

# Global competition in offshore business services: prospects for developing countries



**Rajiv Biswas**

Rajiv Biswas argues that for many developing countries, diversification away from traditional primary industries to international business services has been a highly successful means of achieving economic development. Governments have pursued economic development policies for diversification into industries such as financial services, shipping, commercial services, computer services, and more recently, e-commerce, in order to build comparative advantage in these industries, which are among the fastest-growing sectors of the global economy.

Many Commonwealth countries have benefited strongly from pursuing such strategies, escaping the vicious cycle of deteriorating long-term real prices for agricultural and mineral commodities, highly volatile commodity prices and vulnerability of crops to extreme weather conditions.

### Growth rate of global exports by industry sector, 1990–98 (annual average growth rate in world trade value, per cent)

Agricultural products	4
Mining products	1
Commercial services	7

Source: WTO

While globalisation has often assisted such industrial diversification strategies, since many international services are relatively mobile geographically, there are increasing concerns that global competition in such industries will be

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subjected to regulation by a handful of the most powerful developed countries, potentially locking out developing countries from competing effectively in a number of these industries.

<b>OECD Countries:</b>	
North America	22.0
Western Europe	44.4
Japan	4.8
<b>Developing Countries:</b>	
Africa	2.2
Latin America	4.3
non-OECD Asia	13.0

**% Share of world trade in commercial services, 2000  
Region: (source WTO)**

The recent OECD Initiative on Harmful Tax Competition, as well as other OECD initiatives such as the previous OECD initiative on Multilateral Agreement on Investment (MAI) and planned new e-commerce initiatives, are raising concerns in developing countries that a small number of advanced economies are raising new barriers to competition from developing countries in the global business services industries, where the OECD countries have had a dominant position historically. The WTO is also phasing out use of investment incentives and export incentives as a tool of economic development, which will affect many developing countries.

## 1. The growth of international business services

The international business services industry has shown rapid growth in the last two decades. This reflects a number of global trends, including the deregulation of domestic financial markets in many countries, rapid growth in world trade and investment, and the globalisation of many segments of the services industry. Initiatives in the GATT Uruguay Round to liberalise trade in services have underpinned the growth of the international business services industry. The process of liberalisation of trade in services is likely to continue to be an important component of future WTO discussions. At present, the OECD countries control almost all world trade in commercial services, accounting for around 80 per cent of total global service sector exports.

Although the OECD countries continue to dominate

world trade in services, developing countries have benefited from even their small share of global services trade. Diversification into offshore IT and financial services has benefited many developing economies very substantially in a number of ways. Firstly, the offshore financial services industry has been a high growth sector globally. Therefore it has provided a dynamic growth sector for national output in comparison with the existing alternatives available to many countries. For example, many Caribbean economies were heavily reliant on traditional industries, namely subsistence farming and the export of primary commodities. From a terms-of-trade perspective, for decades the prices of international services have been rising far more rapidly than those of secondary industries, while primary product prices have actually declined. Indeed, a major problem faced by developing nations has been the declining terms of trade for primary commodity exporting nations. Consequently, the international services industry has provided an excellent driver of economic development and a strategic growth industry which has helped to lift per capita incomes and national living standards in many developing countries.

*"The promotion of information and communication services represents, for the Government of Grenada, a vital part of our diversification effort, and our search for alternatives to commodity agriculture. The decline of Grenada's commodity export trade has had a devastating impact on the country's capacity to earn foreign exchange, to generate employment and to pursue agricultural and rural programmes. Moreover, the liberalizing of trade and the reduction of tariffs levels in response to global requirements have seriously weakened the government's revenue-generating capacity, in some areas."*

*Dr Keith Mitchell, Prime Minister of Grenada, June 2001*

For some jurisdictions, the offshore business services industry has transformed their economies. Barbados is a good example of how a strategy of diversification away from traditional agricultural industries to international business services has been a highly successful means of achieving economic development. In the 1950s, the economy was heavily reliant on sugar cane production, with sugar accounting for 30 per cent of GDP, a third of export earnings, and 25 per cent of total employment. Moreover, the economy was subject to large volatility in global sugar prices, which given the high dependency on this single agricultural product, caused great economic vulnerability. Barbados was also subject to deteriorating terms of trade long term, as the price of manufactures and services imports was rising far more rapidly than export prices for its agricultural exports.

