BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Officers and Section Chiefs

From Guy Stevens

Subject Notes on 2nd OECD Meeting on Global Capital Markets & Tax Problems

This was the second of four proposed meetings on the *Globalisation of Capital Markets and the Tax Treatment of Income and Capital* (joint session of OECD's Committees on Fiscal Affairs and Financial Markets). The session included the discussion of four papers, with special attention to "Offshore Financial Centers" and "Withholding Taxes on Interest Accruing to Non-Residents," and the preparation and discussion of a draft outline for a final report (agenda and draft outline attached, all papers and other materials in Info Center).

Offshore Financial Centers. This was a fairly comprehensive survey of the nature of and policy issues concerning offshore centers, by consultant R. Anthony Johns, author of a number of publications in the field and a professor at Keele University. The paper did not, however, give any precise data on the size, importance, or effects of such centers -- despite persistent interventions from the delegations that they needed quantitative answers to such questions as the impact of various tax-rate changes on flows to such centers. (The next paper, by Harry Huizinga, did address such quantitative issues.) As for size and importance, the author asserted that we have little meaningful stock or flow data, but quoted some very large estimates on p.7 of his paper.

Concerning policy questions and possible paths of regulatory change, the paper was much more substantial. An overarching question of course is the prospect for international tax cooperation and harmonization; he specifically asked whether the OECD could and would play the role in this arena that the BIS is playing for bank supervision. An important issue here, to which the delegates returned repeatedly, is the interlinking of withholding taxes, exemptions therefrom, and the exchange of information among taxing authorities. One attempt at international cooperation, Johns noted, was the OECD *Draft Convention on Mutual Assistance on Tax Matters* (*INTERFIPOL*); among many provisions it states, "At the request of the applicant state the requested state shall ... take the necessary steps to recover tax claims of the first-mentioned State as if it were its own tax claims." Although the convention has not be signed by any state, the German delegate asserted that five countries would soon sign. Tax harmonization within the EC is also a central issue; the direction of possible reform is spelled out in the EC's 1992 "Ruding" *Committee of Indpendent Experts on Company Taxation* (pp. 17-18).

The question of more direct regulation of offshore financial centers (more about the sensitivity of the use of the words 'tax haven' below) is taken up in the last section of the paper (pp. 19-22). At a minimum, the consensus of expert opinion is that centers such as Luxembourg and Ireland are living "on borrowed time." As noted in my memo on the first session (11/29/93), the effects of such "offshore" centers that are "inshore but not yet onshore" have been deleterious -- in the view of the Germans, Belgians and a number of other countries. Professor Johns noted, however, that overly harsh regulation of European centers could drive away the burgeoning and very lucrative business from the Pacific rim.

In addition to an energetic discussion of the merits of the paper, an amusing and sometimes heated undercurrent was a debate concerning who was and wasn't a *tax haven*. The Swiss more or less brought down the house when, by some arcane logic, they concluded that Switzerland *was not!*

(written Swiss comments available in the Info Center). This prompted muffled chuckles and the pointed response from the German delegation: "Switzerland is a first class tax haven for first class German tax payers" -- noting a list of 10,000 German companies that are located in Switzerland for tax-saving purposes. Italy (Trieste), Hungary, and even Luxembourg also wanted to demonstrate that their various centers and zones did not fit the definition of a tax haven. Professor Johns graciously suggested to replace the dirty word with "a zero or low tax jurisdiction."

(The Effects of) ***Withholding Taxes on Interest Accruing to Non-Residents***. The innocuous title belied an interesting paper by Professor Harry Huizinga (Stanford and Tilburg Universities), that featured empirical estimates. After a review of efforts to harmonize taxation of capital income (including withholding taxation), Huizinga went on, using a series of arbitrage relationships, to examine whether differences in interest rates on similar financial instruments can be related to tax and withholding rates. He summarized previous (1991) work on interest rates on U.S. bank loans to developing countries, and presented new results on differences in spreads between Eurocurrency rates and various government T-bill rates, and among the T-bill rates. Of the new results, he finds that the spreads between Eurocurrency and T-bill rates seem best explained by *Japanese* withholding rates and tax credits (as opposed to German and U.S. parameters); of interest, also, is the finding that the differential reflects only about 20 percent of what he considers to be the relevant withholding tax rate -- suggesting some possibilities for governments to collect the taxes and to gain thereby. In arbitrage between various T-bill rates, he finds that there is no evidence of tax-credit offsets -- perhaps because the marginal investors are ones, like pension funds, that are exempt from domestic income taxation. Huizinga then goes on to embed key relationships in a standard open economy macromodel to determine the impact of various changes in withholding taxes and tax credits.

The second day of the conference concentrated on the nitty-gritty details of country practices and problems in the areas of withholding taxes on capital income, the sharing of information, and the taxation of certain financial institutions and instruments. The OECD Secretariat presented an overview paper, *Issues in the Use and Design of Withholding Taxes on Interest*, and a consultant, Dr. Julian Alworth, prepared *The Tax Treatment of Financial Intermediaries and Institutional Investors: Selected Issues for Discussion*. Finally, a short part of the session was devoted to papers prepared for related meetings of the Committee on Fiscal Affairs on the general subject of taxing new financial instruments: *Taxing New Financial Instruments* (Working Party #6); *Taxing New Financial Instruments: Securities Lending and Repurchase Agreements;* and *The Analysis of Some New Financial Instruments: Perpetual Debt, Equity Note and Bond with Equity Warrant*.

The attached draft outline of a final report gives some indication of the direction the remaining two sessions will take (scheduled for October 1994 and May 1995). The various issues concerning the taxation of capital income have been thoroughly discussed. However, there are difficult and, probably -- given the time frame -- insurmountable problems that stand in the way of any firm policy recommendations. In particular, it is clear that basic data are not readily available -- basic facts on how much taxes have actually been collected in various countries and other fundamental facts concerning the operation of systems now in place.

Moreover, I have heard no suggestion that, if a concerted push is made for new withholding taxes, the OECD can prevent the movement of capital to non-controlled "zero or low tax jurisdictions."