range of enterprises and households. To a large extent, this contributed to curbing the development of the informal sector that is characteristic in many other developing countries. In the 1950s, South Korean authorities focussed strongly on developing the tax system, particularly for personal and corporate taxes (34 percent of tax revenue derived from direct taxes). This laid the foundations for a broad-based tax system under the regime of president Park in the 1960s. Later, this was the basis for the development of state information systems and databases that made it possible for the authorities to target state credits, subsidies, and other interventions towards individual companies in the process of industrialisation. In Latin America and Africa, Costa Rica and Mauritius can point to similar experiences: The tax system was a key factor for the

⁴ The North American colonists in the 18th century expressed this in their famous protest against the British colonial authorities as "no taxation without representation".

⁵ The building of a legitimate state presupposes fiscal capacity. Democratic elections do not necessarily guarantee the legitimacy of the state. Nor do aid projects aimed at meeting acute needs. Legitimacy is gained primarily when the authorities deliver services that the population wants and needs. In elections, the citizens can express their desires and priorities, but to fulfil these needs, the state must have the capacity to generate and use public resources effectively.

development of an accountable and functioning state. When the state depends on tax income from wide sections of citizens and businesses, the authorities have incentives to expand their presence also in rural and peripheral areas. This presupposes, however, that the state develops an institutional apparatus for registering its citizens and businesses, and an effective tax administration.

In this perspective, the challenge for poor countries is not necessarily to collect more tax, but to tax a larger share of their population and businesses. For several reasons, including economic structure and history, this is not easy. The informal sector is often substantial, and difficult to tax. Another important challenge is to avoid taxes that taxpayers generally regard as unfair, and that require a large measure of coercion to collect (for instance poll tax). Such taxes have been common in many poor countries, and it is characteristic for them that only a small proportion of dues are paid, and the cost of collection is high. They have also blocked the development of a fiscal social contract. However, the past few years have seen substantial resources invested in changing the attitudes and behaviour of tax administrations towards taxpayers (Fjeldstad & Moore 2009). Experience from a number of countries has shown that taxpayer behaviour can be changed by reforming the tax system. In some countries, this has given the public a more positive attitude to the tax system, and has led to the mobilization of interest groups that demand better public services. For example, the authorities in Ghana, Tanzania and Uganda have all increased their fiscal space through higher domestic revenue mobilization in the period 2000-2006 (Gupta & Tareq 2008: 45).

However, in many poor countries, the authorities have no incentives to enter into a dialogue and negotiate with organized groups in society. This is one of the main reasons for bad governance. A complex set of historical factors, including state formation through colonization, has frequently led to a concentration of economic and political power with a small elite. This elite generally does not pay taxes, and is relatively unaffected by organised interest groups in society. The state is powerful vis-à-vis its citizens – and is not answerable to them, but it is weak in terms of capacity for implementing policies. The elite lacks both the will and the ability to build a civil society. The need of the elite to negotiate with organised domestic interest groups is lessened further by the global context, where the political elite has access to enormous resources from sources other than

the taxation of citizens, particularly income from natural resources (Leite & Weidmann 1999; Christian Aid 2008) and organized crime (Bayart *et al* 1999; Chabal & Daloz 1999). Developing countries whose income derives mainly from sources other than taxation of their citizens, for instance from natural resources like oil and minerals, are generally characterized by bad governance and poor public institutions (Ross 2001). Among the few exceptions are Botswana and Malaysia. Bad governance is often correlated with the state being independent of revenue from taxation of citizens and businesses. Access to substantial foreign aid can also contribute to detaching the state from its citizens, and reducing the need for tax reforms (Bräutigam & Knack 2004).

4 Conclusion

The development of effective tax systems is a great challenge for many countries. The total tax revenue is generally low, and tax evasion is widespread. The tax bases are often very narrow, where a small number of firms contribute the greater part of the tax revenue. The informal sector is large and growing. Taxation of international business transactions has become ever more complicated to handle for local tax administrations with limited resources for employing the necessary qualified personnel. Furthermore, capital flight and tax havens contribute to undermining the tax base. It is estimated that capital outflows from Africa represent 7.6 percent of total GDP on the African continent. This implies that African countries as a group are net creditors of donor countries.