With the development of the international business services industry over the last two decades, the domestic

**Contribution of international financial services industry to GDP in selected Commonwealth jurisdictions**

The Bahamas	15%
Barbados	30%
Bermuda	20%
British Virgin Islands	36%
The Cayman Islands	21%
The Cook Islands	7%
Grenada	5%
Isle of Man	42%

economy has been transformed, with Barbados now having a strong economic base consisting of a wide range of international financial and other business service exports. Indeed, these new international service industries account for 30 per cent of GDP, while sugar's share has fallen to just three per cent of GDP. The strategy of diversifying away from sugar has been extremely judicious as the viability of the sugar industry is increasingly uncertain, due to uneconomical field operations, ageing factories and declining world sugar prices. Barbados is now classified as a successful services-exporting economy, with its workforce having employment opportunities in a range of highly skilled

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professions in many service industries, compared with the limited opportunities for agricultural employment a generation ago.

As an industry sector requiring a skilled workforce, the financial sector has also provided a means for bringing about workforce skilling and employment opportunities for tertiary-trained local employees who may have had far more limited opportunities in the absence of such an export-driven financial sector. Graduates in areas such as management, law, accountancy, finance and social sciences have far greater scope for employment through the development of such a sector. Moreover, the relatively high incomes and associated investment in this sector generate considerable multiplier effects through corporate and household expenditure into construction, retailing, business and government services. Generally such multiplier effects could result in two or three jobs created

in other sectors for every job created in the offshore financial sector directly.

The financial services industry, while an important component of international business services, is only one of many industries being developed. Other important sectors include shipping services, distribution services, service centres and company headquartering. The most dynamic new growth sector is e-commerce, software and electronic data processing services.

**Financial services**

The offshore financial services industry has evolved

Table 1: Commonwealth countries and territories with offshore financial centres

<p><b>Europe:</b>                  Cyprus                  Isle of Man (UKDT)                  Jersey (UKDT)                  Gibraltar (UKDT)                  Guernsey/Sark/Alderney (UKDT)                  Malta                  UK (City of London)</p> <p><b>Africa:</b>                  Mauritius                  Seychelles</p> <p><b>Caribbean:</b>                  Antigua                  Anguilla (UKOT)                  Bahamas                  Barbados                  British Virgin Islands (UKOT)                  Bermuda (UKOT)                  Belize                  Cayman Islands (UKOT)                  Dominica                  Grenada                  Montserrat (UKOT)                  St Kitts and Nevis                  St Lucia                  St Vincent and the Grenadines                  Turks and Caicos Islands (UKOT)</p> <p><b>Asia/Pacific:</b>                  Australia                  Cook Islands                  Labuan (Malaysia)                  Nauru                  Niue                  Samoa                  Singapore                  Vanuatu</p>
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Source: IMF

**The evolution of many of these OFCs reflects initiatives for economic diversification into more sustainable, highly skilled industries**

substantially during the last 30 years, in response to the globalisation of the world economy and financial markets. The size of the offshore industry is estimated at US\$5–6 trillion, with around 70 offshore financial centres worldwide. Offshore financial services includes the provision of financial services to overseas clients, so that major international financial centres with a high share of such business, such as the City of London, are also considered to be offshore centres. Indeed, recent IMF estimates of global offshore financial services activity indicate that around 60 per cent of total global offshore centres activity is in London, the United States and the Japanese offshore markets.

After taking into account the substantial offshore centres in other OECD countries, the non-OECD share of the total offshore financial services industry is estimated to account for less than 20 per cent. With major international financial centres such as Hong Kong and Singapore included in this 20 per cent figure, there are a large number of small offshore centres which are involved in the provision of a relatively small share of the total market.

While the City of London has hundreds of years of history as an international centre for the provision of international banking, insurance and other financial services, many of the other offshore centres (OFCs) have emerged relatively recently. A large number of these are Commonwealth jurisdictions, with the recent IMF list of offshore centres including 29 from the Commonwealth. Of the 29, ten are British-administered, reflecting the historic role of British financial institutions in international finance. Indeed, these close linkages with Britain have been an important factor in assisting their competitiveness due to the use of well-established Commonwealth legal systems, stable government and defence security.

