

# **International Competition in Taxation and Financial Regulation: Why There is No Race to the Bottom**

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## **ABSTRACT**

As a result of increasing capital mobility, whereby holders of capital assets can more easily move their assets to offshore financial centers that offer low or zero taxation and lighter regulatory burdens, there have been claims that a tax and regulatory “race to the bottom” (RTB) is taking place. This competition between states regarding levels of taxation and standards of financial regulation is supposedly leading to a lowest common denominator outcome of a fragile international financial system and shrinking tax bases. In turn, this outcome should affect economic growth and development all around the world. However, casual observation and empirical studies of world economic affairs suggest otherwise. Using a neo-institutional economic framework based on transaction costs, property rights, and the risk-return relationship, this paper explains why there is no RTB as the doomsayers claim.

**KEY WORDS:** international taxation, international financial regulation, new institutional economics, offshore financial centers, race to the bottom

## **Introduction**

In this world of speedy communications and freely flowing goods, services and capital, it seems that states are less and less able to manage their economies autonomously. Benjamin Cohen (1998) argues that the “deterritorialization” of money weakens the state’s sovereignty over it.<sup>1</sup> In this sense, increasing capital mobility allows holders of capital assets to “evade the jurisdiction of unfriendly regulators” (Andrews, 1994: 199). This is why there have been arguments that a tax and regulatory “race to the bottom” (RTB) is taking place whereby competition between states regarding levels of taxation and standards of financial regulation leads to a lowest common denominator outcome.<sup>2</sup>

Obviously, offshore financial centers (OFCs) are seen as the leaders of this race to the bottom since they “try to lure financial activity within their borders by imposing less stringent regulation, taxation, and supervision than that prevailing elsewhere” (Bryant, 1987: 139). Hence, according to this view, this race has the unfortunate consequence of (1) lowering economic development in the world and (2) undermining the stability of the international financial system. In the latter case, the argument is that the international financial system is seen to be only as strong as its weakest link, which consists of the OFCs. The potential instability that OFCs create results in greater uncertainty and risk with respect to cross-border investments, which in turn lead to lower economic growth owing to the misallocation of capital and its greater cost. In the former case, the argument is that a lowering of tax rates around the world leads to reduced tax revenues, which in turn limit economic development by making it more difficult for states to finance the political, legal, economic, and social institutions necessary for economic growth (e.g., adequate

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<sup>1</sup> Paradoxically, Palan (2002) argues that capital mobility leads to a strengthening of sovereignty in the sense that sovereign rights become commercial assets that states can sell to individuals and corporations.

<sup>2</sup> This is what Bryant (1987: 139) refers to as “competition in laxity.” Others refer to this phenomenon as “regulatory and/or tax arbitrage” (Kroszner, 1999) or “regulatory shopping” (Picciotto, 1999).

rules and regulations, property rights, enforcement through independent courts, transportation and communications infrastructure, and universal education) (see Tanzi, 2001b).<sup>3</sup> Hence, world economic growth and development is being undermined by tax and financial regulatory competition according to RTB proponents. The problem is that each OFC does not take into account the potential harm its fiscal and regulatory policies could cause the international system. The solution to this negative externality is, therefore, a high degree of international coordination so as to impose minimum standards of taxation and regulation (i.e. create a minimum level playing field) throughout the world (Bryant, 1987; OECD, 1998; Razin and Sadka, 1989). This is the object of the OECD's current project on harmful tax practices.

However, casual observation and detailed empirical studies indicate that no such race to the bottom is taking place (see *inter alia* Chennells and Griffith, 1997; Devereux et al., 2001; Garrett, 1998; Quinn, 1997; Swank, 2002). For example, there is no link between the internationalization of capital and the erosion of the corporate tax base. In fact, the portion of corporate income tax relative to total tax revenues in the OECD has remained stable since 1965, at around 9%. The same applies to personal income tax, undermining the claim that the tax burden has been shifted to less mobile capital: people. Instead, there are many layers of standardization. For example, OFCs offer zero or very low tax rates while OECD countries' corporate tax rates averaged 31.4% in 2002. For a number of emerging economies in Latin America and Asia, the average is about 30.5% (KPMG, 2002).

The question then is: Why is there no race to the bottom when the logic of the argument seems to be pretty compelling? After all, if capital is free to go where it wants, why does it not go where it will gain the highest returns through low taxation and low regulatory burdens? Using

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<sup>3</sup> There is a strong relationship (correlation coefficient of 0.66) between tax revenue as a percentage of GDP and GDP per capita (see World Bank, 2002).

insights from new institutional economics (see Furobtn and Richter, 1998), the present paper answers these questions by considering transaction costs associated with property such as financial capital. That is, it attacks the notion that capital is “free” to go where it wants.

The paper is divided into four parts. The first part of the paper examines the logic of the RTB with a special focus on OFCs as well as assesses its impact on the international political economy. The second part details the empirical evidence against a RTB. The third section explains why there is no “competition in laxity” with respect to taxation and financial regulatory standards. The final section concludes on the meaning that the absence of a race to the bottom has for the international coordination of taxation and financial regulation.

