Nothing Fails Like Success: Online Growth In The Offshore World

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The 1950s and 1960s saw the emergence, from some tax haven jurisdictions, of the offshore financial centre (OFC). The need for a new type of offshore institution was matched by technological developments which helped bring it into being and gave it shape and form.

For example, the technologies of jet planes and advanced airport infrastructures meant that clients could do business in the Channel Islands and be back in London the same day. The same technologies worked for Canadians and Americans and various Caribbean destinations.

As telecommunications technology grew in sophistication geographical proximity to onshore clients became less important. Clients began to use secure, reliable and high capacity phone lines to conduct a variety of banking and commercial services with OFCs.

With the Internet, the picture changes again. As we shall see, the technology of the Internet transforms the potential of online economic activities. It has special implications for the offshore world. It promises to change the role of the offshore financial centre.

This century has seen communications technologies link the economic centres of the world as never before. Wiring up the world has brought global integration or globalization.

Globalization rests on an infrastructure of inexpensive, reliable and accessible digital networks. These networks carry sound, pictures, text or numbers, as a stream of digitized 'bits' of information. A series of 1s and 0s.

As networks become more secure, commercial opportunities expand. Products are bought and sold over networks.

Currently, most net-based merchants follow the same taxation rules that apply to mail-order purchases. There is little difference if a product is ordered through the Web or via a 1-800 toll-free number.

But what happens when the product isn't shipped to the buyer, but is delivered electronically as a digital bit-stream via the Internet? With a typical mail-order purchase, the product is shipped somewhere. But the design of the Internet makes it nearly impossible to determine the location of the buyer. With digital distribution, the seller is likely to have no idea of where the product ends up.

Where does the seller reside? Geographical location or where the computer server is located?

What happens when the electronic product is downloaded from a server located offshore? What happens when other transactions, including financial flows of all types, take place over the net and those transactions are from anywhere to anywhere and anywhere just happens to be an offshore low or no tax jurisdiction?

With encryption tax avoidance becomes easier. The technology that protects buyers and sellers can also keep secret the transaction itself from government tax authorities.

Secrecy is made more effective when payment is not via a charge card such as Visa or Mastercard, rather payment is via digital cash. An anonymous payment from one person to another without a third party intervention.

With computer software, music, movies, magazines, business services including banking and financial transactions--all headed for electronic distribution governments everywhere are facing the threat of tax erosion.

In the online trading environment how will taxes be collected? Who will collect taxes? On whose behalf will taxes be collected and where will they be sent? With little evidence of a papertrail-- what a job for the tax collector!

Digital networks are distance insensitive. Digital data can be stored anywhere, sent anywhere, manipulated anywhere, sold anywhere. Payment can be from anywhere to anywhere on earth.

Little wonder that the major trading nations are worried about their tax base.

Participation in low tax jurisdictions is growing "exponentially." Investment by G7 countries in offshore jurisdictions increased by more than 500 percent between 1985-1994.

One web site (www.finor.com) interested in locating new businesses offshore estimates 60,000 offshore businesses were incorporated in the Caribbean in 1995 and--over 130,000 offshore companies were formed worldwide in the same year. Over the next three years they estimate another 500,000 offshore companies will have been incorporated worldwide.

Offshore entrepreneurs are showing the way to those who want to do business from a low tax location. Consider the web site of Hansa.net. Hansa.net offers "location optimized commerce on the Internet" so that "taxes are an option." Hansa.net offers a wide range of services to those who want to avoid taxes by locating offshore, but do business anywhere.

Each day the Net carries more offers to "get rich by moving offshore." The web site "escapeartist" has a page "One Thousand and One Offshore Tax Havens and Banks." (Which also tells how to acquire a 2nd passport.) Or consider "The Offshore Money Book: How to move assets offshore for privacy, protection and tax advantage" available from the web site of offshore-net.com. And if clicking through web pages to find a tax haven is too onerous don't worry, every few days an unsolicited email arrives. The most recent one offers a guide to offshore riches for US20 dollars. Caveat emptor!!

The promise of tax avoidance is not restricted to exotic islands. In December 1997, the US State of Montana completed regulations on a new law that would allow non-residents to protect their assets in Montana. The first state in the US to have such a law!

Muscovitch of Osgoode Hall Law School in Toronto in his Internet article, Taxation of Internet Commerce (www.lovotax.nl/tax/onderwerp5/11.html) makes the point of tax avoidance as a growing part of everyday life. Companies in Canada or other treaty countries will add the relevant taxes to Internet sales. But what happens when the web site is located in a tax haven? Sales from servers in low or no tax jurisdictions are likely to grow, while sales from servers in other jurisdictions are likely to lag.

