

# Is tax competition ever “harmful”?

## - The OECD dogma

**By Dr. Terry Dwyer<sup>†</sup>, Visiting Fellow, Asia Pacific School of Economics and Management, Australian National University, Canberra, Australia**

“Land is a subject which cannot be removed; whereas stock easily may. The proprietor of land is necessarily a citizen of the particular country in which his estate lies. The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any 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) “An Inquiry into the Nature and Causes of the Wealth of Nations”, pp 848-849.

“Experience, however, shews, that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connexions, and intrust himself, with all his habits fixed, to a strange government and new laws, check the emigration of capital. These feelings,

which I should be sorry to see weakened, induce most men of property to be satisfied with a low rate of profits in their own country, rather than seek a more advantageous employment for their wealth in foreign nations.”

David Ricardo (1821) “On the Principles of Political Economy and Taxation” chapter VII, On Foreign Trade, pp 136-137 Sraffa edition, 1951.

### Background

The history of offshore financial centres reflects the historical evolution of the tax systems of major countries, notably the United Kingdom. When Lloyd George and his Treasury officials refused the request of the Vestey's (a British meat processing company located in Australia) that UK taxation not be extended to overseas income in World War I, the Vestey's decided upon self-help. Their overseas income eventually flowed to the trustees of a settlement based in Paris at a time when France did not seek to tax overseas gains. Given the current attitude of France as an OECD member to offshore financial centres, it is worth noting that France was one of the first.

However, for the vast majority of taxpayers in developed countries, tax havens held little interest till recent decades. With onshore tax havens such as life insurance, pension or superannuation funds available, only the very wealthy found much need to consider the use of offshore tax havens. In the UK, the combination of a still-

wealthy upper class facing extraordinarily high marginal top tax rates, a tradition of overseas investment and the unique circumstances of offshore tax havens within the then exchange control area meant the British were leaders in tax haven development. To these were added, after World War II, the multinational corporations which found that the services of tax havens were essential in overcoming the problems created for international business by inconsistent tax treaties or dual claims to income.

It is not generally recognised by most economists that without tax havens, much multiple national taxation would still exist and pose enormous difficulties for mutually beneficial trade and commerce. That did not stop President Kennedy from launching the assault on controlled foreign corporations, which is the intellectual genesis of most subsequent anti-tax haven legislation (which seeks to attribute to domestic residents the income or gains of entities resident in tax havens).

As public expenditure rose, notably on expanding welfare states, and as onshore tax shelters or tax havens were attacked, one after the other, by treasuries in developed countries, the demand for the services of offshore tax havens rose. No longer were offshore tax havens merely of interest to major multinational corporations or the super-wealthy. Just as Prohibition in the USA spurred the import of alcohol from Canada, so increasing fiscal repression in OECD countries led to the export

of capital to offshore tax havens.

The consciousness of European treasuries was raised after Germany failed in an attempt to impose an interest withholding tax in the face of a flight of capital. It now seemed clear to the treasuries of ageing welfare states that tax competition when combined with freedom of capital movement was a threat to their ability to raise further revenue. European writers increasingly recognised that the emergence of a global capital market inevitably sets limits to the redistributive financing of welfare states.

Since the 1980s, there has been the adoption, generally within Europe, of controlled foreign companies legislation as well as other anti-avoidance legislation. More significantly, the OECD Report on harmful tax competition and its cognate report on tax sparing together with European Union initiatives have seen the emergence of a multilateral attack on tax havens or offshore financial centres. The OECD Council has continued high-pressure “dialogue” with not-yet-co-operative (intimidated?) jurisdictions since. In particular the United Kingdom has clearly come under pressure from its European partners to “do something” about its dependent territories. The first example of this was the UK Edwards Report which examined the Channel Islands and the Isle of Man and which has now been followed by the White Paper on the overseas territories.

The Edwards Report, which, in the method of its inception, broke long-

established constitutional usages governing the relationship between the United Kingdom and the Crown’s offshore islands, did not recommend wholesale elimination of the offshore tax havens. Indeed, the Edwards Report was surprisingly fair, given its genesis, but it did foreshadow substantial inroads on client privacy in the interests of overseas regulators and tax collectors.

The problem facing the United Kingdom is that, since before the American revolution, it has been long-established practice that British colonies with self government are entitled to administer their own taxation affairs.<sup>1</sup> No pressure from its European partners is likely to alter that position. After all, these days, any British colony can pretty much elect for independence and join the Commonwealth of Nations. Hence the British government is proceeding to assuage its European partners by seeking more subtle methods of removing the attractiveness of its overseas territories as tax havens. The ostensible focus of its initiatives is to ensure credible regulation of the offshore financial industry in each of its territories. The overseas territories, on the face of it, can hardly complain if London insists that they co-operate in measures to afford mutual legal assistance to counter criminal activity and eliminate fraud.

However, there seems to be an ulterior motive in this apparently beneficent activity. If measures introduced to secure the integrity of

the overseas territories’ financial sectors have the *effect*, if not the stated *purpose*, of ensuring that the financial affairs of OECD investors in those territories are exposed to the gaze of OECD treasuries, then Britain will have pleased not only its own treasury but those of its European neighbours.

It is clear that a consensus is emerging among many OECD countries that tax competition is harmful and measures need to be taken collectively to eliminate tax havens. This is not a universal OECD view, however. Switzerland and Luxembourg dissented strongly from the Report on harmful tax competition while the USA has its own views on foreign sales corporations.<sup>2</sup> Indeed, House Majority Leader Mr Dick Armey has urged the US Treasury to put a stop to the OECD tax cartel campaign as being inimical to US and global interests (a perfectly rational view for a country which has successfully drawn capital from Europe and one which the Bush Administration is apparently now adopting).

Nonetheless it seems fair to say that tax havens are facing the following OECD agenda:

1. Tax competition is harmful.
2. It should therefore be suppressed.
3. National sovereignty means it cannot be directly suppressed, as no OECD country can rewrite the tax laws of any independent tax haven.
4. Therefore, financial threats or inducements or the use of ostensibly non-tax treaties must be employed for the explicit or ulterior purpose of eliminating tax havens. In the case

## FOOTNOTES

† Terry.Dwyer@anu.edu.au. This is an abridged version of “Harmful” Tax Competition and the Future of Offshore Financial Centres Such as Vanuatu, in *Pacific Economic Bulletin* Vol. 15 No. 1, 2000. The full annotated version can be obtained from Asia Pacific Press at [www.asiapacificpress.com](http://www.asiapacificpress.com).

1 See the Parliamentary speeches of William Pitt, 1st Earl of Chatham, 14

January 1766 and 20 January 1775.