### **The Logic of a Race to the Bottom and its Impact on the International Political Economy**

The logic of a race to the bottom is relatively simple. To grow countries need capital (see Barro and Sala-i-Martin, 1995; Romer, 1994). Non-human capital can take two forms: physical assets (land, plants, machinery, equipment, etc.) and financial assets (equities, bonds, derivatives, etc.). The problem is that capital, like any other resource, is scarce. Hence, countries “compete” with each other to attract it onto their territory by offering tax incentives in the form of tax credits, subsidies, or lower (or no) taxes on income and capital. This can apply both to physical capital (i.e. foreign direct investment) and financial (i.e. portfolio) capital. States can also offer lower levels of regulation to reduce the cost of doing business in a given territory. With time, both physical and financial capitals have become more mobile as a result of technological improvements in transportation and communications. As capital becomes increasingly mobile, it becomes easier for it to seek the best returns after tax. Therefore, to attract and retain capital, states have an incentive to lower their tax burden on capital. Offshore financial centers are at the forefront of this competition for financial assets because they charge little or no taxes on the

capital flowing to their shores. The RTB argument is that this competition will lead all states to adopt the standards of OFCs.

### *The Growth in Offshore Finance and International Capital Mobility*

The rise of offshore finance<sup>4</sup> began in the late 1960s and early 1970s following the increasingly-recognized distortions created by regulations of the financial sectors in industrial countries (Errico and Musalem 1999, 16). These distortions became more and more widely recognized as technological advancements in communications, transport and finance caused capital to become more mobile through the internationalization of production and banking (see Bryant, 1987; Goodman and Pauly, 1993; Johns, 1983: chap. 2; OECD, 1998). In particular, the development of the Eurocurrency market,<sup>5</sup> especially the Eurodollar, through an offshore inter-bank market, based primarily in London, took place as a result of the imposition of reserve requirements, interest rate ceilings, restrictions on the range of financial products that financial institutions could offer, capital account controls, and high effective taxation in many advanced economies (IMF, 2000: 10).<sup>6</sup> According to the IMF (2000), based on data from the Bank for International Settlements (BIS), offshore cross-border assets reached a level of US\$4.6 trillion at the end of

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<sup>4</sup> The IMF defines offshore finance as “the provision of financial services by banks and other agents to non-residents” (IMF, 2000: 2). These services include traditional financial intermediation such as non-resident deposits being used to lend money to other non-residents, funds borrowed from non-residents to lend to other non-residents, and non-resident deposits from individuals being invested in other financial markets. Hence, examples of offshore services are: offshore banking (private and corporate), offshore funds, trusts, offshore companies (often as holding companies), captive insurance, and offshore stockbroking (Hampton, 1994: 238).

<sup>5</sup> Bryant (1987) defines eurocurrency banking as “the denomination of the assets and liabilities of a bank office in a currency other than the currency unit of the nation where the office is located” (24).

<sup>6</sup> Helleiner (1994: chap. 4) and Picciotto (1999: 59-60) detail the role that both Britain and the U.S. played in allowing this market to develop, the former by providing a physical location for the market to operate and the latter by permitting American banks and corporations to participate in the market. Nevertheless, these two states continued to maintain their capital restrictions during the 1960s and early 1970s. According to Johns (1983), industrialized countries realized the important role that OFCs play for the international financial system and, therefore, encouraged their development. For a related argument regarding the intimate connection between offshore and the state system whereby offshore finance does not escape the state, see Palan (1999).

June 1999.<sup>7</sup> Of this amount, US\$0.9 trillion was found in the Caribbean, US\$1 trillion in Asia and the remainder (US\$2.7 trillion) was mainly accounted for by the major international financial centers of London, New York and Tokyo (IMF, 2000: 9). Unfortunately, this data excludes a large portion of offshore activity: (1) activities taking place in OFCs not reporting to the BIS,<sup>8</sup> (2) activities not involving banks (e.g., insurance and reinsurance, mutual funds, private trusts and international business corporations), and (3) off balance sheet activities (i.e. fiduciary activities whereby funds are managed at the risk of the customer).

The growth in OFCs took place alongside that of offshore finance.<sup>9</sup> The increasing mobility of capital and the tax and regulatory restrictions imposed in industrialized countries made that financial centers which developed offshore activities were more attractive for individual and corporate business. For example, Luxembourg began attracting investors from Germany, France and Belgium in the early 1970s because it offered low income tax rates, no withholding taxes for non-residents on interest and dividend income, and banking secrecy rules. The Channel Islands and the Isle of Man provided similar opportunities for British investors.<sup>10</sup> At the same time, Bahrain became a collection center for recycling petro-dollars after passing banking laws and providing tax incentives that facilitated the incorporation of offshore banks (IMF 2000, 10). These early successes prompted many to follow suit; however, most had little

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<sup>7</sup> Given the secrecy rules of many OFCs and their looser regulatory standards, there are incomplete data regarding worldwide offshore activities (IMF, 2000; OECD, 1998).

<sup>8</sup> Other than the major centers such as London, New York and Tokyo, reporting OFCs to the BIS are Hong Kong, Singapore, Bahamas, the Cayman Islands, Bahrain, and the Netherlands Antilles.

<sup>9</sup> An OFC is broadly defined as any financial center where offshore services take place (IMF, 2000: 2). However, such a definition would include all the major financial centers of the world. A better definition is a center where the bulk of financial sector activity is offshore (Cassard, 1994; Errico and Musalem, 1999). Thus, OFCs can generally be best characterized in the following way: (1) “jurisdictions that have relatively large numbers of financial institutions engaged primarily in business with non-residents;” (2) “financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies;” and (3) “centers that provide [...] low or zero taxation, moderate or light financial regulation, and/or banking secrecy and anonymity” (IMF, 2000: 3). It is important to note that low or zero rates apply to direct taxes, since OFCs charge license fees for operating in their jurisdiction (see, for example, Suss et al., 2002).