The evolution of many of these OFCs reflects initiatives for economic diversification into more sustainable, highly skilled industries, so as to boost economic development and living standards in small states. For example, in many Caribbean countries, economic strategies to diversify away from agricultural dependency were encouraged by the international development community,

resulting in strong efforts to move into sectors such as financial services and tourism. In many cases, colonial administrations initiated the establishment of these offshore financial centres, in order to try to create sustainable industries that would allow economies to develop and generate employment, as well as to reduce dependence on fiscal support from their European masters.

In parallel, the deregulation of global business services allowed greater geographic mobility of capital, while the value of world trade and international corporate activity has risen sharply. This has created demand for the international provision of a range of business services, including global banking, insurance, reinsurance, funds management, leasing, factoring, shipping, distribution centres and a wide range of other business services. (See Table 1).

### Many of the largest financial centres have substantial hosting of global institutional investment funds

Many of the largest financial centres have substantial hosting of global institutional investment funds. These include mutual funds, investment trusts, pension funds and hedge funds. This component of international financial services has been growing at a rapid pace as international investors or managers seek to provide for privately-funded retirement, long-term savings and international portfolio investment. Generally these funds are collected and taxed in the country of the investor's residence, but are pooled for investment purposes into a common fund. It is more advantageous to locate such investment funds in a jurisdiction where they will be taxed minimally, since generally the investment distributions are taxed already in the jurisdictions where the investments were originally generated and distributed.

Some offshore centres have specialised in certain areas. Bermuda, for example, is a major international insurance centre. This has resulted in the establishment of highly skilled expertise in Bermuda for insurance-related services, giving the jurisdiction global competitive advantage in this particular sector due to the congregation of large numbers of insurance firms and industry professionals on the island. Barbados is a major centre for foreign sales corporations, with an estimated 2,300 registered in 1997. The Bahamas offshore services industry includes the world's third largest international

shipping registry, with around 1,500 ships registered. A number of Caribbean offshore centres are also major centres for highly specialised commercial products, such as specialisation in aircraft leasing, for international airlines, for which Cayman Islands and British Virgin Islands are major specialist global centres with high quality professional expertise in these sophisticated products. Indeed, the vast majority (on a dollar weighted basis) of Cayman's business is institutional business – ie, Special Purpose Vehicles used in international trade and debt structuring, etc. Much of the business of offshore centres is also sourced from activities of blue-chip multinationals which comply with the highest international accounting standards. A large part of private investments in non-OECD international financial centres relates to blue-chip investment funds fully transparent fully taxed at point of distribution, with around 6,000 funds located in OFCs.

Banking in offshore centres does constitute an important part of the global international banking industry. Based on reporting by a number of major offshore centres to the BIS on offshore deposits, the size of international banking provided by centres such as Cayman Islands and The Bahamas is comparable to the offshore banking sectors of some of the small OECD countries, though just a fraction of major offshore banking centres such as London.

India and China are also providing financial services to their diaspora, due to the very large emigrant communities established abroad. For example, India has provided a wide range of banking and other financial services products for its non-residents globally, with special preferential taxation exemptions. This has helped to generate very large foreign exchange deposits in the Indian economy, providing a key source of capital inflows for the current account. It has also become an important new market for the international growth of its domestic financial institutions, assisting them to become more globally competitive in international financial markets by developing sophisticated international financial products. India has also used its overseas Indian community to raise sovereign debt, rather than the usual tapping of foreign bond markets utilised by most countries. Two such bond issues in 1998 and 2000 raised a total of around \$10 billion from Indians abroad. There are also very large remittances from Indian workers in the OECD and in the Middle East, which have created a significant offshore financial services sector in India. Consequently the offshore financial services sector is playing a key role in financing Indian economic development and providing critical foreign exchange inflows for India's current account position.

The Indian case may provide a useful model for other developing countries. There is probably a strong case on economic development grounds for allowing emigrants from developing countries to be given incentives to invest

in their home countries and exemptions on savings taxation on any such investments back to their home countries by rich industrial countries where they work. This will provide a valuable mechanism for generating foreign exchange for development of many developing countries at a time when finding sources of financing for development is one of the most pressing issues on the international development agenda.

