“BILL GATES would be fabulously more wealthy if he had started Microsoft in Bermuda,” says William Woods, chief executive of the Bermuda Stock Exchange. "He may have known a lot about computer programming when he started the company, but his ignorance about tax cost him a fortune.” Mr Gates has not done badly even so, but he knows better now. Teledesic, a company co-founded by the Seattle-based billionaire that plans to offer broad-band Internet access by satellite, is incorporated in Bermuda.

Any firm that expects to earn profits from more than one country, and to have shareholders from more than one country, should set up in Bermuda, says Mr Woods -- and not just because the British island dependency levies no corporate income tax, but also because it is "tax-neutral" in its treatment of holding companies. A holding company incorporated in America that receives cash dividends from overseas subsidiaries, which have probably been taxed already in their country of origin, would also have to pay some American tax before any money is distributed to shareholders. A Bermudian holding company could pass those dividends, gross, direct to shareholders. The tax savings could easily have been 10-15% for Microsoft, which earns around half its profits outside America, says Mr Woods. This would have meant higher profits and presumably a higher share price -- and thus an even wealthier Mr Gates.

Alas, once a holding company is incorporated in a country such as America, the cost of moving to Bermuda can be prohibitive. The taxman is likely to take the view that a firm transferring its citizenship is, in effect, selling off its assets, and hit it with a hefty capital-gains tax bill. Going offshore makes most sense for truly global firms, says Mr Woods. If you are writing software over the Internet, with teams of workers spread across Seattle, Bangalore and Israel, it would be hard for any one country to claim the right to tax you as a holding company -- and this is increasingly how companies work, particularly in Internet-related business. That is why Bermuda is busy marketing itself to entrepreneurs as an e-commerce centre.

Ireland wants to be the e-commerce centre for Europe, so, like Bermuda, it has passed a state-of-the-art e-commerce law. It has identified 100 global technology companies it wants to attract. Like their counterparts in Bermuda, politicians in Dublin are being bashful about what many would consider Ireland's main attraction: low taxes. Instead, they like to emphasise their high-quality regulation, the advantage of being able to do business in English, Ireland's entrepreneurial spirit, and its highly educated yet relatively low-cost workers.

Pssst...know a good tax regime?
Boasting about attractive tax policies is unwise just now because of international efforts to crack down on "harmful tax competition". This is not, at least not explicitly, an attempt to harmonise taxes. The EU, for example, has been campaigning against the singling out of particular taxpayers for preferential tax treatment, which is how many EU countries now try to attract investment by multinational companies. The main target of this campaign was initially Ireland, which has long annoyed some of its bigger European partners by offering a modest 10% tax rate on profits earned by foreign manufacturing companies that move there, and latterly to foreign financial companies operating there. But in a brilliant (if expensive) pre-emptive move, the government in Dublin agreed to stop giving preferential treatment to some companies and offer the same 12.5% tax rate on profits to Irish as well as to foreign firms by 2010.

This has left other EU countries with more time to accuse each other of offering preferential tax treatment. A report to the EU's Helsinki summit last December identified 66 different varieties, ranging from the Netherlands' willingness to negotiate secret advance agreements with foreign firms on how much tax they will pay, to Gibraltar's tax exemptions for branches of non-resident companies operating there. The report found that all EU members except Sweden engaged in some "harmful" tax practices.

The OECD is mostly after the more familiar sort of sun-drenched tax haven. In particular, it makes a distinction between tax rates designed to attract "real" economic investment and those aimed at merely "financial" capital flows, which are its main targets. It is particularly hostile to countries that attract "brass plate" or "booking" operations, with no real work or employment attached to them. It gets suspicious when a location offers low or no taxes but is unwilling to exchange information with foreign tax authorities, or if companies setting up there do not appear to have "substantial activities".

What constitutes substantial activities is debatable. Gone are the days when finding out what a firm does and where it makes its money simply meant visiting its factories. An increasing share of companies' profits comes from financial and other services, which are much more elusive than manufacturing plants. It can be hard to tell exactly what constitutes substantial activities, and will get even harder as the Internet allows, say, servers and databases to be based in low-tax countries.

The OECD is currently preparing a list of countries that it thinks are indulging in harmful tax competition, which it plans to publish in June. Countries worried that they will be labelled "tax havens" are mounting a furious lobbying effort. Most of them insist that companies within their borders do many worthwhile and substantial things, and no doubt they often do. Bermuda points out that it hosts a thriving, innovative insurance industry, and that its government takes a full 22% of the country's GDP in taxes, though these are levied on consumption and employment rather than on profits or other income. The Cayman Islands claims that it is the world's fifth-largest financial centre, and is home to 45 of the world’s biggest banks.

All this regulatory activity seems to reflect a belief that tax competition does indeed exist, that it is intensifying, and that it can be harmful (although both the EU and the OECD quietly concede that it can sometimes be beneficial by penalising inefficient governments). But is any of this true?