Either directly, through offshore banks or other financial intermediaries, the Internet will allow more people everywhere to participate in offshore commerce. The net and encryption clears the way for average citizens of OECD countries to use OFCs. Numbered bank accounts and on-line payment options open the prospect of tax avoidance to many.

A change in quantity leads to a change in quality. So too with tax avoidance. When relatively few people had the skills and legal advice to benefit from an OFC link, onshore governments seemed to look the other way. But what happens when the dam threatens to burst, when the trickle to offshore threatens to become a flood?

The success of the OFC, coupled with the future promise of Internet commerce is leading onshore governments to react. To deny the growing movement to restrain or control offshore activities is likely to be a strategic error.

The OECD has underway a major review of tax avoidance. It is designed "to counter the distorting impact of harmful tax competition on investment and financing decisions and the consequences for national tax bases." It plans to convene a Forum on Harmful Tax Practices and will issue a report listing those countries deemed to be tax havens.

At least twelve OECD countries have Commissions, Committees or Ad Hoc Groups looking at the tax implications of the Net.

The UK government has announced a wide-ranging review of the financial systems of the Channel Islands (Man, Jersey and Guernsey). Other EU countries are also taking aim at tax breaks and tax havens. A single market and a single currency seems to be leading the way to tax harmonization.

In November, 1997, the Swedish government asked European finance ministers to "get tough" with tax havens. The Swedish tax minister said "tax havens are a threat to fiscal stability."

The US Treasury has noted the problem and say they will act in time. In a parallel move, US officials have acted against offshore gambling via the Internet. US Attorney General Janet Reno (NY Times, March 5, 1998) said "The Internet is not an electronic sanctuary for illegal betting...To Internet betting operators everywhere we have a simple message: You can't hide on line and you can't hide offshore."

The Canadian and Australian governments have gone public with their concerns. An official of Revenue Canada in a public speech (February 11, 1998) said, "The fear is that electronic commerce will gravitate to offshore jurisdictions to take full advantage of corporate and bank secrecy laws, encryption and electronic cash to avoid and evade taxation in other jurisdictions."

Of course it is the existence of tax (and interest) differentials that causes wealthy individuals and many multinationals to shop around for a low-tax location. And the OECD countries have been part of the problem--with tax concessions of all types offered by member countries. But the OECD is concerned that the Internet and links to offshore centres will make tax avoidance much more widespread.

As the OECD has stated,

"Governments cannot stand back while their tax bases are eroded through the actions of countries which offer taxpayers ways to exploit tax havens and preferential regimes to reduce the tax that would otherwise be payable to them."

The offshore has benefitted from a range of technologies and with the technology of the Internet the OFC stands to benefit again. Offshore commerce is a truly successful venture. To deny the success of the OFC is to invite retaliation and the possibility of eventual failure. Hence the title of my presentation, Nothing Fails Like Success.

Success leads to complacency. We see it over and over again in the affairs of people, companies and nations. A recent Wall Street Journal op-ed article (March 18, 1998, p. A23) describes the success of McDonald's--and the problems raised by that success--in just this way, "McDonald's seems to have fallen into the hell that traps many of the best companies at some point in their lives. Having established a dominant position under a previous generation, it is bedeviled by a reverence for the old formulas, while its leadership takes weak steps and then denies all problems."

Success carries with it responsibilities. Here it is the responsibility to protect the place of OFCs. Albert Camus, the French philosopher said "Freedom is not constituted primarily of privileges but of responsibilities." To protect the future freedom of the OFC there is a need to act responsibly.

A crasser way to put it is to quote some folk lore from Guernsey, one of the Channel Islands. "All that comes with the flood will return with the ebb. Riches too rapidly acquired, or ill-gotten, will disappear as quickly as they came." Your job is to act responsibly, even if it involves some enlightened self-interest, so that OFCs can participate in on line commerce now and in the future.

How to do this?

We have seen that more and more ecomm transactions are likely to migrate to OFCs for a variety of reasons. Tax avoidance by buyers and sellers being the major reason. We have seen that onshore governments are watching and will not long tolerate tax erosion.

As tax avoidance grows and threatens tax bases in jurisdictions around the world it might be wise to suggest a defensive move by offshore jurisdictions. The best defence is an offence. Why not mount an offence without being offensive?

