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A TAX COMPETITION PRIMER: WHY TAX HARMONIZATION AND INFORMATION EXCHANGE UNDERMINE AMERICA'S COMPETITIVE ADVANTAGE IN THE GLOBAL ECONOMY

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> A spectre haunts the world's governments. They fear that the combination of economic liberalization with modern information technology poses a threat to their capacity to raise taxes.
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> —*The Financial Times*, July 19, 2000

When tax competition exists, politicians face pressure to keep tax rates reasonable in order to dissuade workers, investors, and entrepreneurs from shifting their productive activities to a lower tax environment. As might be expected, politicians from high-tax countries dislike tax competition, and they have directed the Paris-based Organization for Economic Cooperation and Development (OECD) to eliminate tax competition between nations. The OECD is attempting to achieve this misguided goal by forcing all countries to participate in a system of global information exchange through which governments would collect and share private financial data.[1] This would allow them to tax income on the basis of where investors and entrepreneurs live rather than where income is earned.

The OECD proposal is bad tax policy, bad privacy policy, bad sovereignty policy, and bad foreign policy. Under this type of scheme, residents of high-tax nations would be unable to reduce their tax burdens by shifting economic activity to a lower-tax jurisdiction. This would insulate politicians from having to compete for business, investment, and entrepre-

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1. The OECD's initial report on the issue, *Harmful Tax Competition: An Emerging Global Issue*, published in 1998 and available at *http://www.oecd.org/daf/fa/harm_tax/harmfultax_eng.pdf*, outlines the theoretical argument against tax competition. A second OECD study, *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices*, published in 2000 and available at *www.oecd.org/daf/fa/harm_tax/Report_En.pdf*, identifies so-called tax havens and outlines the financial protectionism to which those nations would be subject.

neurial talent. The result almost surely would be higher tax rates.

Moreover, a worldwide system of information exchange would jeopardize financial privacy, since governments would be expected to collect detailed information about the income and assets of taxpayers and exchange that information with other governments. In addition, the OECD initiative is an assault on fiscal sovereignty, since the Paris-based bureaucracy is demanding that all nations participate in this system. Indeed, the OECD goes so far as to propose that low-tax jurisdictions (so-called tax havens) that do not participate in this cartel be subjected to sweeping financial protectionism. This radical step would hinder cross-border investment and economic development.

The OECD proposal is also a threat to fundamental tax reform. All major plans to fix the tax code (such as the flat tax) call for the elimination of double-taxation of savings and investment and a shift to a territorial tax regime—a system in which governments tax only income that is earned within their borders. The OECD plan, by contrast, is driven largely by a desire to double-tax capital income earned in other nations.

Supporters of the OECD proposal claim that the assault on tax competition is necessary to stop tax evasion and money laundering. Both these issues are red herrings. The information presented below describes tax competition, discusses the OECD proposal, analyzes its likely consequences, and explains why the proposal is misguided.

What is tax competition?

Tax competition occurs when individuals can choose among jurisdictions with different levels of taxation when deciding where to work, save, and invest. This ability to avoid high-tax nations makes it more difficult for governments to enforce confiscatory tax burdens. In effect, tax competition pressures politicians to be fiscally responsible in order to attract economic activity (or to keep economic activity from fleeing to a lower-tax environment).[2]

Tax competition can occur between countries or between state and local governments. Like other forms of competition, tax competition protects against abuses. For example, when there is only one gas station in a town, consumers have no options and likely will be charged high prices and given inferior service. But when there are several gas stations, their owners must pay attention to the needs of consumers in order to stay in business.

Why is tax competition desirable?

Tax competition promotes responsible tax policies. Lower tax rates reduce the burden of government on businesses and create an environment more conducive to entrepreneurship and economic growth. Without competition, politicians can act like monopolists, free to impose excessive tax rates without fear of consequences.

Competition between jurisdictions creates a check on this behavior. Whether this is desirable, of course, depends on one's perspective. Those who want lower tax rates and tax reform favor competition between countries. Those who want more power for the government and higher tax rates do not like such competition.

Is there real-world evidence of the impact of tax competition?

Almost every industrial economy in the world was forced to lower tax rates after Ronald Reagan implemented sweeping tax rate reductions in the 1980s. This did not occur because policymakers in other nations suddenly became pro-market, but rather because investors and entrepreneurs were shifting their activity to the U.S. economy and foreign politicians had no choice but to lower their personal and corporate tax rates in order to remain economically attractive. Tax competition is even more powerful today because it is increasingly easy for taxpayers to shift their resources to lower-tax environments.