#### E-commerce and IT services

E-commerce and other IT services have become a key strategic focus for many developing countries in their export diversification and industrial development strategies. Many Commonwealth developing countries are now focussing policy initiatives on building competitiveness in exporting IT services and e-commerce. This includes software services, e-commerce and data-processing services. Many Commonwealth countries, including India, Malaysia, Singapore, Malta, Mauritius and South Africa have been encouraging the development of these new growth sectors, in order to strengthen their competitiveness in the leading growth industries for the 21st century.

For example, Forrester Research has projected that business-to-business (B2B) e-commerce will reach \$2.7 trillion in 2004, with 17 per cent of all business trade transacted through the Internet. Jupiter Research has predicted that by 2005, the largest online B2B markets would be in computers and telecommunications, food and beverages, autos and parts, industrial equipment and supplies and real estate. Developing countries which are seeking to be at the forefront of global competitiveness are trying to develop industry strategies positioning them to compete effectively worldwide in the digital age.

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For example, India is benefiting from a major transformation occurring in the economy due to its offshore IT industry. This produces a major positive effect on the current account balance, as IT exports are growing at the rate of 50 per cent year after year. Software exports are now making a substantial contribution to overall exports, accounting for around ten per cent of total exports. Software exports are forecast to rise by a further 60 per cent in 2000–01, to an estimated \$6.3

billion, with the very rapid growth of this sector resulting in a fundamental transformation of both the growth rate and overall composition of India's exports. Domestic sales from the industry are estimated at \$2.3 billion, giving total industry output of \$8.6 billion. The US is the dominant export market for India, taking around 65 per cent of India's software exports in 1999–2000, while the EU accounted for a further 25 per cent. However, the EU market is rapidly growing, with Indian software exports to the EU estimated at \$842 million in 1999–2000, but rising by a projected 35 per cent in 2001.

A large share of Indian software companies' domestic revenue is attributable to offshore services, which is work done by a software company in India for an offshore client.

**India's offshore IT services, 2000** (Offshore services revenue as share of total). Source: *Economic Times of India*

Infosys	67
Wipro	52
Satyam	58
Mastek	33
Sonata	47
HCL Tech	63
Polaris	49
Silverline	36
Visualsoft	49

Indian software and related services are expected to grow by a further 50 per cent in 2001–02, with export revenue rising to \$9.5 billion and total output of \$ 13 billion. This rapid pace of expansion in India's technology exports offers new scope for optimism about the medium term external trade outlook, as well as generating new foreign direct investment flows as well as equity capital flows into India. McKinsey & Co has estimated that India's IT exports could rise to \$50 billion by 2008. The Indian National Association of Software and Services Companies has projected industry revenues rising to \$87 billion by 2008, and accounting for 7.5 per cent of national GDP.

In India, there are already tax exemptions for exports from export processing zones (EPZs), free trade zones and software technology parks. Tax holidays are also provided to export oriented units set up anywhere in India. The 2001–02 Budget extended special tax exemptions to profits from on-site exports of services provided from software technology parks.

Developing countries are also working together to build their leading edge IT export industries. In Mauritius, the government has launched a new strategy to make Mauritius a free trade zone for the IT industry and promote the island as a leading regional e-commerce hub. IBM has recently decided to establish its regional HQ in Mauritius. The Indian Institute of Technology in

Chennai has plans to open a hi-tech hardware centre in Mauritius, with a feasibility study underway for the hardware centre, which would be set up under a US\$100m line of credit facility being offered by India to the Government of Mauritius for import of Indian IT related products for a proposed Cyber City and IT education projects. India's ISRO is also planning to establish a space research centre in Mauritius.

#### Free trade zones and other investment incentives

The OECD Initiative extends not just to financial services, but all geographically mobile services, including, but not limited to, shipping, distribution services, service industries, and company headquartering. The OECD is already taking steps to extend their work to e-commerce, and their 1998 Report flagged that manufacturing industries in developing countries would also have to be addressed later.

*"...it is recognised that the distinction between regimes directed at financial and other services on the one hand, and at manufacturing and similar activities on the other hand is not always easy to apply. The Committee intends to explore this issue in the future."*

*OECD 1998 Report on Harmful Tax Competition, Page 8, Paragraph 6.*

The OECD requirements for reforms in developing country jurisdictions which have agreed to make advanced commitments to comply with the OECD requirements under their Harmful Tax Competition Initiative include the requirement that; *"Foreign-owned entities must be able to do business in the domestic economy"*.