Discussions of the importance of taxes for development have, until recently, been nearly completely absent.⁶ This is now changing. Taxation is about to become a central – if not *the* central – topic in the development debate – also in developing countries. In August 2008, for instance, tax admin-

⁶ In the 1960s, a period when a number of countries gained their independence from the colonial powers, many economists argued that developing countries should give the development of effective tax systems priority. In 1963 the economist Nicolas Kaldor wrote an article in the journal *Foreign Affairs* with the title “Will Underdeveloped Countries Learn to Tax?” Kaldor focussed on the linkage between the state’s capacity and taxation (page 417): “No underdeveloped country has the manpower resources or the money to create a high-grade civil service overnight. But it is not sufficiently recognized that the revenue service is the ‘point of entry’; if they concentrated on this, they would secure the means for the rest.”

istrators, finance ministers and politicians from 39 African countries met in Pretoria, together with representatives of the OECD, the World Bank, IMF, and several bilateral aid organizations.⁷

The “Pretoria-communicé” concludes that more effective tax systems are central for a sustainable development because they can:

- mobilise the domestic tax base as a key mechanism for developing countries to escape aid or single resource dependency;
- reinforce government legitimacy through promoting accountability of the government to tax-paying citizens, effective state administration and good public financial management; and
- achieve a fairer sharing of the costs and benefits of globalisation.

State authority, effectiveness, accountability and responsiveness are closely related to the ways in which governments are financed. It matters that governments tax their citizens rather than live from oil revenues and foreign aid, and it matters how they tax them. Taxation stimulates demands for representation, and an effective revenue administration is the central pillar of state capacity.

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⁷ See <http://www.oecd.org/dataoecd/1/33/41227692.pdf>

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Appendix 3

The state of knowledge on what economic research has uncovered about transfer pricing by multinational companies in Norway

by Ragnhild Balsvik, Sissel Jensen, Jarle Møen and Julia Tropina, Norwegian School of Economics and Business Administration, 11.5.2009

- *Not much empirical research has been done on multinational corporations and taxation in Norway. Multinational corporations have an incentive to shift profits out of Norway to low-tax countries and into Norway from high-tax countries. We assess that the net flow goes out of Norway, and that the loss in tax revenue may be in the order of 30 percent of the potential tax revenue from foreign multinational enterprises. This estimate is very uncertain, and the research effort in this field should be stepped up.*

Introduction

Already at the turn of the millennium, trade within multinational corporations made up 60 percent of world trade, and among the 100 largest economic entities in the world in 2005, there were 54 states and 47 corporations. By manipulating the prices of transactions within corporations, multinational corporations can shift profits from high-tax countries to low-tax countries. Such profit shifting can have a large impact on the tax base for corporate taxation in host countries. In Norway, about 10-15 percent of the tax base for corporate taxes derives from foreign-owned corporations, and 20 percent from Norwegian-owned companies with foreign affiliates. This appendix briefly sums up the knowledge produced by academic research on the extent of the problem of transfer pricing by foreign corporations. The appendix is based on a larger report, Balsvik, Jensen, Møen and Tropina (2009), written for the Government Commission on Capital Flight from Poor Countries and The Norwegian Agency for Development Cooperation (NORAD).

No empirical analysis is needed to establish that multinational corporations manipulate transfer pricing to reduce their total tax burden. Many instances have been uncovered by tax authorities,

and have been discussed in newspapers articles both nationally and internationally. Another indicator to the problem is found in the economic literature. Textbooks on international finance will typically discuss transfer pricing in detail, and leave no doubt that problems of taxation are central. However, such sources cannot tell us *how much* profit is withheld from taxation.