I am suggesting that a way of countering any international attempt to control OFCs is to say,

"We have seen the future and it is one of net commerce. It is a world where attempts by one jurisdiction or another to impose a tax will fail because of the nature of the net itself and because of the various tools available to encrypt and keep secret these transactions. Yet a tax base is essential if governments of the world are going to be able to provide the range of infrastructure and public goods that citizens in jurisdictions around the world have come to expect. We therefore suggest a modest turnover tax on net traffic."

I am here to suggest to you today, for your consideration, one such tax. A bit tax. A tax on each interactive digital bit of information. While many will find it odd that I propose such a tax at such a meeting in this jurisdiction I am confident that those concerned with the longer term implications and governance of OFCs will see this as a useful strategic move.

An official from one of the OECD countries said "...if the OFCs suggest an online Internet transaction or bit tax it would set back efforts to regulate the OFCs by a decade..."

Over two hundred years ago Adam Smith wrote his classic book-- The Wealth of Nations. He concluded that wealth was based on the division of labour and the extent of the market. Today we can add to society's production function: knowledge, information, and communications.

The new wealth of nations can be found in the trillions of digital bits of information pulsing through global networks. These are the physical/electronic manifestations of the transactions, conversations, voice and video messages and programs that, taken together record the process of production, distribution, and consumption in the new economy.

Digital networks provide a place to create a new indirect tax, a tax not on the wealth being created but, rather a turnover tax for using the information highway. (I would like to add at this point that the tax is fiscally and economically sound and more detail can be found in a book that I co-authored called The New Wealth of Nations: Taxing Cyberspace.)

While there are few kudos for proposing a new tax, there is a strategic reason for offshore jurisdictions to propose a new indirect tax on interactive digital traffic. The time is ripe to suggest positive and constructive ways of dealing with the fiscal realities created by more and more shopping, banking and trading moving online and offshore. The move to cyberspace suggests consideration of a new and growing tax base. A tax that is difficult to avoid, where collection is in few hands. A tax that can be collected by many jurisdictions.

How do we do this? Consider a turnover tax on digital traffic. This would be similar to a gasoline tax or a bridge toll or license plate fees for a car. These current excise and indirect taxes apply by weight of vehicle, and amount of gas used, not on the value of the commodity carried by the truck or automobile. So why not examine a possible tax on the digital traffic of the Information Highway? Why not tax each digital bit of information?

Imagine a "bit tax." I am proposing that we tax each digital bit of information flowing in global networks. And with convergence, all information--data, voice, images--will be in digital form.

The digital bit may be part of a foreign exchange transaction, a business teleconference, an Internet e-mail or file transfer, electronic check clearance, or an ATM transaction. The tax can be levied on fibre optic, micro-wave, cable or interactive satellite traffic. The bit tax as a new tax is congruent with a new economy based on digital networks.

The bit tax offers a way for Offshore Financial Centres to say to the rest of the world, "Fear not for your financial future, there is a way to conduct commerce in cyberspace and still maintain a tax base, a tax base that is growing."

Say the tax is .000001 cents per bit. Collected automatically it will cause fewer problems than most other direct or indirect taxes. If collected by the telecom carriers, satellite networks, and cable systems, the revenues would flow directly to the national revenue service of the respective country.

The bit tax would be applied to all interactive digital transactions. Interactivity makes the transaction valuable. A conversation, data search, accessing an ATM, shopping on the net, banking via the net--is an activity you choose to do because it does something for you. You get something for doing it, you get something out of doing it-- otherwise you wouldn't be doing it. It is this new value, this new productivity that is creating so much new wealth in networks.

The tax would apply to all interactive digital traffic. Digital broadcast ("one-to-many" broadcasts) would be exempt. But broadcasts of one-to-few, eg., TV broadcast to a few stations for later rebroadcast, or newspaper transmission by satellite to remote printing plants are interactive (because they are "addressable") and would be subject to the bit tax.

Research is needed on many aspects of the tax. For example, two pricing models have been proposed. One is the "letter model." This would operate in a similar way as today's postal system. Here the digital message would carry a further piece of information: an electronic franking mark. The electronic frank would consist of changing one bit in the header of the message. The metaphor is to today's postage stamp and franking by the local post-office which indicates the postage has been paid and the letter can be delivered anywhere in the world. Member countries would have a settlement mechanism, similar to the Universal Postal Union, to assure that revenues are equitably distributed.

Another pricing model is based on the turnpike or the toll road. Here the digital message would be subject to a number of (lower) bit taxes as it travels through the network. With collection taking place at each node in the network, countries would keep what they collect. Here there is no need for an electronic franking mechanism.

