Studies in International Political Economy

# TAX HAVENS AND OFFSHORE FINANCE

## A Study of Transnational Economic Development

R.A. Johns

FRANCES PINTER

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by
Richard Anthony Johns

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## Foreword

*Every blind man who touches a part of the elephant learns some of the truth about it — but not the whole truth; and only the rare unfortunate is unlucky enough to be caught in generalizing about the elephant from an unrepresentative hand-hold on the tip of its tail.* *

The subject of offshore finance centres is one that has not yet been approached within the context of the emerging global trends in international banking and international trade relations. This study attempts just such an analysis. In Part I a comprehensive conceptual approach is provided within which the emergence of and rationale for offshore centres is related. This approach is evolved in relation to the different types of pressure exerted on and the vacuums created for invisible production that is both domestic and external in origin by national economic friction structures and the derived but constrained competitive 'frictioneering' abilities of particular offshore economies. The business potential thereby created in terms of international invisible exchange located in offshore centres and made possible by developments in telecommunications and the growth of world-wide financial networks when actualized is revealed to constitute a new secondary trading system for transnational enterprise. Part II utilizes the above approach to demonstrate how a traditional 'guardian' onshore/offshore politico-economic friction matrix and 'currency bond' can, and has, interacted to transform tax haven centres into offshore finance centres that are globally orientated. This regional case-study of the transformation of the British Isle centres of Jersey, Guernsey and the Isle of Man outlines their differing development profiles prior to and subsequent to the rescheduling of the Sterling Area in June 1972 and the suspension of the 1947 UK Exchange Control Act in October 1979. Part III traces the global pattern of offshore haven centre development that emerged in the 1970s, and considers what changes might result from certain onshore deregulation and reregulation activities that have so far restructured the international friction matrix in the 1980s. As this topic is an area where information and statistics are often hard to come by, the author hopes that the results of his labours do not correspond with those of the rare unfortunate mentioned in the quote from Johnson above.

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*April, 1982*

*Johnson, H.G., 'Technological Change and Comparative Advantage: An Advanced Country's Viewpoint', *Journal of World Trade,* January/February 1975, p.13.

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# PART I
# The General Economic Rationale for Offshore Finance Centre Development

*Like water finding its own level, entrepreneurial business, when constrained in one place, will emerge in another. When restrictions in one place become too burdensome, too discouraging and perhaps too punitive, the businessman will look elswhere . . . As one door closes, another is opened.* *

The emergence of, and rationale for, any offshore centre needs to be considered within the context of particular trends within the international trading system and its constituent onshore and offshore economic parts. Chapter I identifies the existence of onshore national friction structures and distortions therein as the prime factor motivating the international private sector demand for the financial development of tax havens. Chapter II seeks to explain the evolutionary mutation of these 'intermediate' economies in the light of transnational trends in the development of world capitalism in general and multi-national banking in particular. Chapter III surveys the countervailing power that may be exercised, particularly in the areas of fiscal protection and exchange control, to pre-empt or limit the erosion of onshore industrial infrastructures and tax bases. Chapter IV examines the competitive power of offshore states in terms of their ability to attract transnational business and to create such business.

*Hanson, D.G., *Service Banking,* Institute of Bankers, London, 1979, p. 272.

# CHAPTER I
# The Importance of National Friction Structures and Distortions Therein and the International Politico-economic Friction Matrix

Standard textbooks on international trade usually emphasize in their introductory chapters that, while the character of international exchange retains the specialization characteristics of internal national trade in respect of the territorial division of labour, the very process of internal integration of nation states creates the potential for government-induced frictions and factor immobilities. If activated by interventionist policies, such frictions will constrain and thereby provide discontinuities in the free inter-country flows of economic goods, services and resources, with consequences for the global location pattern of production. Ability to impose these frictions is derived primarily from the internal economic sovereignty accorded the government of a country as a decision-making unit in respect of its internal allocation of resources and its control over domestic external entry or internal exit of resources, goods and services. Naturally the number, bias, mix and importance of the frictions in force will change over time in relation to domestic needs, international obligations, and the general regime of international trade, as indeed do private sector market-induced frictions and imperfections, with changes *inter alia* in the concentration of business ownership, the spread of information, changes in technology, etc. The list below is indicative of the source and range of such economic frictions,[1] the first five of which are of particular relevance in this context:

1. The different systemic internal frictions resulting from the various types and mixes of economic control systems participating in the international economy and their underpinning taxation burdens, methods of monetary control and general economic policy objectives. *Inter alia* in respect of taxation, matters such as the relative burdens of direct and indirect taxation; the general provision, definition and treatment of tax deductibles; and rules for the transfer of losses and the allocation of reserves and profits will be important for business. In respect of monetary control, the existence or otherwise of a central bank, support provided by monetary authorities as lenders of last resort to banks experiencing liquidity difficulties, usury laws or interest rate controls, reserve requirements imposed on banks, and differential treatment accorded to domestic and foreign banks and other financial institutions of significance both for the internal allocation of credit and the external competitiveness of domestic financial institutions.
2. Banking laws and other financial laws with regard to entry (branching laws for domestic and/or foreign banks, attitudes to mergers and take-overs, etc.), licensing laws with respect to the type and functional diversification of

financial activities permitted and restrictions or the absence of restrictions governing linkage with other institutions; bank secrecy laws; authorization procedures; capital and capital adequacy requirements and provisions and the weights given to the categories of assets involved; deposit protection insurance schemes; systems of supervision and approaches to liquidity, prudential and solvency control; and the monitoring and regulation of institutions' foreign currency exposure. Such regulations can be constructive or abusive, pro-competitive or anti-competitive with regard to economic activities and financial flows. Some countries, Western Germany for example, may make the bank deposits of non-residents periodically subject to higher reserve ratios than residents, or impose special minimum reserve requirements for any increase in non-resident bank deposits. With respect to insurance and reinsurance, policies of nationalization, 'domestication' and prohibition of insurance business may obtain as well as repatriation requirements for profits earned abroad.

3. Selective foreign exchange regulations and capital controls with regard to 'inward' and 'outward' investment in debt instruments, equity and real estate: this includes interest equalization taxes, programmes of voluntary or compulsory restraint on foreign banking, etc.
4. Company laws relating to incorporation procedures, requirements as to filing accounts and disclosure, the setting of production standards, restrictive business practices, trade-mark and patent rules and consumer protection legislation.
5. Regulations concerning listing procedures and the fees charged on stock exchanges (minimum commission/negotiation/free price/fixed commissions); share ownership and control (in some cases banks are not allowed to own shares in the exchange itself); and whether the organization itself is a single capacity system or not (i.e., whether there is separation between broker and jobber functions).
6. The degree of interventionist control applied to the international value of each national currency.
7. The existence of different selective tariffs, quotas, bounties and domestic subsidies.
8. Anti-dumping regulations.
9. Immigration and emigration policies.
10. Restrictive customs procedures (rules and regulations for classifying and valuing commodities).
11. Restrictive state-trading policies and discriminatory government and private procurement policies that discriminate against the foreign sector and restrict foreign competition.
12. Restrictive administrative and technical regulations with regard to *inter alia* safety and health regulations.
13. Legislation affecting trade unions, wage costs and labour use: this includes factor expenditure levels such as social contributions made by producers, minimum age regulations for employment, equal pay, minimum wages, worker and factory protection, school leaving age and retirement age legislation.