Empirical research into transfer pricing in multinational corporations seeks to quantify the profits that are withheld from taxation in different countries, and to establish which mechanisms are particularly important. Empirical research in fields that border on economic crime, however, is very difficult. If precise data were available, the tax authorities would quickly come to grips with the problem without assistance from researchers.

There are very few previous empirical studies based on Norwegian data. The literature consists of one scholarly article by Langli and Saudagaran in *European Accounting Review* in 2004, and a few Master's dissertations. The central question of these studies is whether multinational corporations report lower taxable profits in Norway than other companies – all else being equal. In Balsvik *et al.* (2009) we update and expand on the analysis of Langli and Saudagaran along several dimensions. Langli and Saudagaran analysed the difference in profitability between Norwegian and foreign-owned companies based on accounting statistics from the mid 1990s. We have available to us a further nine years of accounting statistics, and use modern panel data techniques. Furthermore, we distinguish Norwegian multinational enterprises as a separate group and include more industries. In an innovative complementary analysis, we test a model by Jensen and Schjelderup (2009) of how aggregated flows of goods and services between foreign affiliates and their Norwegian parent companies should vary with the tax

differential to Norway if they engage in tax motivated transfer pricing.

International research on transfer pricing and tax evasion has mainly been conducted on large corporations and in countries with high corporate tax rates, like the USA and Germany. Analyses of Norwegian data are interesting because Norwegian corporate tax rates are not particularly high, and because the structure of our economy includes many small companies. It is therefore not obvious that results reported in the international literature are relevant for Norway – or for developing countries, which along these dimensions are more like Norway than like the USA or Germany. *A priori*, it is not obvious whether the net profit shifting goes to Norway or from Norway.

Data

The analyses in Balsvik *et al.* are based on the linking of three different databases for the years 1992-2005:

- Annual accounts for all Norwegian enterprises with an obligation to report accounts to the Register of company accounts at Brønnøysund
- The SIFON-register of Statistics Norway, which includes an overview of direct and indirect foreign ownership in enterprises registered in Norway
- The census of foreign assets and liabilities from The Directorate of Taxes, which gives a survey of the foreign activity of enterprises registered in Norway (Utenlandsoppgangen)

Future research on multinational corporations would benefit greatly from improved data.

First, the classification of Norwegian-owned enterprises into Norwegian domestic and multinational enterprises is not exhaustive in our analysis. Among the Norwegian-owned enterprises with no activities abroad there will be affiliates of Norwegian multinational enterprises. In order to identify these as parts of multinational corporations, we need to know the complete corporate structure of all Norwegian enterprises, but historical information on the corporate structure of Norwegian companies is not easily available. Further work should be done to survey this.

Second, we do not know the corporate structure of the corporations that the foreign-owned enterprises in Norway belong to. When we do not know in which countries these corporations are active, we do not know their incentives for shifting profits from their Norwegian affiliates. Moreover,

we have no information on transactions between Norwegian-owned enterprises and other foreign enterprises in the same group that are not affiliates owned from Norway. An extension of the obligation to file statements on transactions with closely related companies, as proposed in Ot.prp. nr. 62, 2006 – 2007, *On the law on changes in tax legislation (transfer pricing)*, would remedy this.

Third, Norwegian customs data do not contain information on whether registered trade takes place with an affiliated company. American companies are obliged to give information on this when declaring imports and exports. This is because American authorities have, for a number of years, been concerned with the problem of transfer pricing. A simple improvement like this in the Norwegian data would make it possible to compare prices directly, and will probably also facilitate the control functions of the Norwegian Tax Administration.

The presence and economic importance of multinational corporations in Norway

The number of enterprises in Norway with foreign majority owners has increased gradually from a little more than 2000 in 1993 to nearly 5000 in 2005. If we include enterprises whose indirect foreign ownership share is more than 50 percent, there were more than 7000 enterprises with foreign majority ownership in 2005. Most foreign multinational enterprises are found in the trade sector. About 35 percent of the foreign-owned enterprises are in this sector. Nearly 20 percent of the foreign enterprises are in the knowledge-intensive part of the service sector, and close to 15 percent in the manufacturing and construction sectors.