2 The World Trade Organisation has ruled that a US policy of granting special tax preferences to companies that export (foreign sales corporations or FSCs) is a violation of the WTO rules. The USA was given until 1 October 2000 to either change its tax laws or face retaliatory sanctions that could reach US\$6 billion annually. Daniel J. Mitchell, a senior fellow at

the Heritage Foundation, a Washington-based public policy research institute has written in the *Washington Times* (3 January 2000) that the USA could best respond against the World Trade Organisation by repealing the US tax code’s onerous foreign income provisions and instead shifting to a territorial tax system which would only tax income earned inside its borders, making US companies more internationally competitive.

of dependent territories of OECD members, such measures may carry the implicit threat of the governing power to override internal self-government.<sup>3</sup>

### Are the offshore financial centres “tax havens”?

So far I have used the terms “tax haven” and “offshore financial centre” interchangeably. In fact the offshore financial centres have in many cases progressed for reasons other than tax, though without beneficial tax regimes, they may not have progressed at all. Increasingly, offshore financial centres are used for asset protection against the tort liability revolution. Liberalised no-fault divorce laws which give spouses (now defined in some places to include *de facto* or same sex partners) automatic claims to assets regardless of adulterous or other conduct do not meet with universal moral approval. In some countries, testators are denied freedom to dispose of their estates as they think fit and, increasingly in common law countries, legislation makes it easier for disappointed beneficiaries or others to challenge a will. Assets may be moved to vehicles in offshore financial centres to defeat such legislation. Contrary to Ricardo’s expectations, many British subjects have moved assets offshore to escape new laws (whether arising from law reform or judicial activism) and enjoy old and familiar laws in present and former British possessions.

Other uses of offshore financial centres include catering to expatriate

investors who may be working in many countries over time and wish to manage their investments or pension arrangements from one centre. Prospectus requirements may influence investment managers in choosing to locate their operations in offshore financial centres. Onshore investors denied access to foreign company prospectuses or life insurance products may seek to invest via offshore vehicles. Persons planning a company takeover on a stock market may not wish to alert the market before any legislative requirement to do so. Multinational groups seeking to gain access to lower premiums through the reinsurance markets may choose to operate captive insurance companies in offshore financial centres.

For these reasons, the term “offshore financial centre” is more accurate than “tax haven” as there is often more than one kind of perceived legal inadequacy or repression in the investor’s home or target jurisdiction which provides the impetus to locate assets in an offshore vehicle.

### What is the theory of “harmful” tax competition?

As the expertise of this writer is in economics, not international relations or political science, the rest of this paper addresses the first premise of the OECD argument. The question is whether tax competition is ever harmful. The OECD Report appears to have assumed that the answer to the question is yes. I argue that economic theory points to the opposite

conclusion, namely that tax competition is a healthy and natural economic process which weeds out stupid or inefficient taxes.<sup>4</sup>

If I am correct, then the governments of offshore financial centres are entitled to take the view that they are not being bad international citizens in seeking to profit from the stupidity of treasuries of more “developed” countries. They are equally entitled to take the view that any form of international legal assistance should not extend, directly or indirectly, to the enforcement of other countries’ tax laws whether such assistance is sought by way of debt recovery, insolvency proceedings, information exchange or evidence for tax prosecutions.

Before accepting that tax competition can ever be harmful, one might ask some questions. How does tax competition differ from other competition?<sup>5</sup> What is wrong with general fiscal competition so that a low-spending country can pursue a low or zero income tax policy? (For example, it would be strange if a well-run country with no corruption, low spending and low taxes were seen as a more “anti-social” world citizen than another with corruption, bloated spending and high taxes.) What is wrong with not taxing income you would otherwise never see?<sup>6</sup>

A simple expression of fear that tax competition will lead to a loss of domestic revenue does not amount to an argument that tax competition is harmful either to one’s own or other

3 The threat is fairly clear in Robin Cook’s statement of 17 March 1999 to Parliament introducing the UK White Paper Partnership for Progress. He said “**we have to insist** on the governments of the Overseas Territories **fulfilling their** [sic] **obligations** to meet the standards of international organisations in which the United Kingdom represents them. There are two issues which are of priority in meeting those obligations. The first is to match the best

international standards in financial regulation. ... **We will therefore be requiring** all Overseas Territories, by the end of this year, to meet in full international standards on money laundering, transparency, cooperation with law enforcement authorities, and independent financial regulation. The globalisation of international finance means that **we cannot tolerate** a weak link anywhere in the chain without exposing investors everywhere to risk. The second area of priority is in

human rights. ... Specifically, **we require** changes in the law in a minority of Overseas Territories which retain corporal punishment and criminalise consensual homosexual acts in private. Our strong preference is that the Overseas Territories should enact the necessary reforms themselves, but we are ready to make such reforms by Order in Council if they fail to do so.” [emphasis added]. It seems the EU view is that there is a human right to privacy in sexual, but

countries, no matter how unpleasant it may be for the treasury concerned.

### Defining “harmful” tax competition

A basic problem in defining “harmful” tax competition is to define who wins and who loses. Are the losers OECD governments? Or some OECD governments and not others? Or are they the citizens of OECD countries? Or is the world at large a loser?

The OECD Report (1998, p 8 para 4) argues that “tax havens and harmful preferential tax regimes, collectively referred to as harmful tax practices, affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally. Such harmful tax competition diminishes global welfare...”

This statement raises a multitude of questions. Apart from the circularity of referring to a harmful preferential tax regime as harmful, in what sense is it harmful for another country to be a tax haven? If the alleged harm is that tax havens affect the location of financial and other service industries, it needs to be observed that all taxes affect location decisions, including the taxes of the country allegedly harmed. If country “A” puts on taxes while country “B” does not, whose action causes financial and other service activities to relocate? Are not country “A’s” taxes the ultimate reason for the erosion of its tax base? Is not the harm self-

inflicted? As for distortion of trade and investment patterns, all taxes on labour and capital are distorting - only taxes on rent are non-distorting and there is no international law which prohibits countries from adopting rent taxes.

As regards the fairness and broad social acceptance of tax systems, it is curious that revenue collectors who traditionally insist in the courts that taxes must be collected according to law - without regard to fairness - should raise this issue. The obvious point is that many citizens in high-taxing countries do not accept their tax systems as “fair” and, failing to obtain equity from their political systems, do what they can to protect themselves and their families. Their responses can range from simple legal tax planning such as deductible pension fund contributions, or geared investments or income splitting to more complex tax planning or avoidance and even to minor or massive unlawful evasion.