Why is the OECD against tax competition?

The OECD is comprised of 30 industrialized economies, most of which are high-tax European

2. For a more complete discussion of tax competition and the drawbacks of the OECD initiative, see Daniel J. Mitchell, "An OECD Proposal to Eliminate Tax Competition Would Mean Higher Taxes and Less Privacy," Heritage Foundation *Backgrounder* No. 1395, September 18, 2000, at *http://www.heritage.org/library/backgrounder/bg1395es.html*.

nations. Many of the politicians from these nations resent low-tax countries for luring away savings, investment, and entrepreneurship. In an effort to eliminate the pressure of having to compete, they have directed the OECD to undermine the process of tax competition. This situation is similar to one in which a group of high-price, bad-service gas stations create a cartel to prevent new gas stations from opening.

What is the OECD trying to do?

The OECD has identified 41 jurisdictions around the world as "tax havens." These are jurisdictions that have both strong financial privacy laws and low or zero rates of tax. The OECD wants its member nations to be able to tax income that is earned by their residents in these low-tax countries, so it is demanding that the so-called tax havens change their laws to help foreign governments identify those earnings.

Specifically, these low-tax jurisdictions are being asked to provide private financial data to OECD member nations (the OECD calls this "information exchange" even though low-tax nations get nothing from the deal). If the low-tax countries do not agree to become informers, the OECD will declare that they are "uncooperative" and ask member nations to subject these countries to financial protectionism.

What is the OECD's ultimate goal?

The OECD thinks it is wrong for taxes to influence decisions regarding where to work, save, and invest. The only way to keep taxes from influencing economic choices, however, is for all countries to "harmonize" their tax systems.

What is tax harmonization and why is it wrong?

Tax harmonization can be achieved in two different ways. Explicit tax harmonization occurs when nations agree to set minimum tax rates or even decide to tax at the same rate. In the European Union, for instance, member nations must have a value-added tax (VAT) of at least 15 percent. If tax rates in all countries are explicitly harmonized, a taxpayer's only option is the underground economy—which already accounts for one-fourth to one-third of GDP in many of Europe's welfare states.

The other way to stop tax competition is implicit harmonization. This occurs when nations are able to tax their residents on the basis of worldwide income so that it becomes impossible to reduce taxes by shifting activity to a lower-tax jurisdiction. In order to tax worldwide income, however, a country's tax collectors must find out how much income residents earn in other nations. This is why "information exchange" is such an important part of the OECD agenda.

Either type of tax harmonization would have grave consequences. Specifically, the OECD tax harmonization proposal:

- **Will lead to higher taxes.** Without the pressure of competition, politicians will be likely to impose higher tax rates and heavier tax burdens.
- **Will result in slower growth.** As fiscal burdens climb, the most likely impact will be higher taxes on savings and investment. This will reduce capital formation, leading to less productivity growth and lower wages.
- **Will undermine tax reform.**[3] Simple and fair systems like the flat tax are based on the premise that income should be taxed only once and that governments should not seek to tax income earned in other countries (in other words, that the tax system should be territorial). The OECD initiative is diametrically opposed to these principles. It is based on the premise that savings and investment income should be double-taxed and that governments should be allowed to tax income earned outside their borders (what is known as a worldwide tax system).

3. For more information on the flat tax and fundamental tax reform, see Daniel J. Mitchell, "Jobs, Growth, Freedom, and Fairness: Why America Needs a Flat Tax," Heritage Foundation *Backgrounder* No. 1035, May 25, 1995, at *http://www.heritage.org/library/categories/budgettax/bg1035.html*, and "Flat Tax or Sales Tax: A Win-Win Choice for America," Heritage Foundation *Backgrounder* No. 1134, August 17, 1997, at *http://www.heritage.org/library/categories/budgettax/bg1134.html*.