TABLE I The growth of incomes compared with that of direct taxes on corporations and households in terms of per annum average percentages for the period 1970–78 in the main industrial countries

| | *Corporations* *Per annum av. increases in* | | | *Households* *Per annum av. increases in* | | |
|---|---|---|---|---|---|---|
| *Countries* | *Surpluses* | *Other* incomes* | *Direct tax* | *Wages & salaries* | *Indirect taxes* | *Direct taxes* |
| Japan | 6.2 | 11.2 | 17.5 | 16.9 | 12.8 | 18.5 |
| USA | 13.0 | 11.8 | 9.2 | 10.0 | 8.8 | 10.2 |
| Canada | 17.3 | 12.7 | 14.8 | 13.6 | 13.4 | 14.2 |
| UK | 11.3 | 14.1 | 15.9 | 15.8 | 13.0 | 15.2 |
| France | 10.0 | 11.1 | 15.8 | 14.8 | 12.1 | 17.2 |
| W. Germany | 6.8 | 6.1 | 11.4 | 8.9 | 7.7 | 11.9 |
| Netherlands | 10.8 | 9.2 | 14.2 | 12.3 | 13.1 | 17.0 |

*Source:* derived from charts in Doggart, *Tax Havens*, p. 135.

*Entrepreneurial income, interest, rent and dividends paid to households.

National friction structures created by the above, whether overt or covert, will indicate the extent to which national intermediation is privileged over foreign intermediation, and the openness or otherwise of the economy to foreign companies and investors. Relative success in the achievement of policy objectives pursued will also have implications for national and international investors with regard to the currency and country risks involved in their activities. These policies may also pre-empt the development of any effective or pioneering role in the international money markets by indigenous banks or in domestic markets by foreign banks. In general within the international trading system, however, these frictions create localized production pressures and vacuums both for internal 'outward' business and external 'inward' business activities that encourage, whether desired or not, implicitly or even explicitly, industrial seepage and relocation of activity within the international trading system motivated by tax and regulation avoidance/evasion.

As regards systemic frictions, the period since the early 1960s has seen an extension of national tax bases to include within their nets capital gains taxation and a more comprehensive taxation of accumulated wealth and its transfer by gift or on death. Moreover, with the emergence in the late 1960s of inflation as a central macroeconomic problem, fiscal instability and pressures have been exerted on economic sectors through general and intermittent regulation of many types of earnings by means of incomes and/or prices policies. Doggart summarizes the impact of these trends thus in relation to the period up to the end of the 1970s:

> tax takes have increased a good deal faster than incomes in the last 20 years . . .
>
> 1. In six out of seven major industrial nations direct taxes on households grew at a consistently higher rate than incomes between 1970 and 1978 (the USA, Canada, Japan, France, West Germany and the Netherlands), the only exception was the UK . . .

TABLE II Changes in tax elasticities and total tax burdens of OECD countries in terms of a comparison of their average figures for the periods 1965–70 and 1970–78

| | *Tax elasticities* | | *Total tax burden %* | |
|---|---|---|---|---|
| *Countries* | *1965–'70 av.* | *1970–'78 av.* | *1965–'70 av.* | *1970–'78 av.* |
| Japan | 1.08 | 1.23 | 19 | 24 |
| USA | 1.15 | 1.0 | 30 | 30 |
| Canada | 1.22 | 0.99 | 32 | 31 |
| UK | 1.22 | 0.90 | 38 | 34 |
| Finland | 1.08 | 1.13 | 32 | 37 |
| Norway | 1.18 | 1.19 | 39 | 47 |
| Sweden | 1.13 | 1.25 | 41 | 54 |
| Denmark | 1.34 | 1.06 | 40 | 43 |
| W. Germany | 1.04 | 1.76 | 33 | 38 |
| Belgium | 1.13 | 1.27 | 35 | 44 |
| Netherlands | 1.12 | 1.11 | 40 | 47 |
| Luxembourg | 1.06 | 1.55 | 32 | 50 |
| France | 1.02 | 1.11 | 36 | 40 |
| Switzerland | 1.13 | 1.32 | 24 | 32 |
| Italy | 1.02 | 1.16 | 28 | 33 |
| Austria | 1.03 | 1.17 | 35 | 42 |
| Spain | 1.17 | 1.32 | 17 | 23 |
| Portugal | 1.25 | 1.14 | 23 | 26 |
| Greece | 1.17 | 1.32 | 24 | 28 |
| Ireland | 1.20 | 1.03 | 31 | 33 |
| Australia | 1.08 | 1.14 | 26 | 29 |
| New Zealand | 1.15 | 1.10 | 28 | 30 |
| +Countries | | 14 | | 19 |
| −Countries | | 8 | | 3* |

*Source:* derived from charts in Doggart, *Tax Havens*, p. 132.