While one can understand why a high-tax country’s tax administrators would view all such responses by its citizens as “harmful” to revenue collections, that does not mean taxpayer responses to high tax burdens are necessarily always harmful to the country itself. In the case of onshore havens such as pension funds, the capital accumulated may increase investment and productivity while reducing future demands on the treasury from an ageing population. In the case of offshore havens, similar responses by citizens may have similar

if more attenuated benefits and may serve as an economic and political safety valve,<sup>7</sup> forestalling the physical emigration of talented labour and capital or the emergence of violent minority political movements. In an ideal society, people would want to pay their taxes or be unable to avoid them, but only benefit taxes or taxes on economic rent are likely to approach such an ideal. With other taxes, it is moderation in their levels and administration which best promotes their acceptance and mitigates avoidance and evasion.

It is therefore impossible to assume, without a well-reasoned argument, that tax competition harms the country losing revenue. It is even more difficult to conclude that “harmful” tax competition diminishes global welfare unless one can show that the gains to the competing country and its clients from the revenue-losing country plus gains to third countries are less than the losses to the beneficiaries of the revenue-losing country’s taxes and the marginal deadweight losses of those taxes. Nowhere does the OECD Report attempt such a demonstration.

The difficulty of defining “harmful” tax competition is further exemplified by the OECD concession (1998, p 8 para 6) that: “Tax incentives designed to attract investment in plant, building and equipment have been excluded at this stage...” The focus of the OECD Report is upon tax competition for mobile financial capital or services. It seems to be assumed sometimes (or for the time being?) that competition

*not financial, affairs. Since this article was first drafted the OECD seems to be shifting the debate to one of moral outrage over “tax evasion” in order to overcome US resistance to its blanket agenda. The simple notion seems to be that a country which has financial privacy for offshore investors is as morally delinquent as a taxi driver giving a lift to a fleeing bank robber. But OECD taxpayers might say they are the ones fleeing highway robbery. Questions of*

*morality are very important and should be debated. But morality is not a trivial issue of enforcing every country’s statute laws - should Switzerland have handed over Jews and their money to Nazi tax collectors? Incidentally, for those disposed to view this debate as a moral issue of tax evasion, one might note that no country has a moral obligation to assist others whose labour tax bases are shrinking demographically because their citizens*

*practice, for example, infanticide or abortion. Where there are unfunded inter-generational tax-financed transfers, one could rationally see deliberate childlessness as a form of tax evasion, much as Augustus Caesar saw childlessness as a form of shirking one’s duty to the Roman State.*

<sup>4</sup> I am not alone in this view. Sinn (1993, pp 43-44, 70) also argues that tax competition is beneficial for the citizens of the “losing” high tax



for financial capital is harmful but competition for physical capital is, so far, legitimate.

But physical and financial capital are not so neatly distinguished and tax competition affects labour mobility as well. This seems to be no logical stopping point short of the assertion that all tax competition is harmful. In particular, it seems odd to complain that tax competition for location of financial capital or regional headquarters is harmful while tax competition for factories and jobs is not. As Barry-Bracewell Milnes (1980) and Keen (1993) have pointed out, paper tax avoidance, which means a factory continues to operate and create jobs in a high tax country, may be seen as less harmful than the tax avoidance involved in closing down the factory, sacking workers and setting up in a country which grants tax incentives for plant and equipment. Which is worse - the oft-deplored *legal* “paper” avoidance, which means a factory still operates in an OECD country employing workers and generating PAYE etc., or *economic* tax avoidance - closing down the factory and relocating in China? Why is the former denounced so strongly and the latter recognised as a legitimate business decision? And if the OECD is to move on to denounce both forms of avoidance with equal force, when will it start telling China, Hong Kong, Singapore, Malaysia and dozens of other countries that they are somehow anti-social economic threats to OECD prosperity? Does the OECD suggest

Europe impose economic or military sanctions on China and the USA to stop them “stealing” capital and jobs? If not, why start down an intellectual road leading to such dangerous neo-mercantilism?

There would be little point to a “successful” OECD anti-offshore tax avoidance drive to defend domestic tax systems if the result is that so much capital and talent are driven physically offshore that OECD economies stagnate. An OECD attack on tax avoidance which results in a physical exodus of capital or skilled labour deserves the reproach Tacitus (*Agricola* 30) records of a German chief on his Roman invaders: “They make a desolation and they call it peace.” The price of tax victory may be too terrible a price to pay - economic strangulation - nor is a fiscal “scorched earth” policy likely to be profitable to the OECD revenue authorities.

The OECD (1998, p 17 para 34) “recognises that some investors may seek to invest in a location with lower rates (and greater after-tax return) even if only low public services are available ... but these genuine location decisions have to be distinguished from the type of behaviour which is the focus of this Report.” Again, the OECD Report gives no criterion by which any such decisions can be distinguished from any other economic decision.

Nor is it satisfactory to define “harmful” tax competition as that which is “designed” or “intended” as tax competition. An attempt to do so may be seen when the OECD (1998, p 16

para 29) argues: “Where the interaction of tax systems is exploited by the enactment of special tax provisions which principally erode the tax base of other countries, the spillover effects on the other countries is not a mere side effect, incidental to the implementation of a domestic tax policy. Here the effect is for one country to redirect capital and financial flows and the corresponding revenue from the other jurisdictions by bidding aggressively for the tax base of other countries. Some have described this effect as ‘poaching’ as the tax base ‘rightly’ belongs to the other country. Practices of this sort can appropriately be labelled harmful tax competition as they do not reflect different judgements about the appropriate level of taxes and public outlays or the appropriate mix of taxes in a particular economy, which are aspects of every country’s sovereignty in fiscal matters, but are, in effect, tailored to attract investment or savings originating elsewhere or to facilitate the avoidance of other countries’ taxes.”

Here a new definition of harmful tax competition is attempted. It is harmful tax competition if you *intend* to poach another country’s tax base but not if you pursue a domestic policy which merely has that *effect*. Such a definition is nonsensical.<sup>5</sup> It would mean that Hong Kong, which pursues a low tax policy assisted by land revenues, is a “non-harmful” tax haven competitor but Singapore, which is a higher tax jurisdiction, with specific incentives for international business,

*country. It forces Leviathan governments to put their houses in order by cutting wasteful spending and shifting taxes from mobile to immobile factors of production. Since this article was first drafted the OECD has ostensibly changed its language to combating “unfair” tax competition or “tax evasion”, but they have never addressed the substantive points made in this article and an earlier version sent to them for any comment they might wish to make. Just as taxpayers*

*may wish to minimise, avoid or evade tax, so it is not unusual for officials to wish to avoid or evade questions and scrutiny.*

5 *One can think of a sovereign competing for subjects and investment like any other economic agent maximising his wealth or of a democratic government maximising the wealth of its people. In either case, what is to be maximised is that country’s welfare, not some abstract*

*concept of world welfare. If economists believe free competition maximises group welfare among self-interested individuals, one might expect a similar result in similar competitive processes.*

6 *From an individual nation’s viewpoint, it is clearly welfare-improving to have something rather than nothing. What the critics of tax competition have to prove is that such actions are collectively welfare-*

is a “harmful” tax competitor. Curiously, it would also mean that the classic tax havens, Jersey, Guernsey and the Isle of Man, were not engaging in “harmful” tax competition as their tax haven features grew out of domestic policy decisions and long-established tax practice.<sup>9</sup>

Many tax havens have evolved their own tax systems without any particular interest in the wider world, yet the OECD Report recommendations clearly conclude by focusing on the *effects* of tax competition upon the revenue-losing countries more than any *intentions* on the part of tax havens. In the end, the OECD sees all tax competition as harmful to the interests of revenue-losing tax authorities, regardless of whether it is intended and whether it operates on physical or financial capital or on labour. As Mason Gaffney (1999) has pointed out, the OECD Report has not been accurately titled. It should have been called, “Tax competition: a problem for high tax countries”.