- **Is a threat to free trade.** The OECD is trying to coerce low-tax countries to change their laws by threatening them with a wide range of taxes, fees, penalties, restrictions, and other trade barriers if they do not cooperate. This attack on global commerce could destabilize world markets and initiate a dangerous spiral of protectionism.[4]
- **Violates national sovereignty.** Countries should be free to determine their own laws. Rather than bullying and threatening low-tax countries that are attracting "too many" investors and entrepreneurs, high-tax countries should take this as a signal that they should lower their own tax rates.
- **Is an attack on privacy.** An inherent feature of the OECD initiative is "information exchange," which means that foreign tax collectors would be allowed to rummage through financial institutions in low-tax countries for private financial information. Information exchange is a back-door form of tax harmonization.
- **Is a threat to American interests.** America is a low-tax country by industrial world standards. Indeed, because we impose low or no taxes on foreign investors who purchase financial assets, we are a tax haven according to the OECD's definition.[5] This has enabled us to attract trillions of dollars of investment from overseas, thus boosting our capital stock, increasing wages, and stimulating stronger growth. Undermining tax competition will harm our economy since it is quite likely that the OECD eventually will seek to compel the United States to change its desirable tax and privacy laws.
- **Is bad for the developing world.** As part of a market-based economic development strategy, countries should be encouraged to lower their tax rates. But if OECD countries impose their tax rates on the income that investors and entrepreneurs earn in other countries, tax competition is essentially eliminated. This will make it harder for poor countries to grow.
- **Is a threat to the Western Hemisphere.** Many of the so-called tax havens are Caribbean islands. These nations and territories depend heavily on their financial services industries to generate good jobs and enhance overall economic performance. If the OECD proposal succeeds, the impact on the region could be devastating. Potential consequences include political instability, increased crime, and widespread emigration.

How does the OECD justify its attack on tax competition?

In its two major reports, *Harmful Tax Competition: An Emerging Global Issue* (1998) and *Towards Global Tax Cooperation* (2000), the OECD argued that tax competition is not fair to high-tax countries because taxpayers shift their activity to low-tax jurisdictions. Recognizing that this is not the most persuasive argument, the OECD is now asserting that its anti-tax-competition proposal is needed to stop tax evasion and money laundering.

Should low-tax jurisdictions help enforce the tax codes of high-tax nations?

Countries with heavy tax burdens and high tax rates drive economic activity to other nations or into the underground economy. Assuming that taxpayers do not report the income from these activities, this is what is known as tax evasion. The OECD initiative, particularly the information-exchange proposal, seeks to make it harder for taxpayers to "evade" taxes by shifting economic activity to lower-tax jurisdictions. (The organization does not address the other form of tax evasion, probably because it realizes that the underground economy will grow if the OECD succeeds in creating a global tax cartel.)

This approach is controversial because it assumes that governments have the right to tax income earned outside their borders. Perhaps even more disturbing, it assumes that low-tax nations are obliged to put the laws of other nations above their own, which violates a long-standing princi-

4. For a discussion of this issue, see *http://www.freedomandprosperity.org/Articles/tni04-25-01/tni04-25-01.shtml*.
5. See Marshall Langer, "Harmful Tax Competition: Who Are the Real Tax Havens?" December 18, 2000, at *http://www.freedomandprosperity.org/Articles/tni12-18-00.pdf*.

ple of international law known as "dual criminality." Dual criminality ensures that nations are not obliged to help enforce the laws of other nations unless the alleged offense is a crime in both jurisdictions. The United States, for instance, presumably would not help China investigate and prosecute pro-democracy protesters because supporting freedom is not a crime in America. This explains why most low-tax countries do not help high-tax countries enforce their tax laws, particularly when the high-tax country is trying to tax income that is being earned in the low-tax country.

Is tax evasion a major problem?

Given that even the OECD admits that tax revenues in its member nations are consuming a record share (more than 37 percent) of economic output, it is hard to make the case that tax evasion is widespread. Nonetheless, the fact that any tax evasion exists is troubling for those who believe that the laws should apply equally. This is true for both supporters and opponents of tax competition. The conflict is over how to deal with the issue.

What is the best way to reduce tax evasion?

Assuming that tax burdens are reasonable and governments are behaving justly (few people, of course, would condemn those who evade taxes that are confiscatory or those who refuse to pay taxes that are used to support corrupt and/or dictatorial regimes), there is a societal interest in minimizing tax evasion. The key question is how this goal can be achieved, particularly when dealing with cross-border economic activity.

The OECD assumes that tax evasion is rampant and presents its proposal as the only way to address the presumed crisis. This is a clever strategy, but it is also very misleading. An alternative, and far more effective, approach to reducing tax evasion incorporates territorial taxation and tax reform.[6] The OECD's anti-tax evasion rhetoric is in fact a red herring: a tactic designed to draw attention away from the more critical debate between proponents of territorial taxation and advocates of worldwide taxation.

Which approach is better: worldwide taxation or territorial taxation?