<sup>10</sup> So did the Cayman Islands and the Bahamas for American investors.

success since they were unable to offer similar or better advantages than the more established OFCs provided. Consequently, some of these new centers turned themselves towards the “less legitimate side of the business” like tax evasion and money laundering (IMF, 2000: 10). At the end of the 1990s, there were an estimated 69 OFCs (Errico and Musalem, 1999). For the early 1990s, Cassard (1994) estimated that funds managed in OFCs represented 20 percent of the world’s total private wealth. This amount has surely grown significantly since then as a result of the boom in asset management (e.g., mutual funds) that has taken place during the 1990s.<sup>11</sup>

In response to the rise of OFCs, industrialized countries began liberalizing their capital accounts in the late 1970s. Since then, they have also deregulated their financial system (see Cassard, 1994: 29-37). In many cases they have also made offshore incentives available in their home territory. For example, in 1981 the U.S. established International Banking Facilities (IBFs) in its major cities. Later, Japan followed suit with the creation of the Japanese Offshore Market (JOM). Advanced industrial countries also modernized their tax systems by adopting the principle of consolidation, whereby an individual’s or corporation’s worldwide income is taxable in the home country, with tax credits offered to compensate for taxes paid to foreign fiscal authorities.<sup>12</sup> They also broadened their tax base by reducing the value of allowances for investment (Chennels and Griffith, 1997; Swank, 2002: chap. 7). As a result of these reforms, they have been able to decrease their direct tax rates. Between 1977 and 1993, the average corporate tax rate in 15 advanced-industrial countries decreased from 46 to 36 percent (Cassard, 1994: 33). In 2002 the average corporate tax rate among OECD countries was down to near 31 percent (KPMG, 2002). All these reforms by industrialized countries have had for consequence to reduce the attraction of

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<sup>11</sup> According to a recent OECD (1999) study, the number of offshore funds increased from approximately 1,000 in 1988 to almost 6,000 in 1997.

<sup>12</sup> A similar principle of “consolidated regulation and supervision” of banks’ worldwide activities was adopted by industrialized countries through the 1983 Basle Concordat (see Cassard 1994, 34). The Basle agreement recommends

traditional OFCs for conventional banking. Cassard (1994: 38-39) notes that the importance of OFCs for international banks has diminished because the latter's involvement in the inter-bank markets has also decreased in favor of the derivatives market, which tends to take place in the major financial centers where high-level prudential supervision and economies of scale are present.<sup>13</sup> For instance, 93 percent of derivatives trading, between 1986 and 1992, took place in the major financial centers of the U.S., Japan and Western Europe. Regional OFCs, essentially Singapore, took care of the remaining trading activity (Cassard, 1994: 38). However, other OFCs' relative tax advantage has allowed them to benefit from the growth in asset management (IMF, 2000: 10), whereby more and more individuals, corporations, fund managers are in a position—owing to the elimination of capital controls, the deregulation of financial systems and better communications technology—to make good use of the services and incentives offered by OFCs.

It is this competition between OFCs and other states that, as those like Bryant (1987), Andrews (1994), and Palan (1999) argue, leads to a race to the bottom within the international financial system. Obviously, such “competition in laxity” is said to have a negative impact on the welfare of world societies, especially those in industrial countries, since it distorts the location of financial and other geographically mobile capital. In the words of an OECD (1998) report on harmful tax competition, “These actions [policies to minimize taxes and facilitate tax evasion] induce potential distortions in the patterns of trade and investment and reduce global welfare” (14). This is why the OECD report calls for a “level playing field” that will ensure that location

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that home-country authorities be responsible for monitoring the operations of their internationally-active banking groups.

<sup>13</sup> Cassard (1994) defines economies of scale as deep and liquid markets, efficient clearing and settlement systems, and sophisticated technology.

decisions for capital will be driven purely by economic considerations and not primarily by tax factors.<sup>14</sup>

### *Impact of a Race to the Bottom for Economic Growth and Development*

Both international tax and regulatory arbitrage can affect economic growth and development in the world. Tax arbitrage does it directly by reducing states' capacity to provide public goods. Financial regulatory arbitrage does it indirectly by creating potential instability in the international financial system.

The reason why tax competition tends to be frowned upon by countries with higher tax rates is that it decreases their tax base as capital moves to states with low rates such as OFCs, in the same way that firms with higher prices generally lose customers to competitors with lower prices. Consequently, these countries see their tax revenues decrease. In turn, this affects their ability to provide public goods and other welfare benefits to their residents (Tanzi, 2001b). Lower tax revenues make it more difficult to fund the necessary institutions for economic growth and development such as regulatory agencies, universal education, independent courts, transport and communication infrastructures, etc. (see North, 1990, World Bank, 2002). If residents see their welfare reduced as a result of lower growth and welfare benefits, they will penalize those in power by withdrawing their electoral support. Hence, governments should have every incentive to limit international tax arbitrage. However, limiting tax arbitrage requires a high degree of cooperation between states in the form international tax harmonization. But because international cooperation is difficult to achieve—there is no overarching world authority to enforce agreements, states face a prisoners' dilemma type of situation (Oye, 1985). This means that states

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<sup>14</sup> What the OECD (1998) means with a level playing field is that “countries should be free to design their own tax systems as long as they abide by internationally-accepted standards of doing so” (15).

would be better off cooperating to harmonize their tax systems; however, because they need to attract capital to fuel economic growth, they have an incentive to reduce their tax burden on capital. When all states follow this incentive, one ends up with a race to the bottom. This is why the OECD has threatened sanctions on OFCs considered to have harmful tax practices if they did not cooperate to help level the playing field of international taxation (see Owens, 2000).