### Defining “fair” tax competition

The difficulty of defining “harmful” tax competition is paralleled by the difficulty of defining “fair” tax competition. The OECD (1998, p 9 para 8) argues that “the proposals set out in the Report will reduce the distortionary influence of taxation on the location of mobile financial and service activities, thereby promoting *fair* competition for *real* economic activities. If governments can agree that these location decisions should be

driven by economic considerations and not primarily by tax factors, this will help move towards the ‘level playing field’ which is so essential to the continued expansion of global economic growth.” [emphasis added].

Nowhere does the OECD Report define what is “fair” tax competition. Nowhere does it explain what is a “real” versus an “unreal” economic activity. Is banking unreal? Is insurance unreal? Is e-commerce unreal? Is the Internet unreal?

And why is tax not an “economic” consideration? The House of Lords, the Australian High Court and the United States Supreme Court have taken it as axiomatic that taxation is a normal part of any business decision-making when dealing with cases of alleged tax avoidance.

The OECD (1998, p 34 para 81) admits: “Determining whether investment represents a new investment or a shift from another location to exploit tax differentials is a difficult empirical matter. ...On the margin, observed investment may be stimulated either by the additional savings of individuals in response to lower taxes or by a distortionary reallocation of investment from one location to another to exploit tax differentials.”

If the concern is with whether a country’s tax regime induces economic activity to shift, then *all* tax competition is necessarily “harmful”. The only way to prevent tax-induced changes of investment location would be for all countries to adopt the same tax system

and the same tax rates. Implicitly, despite disavowals, the OECD seems to assume there is never “good” tax competition or at the most such “good” tax competition would involve countries taxing on the same base with a minimum floor rate. (Though it is unclear how one would establish an optimal floor tax rate: the current EU floor rate is essentially arbitrary.)

As the Report evidences in its recommendations, the OECD does not really accept any logically limited definition of “harmful” tax competition. The inference is unavoidable that all low-tax countries are engaging in “harmful” tax competition and the Report evinces in its recommendations an intention to eliminate all forms of tax competition as harmful, no matter how they arise.

### The “harm” caused by tax competition

More insight into what the OECD sees as “harmful” tax competition comes from its description of the harm caused by tax competition. The OECD (1998, p 14 para 23) argues tax competition “may alter the structure of taxation (by shifting part of the tax burden from mobile to relatively immobile factors and from income to consumption) and may hamper the application of progressive tax rates and the achievement of redistributive goals.”

If tax competition shifts the tax burden from mobile to relatively immobile factors, it is doing the world a service. Economic theory has always held that, from an efficiency point of

*reducing and that “all” nations could do better by not competing.*

7 *The late Professor Wheatcroft, an expert on the UK capital gains tax, is said to have remarked that: “A tax system breathes through its loopholes”. That remark recognises that all taxes on labour and capital are distorting and, if they can ameliorate the economic distortions created by taxation, taxpayers may be contributing to a more productive economy.*

8 *As equally illogical as to say that tax competition which poaches a tax base but not physical investment is “harmful” yet tax competition which snares both is acceptable.*

9 *The logical difficulties being faced by the OECD are shown by the subsequent decision since the Report to treat Switzerland as a non-tax haven. Nor do subsequent OECD statements on the reasoning behind the OECD project answer the logical*

*problems raised in this paper.*

10 *If a government wants to see income redistributed, a global graduated income tax is not necessary to do so. A government can distribute the proceeds of resource revenues and can allow tax deductions for income transferred to low income relatives or to charity. Hong Kong has used low flat-rate taxes and land revenues to provide large subsidies to public housing.*

view, taxes should be laid on things which are inelastic in supply (of which the prime example is land rents). It is also rather odd that OECD countries which have led the way in imposing consumption taxes should complain of being forced to do that which they have chosen to do. As for progressive marginal tax rates and income redistribution, there are many economists who would argue that both are economically inefficient, especially when it is sought to finance redistribution by high marginal tax rates on labour and capital incomes as opposed to land rents.<sup>10</sup> It is also odd that a report which complains - without proof - that tax havens are “free riders” (1998, p 15 para 25) accepts as given the “free riding” implicit in redistributive taxation (1998, p 14, para 23). Some “free riders” are more equal than others, it seems.

### Should tax systems be the same?

Curiously the OECD (1998, p 15 para 26; p 20 para 41) “recognises that there are no particular reasons why any two countries should have the same level and structure of taxation. Although differences in tax levels and structures may have implications for other countries, these are essentially political decisions for national governments. Depending on the decisions taken, levels of tax may be high or low relative to other states and the composition of the tax burden may vary. ...Countries should remain free to design their own tax systems as long as they abide by internationally

accepted standards in doing so. ...It is not intended to explicitly or implicitly suggest that there is some general minimum effective rate of tax to be imposed on income below which a country would be considered to be engaging in harmful tax competition.”

These statements are self-contradictory and disingenuous. Who is to define what are internationally accepted standards? Should it be internationally unacceptable for a country to raise its revenue entirely from land taxes or resource taxes (e.g. oil royalties) and have no taxes at all on capital or labour? If it is to be unacceptable, why should that be so, given the obvious efficiency benefits of such a tax regime and, if, on the other hand, it is to be acceptable, how can one logically object to tax competition? If a zero tax rate on capital and labour income is acceptable to the OECD why does the OECD have *any* concerns about tax competition? These statements, like others in the Report, seem designed to dissemble the real objective of an OECD-led global tax cartel with worldwide enforcement powers.

### The OECD advocacy of a global tax cartel

The OECD response to tax competition is to try to organise a tax cartel.<sup>11</sup> The OECD argues that all countries can benefit by joining a global tax cartel. Thus the OECD (1998, p 10 para 13; p 34 para 80) states: “The broader the economic grouping of countries engaged in this dialogue, the greater the effectiveness of any

solutions proposed, since this would minimise any displacement of activities to jurisdictions with harmful tax practices outside of the participating countries. ...although tax is only one of the factors which may influence investment decisions, mobile services are very tax sensitive so that companies may actively seek out tax breaks and encourage countries to match preferences available in other countries. In these cases governments may find themselves in a ‘prisoner’s dilemma’ where they collectively would be better off by not offering incentives but each feels compelled to offer the incentive to maintain a competitive business environment.”