The implications of this requirement as part of the OECD programme of eliminating harmful tax competition are very significant for many developing countries. Many developing countries, including major economies such as India and South Africa, do not allow equal access to foreign-owned entities in their domestic economies.

Foreign ownership is strictly limited in many industry sectors throughout the Commonwealth, and many developing countries do not allow automatic access to foreign companies to do business in their domestic economies in all sectors. In many industries, developing countries require a phased approach to liberalisation, in order to allow domestic firms time to develop efficient and competitive industry sectors before being forced to compete on equal terms with international market leaders.

The removal of harmful tax competition in geographically mobile services also has implications for the tax and investment practices of many Commonwealth countries other than those listed by the OECD. Specifically, the OECD requires that *"Any preferential tax rates available to offshore regimes must also be available to domestic business of the same type."*

Many developing countries offer preferential tax

regimes to foreign investors or export-related investment, which is not available to domestic companies that are operating in the domestic market, or even to domestic company business sales to the domestic market. Many developing countries also offer special export processing zones, free trade zones and other incentive regimes to encourage investment in export processing industries.

Many of the East Asian economies have had considerable success through use of competitive taxation packages for attracting foreign investment into infant industries, and countries like Mauritius, India and Dubai have used free trade zones and other low tax regimes for

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export development very successfully.

Indeed, the Indian Budget for 2001–02 has introduced ten-year tax holiday to developers of special economic zones, with income from long-term investment for the development of special economic zones to be exempt from tax. There are already tax exemptions for exports from export processing zones, free trade zones and software technology parks. Tax holidays are also provided to export oriented units set up anywhere in India. The Budget extended special tax exemptions to profits from onsite exports of services provided from software technology parks. Similar fiscal regimes are in place in many of the other developing countries in Africa and Asia, in order to encourage foreign investment.

The importance of subsidies for economic development has, however, been recognised by the WTO. Even though the World Trade Organisation's Agreement on Subsidies and Countervailing Measures (SCM) which came into effect in January 1995 requires the phasing out of most export subsidies by developed countries by 2000 and developing countries by 2002, there are exemptions. In particular, the WTO SCM Agreement recognised the important role that subsidies can play in economic development of developing countries, and has exempted countries with a per capita GDP income of less than \$1,000 per year from any SCM rules on prohibited export subsidies. A key concern is the impact of such a low level of cut off for GDP per capita, since – for no particularly compelling economic rationale – many relatively poor developing countries could face a large-scale shift in foreign investment in export processing industries to developing countries with GDP per capita

below this cut-off level.

*"The basic idea behind an export platform (such as a free trade zone) is to create an enclave in which the problems of poor trade policies, weak infrastructure, and inconsistent rule of law that plague the rest of the economy are at least partially eliminated.*

*Perhaps the most compelling piece of evidence in support of export platforms is that the vast majority of manufactured exports in the successful economies utilised at least one of these facilities. In Taiwan and*

## The basic idea behind an export platform...is to create an enclave in which the problems...that plague the rest of the economy are at least partially eliminated

*Korea, for example, essentially all manufactured exports were either produced in a zone or a bonded warehouse. The vast majority of China's manufactured exports come through the special economic zones. Over 95 per cent of Mauritius's manufactured exports are produced in EPZs. Exports from Mexico's maquiladoras account for over 50 per cent of total manufactured exports."*

Steven Radelet, Harvard Institute for International Development, CAER Discussion Paper 43, November 1999.

## 2. New challenges to developing countries

Developing countries that are exporting international business services are currently facing considerable pressures for change from a number of initiatives coming from the OECD countries, including from the Organisation for Economic Co-operation and Development's (OECD) 'Harmful Tax Competition' and e-commerce initiatives. The Harmful Competition Initiative is focussed on eliminating what the OECD determines to be 'harmful' practices in all geographically mobile services provided by all countries worldwide. This extends not just to financial services, but all geographically mobile services, including, but not limited to, shipping, distribution services, service industries, and company headquartering. The OECD is already taking steps to extend their work to e-commerce in developing countries, and their 1998 Report flagged that manufacturing industries in developing countries would be likely to have to be addressed later. Hence the OECD moves to eliminate harmful tax competition in financial services in non-OECD countries is part of a broader

initiative to remove 'harmful' competition in a wide range of industry sectors, including e-commerce and manufacturing.