In the case of financial regulatory and supervisory arbitrage, the same logic applies. Mobile capital should move where regulatory costs and burdens are the lowest. Regulatory shopping leads to lower regulatory standards, thereby creating greater risk in the system. The presence of low regulation havens can affect the whole international financial system because the failure of a major financial institution, especially a bank, can have repercussions throughout the system. If banks and other institutions do not make adequate capital provisions for their risky activities (e.g., lending and trading), then they face a greater probability of failure. Given that the links between financial institutions are ever tighter, even one major failure could seriously affect the survival of others. This is why most industrialized countries have introduced deposit insurance schemes to prevent runs on banks facing difficulties, and thus to prevent a financial crisis at one institution spreading to others within the *domestic* system. Moreover, these countries generally have relatively high levels of financial supervision to enforce capital adequacy ratios and other preventive measures. However, at the *international* level, there is no global regulator that supervises the system and enforces regulatory measures such as the Basle Accord, nor is there a global deposit insurance scheme. Hence, systemic risk is much greater. This is all the more dangerous given that many countries with higher standards feel pressured to deregulate in favor of more laxity so as to attract and retain financial capital. Bryant (1987) sums up the situation well when he writes:

For these regulatory issues, each nation or political unit in effect regards itself as individually small in relation to the rest of the world. It regulates intensively only those domestic aspects of financial intermediation that are perceived as most directly affecting its own economy. It then adopts a hands-off policy, or in any event a less stringent regulatory posture, with respect to the remaining international activities of financial institutions located within its borders (140).

Unilateral tightening of supervision and regulation by a single nation, for intermediary offices within its borders or for intermediary offices located abroad controlled by national residents, might merely induce a transfer away from intermediary offices to those of other nations (141).

In this sense, a weak link in the chain may cause it to break, with harmful consequences for global welfare, especially that of (industrialized) countries with significant links to the international financial system.

### **There is No Evidence of a RTB in International Finance and Taxation**

It was argued above that the liberalization of capital controls contributed significantly to international capital mobility, which in turn made it easier for OFCs to attract capital from those countries with higher tax rates. As a result, this suggests that the tax base in those latter countries should have decreased. However, Quinn (1997) provides strong evidence to the contrary. He shows that in fact there is no link between international capital liberalization and the erosion of the corporate tax base (see also Chennels and Griffith, 1997; Garrett, 1998: 90; Swank, 2002: chap. 7). Actually, it is the opposite. Capital account liberalization is significantly and positively related with increasing corporate tax revenue. Table I shows that in fact the portion of corporate income tax relative to total tax revenue in OECD countries has remained stable since 1965 at around nine percent. The same applies to the share of personal income tax, which has remained stable at 26 percent. These percentages undermine the claim that the tax burden has been shifted onto less mobile factors of production like labor. Social security contributions by employers have even increased to 15 percent of total tax revenue from 10 percent in 1965. Thus the evidence refutes the claim that easing mobile capital's ability to leave a country leads it to do so. In fact,

according to a survey by KPMG (2002), countries that were not considered OFCs had corporate tax rates of over 30 percent in January 2002. For example, OECD countries had on average corporate tax rates of 31.4 percent while emerging countries in Latin America had rates of 30.2 percent. This is far higher than the zero or close to zero rates found in OFCs.<sup>15</sup> So if convergence in taxation is taking place as Cassard (1994) concludes, these numbers indicate that it is not doing so towards zero taxation rates as the RTB suggests.

Table I approximately here

Hines and Rice (1994) provide further evidence in support of Quinn's (1997) and others' findings. Although U.S. corporations located a significant portion of their foreign activities in tax havens, it did not seem to affect the United States' corporate tax base.<sup>16</sup> This is because taxes paid to foreign states generate foreign tax credits under U.S. corporate tax rules. These credits reduce the amount of U.S. tax that U.S. corporations pay on their worldwide income. However, in the case of income generated in (or attributed) to tax havens, it generates low or no foreign tax credits, thereby increasing taxes paid to the U.S. government. However, if the U.S. is not disadvantaged by U.S. corporations making use of tax havens, it might be affected by foreign companies active in the U.S. These corporations might avoid U.S. taxes by arranging for the income to be attributed to tax havens, just like U.S. corporations do with much of their foreign income. As Hines and Rice note: "American relations with tax haven countries may be changing,

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<sup>15</sup> It should be noted that corporate tax rates only provide part of the of the overall corporate tax burden picture. For instance, other factors to consider are indirect taxes (such as social security taxes), tax inducements for inward investment, and other tax credits (for more details, see OECD 2000). It should also be noted that in many emerging and less developed countries, tax collection is ineffective (e.g., Russia), which means that official tax rates are less meaningful.