In 2005, 1200 enterprises in Norway had direct foreign investments. They had a total of 4800 establishments abroad. The value of these investments was about 600 billion NOK. In 2005, the 10 enterprises with most capital invested abroad held as much as 52 percent of the total. Between 1990 and 1998, this share was more than 70 percent. This indicates that the strong increase in the number of enterprises registered with foreign investments between 1998 and 2001 is driven by a series of relatively small engagements. It is not clear whether the increase between 1998 and 2001 is real or is primarily caused by the fact that the work on the Census of foreign assets and liabilities was transferred from the Central Bank of Norway to Statistics Norway in 1998, and that the

registration of ownership interests abroad was somewhat expanded in that connection. Manufacturing accounts for the greatest part of Norwegian enterprises with ownership interests abroad in 2005. A little more than 26 percent of Norwegian enterprises with ownership interests abroad are in the manufacturing industry.

About two thirds of the Norwegian-owned companies abroad are in the OECD-area, but the number of investments in Asia and Eastern Europe has increased since 1997. Based on country information in the Census of foreign assets and liabilities, it does not seem that Norwegian enterprises particularly often establish affiliates in tax havens, but there may be a significant under-registration of such companies. In 2005, 138 establishments were registered in tax havens. The shipping industry owned more than 40 percent of the establishments located in tax havens in the period from 1990 to 2005.

The count of the number of Norwegian enterprises that are a part of multinational corporations clearly shows that the Norwegian economy has seen an increase in multinational presence, and consequently an increased globalization. The importance of foreign multinational enterprises measured by their share of combined operating income, wage costs, and net capital has grown from about 10 percent in 1992 to somewhere between 20 and 30 percent in 2005. Unlike foreign multinational enterprises, Norwegian multinational enterprises have seen a slight reduction in their share of the economic activity in Norway in this period. The activity of Norwegian multinational corporations is concentrated to a few large corporations.

We find that enterprises that are a part of a Norwegian or foreign multinational corporation have a 10 to 15 percentage points higher probability of not being in a tax position than purely Norwegian enterprises in the same sector with a comparable size and debt/equity ratio.

The shifting of profits from Norway to low-tax countries by multinational corporations

The most convincing studies of transfer pricing compare the prices of goods traded within multinational corporations to the prices at which the same goods are traded in a market where the parties are independent, and discrepancies are seen in relation to the tax incentives of the companies. Although there are other management rationales for allowing transfer prices to diverge from mar-

ket prices, such divergence is not allowed by OECD guidelines, which are based on the principle of "arms' length". Prices should be set as if the transaction took place between independent parties.

Researchers are seldom allowed access to suitable price data. For this reason, most of the literature on transfer pricing uses "indirect" methods. Since the point of manipulating transfer prices is to influence taxable profit, the most common research method is to compare the profits of national and multinational corporations by regression analysis. One advantage of the indirect method is that it can account for the effects of manipulated transfer prices on very company-specific goods and services, such as semi-finished products, royalties and head-office functions. The problem of transfer pricing is particularly important for such goods and services, precisely because a direct comparison of prices is not possible.

One main objection against the indirect method is that one can never "prove" that the observed differences are caused by the manipulation of transfer prices. In principle, other unobserved characteristics of multinational enterprises can be the cause of the observed difference. However, the suspicion that transfer prices are manipulated is strengthened if one finds that the differences between various types of companies vary according to the ease or difficulty with which transfer prices can be controlled, and according to the size of the tax differentials faced.

Langli and Saudagaran (2004) compare the profitability of Norwegian-owned and foreign-owned companies in manufacturing and trade in the years 1993 to 1996. They find that foreign-owned enterprises have a profit margin 2.6 percentage points lower than Norwegian-owned enterprises. This is consistent with a net shifting of profits out of Norway by foreign-owned enterprises. Langli and Saudagaran thus show that the problem of profit shifting is not limited to large enterprises and enterprises in countries with particularly high corporate taxes.