### Tax harmonisation

For the European Union countries, these initiatives are part of a broader strategic objective to harmonise taxes within the EU. This is also an integral part of plans by some EU members for an EU-wide tax that will give greater taxing powers to the EU bureaucracy in Brussels. However, harmonisation within the EU will not be sustainable if other major competitors are not also harmonising to EU rates, as there will be large-scale relocation of private investment to other countries and out of the EU. This therefore creates considerable pressure for the EU to seek that other lower-taxing countries harmonise to its tax rates. The importance of low corporate tax rates for corporate investment inflows is demonstrated by the case of Ireland, which has managed to achieve rapid economic growth for over a decade, assisted by a very low tax environment for foreign corporations, now to be extended to all corporations, combined with a strong fiscal surplus.

*"Combating 'tax dumping' is one immediate priority; it is not acceptable for certain member states to practice unfair tax competition in order to attract international investment and offshore headquarters of European groups. Ultimately, the corporate tax system as a whole will have to be harmonised."*

Mr Lionel Jospin, Prime Minister of France, Address on 'The Future of an Enlarged Europe', May 28, 2001, Paris.

This raises concerns from an economic development policy perspective. At the OECD Forum on Harmful Tax Competition in June 2000, which 30 developing countries attended, a number of developing countries felt that action should also be taken against low-tax OECD regimes to prevent them 'poaching' developing country companies away from their home bases.

The World Trade Organisation (WTO) has observed that "protectionism is not the first best choice to deal with fiscal challenges arising from trade liberalisation and globalisation". In fact, governments are already responding to these challenges in more appropriate ways. High marginal income tax rates and corporate tax rates are coming down while consumption taxes rise. The WTO's Annual Report for 1998 observed that tax harmonisation was being discussed in the European Union (EU) and the OECD to deal with harmful tax competition, but noted: "This option, however, should be treated with considerable caution, as the fight against a 'race to the bottom' in tax rates may be used as a pretext for introducing a tax cartel." The danger with the OECD initiative is that the new global model will be a 'race to the top' for corporate tax rates, as countries harmonise to the highest common denominator and pressurise low taxing countries to increase tax rates.

A major concern is that the continental European

welfare states face significant demographic problems over the next two decades due to ageing populations, but unlike the UK, have failed to develop adequate private pension provision. This creates a further risk of a global 'race to the top', driven by rising fiscal burdens in 'socialist' Europe.

### International tax competition

*"Competition among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or*

## A governmental cartel is no less damaging than a private cartel

*enterprises in the goods and services they offer for sale and the prices at which they offer them. Both lead to variety and innovation; to improvement in the quality of the goods and services and a reduction in their cost. A governmental cartel is no less damaging than a private cartel. The principle of subsidiarity – that government services be provided, and paid for, so far as possible, at the level of government closest to the citizen – would be violated by any attempt to impose from the center a uniform tax regime."*

Milton Friedman, Hoover Institution, Stanford University and Emeritus Professor, University of Chicago, May 2001.

By lowering fiscal burden and government intervention, countries grow quicker, resulting in stronger total tax revenues and government expenditures than in high-taxing countries. In sum, lowering the fiscal burden gives government a smaller percentage share of the economy, but of a much larger total pie. Moreover, it reduces the moral hazard that government bureaucracies create a culture of dependency on the state, particularly through political pork-barrelling by targeted handouts to various segments of the electorate. The continental European welfare state is an example of how such moral hazard results in economic rigidities such as inflexible labour markets and structural budget deficits, which impede economic progress.

For the Commonwealth, this is a key area for policy focus as developing countries search for more rapid economic growth and the path to economic success. While many forms of external assistance are possible, in the end a critical determinant of economic success lies

in domestic economic management, as these indexes demonstrate forcefully. Singapore and Ireland are the leading fiscal models that other countries need to emulate if they are seeking to develop their industries and employment. Ireland has transformed its economy into one of the most successful in the world through a range of policy initiatives, of which low tax regimes were a very important component.

India's 2001-02 Budget indicates how some major developing countries are beginning to recognise the importance of creating a favourable taxation regime that encourages entrepreneurship and the development of new industries. The Indian Budget cut the top rates of corporate and personal taxes to 36 and 30 per cent respectively, both important steps towards creating a more dynamic economy. Savings incentives are also assisting in creating a fast-growing Indian mutual funds industry, creating a significant pool of domestic savings for equity and venture capital investments, including remittances from millions of non-resident Indians working in OECD and other countries.