High-tax countries that dominate the OECD's membership strongly prefer worldwide taxation, especially because it permits the double-taxation of income that is saved and invested elsewhere. This is why they are such ardent advocates of "information exchange," whereby financial privacy is sacrificed to allow governments access to the information they need to collect tax on any income their residents earn in other nations. Territorial taxation, by contrast, is based on the common-sense notion that governments should tax only income earned inside their borders.

Both approaches presumably would reduce tax evasion, but as the following discussion indicates, a territorial system does not cause the damage that is associated with worldwide taxation.

- Tax competition. A territorial system promotes competition since investors and entrepreneurs can take advantage of lower tax rates by doing business in jurisdictions with pro-market tax systems. A worldwide system, by contrast, essentially destroys competition since high-tax governments would have the right to impose their tax burdens around the world. Recalling the gas station analogy, this is similar to what would happen if a gas station charging $2.00 per gallon asserted the right to charge its customers a 50-cent surcharge if they switched to a gas station that charged only $1.50 per gallon.
- Financial privacy. A territorial system is much more protective of financial privacy, especially if capital income is taxed at the source (i.e., companies would pre-pay taxes on behalf of stockholders and bondholders, regardless of where they lived). Under this system, people would not be forced to divulge their personal financial information to the government every year. By contrast, a system of information exchange necessarily requires that at least two governments have access to wide-ranging details of a taxpayer's financial activity.

6. For more information, see "Big Brother or Financial Privacy," December 3, 2000, at *http://www.freedomandprosperity.org/Articles/twt12-03-00/twt12-03-00.shtml.*

- Fiscal sovereignty. By definition, a territorial system does not create conflicts among nations regarding claims for the right to tax a particular flow of income. Each country has the right to impose any and all taxes on any and all income earned inside its borders. Any income earned in other countries, however, is off limits.
- Tax reform. A territorial system is consistent with fundamental tax reform. A flat tax, for instance, taxes only income earned inside national borders. A worldwide tax system, by contrast, is an impediment to tax reform, particularly since many high-tax countries favor information exchange because it allows them to double-tax income that is saved and invested. All major tax reform plans, including the flat tax, are based on taxing income only one time.

Why does the OECD highlight money laundering?

Accusations of money laundering provide a vehicle through which the OECD hopes to undermine financial privacy, paving the way for a worldwide system of information exchange. In reality, money laundering is not a problem that is typically associated with low-tax nations. In fact, reports indicate that most criminal proceeds are both earned and laundered in OECD nations. And a 1998 United Nations report acknowledged that money launderers tend to avoid so-called tax havens since they are viewed as a "red flag" by investigators.[7]

How should countries deal with money laundering?

Assuming that basic civil liberties are respected and constitutional freedoms are protected, illegal activities should be vigorously prosecuted and criminal proceeds subject to forfeit. In the international arena, all countries should cooperate in the investigation and prosecution of universally recognized crimes. If a nation fails to assist in criminal investigations—for example, by acting as a safe harbor for terrorists—then coordinated international pressure is warranted.

Can the OECD's assault on tax competition be stopped?

The OECD has no rule-making authority. It has neither the power to impose sanctions nor the power to order its member nations to implement financial protectionism against low-tax countries. At most, it can ask its member nations to impose those barriers, and this is the Achilles' heel of the OECD agenda. For the OECD to succeed, it must convince all of its member nations to participate in a coordinated attack on low-tax countries.

Most important, the OECD needs the active support of the world's largest economy: the United States of America. This is why U.S. lawmakers control the outcome of this debate. If America chooses not to participate in the financial attack on low-tax countries, the OECD initiative will collapse.

Should America support the OECD agenda?

The OECD agenda is contrary to America's interests. The United States is a low-tax country and a tax haven for foreign investment. Millions of jobs depend on the economic activity generated by our attractive tax and privacy laws. And if President Bush continues his efforts to reduce tax rates and eliminate the death tax, America is going to become an even more effective competitor in the world economy. It would therefore be self-defeating for the United States to support the OECD's attack on tax competition.

Some concluding thoughts on the taxation of capital from the founder of modern economics:

> An inquisition into every man's private circumstances, and an inquisition which, in order to accommodate the tax to them, watched over all the fluctuations of his fortunes, would be a source of such continual and endless vexation as no people could support…. The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any

7. United Nations, *Financial Havens, Banking Secrecy, and Money Laundering*, 1998, at *https://www.imolin.org/finhaeng.htm*.

particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour would necessarily be more or less diminished by its removal.

—Adam Smith (1776)

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