The assumption that all countries could be better off by joining a tax cartel depends, first, on all countries joining the cartel and, second, upon a fixed worldwide supply of the factor sought to be taxed. While some countries may be tempted to join such a cartel if promised a share of the tax revenue, others will observe that, the larger the cartel, the greater the profits to be secured by those remaining outside it. Apart from the improbability of all countries joining a tax cartel, since the rewards for staying out are increased as more join, the key assumption is that the worldwide supply of capital or labour would not be reduced if all governments colluded to increase tax rates. That this assumption is false is suggested by declining savings rates, labour force participation and birth rates in high-tax countries. Even in a closed

11 The European Union has tried to counter tax competition by prescribing minimum levels of corporate or value added tax. Minimum withholding tax rates are under consideration. This is the action of a tax cartel and the OECD is clearly heading in the same direction, notwithstanding the sops in its 1998 Report to the right of countries to make their own revenue/spending decisions.

12 The distinction between lawful tax avoidance and illegal tax evasion is basic to the rule of law. One of the most depressing features of modern taxation systems is their tendency to corrupt basic legal principles. The British legal tradition held that all tax legislation is of its nature penal legislation which takes away common law rights. Since taxes were voluntary grants by Parliament to the Crown which derogated from common law rights, taxing statutes

had to receive a strict construction. Increasingly, OECD countries have tended to rely upon statutory or judicial anti-avoidance doctrines which overturn the principle that the subject is not to be deprived of his property except by clear words, e.g. see Cooper (1997). The rule against self-incrimination is routinely ousted in tax administration. Retrospective tax liabilities are often created and the onus of proof increasingly reversed not only in civil tax

economy, high taxes on labour and capital have negative consequences.

Such considerations do not appear to deter the OECD from planning the means to enforce a tax cartel. The OECD (1998, p 24 para 54) notes: “Some progress has been made in the area of access to information, in that certain tax haven jurisdictions have entered into mutual legal assistance treaties in criminal matters with non-tax havens that permit exchange of information on criminal tax matters related to certain other crimes (e.g. narcotics trafficking) or to exchange information when criminal tax fraud is at issue. Nevertheless, these tax haven jurisdictions do not allow [other countries’] tax administrations access to bank information for the critical purposes of detecting and preventing tax avoidance which, from the perspectives of raising revenue and controlling base erosion from financial and other service activities, are as important as curbing tax fraud.” The OECD (1998, p 52 para 137) goes on to assert, “In an era of globalisation and increased mobility for taxpayers, traditional attitudes towards assistance in the collection of taxes may *need* [sic] to change. The purpose ... is to encourage countries to review the current rules ... with a view to encouraging the enforcement of tax claims of other countries.”

The implications of this OECD bureaucratic view for both OECD and non-OECD countries are breathtaking. It implies there is to be no distinction drawn between legal tax avoidance and

illegal evasion.<sup>12</sup> It means international crime fighting is being used as a stalking horse to attack so-called tax crimes. It means the destruction of sovereignty and the principle of no extra-territorial enforcement of other countries’ taxes. (It would be a curious historical irony if a US Congress agreed to US citizens being obliged after 225 years to render assistance to Her Majesty’s revenue officers!). It means the complete destruction of privacy as a social value in OECD societies, notwithstanding its status as a human right under some Constitutions, e.g. in the USA.<sup>13</sup> Non-OECD countries are expected to legislate to force their citizens to divulge information to OECD authorities not merely for the purpose of prosecuting common criminals but for the purpose of preventing both evasion and avoidance of OECD countries’ taxes. No decent person wishes to support drug cartels but many would feel that the loss of all personal financial privacy is too high a price to pay for their elimination, especially as the history of increased police powers in OECD countries seems to have gone hand in hand with greater police corruption.

Just as modern Western states are imitating the later Roman Empire in their population decline, so they are imitating it in their increasingly punitive approach to taxation enforcement as their labour tax bases shrink. Tax defaults are increasingly being criminalised and attempts are being made successfully to prosecute tax evasion as if it were common law

fraud (even though taxes - originally called aids or subsidies - are a creature of statute alone and not known to the common law). The great tactical advantage of this confusion of the sources of legal obligation is that the authorities in the OECD country can then seek to use treaties on mutual legal assistance to pursue tax collection outside their borders by claiming they are pursuing criminal acts rather than seeking extra-territorial tax enforcement. There is little point to offshore financial centres saying they will cooperate with OECD measures against illegal tax evasion but not against lawful tax avoidance, if the OECD countries are determined to confound the two: offshore centres have in effect only one choice regarding exchange of tax information - to force their citizens to provide information to OECD countries for all tax purposes or for none. Governments of offshore financial centres will doubtless study more closely the precise wording of legal assistance treaties to ensure such indirect attempts to erode their sovereignty do not seriously undermine their own revenues.

In essence, the OECD is arguing that the rest of the world should be forced to design their legal and administrative systems to facilitate the application of residence-based income taxation by OECD countries. Even in the heyday of colonialism, imperial powers tended not to make such demands of their colonies. Faced with the prospect of such drastic abuse of legal assistance treaties, one suspects

*collection but also in criminal prosecutions for tax fraud. Lawyer-client privilege is attacked and assets are seized without due process of law under a presumption of guilt. More recently, the US House Judiciary Committee and others have expressed concern over the abuse of forfeiture laws and asset freezing or confiscation ahead of conviction. The mere fact that OECD countries have increasingly abandoned basic legal principles and vital distinctions*

*between legal and illegal or civil versus criminal acts is no reason why offshore financial centres should follow suit by allowing tax matters to come under treaties dealing with mutual assistance in criminal matters.*

<sup>13</sup> Some (perhaps many) would argue that privacy, including bank secrecy or confidentiality of personal or business affairs, should give way to the need to investigate criminal

*activity. This is not essential to this paper - what right does one country have to force its social consensus on this question into the legislation of another sovereign country which may have a different view? Those readers who are interested can pursue the debates elsewhere but, for normal investigations in civilised countries, reasonable suspicion and judicial warrants are required before telephones are tapped, records examined or houses entered. Before*



that some non-OECD countries will reach the view that legal assistance treaties are not in their national interest and should be denounced or amended. It would be unfortunate if the unbridled demands of OECD tax bureaucrats were to trigger a decline in international cooperation against real criminality, under which tax offences are not necessarily included by most of humanity.<sup>14</sup>

Just why some countries should be made to enforce other countries' tax laws when it is not in their interests to do so, nor in the interests of world economic growth, is not explained. The radical assault on sovereignty implicit in such sentiments should cause observers to ask what is wrong with the OECD tax systems that they need such drastic extraterritorial enforcement. Territorial income tax systems, or land taxes, do not require such extraterritorial assistance.