However, the shift towards reducing the role of government is still budding in many developing countries after decades of socialist and communist economic philosophy which have left many nations in economic stagnation and decline. Such a shift can easily be undone in a global tide towards a high tax model, given the demonstrated inclination for governments to try to increase revenues in order to fund their expenditure programmes, rather than lowering spending in order to reduce tax burdens.

*"...the likelihood of maintaining a still satisfactory overall budget position over the longer run is greater, I believe, if surpluses are used to lower tax rates rather than to embark on new spending programs. History illustrates the difficulties of keeping spending in check, especially in programs that are open-ended commitments, which too often have led to larger outlays than initially envisioned. Decisions to reduce taxes, however, are more likely to be contained by the need to maintain an adequate revenue base to finance necessary government services. Moreover, especially if designed to lower marginal rates, tax reductions can offer favourable incentives for economic performance."*

Testimony of Chairman Alan Greenspan The Federal Reserve's Semiannual report on the economy and monetary policy before the Committee on Banking and Financial Services, U.S. House of Representatives, February 17, 2000

The average tax burden in OECD countries has risen from 35 per cent in 1988 to an all-time high of 37 per cent of GDP in 1998, despite buoyant tax revenues, reflecting the tax and spend policies of many European countries.

*"...tax competition can even be helpful, not harmful because it keeps governments in check. Tax competition*

can be a good spur for governments to keep to their core functions; to create a competitive business environment and not proliferate activities; to look for efficiencies and productivity gains, and to keep costs down."

Intervention by Singapore at Commonwealth Senior Finance Officials Meeting, Sept. 2000.

The WTO Annual Report for 1998 stated: "The empirical evidence does not provide convincing support for the claim that globalisation undermines governments' abilities to pursue their core functions. Revenue has increased strongly in industrialised countries in recent decades. Only the structure of revenue collection is changing." (WTO Annual Report, 1998). According to Professor Devereux of Warwick University, average OECD corporate tax revenue as a share of total tax revenues has remained constant over the last 20-30 years. Indeed, the OECD's 1998 Report on Harmful Tax Competition states that "the available data do not permit a detailed comparative analysis of the economic and revenue effects involving 'low tax jurisdictions' and 'preferential tax regimes'".

**...tax competition can even be helpful, not harmful because it keeps governments in check**

#### International rule-making and global standards

There is a wide range of initiatives by various international organisations, other than the OECD initiative discussed above, to develop global standards that allow nation-states to be bound voluntarily by entering into bilateral or multilateral treaties. However, there is growing concern among developing countries about the trend towards the production of new international standards by international organisations where developing countries have little or no voice. Perhaps the most extreme example of exclusion of developing countries in international rule-making is the OECD, which is a club of 30 rich countries, comprising predominantly European nations bound by a commitment to the European Union. Developing countries have no vote in the development of standards through this organisation.

Even in the IMF and World Bank, developing countries have only a small voice, with the majority of the voting rights being controlled by the OECD countries. For example, the 44 sub-Saharan African countries have just 4.5 per cent of the voting rights and only two Executive Directors at the IMF. The problem is

accentuated by several unusual constituencies of large groups of developing countries headed by an OECD country in the Executive Directorship.

The fear is that such international standards can be used as new forms of protectionism, to block competition from developing countries in the fastest growing segments of international services trade where OECD countries have concentrated their own strategic economic focus.

In e-commerce, ICANN, the international organisation which manages internet space, has negligible developing country representation for an industry that is so critical to the future potential of developing countries to make a transition to a more rapid growth path.

"So far, developing countries are only observers of the process. They do not participate on the boards of key organisations such as ICANN, which allow a minority to make decisions affecting their Internet space. A lack of economical resources as much as awareness of the understanding of these strategic issues are the main reasons for non-participation."

'The Role of Domain Names', Rosa Delgado, Director, Societe Internationale de Telecommunications Aeronautique (SITA), E-COMM, 3 June 2001.

These OECD initiatives in areas such as the Multilateral Agreement on Investment (MAI), the Harmful Tax Competition Initiative and the latest e-commerce initiatives are examples of how rule-making by the most powerful nations can erode the sovereign powers of developing countries. A key issue for small and developing countries is to ensure that they have an effective voice in the development of any international rules and standards.