However, there is likely to exist long lasting differences in profitability between enterprises related to unobservable characteristics. Such effects can be caused, for instance by technology, market power, quality of management, location, or discrepancies between the real value of capital and its book value. It cannot be ruled out that such unobservable differences are correlated with foreign ownership. On the contrary, econom-

ic theory suggests that foreign-owned companies – or at least their parent companies – should have a better quality of management and better technology. This may have led previous comparative studies of profitability to misjudge the extent of profit shifting.

The problem of long lasting – fixed – unobservable effects can in principle be solved using methods that compare the *change* in profitability for companies which have been bought up (or bought home) with the *change* in profitability for companies whose ownership has not changed, and whose possibility for shifting profits has consequently not changed. However, such methods will underestimate the extent of profit shifting if some companies are wrongly classified. In that case, we would mix enterprises that have the possibility to shift profits with enterprises that do not. Another possible source of error is that “shocks” in profitability systematically influence the probability that ownership of enterprises shift between Norwegian and foreign owners. If foreign owners tend to buy enterprises that perform badly in order to restructure them, we will overestimate the extent of profit shifting out of Norway, and if foreign owners tend to buy up growth companies, we will underestimate the extent of profit shifting out of Norway. Earlier findings indicate that foreign take-overs in Norway are most frequently directed at growth enterprises.

An analysis of profit shifting based on a comparison of the profitability of multinational corporations in Norway to the profitability of similar Norwegian domestic corporations

The main analysis in Balsvik *et al.* explicitly takes Langli and Saudagaran (2004) as its point of departure, because it is the only published work based on Norwegian data and because it uses a recognized method. Thus, we can compare our results to theirs to provide a control for the quality and plausibility of our results.

Our selection includes only enterprises with limited liability with more than 1 million NOK in balance. Observations that lack central variables, or whose values diverge greatly, are also omitted. In the first part of the analysis, we use only enterprises in the sectors of manufacturing and trade, as did Langli and Saudagaran. The proportion of foreign-owned enterprises is about 3.6 percent in manufacturing, 1.1 percent in retail trade and 15.3 percent in wholesale trade. The foreign-owned en-

terprises are about four times as big as the Norwegian-owned ones. Our primary dependent variable is the profit margin, measured as results before tax as a proportion of sales. Results before tax are adjusted for changes in deferred tax costs and tax benefits. The average profit margin is 4.78 percent for Norwegian-owned enterprises and 3.10 for foreign-owned enterprises. The unconditional difference is thus 1.68 – or 35 percent.

In the regression analyses, we control for age, size, leverage, branch of industry, proportion of real capital and accounting year. We only partly succeed in replicating the results of Langli and Saudagaran. For the years 1993 to 1996, we find a dependent difference in profit margins between Norwegian-owned and foreign-owned enterprises in manufacturing and trade of 1.56 percentage points. The foreign-owned enterprises are the least profitable. The corresponding difference in Langli and Saudagaran is 2.57 percentage points. Qualitatively, however, the two analyses correspond well.

When we expand the sample to all the years from 1993 to 2005 and compare profitability within a detailed industrial classification, we estimate a dependent difference in profitability of 2.52 percentage points. The estimated difference is fairly stable from year to year, and there is no clear trend towards greater or lesser difference in profitability between Norwegian-owned and foreign-owned enterprises. If we control for unobservable, lasting, enterprise-specific fixed effects, the estimate is reduced to 1.64 percentage points.

The difference in profitability between Norwegian-owned and foreign-owned enterprises is greater for small enterprises than for large ones. We also find that the difference between Norwegian-owned and foreign-owned enterprises is particularly great for enterprises with poor profitability. Among the enterprises that are most profitable, for given characteristics, it seems that foreign-owned enterprises are somewhat more profitable than Norwegian-owned ones. The most obvious interpretation of this finding is that the tax authorities should focus particularly on foreign-owned enterprises that are substantially less profitable than expected. However, such a conclusion may be too hasty, as these findings are based on estimates that do not control for unobservable fixed effects. Enterprises with a high fixed effect, i.e., enterprises that are consistently more profitable than one would expect given their observable characteristics, will have a strong incentive to reduce taxes through manipulating transfer prices.