<sup>16</sup> Hines and Rice (1994) define tax havens simply as countries having unusually low tax rates. They identify 41 such countries or regions for their study.

as foreign direct investment into the United States increases in volume and seeks tax-minimizing channels through tax havens that American firms have used for years” (175). Provided that companies do not evade taxes, then tax havens may cause more distortions than actual pain: more taxes on worldwide income would end up being paid in the home country of the corporation than in the country where the income was generated. Net losers might be those countries with a net inflow of FDI; however, their overall economic activity would surely benefit from this FDI, thereby enhancing tax revenues. The net effect on the tax base is, therefore, not clear in such a case, and may not be significant.

So it is quite likely that the increasingly-integrated international financial system has forced greater convergence in taxation and financial regulation. However, this convergence does not appear to be taking place at the low end of tax and regulatory standards. This conclusion is confirmed by a report of the Financial Stability Forum’s Working Group on Offshore Financial Centers that states that “OFCs, to date, do not appear to have been a major causal factor in the creation of systemic financial problems” (Financial Stability Forum, 2000: 1).

### **Why There is No RTB: Investor Confidence, Property Rights, and the Transaction Cost of Capital**

The RTB view of international taxation and financial regulation appears to assume that states compete in a perfect market, where all countries offer homogenous products or services at a common price and information is freely available to all instantly. Thus, the “bottom” in the case of international taxation and financial regulation is the common price (i.e. the tax rate or regulatory burden). The only problem for the RTB argument is that such a model of state competition is supposed, in principle, to maximize society’s welfare, not reduce it. Hence, the welfare properties of the competitive model are opposite those the doomsayers want to claim.

The key issue regarding international finance and taxation then is whether capital, as a good, is homogeneous and freely traded. The rapid increase in the mobility of capital mentioned above would suggest that it is indeed the case. However, as we have mentioned in the introduction, there is no RTB and not all the world's capital has ended up in OFCs. This indicates that capital is not perfectly mobile, as the RTB proponents claim. The traditional explanation for imperfect capital mobility is that capital is not freely traded as the model of perfect competition assumes. In reality, there are transaction costs to moving capital around the world. Such costs include banking transfer fees but also those of accountants and lawyers involved in planning and preparing the paperwork for such transactions. Given that the average cost of moving capital decreases with the amount involved, it may not be surprising that a majority of individuals still invest their savings in their home country. For example, although decreasing since the early 1970s, the correlation coefficient between domestic savings and investment remained at a little over 0.6 in the early 1990s (see Taylor, 1996). The reason for this relatively high coefficient is that the great majority of individuals' investment portfolios (i.e. savings) are simply too small to make it worthwhile to transfer them, in part or in whole, offshore. For example, according to the 2001 Survey of Consumer Finance conducted by the U.S. Federal Reserve Board, the median value of financial assets held by U.S. households holding assets was only \$28,000 (Aizcorbe et al., 2003).

The reason why transaction costs on capital arise is because any investor, whether an individual or a corporation, desires a minimum of security for its assets. Hampton and Abbott (1999) refer to this need for asset security as "investor confidence" (7). Investors wish to safeguard the value of their assets over time, whether they invest at home or abroad. In order for the assets to retain their value for an investor, the latter must be able to enjoy the returns (if any) that its assets generate and retain control over those same assets. Consequently, investors require

property rights that allow them to enjoy the fruits of and to ensure control over their investments. Eggertsson (1996), referring to Alchian (1965), defines property rights as “the rights of an actor to use valuable assets” (7). The term “rights” in this case is closely associated with that of “control.” As Eggertsson (1996) makes clear, “The value of an asset to an actor varies with the number of attributes he or she controls. A formal ownership but without control of any valuable attributes has no value” (fn. 8). These valuable attributes include such things as the exclusivity of enjoyment of the returns provided by the asset, the ability to transfer the asset to someone else who might value it more or to modify the asset to make it more productive. Associated with the issue of control is the concept of enforcement of property rights. For example, even if ownership of an asset is legally granted to an agent, the latter must be able to retrieve his asset should it be taken away from him without his consent. This means that investors should require legal procedures that allow them to seek compensation should their contractual party not pay the expected return (e.g., interest or dividend) or not return the asset. Eggertsson (1996) notes that an agent’s ability to use valuable assets derives from having both external and internal control. Internal control refers to agents themselves ensuring control over their assets through such actions as monitoring and checking reputation. External control is a function of the agent’s institutional environment, which constrains and directs both the agent itself as well as other agents. According to Eggertsson, this institutional environment is comprised of constitutions, statutes, regulations, norms, as well as enforcement and sanction mechanisms.

For the agent, the cost of establishing and maintaining internal control over his or her assets is termed “transaction cost.” This cost is incurred by the agent to protect the value of his assets in both “voluntary and involuntary exchanges” (Eggertsson 1996, 8). With respect to holders of financial capital, the transaction cost is equivalent to the “cost of capital.” It is the minimum return that investors require to maintain the value of their assets. It reflects the risk of

loss of value and control associated with a particular investment. Loss of value from the uncertainty relating to the intrinsic performance of the asset (e.g., a company's profits) can be referred to as business risk. However, loss of value associated with the loss of control over the asset is most often called political risk, since the loss generally depends on the ability and willingness of the state to guarantee and enforce property rights. This is because the state is in a position to provide (external) control at a much cheaper cost than the individual would for equivalent internal control. In that sense, the state can play an important role in reducing the cost of capital in a given financial market by providing institutions that produce economies of scale with regards to the security of property rights (see North, 1990). Eggertsson (1996) makes this role for the state clear when he claims that

The state can play a very large role in lowering the cost of contracting of individual actors by providing clear and stable property rights, including a consistent system of enforcement, and also supplying standards, such as weights and measures, which lower measurement costs (9).