### 3. Creating a shared vision

A key challenge for Commonwealth nations is to work together to build a greater global consensus on how all nations can benefit from the opportunities arising in the fast-growing international business services industries. Important issues include how international standards should be set and how international organisations can facilitate this process. The need to achieve high standards of international prudential regulation and transparency are also critical objectives for Commonwealth countries.

#### Global inclusiveness

It is essential that developing countries are fully included in any process of setting of international standards, whether for tax, environment, trade, labour standards or other international standard-setting.

There are many positive ways in which developed and developing countries can work together to develop standards in many areas of international business

services. The properly constituted international bodies that represent all regions already exist, in the form of the United Nations, the IMF and World Bank, as well as the World Trade Organisation.

For example, in the area of e-commerce, a model law on e-commerce has already been developed by the United Nations. The Model Law on Electronic Commerce (MLEC), was adopted in 1996 by the United Nations Commission on International Trade Law (UNCITRAL). This provides a means by which all countries can rapidly address gaps in their legislation regarding e-commerce, and 12 countries have already adopted the MLEC by the end of 2000, with many others considering its adoption.

Similarly, the World Intellectual Property Organisation (WIPO), an intergovernmental organisation comprising 175 member nations, has developed two internet treaties. These are the WIPO Copyright Treaty, and the WIPO Performances and Phonograms Treaty.

These forms of globally inclusive and co-operative approaches to developing best practice have generated considerable enthusiasm from developing countries, which feel they are consulted and included in the development and management of these global standards. Many developing countries are then able to push for their adoption within their own legislative systems, since they have had inclusive participation in the development of these standards.

### High financial standards

Strengthening regulation of the financial services industry worldwide is one of the key priorities for creating a more stable, dynamic global economy. The need for better regulation, strengthening of capital adequacy of financial institutions, development of high quality prudential regulation and implementing high levels of transparency and international best practice accounting standards are critical issues for all nations in the decade ahead. Many international business services centres already have very high standards of regulation and supervision, both within the OECD and in non-OECD jurisdictions. However, there needs to be a wider approach to improving transparency and regulatory standards than just focussing on the international business services segment of the global business services industry.

All countries and territories in the Commonwealth can benefit by ensuring that they implement the highest standards of prudential supervision and regulation, as well as developing transparent accounting and management practices that meet international best practice and global standards. Financial disclosure and transparent practices are essential components of achieving high quality financial systems, combined with adoption of advanced risk management techniques. However, such initiatives cannot be ring-fenced to international financial services centres alone – they must encompass the full range of domestic financial

institutions in all Commonwealth jurisdictions, as well as financial systems in all developed and developing countries. The recent domestic financial sector crises in three of the OECD countries – Japan, Korea and Turkey – which by some estimates will cost over \$600 billion of taxpayers funds, highlight the critical importance of establishing well-regulated, properly supervised financial systems that are transparent, meet international accounting best practice and international capital adequacy standards. Similarly, high standards of corporate governance and accounting practices, including a high degree of transparency, are critical for all companies and financial institutions. Such standards are also critical for an efficiently operating domestic financial system, which underpins a dynamic economy.

### Conclusions

As with other major global industries, international business services will remain subject to a high level of global competition, not only in the marketplace but in the global arena of international law, trade and investment regulation and global standards, as countries vie with each other to obtain the greatest competitive advantage for their own financial services sectors.

All Commonwealth countries need to give urgent attention to ensuring their financial systems are the meeting highest international standards, and to ensure the future success and competitiveness of their own economies. At the same time, globalisation is about international competition and developing competitive advantage. The benefits of globalisation accrue to the most competitive and efficient segments of industry – and international business services are no exception.

International business services are a rapidly growing, high-value-adding market segment globally, and a sector in which many countries wish to strategically position themselves to become global market leaders. At a time when many countries are suffering from high dependency on commodity exports with declining terms of trade, and even manufacturing is suffering from intense price competition and global overcapacity, traded services are the new frontier and a key focus for national competitiveness strategies.

Developing countries must strengthen their capacity to represent effectively in international negotiations on traded services, in order to protect their right to compete in this key global export industry. Traded services have the potential to play a leading role in the economic development of many developing countries, as well as in bridging the digital divide and transforming these nations into knowledge economies. n

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