### The problem of trying to tax mobile factors of production

The OECD's campaign against tax competition is as misconceived as Xerxes' ordering the sea to be flogged or Canute halting the tide. The real problem the OECD is grappling with is trying to tax what can run away. Coercive taxation and liberty are, at heart, strangers. The OECD Report (1998, p 56 Box III) states: "Member countries have concluded that they need to act collectively and individually to curb harmful tax competition and to counter the spread of harmful preferential tax regimes directed at

financial and service activities. Harmful preferential tax regimes can distort trade and investment patterns, and are a threat both to domestic tax systems and to the overall structure of international taxation. These regimes undermine the fairness of the tax systems, cause undesired shifts of part of the tax burden from income to consumption, shift part of the tax burden from capital to labour and thereby may have a negative impact on employment. Since it is generally considered that it is difficult for individual countries to combat effectively the spread of harmful preferential tax regimes, a co-ordinated approach, including a dialogue with non-member countries, is required to achieve the 'level playing field' which is so essential to the continued expansion of global economic growth. International co-operation must be intensified to avoid an aggressive competitive bidding by countries for geographically mobile activities."

The reasoning behind these assertions is incomplete. Tax policy is really quite simple. There are only three sources of income you can tax - land, labour and capital - and only one of them cannot flee. Capital can flee at the speed of light today and it can stop replenishing itself as people either stop saving or investing. Like water, capital can evaporate or leak away from an open economy. Labour has a harder job escaping tax burdens, but it can stop working, shift to the black economy, emigrate (especially if it is

skilled) or stop breeding (as under European VATs). Only land (which includes all scarce natural resources) can command a true economic rent which cannot be diminished by taxation.<sup>15</sup>

There is no reason why reduced taxes on mobile capital could not be financed by increased land taxes within the OECD countries. If they choose to tax their workers and their families more rather than tax land, that is their domestic political decision, just as it was a domestic political decision for many OECD countries, notably in Europe, to embark on high welfare spending programmes which necessitated high taxes on labour and made them internationally uncompetitive. Having made those decisions, they should not blame the rest of the world for the logical economic consequences.

Just why countries, for example in the Asia-Pacific, should be expected to provide a "level playing field" for OECD countries by embarking on similar high-tax, high-spending policies is not explained. Why should places such as Singapore and Hong Kong with no natural resources be expected to forego any chance of maintaining the living standards of their people by imposing OECD tax rates which would drive away business and employment? To blame emerging economies in the Asia-Pacific for the economic woes of European welfare states may be good domestic politics in Europe but it is bad economics, both for Europe and the world at large.

*agreeing to any exchange of information or mandatory obligation of disclosure of private records, offshore financial centres might reasonably insist on judicial and other procedural protection for the rights of their citizens and their clients.*

<sup>14</sup> Adam Smith (1776, pp 647-648, 826-827, 898 ) remarks that: "The severity of many of the laws which have been enacted for the security of

*the revenue is very justly complained of, as imposing heavy penalties upon actions which, antecedent to the statutes that declared them to be crimes, had always been understood to be innocent. ... In those corrupted governments where there is at least a general suspicion of much unnecessary expense, and great misapplication of the public revenue, the laws which guard it are little respected. Not many people are scrupulous about smuggling when,*

*without perjury, they can find any easy and safe opportunity of doing so. To pretend to have any scruple about buying smuggled goods, though a manifest encouragement to the violation of the revenue laws, and to the perjury which almost always attends it, would in most countries be regarded as one of those pedantic pieces of hypocrisy which, instead of gaining credit with anybody, serve only to expose the person who affects to practise them to the suspicion of*

It is quite remarkable that a report which sets out no theory to support its assertions, contains no precise or operative definition of harmful tax competition and cites no academic literature in support of its assertions should have ever received the endorsement of major governments. The assertion is essentially that tax competition between nations can lead to “beggar thy neighbour” policies and less-than-optimal public expenditure, leaving everyone worse off. But conclusions in economic theory depend on assumptions. From the point of view of worldwide economic welfare, the OECD argument that tax competition is harmful implicitly rests on the assumption that there are only two factors of production, labour and capital, and these are fixed in their total worldwide supply. Both assumptions are quite false.

From the point of view of national economic welfare, the view that tax competition is harmful is correct only if there are no immobile tax bases available. Where there are mobile tax bases (e.g. capital) and immobile tax bases (e.g. land), tax competition can force a country to shift its tax base from mobile capital to immobile land. Such a shift is, in fact, a shift to a more efficient tax base, one conforming to the general Ramsey efficiency rule of taxing more those things which are less elastic in supply. Tax competition may thus be efficiency enhancing and no bad thing for a country, even if its tax administrators or politicians find it uncomfortable.

The economic theory underpinning the concept of “harmful” tax competition is essentially non-existent. The theoretical models employed in the economic literature to show harmful effects from tax competition and a loss of collective revenue are essentially based upon models which assume a fixed worldwide supply of capital. In those models, tax competition is a “beggar thy neighbour” policy or “a race to the bottom”, whereby the gains of financial centres or tax havens *must* be at the expense of tax revenue in the capital exporting countries. Obviously, if the world conformed to such models, if there were a fixed world stock of capital, governments could collect more tax by operating a tax cartel. It would be in their collective interest to eliminate tax competition. In such models, it would make sense for a UK government to pressure its dependent territory governments to put up their tax rates and compensate them for any revenue lost by paying subsidies (increased foreign aid) out of the increased revenue generated by driving capital back to the UK.

However, the implicit assumption of the OECD model is quite wrong. The world supply of capital is not fixed and depends on the net rate of return. If all governments increase the tax burden on capital income, world capital accumulation slows down and economic growth will slow. Once this fundamental error of the harmful tax competition model is grasped, the concept collapses - it is really a new

mercantilist error of the kind excoriated by Adam Smith.

### The zero optimal tax rate on capital

A key question is whether all forms of income should be taxed equally. Leaving aside ethical views in favour of graduated income taxes,<sup>16</sup> the answer depends on how responsive different parts of the tax base are. Income is not a homogeneous tax base.<sup>17</sup> It is not sensible to tax all forms of income at the same rate if the factors of production generating the income are not all equally mobile. In particular, it does not make sense to tax mobile capital, especially capital supplied by foreigners, at the same tax rate as income arising from land or immobile labour tied to the jurisdiction. Though not essential to the case against the OECD’s views on harmful tax competition, it is reasonable to suggest that the optimal tax rate on capital income is zero. (By having a zero tax rate on interest income, Hong Kong to a large extent exempts that part of capital income which represents a riskless rate of return.)