Tax-competition sceptics point out that in most developed countries tax revenues as a proportion of GDP have in fact risen over the past 30 years, and that the share of taxes on corporate profits in overall tax revenues has remained much the same. On the other hand, there is plenty of evidence that lower tax rates have pulling power, and as economies become more open, the pulling power is getting stronger. A 1998 OECD report on harmful tax competition noted that total direct investment by G7 countries in tax havens in the Caribbean and South Pacific grew more than fivefold between 1985 and 1994, to over $200 billion.

So-called tax havens accounted for 1.2% of world population and 3% of world GDP, but 26% of the assets and 31% of the net profits of American multinationals (though only 4.3% of their workers), according to a 1994 study. A more recent analysis, by James Hines of the University of Michigan, found that "taxation significantly influences the location of foreign direct investment, corporate borrowing, transfer pricing, dividend and royalty payments." Another recent study asked, "Has US investment abroad become more sensitive to tax rates?" It analysed corporate tax-return data for 1984-92 (the latest then available), and found that by the end of this period the typical American multinational had become twice as likely to locate its operations where taxation was lowest as it had been at the beginning.

Falling corporate tax rates around the world also provide strong circumstantial evidence that governments are trying harder to cater for international firms’ and investors’ appetite for lower taxes. Yet such rate cuts have often been accompanied by a widening of the tax base -- for instance, by scrapping corporate-tax exemptions -- which has reduced the impact of rate cuts on the bottom line.
Are governments wise to engage in tax competition? Ireland’s example suggests they may be. The country’s recent economic boom owed much to low taxes on foreign firms moving there. Its GDP per head, which as recently as 1990 was 70% of the EU average, now exceeds Britain’s, and is expected to exceed the EU average by around 2005. But within the EU, no other country has tried to compete head-to-head with Ireland on tax. By contrast, some developing countries have found that their attempts to attract firms by offering low taxes have been trumped by similar countries taxing even less.

In some countries, the tax authorities have responded to tax competition by getting tough with multinational firms that operate within their borders but try to take advantage of lower taxes elsewhere. When filing tax returns in a high-tax country, multinationals typically claim that they have earned as little of their profits there as they can get away with. Instead, they try to attribute as much profit as possible to their operations in low-tax countries. They do this by arranging "transactions" between their subsidiaries in the two countries, and setting the "transfer price" of those transactions so that it has the desired effect on profits.

In theory the transfer price is supposed to be the same as the market price between two independent firms, but often there is no market, so nobody knows what the market price might be. This is particularly true of firms supplying services or intangible goods. So multinationals spend a fortune on economists and accountants to justify the transfer prices that suit their tax needs. Increasingly, firms try to restructure their operations to get their tax bill down as far as possible. There are plenty of opportunities: according to the OECD, around 60% of international trade involves transactions between two related parts of multinationals. But tax authorities are increasingly looking out for such wheezes. In America, in particular, the taxman has been putting the squeeze on companies, which have responded by allowing more of their taxable profits to arise there to keep him happy. This is prompting other countries to get tougher, too.

America is also trying to get a grip on American-based multinationals’ tax behaviour in other countries, using an instrument know as controlled-foreign-company legislation. The main way American multinationals take advantage of low-tax regimes is by "deferral", which means sitting on profits earned in those countries instead of sending them back to the parent. If the tax authorities think that a foreign subsidiary is used only for avoiding tax, the subsidiary can be deemed a controlled foreign company and obliged to repatriate its profits to the holding company, where it is subject to full American taxation.

This kind of tightening up does not necessarily produce a lot more revenue for the tax authorities in question, but it does mean companies are spending ever more money on tax advice and wasting ever more time filling in forms. "Transfer pricing is increasingly complex, and divorced from economic reality," says Huub Haemaekers, of the International Bureau for Fiscal Documentation in Amsterdam, who helped design the transfer-pricing system in the 1970s. The "arm's length principle" on which transfer pricing is based -- in essence, that a multinational's businesses in different countries are taxed as if they were independent firms operating at arm’s length from each other -- makes it ever harder to run multinationals as global businesses.

Philip Gillett, group tax controller at ICI, explains:

Commercially, transfer pricing makes no sense. It forces us to spend a lot of time doing things that are pointless from a business point of view. We have to waste time trying to price unfinished goods being sold' from one plant to another. It is like asking Ford to value a camshaft half-way along the production line: a nonsense. Businesses want to organise as if there were a single global or regional product market. Instead, tax is determining how they organise themselves. It makes local managers think more territorially, to start looking after their own particular country issues. The tax system promotes parochial thinking.

National tax systems also put a huge price on reorganising national businesses into single, seamless global operations. For instance, consider a multinational with a buying and selling operation in France that it wants to scale back to the status of a sales agent, transferring most customers to a marketing operation in, say, Germany. The tax authorities in France would say that the multinational had transferred the goodwill in the French operation to another country, incurring a huge tax liability. This is such a big problem in the EU, says Mr Gillett, that "it can be easier for a multinational to come from the US or Japan and set up on a pan-European basis than for an existing European firm to make that transition."

A better way?