Obviously, in exchange for providing external control the state requires a fee from agents in the form of taxation. Nevertheless, this fee is lower than what each individual agent would have to pay to secure his property rights on his own, thereby making everyone better off. To ensure external control over their property rights over financial assets, investors need to hire trusted lawyers, accountants, bankers to help them obtain the proper guarantees and facilitate the transfer of financial assets. The services of these advisors tend to be very costly. The more complicated the transaction (e.g., transfers to OFCs), the more costly becomes the transfer of capital.

The greater the risk associated with a loss of value (through a high probability of adverse performance or loss of control) of an asset, the higher the return required by the investor.<sup>17</sup>

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<sup>17</sup> For example, an investor can invest \$100 in a safe asset (i.e. no risk) and get \$105 after one year (giving a rate of return of 5%). However, the investor can also invest \$100 in a risky asset where he faces a 50 percent chance of losing control over the asset. In the latter case, the investor will require at least a return of \$210 after one year [ $105 / (1 - 0.5)$ ], for a rate of return of 110%, in order to compensate the risk premium of losing the asset and a 5% minimum expected rate of return.

However, this risk-return trade-off can only go so far. In many cases, the returns demanded may be so high that those deemed to provide them will not be able to do so and, consequently, the value of the investment will collapse. For example, how long could a corporation already in financial difficulty survive if it had to borrow funds at (real) rates of 20, 30, or even 50 percent? It will not take long for it to go bankrupt, thereby making the original loan worthless. In such a case, it is doubtful that any investor would come forward and lend to this corporation in the first place. The same could be said for a corporation or country that cannot guarantee an investor a high probability that it will retain control over its asset. In such cases, no investment is likely to take place because the risk of loss of value is simply too large for any reasonable expected return. This is exactly what has happened in many African countries (see Freeman and Lindauer, 1999).<sup>18</sup> In advanced-industrial and emerging markets, the exact opposite has taken or is taking place; as a result, investment, growth, and development have flourished (see Clague et al., 1997). Hence, an investor will put its capital where the expected return is greater than or equal to its cost of capital.<sup>19</sup> This is why North (1980) notes that the “security of property rights has been a critical determinant of the rate of saving and capital formation [in a given territory]” (6).

This means that the cost of doing business for those countries that want to attract and retain capital is to invest in institutions that clearly define and secure property rights in order to reduce investors’ cost of capital. If investors face too high a cost of capital, then they will simply

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<sup>18</sup> Even in countries with high political risks, there are still some (but few) investors who are willing to tolerate high costs of capital, because their expected returns are also high. In such cases, these investors will incur substantial transaction costs to ensure *internal* control over their assets. For example, mining or petrochemical companies may pay corrupt governments fees (bribes) to secure protection, or they may hire their own private security (i.e. military force to protect their assets and employees (which may also be considered as assets, i.e. human capital). They may also pay high insurance policy premiums. These are all forms of taxes, but not necessarily paid to the host government.

<sup>19</sup> The expected return for V dollars invested at time t for one period can formally be defined as

$$E(R) = p_1V_{1,t+1} + \dots + p_NV_{N,t+1}$$

not invest in that particular country. However, this does not mean that states should invest in institutions at any cost. In the words of Eggertsson (2000): “Different circumstances [...] call for different structures of property rights. ... Wealth maximization requires that social groups invest in those structures with highest positive yield” (4).<sup>20</sup> This is the same thing as firms internalizing their investors’ cost of capital into their cost structure, because they have to reward their shareholders and creditors with the minimum returns that they require in order to invest in those firms.

According to this logic of transaction costs, one could as well argue that there could be an international “race to the top,” whereby financial centers put into place the necessary legal, regulatory, and supervisory institutions in order to attract investors, in return charging investors a reasonable fee (i.e. tax) to cover the cost of providing these institutions. Thus, even if capital were perfectly mobile, the bottom for tax rates and financial regulatory standards could never be zero. Some countries would always have an incentive to impose positive tax rates in order to provide regulatory standards high enough to attract capital, up to the point where the risk-adjusted (i.e. expected) returns for the investor equals his opportunity cost of capital.

The end result is, therefore, a situation where financial centers (both on- and off-shore) provide a varied mixture of taxes (prices) and institutions (services). Investors who require higher (lower) levels of services should be willing to pay more (less) taxes for them. If we are to characterize this situation in terms of a market where states compete with each other to attract and retain capital into their jurisdiction, then the analogy should be monopolistic competition, not

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where  $p_i$  is the probability that  $V_i$  dollars will be returned at time  $t+1$  and  $\sum_i^N p_i = 1$ . Note that the greater the probability  $p_i$  that  $V_{i+1} = 0$ , the lower  $E(R)$  becomes.