The fundamental Ramsey principle of taxation is that taxes should be levied on those activities which are least responsive. One would not tax a factor of production which was in perfectly elastic supply. This has profound implications for internationally mobile capital. Theoretical models of optimal taxation produce three broadbrush results (Frenkel and Razin, 1996 chap 14):

*being a greater knave than most of his neighbours.”*

- 15 *That economic rent can even be increased by taxation if the proceeds are spent on useful public works or to remove taxes on labour or capital which will move in to use the land. See Mieskowski and Zodrow (1989) on this “Henry George” theorem, of which Hong Kong has afforded some demonstration (see Rabushka, 1979, p 62).*

- 16 *The view that all income should be taxed at graduated rates regardless of its source is a common, if not the prevailing, view among economists. Despite its popularity, it is essentially an ethical, not an economic, view and only one of several possible ethical views. But one does not have to get into such ethical debates to realise that a Brunei or a Saudi Arabia is quite within its sovereign rights in raising revenue solely from selling or leasing its natural resources (after*

*all, Adam Smith started his discussion of the sovereign’s revenues with land). A policy of looking first to resources for revenue also happens to allow reduction of economic distortions since one can reduce labour and capital taxation: Hong Kong’s low tax rates would not have been possible without its land revenues. But whatever ethical view one takes, the OECD cannot legitimately complain about countries which take a differentiated*

1. The optimal principle of international taxation is the residence principle; that is, non-residents should not be taxed on their capital income from a country.
2. The optimal tax rate on capital income from all sources is zero.
3. The optimal tax rule for a country that cannot enforce taxes on foreign source capital income is to abstain entirely from taxation of domestic source capital income as well.

Even in a closed economy, it may be efficient to exempt capital income from tax in the long run (Chamley 1986, Correia 1996).

The intuition behind these conclusions is not that difficult to understand, even though the policy implications are dramatic.

One would not tax non-residents on their capital income because that drives up the cost of capital to the local economy - non-residents can take their mobile capital and invest it elsewhere. By driving away mobile capital, the tax becomes an inefficient tax on immobile factors of production, such as immobile labour or land (Kopits 1992 p 5, 15). One should not tax the capital income of non-residents just as one does not outlaw foreign investment. One wants foreign capital to increase the productivity and wages of the local population.

Just as capital can flow across borders, so capital can evaporate over time. Hence, in the long run, the optimal tax rule is not to tax capital income at all. Taxing the return on capital lowers the capital intensity of

the economy and reduces the productivity and wages of labour. This is one of the major arguments for shifting from an income to a consumption tax base (although that can be done just as - or more - easily by exempting capital income from tax).

The third principle states that if capital income is to be taxed without distorting the allocation of investment then, other things being equal, it is desirable to tax income from domestic and foreign investments equally. But if one cannot tax foreign income equally - and even with the most sophisticated legislation that is likely - then one should cut the rate of tax on domestic capital income.

### Territorial revenues from land rents

A further fundamental defect of the harmful tax competition thesis is that it ignores territorially- fixed and stable sources of revenue such as land rents. Economic theory since the Physiocrats and Adam Smith has taught it is better to tax what is inelastic in supply (e.g. land) in preference to what is mobile (e.g. capital). Modern optimal tax theory is just another rediscovery of that principle.

Hong Kong, for example, has made a policy of raising much of its public revenue from land rents, which has enabled it to keep its tax rates on capital and labour comparatively low. That policy attracts capital investment which in turn pushes up land rents and enhances the (land) revenue base - a virtuous economic cycle. There is

nothing to stop developed countries such as the UK, the USA or Australia pursuing similar policies if they wish. Rather than complaining about "harmful tax competition" they would do better to emulate Hong Kong. For example, the US economic revival owes much to President Reagan's tax cuts and it is notable that the USA is somewhat more comfortable than the EU with economic competition (and internally has long lived with state tax competition).

Indeed, this leads to the logical point that international tax competition, by forcing governments to reduce tax rates on mobile capital income or mobile labour, is directing governments' attention to the desirability of shifting the tax base towards immobile factors (which includes full licence fees for natural monopolies such as the broadcast spectrum). Economic theory declares that the most desirable tax base is a tax on unimproved land values because it cannot be shifted and has no distorting effects on investment in physical capital or labour supply. The beauty of such territorial-based taxation is that it also solves the tax treaty issue - international double taxation becomes a non-issue and the OECD tax treaty network becomes unnecessary.

As countries have reduced their company tax and top marginal personal income tax rates, they have turned to value added taxes, user charges, expenditure co-payments, social security levies and mandated

*or schedular approach to income taxation (as have the Scandinavian countries). If, for example, Brunei does not collect a personal income tax for itself why should it be expected to assist other countries enforce their residence-based income taxes within Brunei's territory?*<sup>9</sup>

17 *In reality, there is no such thing as an income tax. As Adam Smith recognised, a tax on income is three taxes - a tax on the wages of labour, a*

*tax on the rent of land and a tax on the profits of capital.*

18 *The OECD complaint that tax competition forces a shift in tax burden from (mobile) capital to (immobile) labour not only ignores the possibility of taxing land or other natural resources but it also sounds rather odd coming from European countries which have willingly raised social security payroll taxes and value added taxes to extremely high levels.*

19 *"Arguments for creating a level playing field are troublesome at best. International trade occurs precisely because of differences among nations - in resource endowments, labour skills and consumer tastes. Nations specialise in producing goods and services in which they are relatively most efficient. In a fundamental sense, cross border trade is valuable because the playing field is **not** level. ... Taken to its logical extreme, the notion of leveling the playing field*

social insurance because there is less incentive or ability for such tax bases to leave the jurisdiction. Thanks to tax competition, tax policies are *de jure* shifting taxes from capital towards labour income, from the more mobile towards the less mobile factor. This could be to labour's advantage as *de facto* shifting is eliminated and jobs and wages are nourished by increased investment.

But the process can - and should - go further than simply shifting taxes from capital to labour.<sup>18</sup> As Kopits (1992 p 5) notes, a country can use its resource rents to respond successfully to tax competition for mobile capital. Although there does not seem to have been an international trend to shift taxes from capital income to land (as opposed to labour, which raises its own problems), some observers have noted that Hong Kong and Singapore have been able to compete on their company tax rates because they have placed heavier reliance on taxing land. Professor Martin Feldstein, former Chairman of the US Council of Economic Advisers, acknowledges (1976, p 96) that a tax on unimproved land values "involves no distortion" and is clearly efficient.

So, economic freedom and international tax competition are *world* welfare enhancing. Far from hurting the OECD, it is nudging OECD countries towards optimal tax policies which are in the best interests of their citizens.