Pilot studies are needed on how to impose the tax. User-pay or applied at a regional level, say, by area code, metro area, province or state? Or some combination of both? Part of the tax in the customer's base rate and the rest based on actual use.

Note the implications of including area code or other region as part of the taxable base. If transactions greatly increase in one region, new network investments and operations would likely take place in a lower bit tax rate region.

Research must be done on the burden or incidence. Is it progressive or regressive? Will it be absorbed by carriers, or passed on to consumers, or both? Should lower rates apply to very large files such as digital movies downloaded to the home?

Leased or private lines would be charged a fixed rate depending on the bit-carrying capacity of the line. Thus a 1-800 number or other leased line would have a bit tax rate of, say, 70 percent of the carrying capacity. With no built-in meters in these lines and because the traffic fluctuates, it is easier to settle on a fixed percentage of capacity.

It is unlikely that any single country could institute a cybertax such as a bit tax. It is equally unlikely that I can clearly see as of this day in 1998 when and how a global bit tax would be fully implemented. But it is quite clear to me that if offshore jurisdictions suggest a constructive and responsible way to deal with the world of online transactions, then direct notice will be taken. And direct notice will be taken almost immediately.

Those concerned with global governance, those who have been worrying about tax erosion will take notice of any suggestion by OFCs to dialogue on cybertaxes.

This suggestion to look at cybertaxes. From offshore jurisdictions! Imagine!

To speed things along there may be merit in establishing a leadership position. Set in motion some pilot projects among a number of offshore jurisdictions to lead by example. Maybe the bit tax as outlined is too difficult to implement, maybe it will be a modified bit tax or some other form of cybertax. What is important is that offshore jurisdictions will be seen to be sensitive to the issue, will be seen to acting in a responsible way to deal with the challenges and opportunities posed by online commerce.

And what about the tax rate itself? Is it too high or not high enough? If .000001 cents per bit yields too much revenue, it can always be adjusted. As network-based commerce expands, the number of bits increases. During peak periods in North America 1 trillion bits per second (bps) are transferred on telephone networks. In the future, with fibre optic networks the capacity will be expanded to a peta bps. A "1" followed by 18 zeros! The bit tax rate will have to be adjusted for changing times.

Some oppose the tax, arguing that a tax on this new area of economic activity risks slowing its introduction. My answer is: did the imposition of the gasoline tax slow the development of the automobile industry?

Other opponents are those want to decrease the power of the nation state. To do this they would choke off all its taxing powers. They see the bit tax as a sort of stealth tax. To this group I can only say that I take a different view. From my perspective, I offer a quote from US Supreme Court Justice Oliver Wendell Holmes, Jr., who wrote in a decision in 1904 that "taxes are what we pay for civilized society."

As more and more commerce takes place on global digital networks it is important to develop new fiscal tools that are effective in the digital environment.

I am sure that most can recall the mantra of "thinking globally but acting locally," an idea that came from the environmental movement. It may be that globalization is leading to a reversal of the mantra: it may be that the new reality is one where acting globally and thinking locally is all that nation-states can effectively manage.

One step in global action could be the bit tax. It could supplement the revenues of nations everywhere. As an additional source of tax revenue it could have applications locally.

While the economy has gone global, the nation state is the place where citizens turn for a host of services: from education to medical care to income support when jobs are lost. The nation state provides the social and physical infrastructure in which individuals come into the world, are educated, raise families, find meaningful work, and finally leave the world.

While the role of the nation state is undergoing a re-evaluation--there are bills to be paid!

How does the nation meet the fiscal challenge in a globalized economy? How does the nation maintain its tax base in a porous globalized world? How do the developed countries of today avoid becoming part of the "third-world" of tomorrow's information-based global economy?

Today I have suggested one way. A cybertax--a bit tax or some variant offers a way for nations to maintain their tax base.

And it could be, as we peer into a still somewhat murky future, that the bit tax itself--once implemented--could be but the basic turnover tax on the information highway. It could be that somewhere out there we will see the development of a range of bit taxes. Bit tax, bit tax plus and bit tax plus-plus. Might this be one way that low, medium and high tax jurisdictions distinguish themselves in the future?

This line of speculation is for another time, for another venue.

The title of my talk is Nothing Fails like Success. I hope I have offered to this group some thoughts on how to deal with the present and projected success of the OFC in a positive and responsible way. A way that can ensure the continuing success of the offshore environment.