*Includes the USA where there was no change.

2. Revenue raised by direct taxes on corporations outpaced the increase in corporate savings everywhere except in Canada and the USA . . .
3. All 23 (OECD) countries . . . had tax elasticities (the ratio of trend growth rate of total tax and social security receipts to trend growth rate of GDP) above 1.0 in 1965-70.[2]

The evidence for 1 and 2 is contained in Table I. In terms of 3 mentioned in the quotation above, changes in tax elasticity (the ratio of the growth of taxation to the growth of Gross Domestic Product: a figure greater than 1.0 means that a 1.0 per cent change in GDP is accompanied by a more than proportionate increase in taxation) are shown in Table II for OECD countries, together with changes in their national tax burdens as measured by tax revenue (including social security contributions) as a percentage of GDP at market prices. In respect of the twenty-two reported countries, there was an increase in tax elasticities in fourteen and an increase in tax burdens in nineteen cases. It is clear therefore that, as compared with the late 1960s, the 1970s was a period in which there was an overwhelmingly general increase in domestic taxation pressure in OECD countries, including even the traditional continental haven centres of Switzerland

and Luxembourg, although this pressure was not quite as strong in terms of national tax elasticities.

Given that some countries adopt a permissive regulatory environment and others a stringent one, disparities, gaps and differentials arise in national systems of regulation. These differences can lead to perverse competition in regulatory laxity and a gravitation by some institutions to the least regulated financial centres, although, as will be seen later, this does not always have long-term development benefits for such centres given the reputation they have with reputable international bankers and some national tax authorities. In so far as operational costs are lowered by for example, a lack of a deposit insurance scheme, banks located in such centres have a higher financial leverage potential which can enable them to operate on narrower spreads between payments to depositors and interest charges made to lenders. Dangers posed by such uneven regulatory practices led to the establishment of the Bank for International Settlements' Committee on Banking Regulations and Supervisory Practices (the 'Cooke Committee') in 1975, which established general guidelines in their Basle 'Concordat' of that year on 'The Supervison of Banks' Foreign Establishments', although these have as yet no mandatory force. Five general recommendations were made:

1. Surveillance and supervision of foreign banks should be the joint responsibility of parent and host authorities.
2. No foreign bank should be able to evade/avoid supervision.
3. Host authorities should have the prime responsibility of supervising the liquidity of such banks.
4. Solvency supervision should be a matter for the parent authority with respect to foreign branches and primarily the host authority's responsibility in the case of locally incorporated foreign subsidiaries.
5. Ideally, international co-operation should be promoted by information exchanges between host and parent authorities.

As regards control of parent banks, Western European governments are in the process of adopting a system of common procedures and directives that could in future be jointly activated in such a way as to render the offshore activities of their national banks subject to a common onshore control. This movement began with the Council Directive of 12 December 1977: Directive 77/780/EEC relating to the setting up and pursuit of the business of credit institutions advocated *inter alia* the elimination of the most obstructive differences between members states' laws governing such institutions. If activated, this directive would significantly lessen the degree of international financial regulatory differentials. Moreover, in June 1979 the Central Bank Governors of the Group of Ten (Belgium, Canada, France, W.Germany, Italy, Japan, the Netherlands, Sweden, the UK and the US) and Switzerland recommended that their supervisory authorities should adopt a system of supervision on the basis of consolidated accounts. This was taken up by the EEC Commission on 28 September 1981 and put to the Council as a proposal, which also provided for the removal of any legal impediments to the exchange of information without which consolidation cannot be implemented, and for the conclusion of bilateral agreements between member states and third countries in the interests of world-wide consolidation.

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