### Who says what is a "level playing field"?

Another key theoretical defect of the OECD report lies in its concept of the "level playing field". It appears to be assumed that the optimal approach to maximising world economic growth consists of identical tax and regulatory systems. But why should this be so?<sup>19</sup> The absurdity of the proposition is immediately obvious if it were suggested to OECD countries that they should now harmonise on a Soviet-style command economy system. If the countries of the world cannot all agree on the first-best taxation system of taxing land rents, is that any reason why some countries should not do so and become tax havens for the avoidance of other countries' less efficient taxes? It might also be pointed out that OECD countries often cannot agree themselves on what the regulatory level playing field shall be. For example, New Zealand has not taken the view that insider trading should be a criminal matter but treated as a civil law matter between a company, its employees and others having a fiduciary duty.

The reality is that, while comparative advantage is a basic source of gains from international trade and commerce, comparative advantage may be largely man-made. It may depend substantially on how countries tax and spend (e.g. whether they spend on infrastructure or age pensions) and how they regulate or tax mobile business. Countries which are resource-rich are sometimes poor because of oppressive government and oppressive taxation

while countries which have little by way of natural resources (e.g., Switzerland, Singapore and Hong Kong) have sometimes become rich by pursuing policies of good government and lower business taxation. A perfect identity of regulatory systems in search of a level playing field can destroy the gains from trade and deny the world the beneficial demonstration effects of genuine free market economies. The offshore financial centres could do worse than remind Europeans and Americans that European civilisation rose to greatness not from the slavish Imperial uniformity of the later Roman Empire but from the competition between the nation states which succeeded it.<sup>20</sup> It was the ability to cross a frontier or cross the Atlantic and escape from tyranny which protected the vitality of Western culture and enterprise. The Anglo-American tradition is one of liberty rather than uniformity.

The offshore financial centres might also point out that federations such as the USA and Australia have lived with tax competition for decades without disintegration. A New Hampshire or a Queensland has not only served its own interests by following a low-tax policy but also, by putting pressure on the tax policies of neighbouring states, has helped to keep economic activity within the federation as a whole.

In the international sphere, the USA and the UK have long engaged in tax competition. The USA is an offshore banking tax haven while the UK rules granting the remittance system to non-

*implies that nations should become homogeneous in all major respects .... [but the] core of the idea of political sovereignty is to permit national residents to order their lives and property in accord with their own preferences."* in Tanzi (1995, preface p xvii)

<sup>20</sup> Douglass North (1995, p 32) also argues that European development profited from institutional competition between competing nation states.

<sup>21</sup> Although it is treated as axiomatic by many writers that foreign income should be taxed, it is not clear that this is so. Suppose, for example, another country raises all its tax revenue through consumption or payroll taxes. The idea that a dividend from that country represents untaxed income is somewhat naive. Further, unless that foreign country supplies the same level of public services to an investor in return for low or no

taxes, one cannot assume that taxing the investor at home produces a neutral result. For example, a company operating in Liberia may pay no tax but would be spending considerable amounts of money on providing the sort of physical protection which home taxes would provide. There is thus both pragmatic and theoretical justification for the policy adopted by more than a few Asian, European and Latin American



domiciled residents has meant that London has been a tax haven for many wealthy expatriates.

Without a refund system for embedded state indirect taxes on exports and with a system of taxing worldwide income, the USA stands to disadvantage itself uniquely by continuing to endorse the OECD attack on “harmful” tax competition. Having felt the sting of international tax conformity in the form of the adverse World Trade Organisation ruling on its foreign sales corporations, the USA would do well to reconsider its support for the OECD and EU attacks on tax competition. The US Congress is starting to ask itself the right questions by examining a bill to implement a territorial system for taxing business income.<sup>21</sup>

## Conclusion

The governments and citizens of offshore financial centres should remember what John Maynard Keynes wrote in “The General Theory of Employment, Interest and Money”. He remarked that “the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power

of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or for evil.”

Because mistaken and unexamined OECD nostrums on tax competition are affecting world economic policies by appealing to the prejudices of EU and other politicians, offshore financial centres should undertake their own research to examine the “harmful” tax competition issue so that the implicit errors of OECD policy reasoning can be debated openly and flushed out. They need to enter the global economic policy debate. Ideas matter!

The governments and citizens of offshore financial centres are entitled to resent strongly a situation in which they are being pressured (or pilloried) by the OECD on the basis of wholly incomplete economic theorising. They need to point out to the OECD that the remedy for the alleged “harm” of tax competition lies in the hands of OECD countries themselves. No offshore financial centre is preventing any OECD country from privatising or implementing “user pays” for social

insurance. No offshore centre is forcing any OECD country to have a bloated welfare state or impose high taxes on labour and capital. No offshore financial centre is preventing any OECD country from taxing immobile land and resource rents which are immune to tax competition.

Offshore financial centres have no reason to cut their own incomes by winding back their services. As parts of Adam Smith’s “invisible hand” they serve not only their own, but the world’s interests, by facilitating the freedom of trade and investment and the protection of property. Those who seek to eliminate offshore financial centres might do damage to their own countries were they to succeed.

No doubt, offshore financial centres should cooperate as good international citizens in combating common criminality. But they should politely decline any suggestions to harmonise taxes or to assist OECD tax enforcement directly or indirectly through any exchange of information. Perhaps some offshore financial centres may be coerced or bribed by the OECD to join its tax cartel, but, as with all cartels, the fewer there are outside the cartel the greater the profits to be had by them. Notwithstanding the current clouds over offshore financial centres, it is hard to see anything but increased demand for their services so long as there is scorn elsewhere for “the obvious and simple system of natural liberty” which commended itself to the Physiocrats and Adam Smith.<sup>22</sup>

*countries of excluding foreign income from the tax base. Interestingly, the USA has spent the most effort over the years trying to tax foreign income, but at the same time invented foreign sales corporations to try to mitigate the adverse effects on American exports! The USA may get no tax revenue from its foreign tax regime because the USA credits foreign taxes and allows active income of subsidiaries to remain*

*untaxed (Grubert and Mutti 1995). The use by US companies of low rate havens may even enhance US tax collections (Hines and Rice, 1994). A territorial system of international taxation of business income has been suggested for the USA (Hufbauer, 1992 p 135-136). The tax-writing committee in the House of Representatives is considering a Bill to replace the corporate income tax (and the business parts of the personal*

*income tax) with a business transfer tax that would be territorial. This may not happen, but the World Trade Organisation decision that the US Foreign Sales Corporations were in breach of WTO rules has created a new US appreciation for territoriality (though part of the motive for the Bill is border-adjustability for indirect taxes).*

<sup>22</sup> Adam Smith (1776, p 687).

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