<sup>20</sup> Wealth maximization by social groups could also mean the absence of secure property rights. For example, a dominant political group that does not expect to be in power for very long might decide to take control over the assets located in the territory under its control and exploit them for the exclusive benefits of the group (see Olson 2000 and Shleifer and Vishny 1998).

perfect competition. For example, Baldwin and Krugman (2001) find that European countries with large clusters (“agglomeration”) of capital—whereby capital benefits from the presence of other capital (e.g., supply chains, knowledge sharing, strengthened infrastructure, etc.)—have higher tax rates than those countries that offer lesser agglomeration benefits. These agglomeration benefits allow countries to demand higher taxes without seeing capital leave their territory. If investors feel that they are paying too much for the services they receive, then, like in any market with some degree of competition, they will move their assets to another country that better reflects their risk-return expectations. This implies that there should generally be a minimum level of services that investors require in order to make an investment, because, as mentioned above, there are limits to the risk-return trade-off.

In the case of OFCs, they are able to attract capital because they increase returns by lowering tax rates. Moreover, they often increase returns by facilitating tax evasion and money laundering through banking secrecy. However, they also increase risk by lowering regulatory standards. So in some cases, the risk-adjusted returns of investing in an OFC will be higher than the returns from investing at home. This is why the most successful OFCs offer relatively high levels of financial regulatory standards. The less successful OFCs tend to attract illegitimate capital because tax evaders and money launderers have high risk-adjusted returns at home (i.e. they lose control over their capital if they get caught).<sup>21</sup> Investors will only move their financial assets offshore if the risk-adjusted returns from investing in an OFC (abroad) is greater or equal the opportunity cost (risk-adjusted return) of capital of investing at home.

Cassard (1994) notes that the decision to move assets to a regional OFC is not only a function of a low-tax and flexible regulatory environment, but also of “the depth and liquidity of

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<sup>21</sup> Money launderers wish to avoid financial centers with high standards of regulation and supervision in order to avoid losing control over their assets.

financial markets, the quality of the supervisory regime [...] and the efficiency of the payment and clearing systems” (11). Hence, both efficiency and regulation matter to most offshore investors. In the case of efficiency, financial depth and liquidity and efficient payments and clearing contribute to enhancing the returns that a firm may gain on its investment by providing lower transaction costs. The quality of the supervisory regime deals with the loss-of-control concerns of the investor. According to Cassard, the quality of the supervisory regime tends to increase as the nature of the financial instruments traded becomes increasingly sophisticated.<sup>22</sup> For example, OFCs vary in the amount of value added that is brought to transactions undertaken for non-residents. OFCs like Hong Kong and Singapore, with well-developed financial markets and infrastructures, provide high levels of value added to transactions. Other OFCs limit their added value to the provision of a professional infrastructure.<sup>23</sup> Finally, in others where financial institutions have little or no physical presence, the value added consists only of “transaction booking” (IMF, 2000: 3).<sup>24</sup>

It is interesting to note that many, if not most, of the OFCs that offer political stability, currency stability, and relatively good physical and legal infrastructures are former British and Dutch colonies or existing protectorates. They inherited the political, legal and physical infrastructures put in place by their colonial masters, which have also been useful in preserving political stability. Hampton (1994: 238) notes that the Channel Islands have increasingly tough commercial and banking regulations. Le Marchant (1999) adds to this list Bermuda, the Isle of

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<sup>22</sup> This seems to contradict Kroszner’s (1999) claim that private regulation of financial markets is sufficient. He says: “The overall stability and integrity of those markets is due primarily to the role of private regulators [i.e. market forces], not public ones. To be successful in this anarchic but orderly realm, firms and markets must develop strategies that promote credibility and induce contractual performance, largely without recourse to traditional government-supplied legal devices” (355). Although Kroszner is right about credibility and contractual performance, he ignores the important role played by the public realm when contractual performance is not forthcoming because private agents find it too costly to secure on their own their property rights or when credibility is difficult to establish because information is costly to obtain.

Man, Hong Kong and Singapore.<sup>25</sup> Hampton (1994) believes that these regulations are just a response to the demands of investors and the agents that serve them.<sup>26</sup> Analyzing the case of Jersey, Hampton lists the following factors as key to this OFC's success:

- Political stability;<sup>27</sup>
- Proximity to a major financial center (e.g., London);
- Low direct taxes (no value-added, estate, death or capital gains taxes);
- Modern legal infrastructure;<sup>28</sup>
- Bank secrecy;
- Sophisticated financial infrastructure;<sup>29</sup>
- Educated and English-speaking labor force.

Hampton argues that these success factors need not be specific to the State of Jersey, so long as the countries wanting to build a “clean” OFC are willing to bear the costs. For example, according to Cassard (1994: 21), Bermuda's tight regulatory procedures, whereby fund managers must substantiate their reputation and experience to local authorities, have made it more appealing than its neighboring competitors. Another example of many OFCs' willingness to maintain a reputation for acceptable international standards is that, in the wake of financial scandals that reduced investors' confidence in OFCs,<sup>30</sup> they decided to tighten their screening of companies coming to their jurisdiction and to monitor illegal activities (Cassard, 1994: 36). For instance, in 1986 the Cayman Islands signed treaties of mutual assistance with the U.S. and the

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<sup>23</sup> Hampton (1994: 237) refers to OFCs providing a mix of activities such as international banking, offshore fund and trust management, legal and accounting advice, etc. as “functional” centers.

<sup>24</sup> Of course, one may find that booking also takes place in centers where the degree of added value is higher.

<sup>25</sup> Le Marchant refers to these OFCs as “hard” offshore centers.

<sup>26</sup> For example, Errico and Musalem (1999: note 27) found that several OFCs require, as a licensing criterion, that a parent bank provide a guarantee of liquidity support should the offshore establishment experience a liquidity shortage.