Mr Gillett would prefer to scrap transfer pricing and replace it with a system better suited to the needs of global firms. There is no ideal solution, but one option would be a "unitary tax", which involves taking a firm's total profits and allocating different slices of that total to individual countries on the basis of a formula that reflects the firm's relative economic presence in that country. The country can then tax that slice of profit at
whatever rate it sees fit. This would still allow tax competition, but without the inefficient corporate structures. "Businesses still want tax competition," says Mr Gillett. "If government faces no downward pressure on tax rates, they tend to rise."

The prospects for the EU and the OECD "harmful taxation" initiatives look distinctly unpromising. Neither carries a big stick, and both are relying on drawing up blacklists and "naming and shaming". Yet it is doubtful whether many countries blacklisted by the OECD will feel shamed. After all, two wealthy member countries -- Switzerland and Luxembourg -- have said they will not be bound by the OECD's recommendations. Indeed, some of the wilder tax havens regard the whole exercise as a welcome bit of free advertising.

OECD officials speculate that it might be possible to do some sort of deal with tax havens to buy their good behaviour. As one of them puts it, "The amount of tax revenue being lost to the world to give only a very small nick to the tax havens is very large. It would make sense for the bigger countries to buy them off." Or perhaps OECD governments could bring co-ordinated pressure to bear on multinationals not to use tax havens -- after all, 85% of multinationals are incorporated in OECD countries. But there is so much tax competition amongst OECD and EU countries that hopes of such co-ordinated action seem forlorn. As Mason Gaffney, an economist at the University of California, Riverside, trumpeted in a recent speech in the Bahamas in favour of tax competition: "Freedom anywhere foils tyranny everywhere. Tax tyranny is a balloon: seal every leak, or it collapses."

Certainly, if the EU were to put a stop to the "harmful" tax practices within its borders, many of the businesses now taking advantage of them might simply move to, say, Switzerland. All the same, the EU's initiative has a slightly better chance of succeeding than the OECD's. It is possible that the European Commission, the nearest thing the EU has to an executive government, will add muscle to its code of conduct by taking action against miscreants in the European Court of Justice, on the argument that preferential taxes are essentially the same as state aid. The commission has been waging war on such state aids for years on the ground that they distort competition in the EU's single market. It has taken disputes to the European Court, and usually won, so it believes it can do the same with taxes. The trouble is that such cases usually take years to work their way through the court, so the commission would prefer countries to fall into line voluntarily.

Some experts think that the European Court may even cause corporate tax rates within the EU to be harmonised -- long a dream of politicians in Germany and France, and a nightmare for their counterparts in lower-taxing Britain and Ireland. According to Albert Radler, a tax lawyer at Oppenhoff & Radler in Munich, the court sees its mandate as completing a single market in Europe, and its verdicts on tax have been moving steadily in the direction of harmonised corporate taxation, even though the member states' governments think they have a veto over EU tax policy. If the European Court makes a decision, the member states have to accept it.

Last year the European Court found that denying benefits under the German-American bilateral tax treaty to the German permanent establishment of Saint-Gobain, a French firm, amounted to a denial of fundamental EU rights. "This was a revolution in taxes, extending bilateral-treaty benefits to non-residents," says Frans Vanistendal of the University of Louvain. In future, EU member governments may become much keener to co-ordinate tax policies, if only to stop the European Court eroding their political control of taxation, says Pasquale Pistone, a lawyer at the European Tax College in Louvain, who has been working on proposals for an EU model tax convention.

A contradiction in terms

Some officials at the OECD now regret ever using the phrase "harmful tax competition". As one of them puts it, "As an economist, how can you ever say anything bad about competition?" The OECD's main objection to some forms of tax competition is that they reduce another country's tax base, or force it to change its mix of taxes, or stop it taxing in the way it would like. But that seems a bit one-sided: what about the democratic rights of people in poor countries to enjoy a higher standard of living by pursuing tax policies that attract overseas investment? Indeed, says Edward Troup, a lawyer at Simmons & Simmons in London, it would be possible to argue that the OECD initiative is "an attempt to create a cartel amongst certain developed countries who have an unsustainable activity -- raising revenue by taxing capital -- that they want to protect."

Economists favouring tax competition often point to an article by Charles Tiebout entitled "A Pure Theory of Local Expenditures", published in 1956. In that article he argued that, faced with a choice of different combinations of tax and government services, taxpayers will choose to be where they get closest to the
mixture they want. Variations in tax rates across different countries are a good thing, because they give taxpayers more choice, and thus more chance of being satisfied. They also create pressure on governments to be efficient. That makes harmonising taxes a bad idea.

A fascinating paper by Reuven Avi-Yonah, of Harvard Law School, questions that optimistic conclusion. Certainly, tax competition can make governments deliver services more efficiently. Even so, argues Mr Avi-Yonah, tax competition may reduce redistribution and thus weaken the social safety net that in a global economy is needed more than ever. This could start a backlash against globalisation of the sort that pushed the world into depression 70 years ago.

Tiebout assumed that taxpayers are highly mobile, but many taxpayers, including the great majority of workers, have not so far shown much sign of getting on their bikes. Perhaps they are happy with their lot. Perhaps, though, they are simply unable to move. Will globalisation, supercharged by the Internet, change that?

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