They would also have a low risk of being discovered, since the resulting profits after the manipulation of transfer prices will seem quite normal. The tax authorities should therefore also verify transactions in enterprises with normal profitability.

Norwegian-owned multinational enterprises are more profitable than both foreign-owned multinational enterprises and Norwegian-owned enterprises with no activity abroad. This is reasonable. We would expect that the best domestic companies would be the ones to expand internationally. When we include a enterprise specific fixed effect in the regression, we analyse the change in profitability when enterprises change status. We find that when Norwegian-owned enterprises with no foreign activity establish affiliates abroad, their profit margins fall by 1.14 percentage points. This is consistent with a hypothesis that enterprises begin to shift profits out of Norway when they establish affiliates abroad. This effect is identified by those enterprises that change status in this respect during the period of observation. We probably misclassify several changes in multinational status, as the number of enterprises that submit a statement of foreign assets and liabilities varies conspicuously over time. As mentioned earlier, this will tend to make us underestimate the difference in profitability. For enterprises that are bought up by foreign owners (or bought home), we find that profit margins are 1.70 percentage points lower in years where enterprises are classified as multinational because of foreign ownership.

In the final part of our analysis, we include all industries in the private sector, except oil extraction and mining. We wish to exclude this sector from our analysis because oil companies are substantially larger than other companies, and are subject to a special tax regime. We find that *foreign* multinational enterprises have a profit margin 3.93 percentage points lower than Norwegian domestic enterprises. When we control for unobservable, enterprise-specific, fixed effects, the estimate falls to 2.38. This should be regarded as average values for the Norwegian mainland economy over the past decade. If we look at large, single industries, we find that the result is especially marked in real estate, renting and business activities. Here, the difference in profitability is estimated to 7.42 percentage points, 3.93 when we control for lasting effects. The results are also clear for construction and wholesale trade. We find that *Norwegian* multinational enterprises

have a profit margin 1.69 percentage points lower than Norwegian domestic enterprises when we control for unobservable, enterprise-specific, fixed effects. It is thus a general trait that Norwegian-owned enterprises, too, become less profitable when they become multinational.

If we assume that the estimated differences in profit margins between Norwegian domestic and multinational enterprises is caused by the manipulation of transfer prices, we can use our estimates for a counterfactual analysis to give a rough estimate of what the tax revenue would have been if transfer prices were correct from the point of view of taxation. Our best guess is that between 25 and 40 percent of the potential tax take from foreign multinational enterprises in Norway is lost because of profit shifting. For the companies in our selection, this could amount to 15-25 billion NOK. Our selection represents around 90 percent of the turnover of all foreign-owned joint stock companies in Norway outside of oil extraction and mining. As a comparison, the Norwegian Tax Administration last year uncovered about 50 cases of what they believe is juggling with prices and invoices between closely related companies, involving all told 6.6 billion NOK.

An analysis of profit shifting based on the internal data of corporations on export and import

The analyses summarised above estimate *net* profit shifting. Many multinational corporations have affiliates in several countries, and in such cases, the incentive to manipulate transfer prices will vary according to the tax differential between Norway and the host country. This variation is lost if one analyses the effect of transfer pricing only on profits in Norway, since it is aggregated across the total engagement of the enterprise. There is every reason to believe that profits are moved out of Norway to countries with lower corporate taxes, and into Norway from countries with higher corporate taxes.

In the final part of our report, the analysis of the effect of tax incentives is based directly on book values of trade within corporations. The effect on corporate profits must necessarily derive from the effect on the value of trade within the corporation, so this approach may be regarded as somewhat more “direct” than the comparison of profits. Our analysis uses data from the Census of foreign assets and liabilities for the aggregated flow of goods and services between Norwegian

parent companies and their foreign affiliates. Note that this set of data only involves a minority of the enterprises used in the profit comparisons.