<sup>27</sup> Hampton considers political stability as “one of the most significant factors [... because] banking is built on the notion of ‘confidence’” (241).

<sup>28</sup> According to Hampton, the objective was to “promote the island as a quality OFC for reputable business and so the States [of Jersey] set strict entry requirements for banks. These favored major international players, banks from the world's top 200. Interestingly, BCCI was refused a license by the Jersey authorities” (240).

<sup>29</sup> Hampton indicates that this arose as a result of the demands of wealthy residents.

<sup>30</sup> E.g., the financial collapses the Savings & Investment Bank in 1982 and the Maxwell pension fraud in 1993 (Isle of Man); the Signal Life affair and the Barlow Clowes International affair in the 1980s (Gibraltar); the failure of the BCCI in 1991 (Dubai and the Cayman Islands).

U.K. with respect to non-tax criminal matters. In the beginning of the 1990s, they also tightened reporting requirements, lending guidelines, and performance reviews. For its part, Luxembourg decided to relax its banking secrecy laws for criminal activity. It also required that in order to obtain a license banks and holding companies had to conduct business in the country. The Channel Islands decided to impose drug-trafficking laws modeled on those of the U.K.

For Hampton (1994), the rapid increase in OFCs in the last 20 years “may be a reflection of the idea that offshore finance is a ‘quick fix’ or short-cut to economic development” (242). However, Hampton notes that as competition between OFCs increases, specialization also increases. For him, “new entrants have to offer a new product or have an advantage over longer established rival centers to survive” (246). On the one hand, he cites the examples of The Bahamas and the Cayman Islands as OFCs that have successfully upgraded from paper to “functional” centers. On the other hand, Cassard (1994: 41) lists Antigua, the Cook Islands, Dubai, Nauru, Turks and Caicos, and Vanuatu as OFCs that have been unable to attract significant financial activity to their jurisdictions. The latter’s lack of competitiveness is due to, *inter alia*, underdeveloped infrastructure, unskilled labor force, political instability, and involvement in money laundering.

## **CONCLUSION**

Without a doubt, capital is necessary for a country to grow economically. To attract and retain capital, countries must offer positive risk-adjusted return, i.e. returns that at a minimum cover investors’ cost of capital associated with a particular investment. Given that investors are concerned with the loss of value of their assets, especially the risk associated with the loss of control over their asset, they require property rights and the means to enforce them. If investors have to secure their property rights themselves, then it increases their cost of capital. Instead, if

states provide this security through clearly-defined laws, regulations, and enforcement procedures and are stable enough to apply them, then investors will see their cost of capital decrease. In such a case, the latter's risk-adjusted returns will increase accordingly, even if they have to pay some fees or taxes to cover the costs incurred by states to provide this institutional environment. The more expected returns increase in a given state, the more it should attract capital, which in turn should lead to greater economic development.

For this reason, the increasing mobility of capital in the last 30 years and the growth of OFCs have not led to a "race to the bottom" that seriously undermines the stability of the international financial system nor greatly affects the tax bases of countries. Moreover, it is unlikely to become so as capital continues its trek towards greater mobility. It seems that most investors require that the bottom in terms of financial regulation and supervision be high enough to commit their capital to a given state. Consequently, this limits the potential for instability in the system. It also leaves the state in a key position to provide a degree of protection to investors' assets and reduce their transaction cost of capital. The success of those OFCs that have sought to provide high-quality institutional environments for their investors confirms this viewpoint. For sure, bank failures and financial crises will remain. However, these need not necessarily be caused by activities occurring within OFCs' jurisdictions. If such failures or crises should arise in OFCs, then it is more than likely that their impact on the world's financial system will be limited and that the affected OFCs will work hard at improving their reputations in order to continue attracting business, as history has shown so far. Otherwise, OFCs will see limited business activity, often of the illegitimate form, and their economic development will suffer as a result. For this reason, it appears unlikely that the doomsayers will be vindicated.

This implies that an artificially high-level playing field should not be imposed across the globe. If it were so, we would find that global welfare has been reduced. Investors would then

face higher taxes and reduced opportunities to invest their assets. The states incapable of upgrading their institutions in time (because of financial or other structural constraints) would see their economic development halted or even reversed. The better approach is to increase transparency and information in the international financial system. This will allow investors to make more enlightened decisions regarding their investments, reduce their cost of obtaining the information needed to make their decisions, and help uncover illegitimate capital. If this is the level playing field that policy-makers and international organizations like the OECD have in mind, then global welfare should benefit.

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**Table I**  
**Tax Structures in the OECD-area**  
*(Percentage share of major tax categories in total tax revenue)*

	1965	1975	1985	1995	2000
Personal Income Tax	26	30	30	27	26
Corporate Income Tax	9	9	8	8	10
Social Security Contributions – Employee <sup>1</sup>	8	8	9	11	10
Social Security Contributions – Employer	10	14	13	14	15
Payroll Taxes	1	1	1	1	1
Property Taxes	8	6	5	5	5
General Consumption Taxes	12	13	16	18	18
Specific Consumption Taxes	24	18	16	13	12
Other Taxes	2	2	2	3	3
<b>TOTAL</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

<sup>1</sup> Includes social security contributions paid by the self-employed.

Source: OECD, Revenue Statistics 1965-2001, p. 21.