Based on Jensen and Schjelderup (2009), Balsvik *et al.* set up a stylized model for trade between a parent company and an affiliate in another country. The model shows that changes in tax rates will have an effect on both price and quantity. We have data for the value – price multiplied by quantity – of the goods and services traded by parent companies in Norway with their affiliates abroad. From the model, we therefore derive predictions for the value of imports and exports in Norwegian parent companies – and for net export, which is the value of exports minus the value of imports. The theoretical analysis shows that the following relations should apply:

1. When the tax in Norway is higher than in the foreign country, and the tax level relative to the foreign country increases, the value of *imports* to the parent company from the foreign affiliate will increase. In this case, the extent of profit shifting from Norway to the foreign affiliate will increase. When the tax level relative to the foreign country falls, the effect will be the opposite. The effect on the value of the parent company's imports cannot be unequivocally established in cases where the tax in Norway is lower.
2. When the tax in Norway is lower than in the foreign country, and the tax level relative to the foreign country increases, the value of the parent company's *exports* to the foreign affiliate will decrease. In this case, less profit is shifted to Norway from the foreign affiliate. When the tax level relative to the foreign country falls, the effect will be the opposite. The effect on the value of the parent company's exports cannot be unequivocally established in cases where the tax in Norway is higher.
3. When the tax level in Norway relative to the foreign country increases, the value of the parent company's net export to the foreign affiliate will decrease. If the tax in Norway is lower at the outset – so that the change in taxation leads the tax levels of the two countries to converge – less profit will be shifted to Norway. If taxes in Norway are higher at the outset, more profit will be shifted from Norway.

We test these relationships on foreign affiliates, located in the OECD-area, of enterprises registered in Norway. Regression analyses that seek to explain the data from the Census of foreign assets

and liabilities on the value of exports, imports, and net export with the tax differential between Norway and the respective host countries, support hypotheses 2 and 3. Hypothesis 1 on the effect of tax differentials on the shifting of profits out of Norway through manipulating the book value of imports to the Norwegian parent companies, does not find support. The reason for this can be that the prediction here refers to cases where the tax in Norway is higher than in the host country, and there are not many host countries in the OECD area where this is the case. There may also be questions in connection with offshoring of production that are not captured by the model.

Finally, we perform some calculations that illustrate the magnitude of the estimated effects. We find that if the tax rate in Norway increases from 28 to 30 percent, the value of exports from Norway to foreign affiliates in countries with higher taxes than Norway will be reduced by 7 to 14 percent. The imports to Norway from foreign affiliates in countries with lower tax than Norway will increase by 1 to 2 percent. The asymmetry between the effect on import and export values is primarily caused by the fact that the selection includes more parent company/affiliate-relationships where the host country has a higher tax rate than Norway.

Conclusion

We have performed extensive analyses of data for Norwegian enterprises, and have uncovered interdependencies that are consistent with profit shifting through the manipulation of transfer prices. The analyses are documented in Balsvik, Jensen, Møen and Tropina (2009). We find that multinational corporations shift profits both out of Norway and into Norway. We assess that the net flow is out of Norway, and that the loss in tax revenue can be in the order of 30 percent of the potential tax revenue from foreign multinational enterprises. We find that multinational enterprises in Norway have a profit margin of 1.5 to 4 percentage points lower than comparable domestic enterprises. This is consistent with the findings of Langli and Saudagaran (2004).

In the empirical analyses, we have had to make a number of discretionary choices about specific definitions and how to limit the selection. It would have been desirable to perform more robustness analyses than what has been possible within the project's time frame. The results must

therefore be regarded as indicative rather than finished and fully quality controlled. The estimate for the loss in tax revenue is particularly uncertain, and we will continue working on questions connected to this problem within the framework of other projects. However, the analyses we have summarised in this appendix back up the conclusion that, *potentially*, multinational corporations can withhold large amounts of money from taxation by shifting profits out of the country. Empirical research on multinational corporations and tax must therefore be characterized as a neglected field in Norway.

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