The Real Story of the Tax Haven War

By Daniel J. Mitchell

Martin A. Sullivan’s recent analysis (“Lessons From the Last War on Tax Havens,” Tax Notes, July 30, p. 327, Doc 2007-17436, 2007 TNT 147-5) was an interesting look at the status of the OECD’s anti-tax-competition campaign. Using a review of Jason Sharman’s excellent new book (Havens in a Storm: The Struggle for Global Tax Regulation) as a springboard, Sullivan concludes that the OECD largely has failed in its efforts to force so-called tax havens to change their domestic laws for the benefit of foreign tax collectors.

I certainly do not disagree with this general conclusion, and I also appreciate a mention of my small role in the demise of the OECD’s anti-tax-competition scheme, but there are several elements of the article that merit a response.

Sins of Omission

Most relevant are the sins of omission. In his discussion of the history of the tax competition fight, Sullivan mentions that the OECD put together a blacklist of so-called tax havens. He also lists the criteria that were used to develop this list. But he should have revealed the hypocrisy of the exercise. When the OECD put together the blacklist, it conveniently chose to identify only non-member jurisdictions — even though OECD nations such as Austria, Belgium, the U.S., Switzerland, the Netherlands, Luxembourg, and the U.K. all qualify as havens, according to the Paris-based bureaucracy’s own definition. Moreover, these OECD nations control 80 percent of the world’s “offshore” market, so this is not just nitpicking.

But this is just part of the hypocrisy angle. The OECD also was deliberately careful to blacklist only the smallest and least powerful jurisdictions. Singapore, Uruguay, Hong Kong, and Malaysia were among the bigger non-OECD jurisdictions that somehow were omitted from the original list of havens. No wonder the blacklisted jurisdictions were able to exploit the hypocrisy angle. But some discussion of how the OECD operated in bad faith would have given a more accurate portrayal of what really happened.

Sullivan also should have included some discussion of how the OECD misjudged when it threatened blacklisted jurisdictions with financial protectionism. The article did list many of the so-called defensive measures (a rather ironic term, somewhat akin to Hitler’s defensive attack on Poland) proposed by the OECD, but there was no mention of how these discriminatory sanctions were inconsistent with WTO rules. Since at least one former OECD staffer has gone public with the turmoil this caused inside the Paris-based bureaucracy and trade experts also have written about how the sanctions are noncompliant with treaty obligations, this issue should have been discussed.

The biggest sin of omission, however, was the absence of any economic analysis, particularly how tax havens are playing an important role in the tax-competition-induced shift to lower tax rates and better tax policy around the world. There is an old joke with the punch line “Other than that, Mrs. Lincoln, how was the play?” Turning that around, Sullivan’s article on tax havens is akin to a review of the April 14, 1865, performance of Our American Cousin without mentioning the assassination of President Lincoln.

In reality, the assault on tax havens is an effort by politicians from high-tax nations to resist the liberalizing impact of globalization. While their ideological beliefs may be wrong, they are correct to be concerned. The increased mobility of labor and capital is a nightmare for statist politicians. The global shift to lower tax rates began more than 25 years ago with Margaret Thatcher and Ronald Reagan. Combined with the growing ability of taxpayers to shift resources to tax havens, this created enormous pressure on politicians to make their tax regimes less onerous. In other words, politicians felt compelled to lower tax rates to prevent jobs and investment from fleeing to jurisdictions with better fiscal policy.

The impact of this tax competition has been enormous. Top personal income tax rates have been reduced by more than 100 percentage points since 1980. Corporate rates have dropped by more than 20 percentage points in the same time span. And there are now about 20 countries with simple and fair flat tax systems, and many nations have implemented low tax rates for capital income, abolished wealth taxes and death taxes, or done both.

But even though these reforms have boosted the global economy, many politicians want to stop tax competition (bitterly complaining about a race to the bottom even though overall tax revenues are at all-time highs),
and this is the real reason for the OECD’s anti-tax-competition project. Defenders of the Paris-based bureaucracy sometime argue with this assertion, but the 1998 report that launched the campaign specifically complained that tax competition is “re-shaping the detailed level and mix of taxes and public spending” and that tax competition “may hamper the application of progressive tax rates and the achievement of redistributive goals.”

Acting at the behest of politicians from high-tax nations, the OECD was trying to create a tax cartel. But an OPEC for politicians would be damaging to taxpayers and macroeconomic performance in the same way the real OPEC is damaging to energy consumers and macroeconomic performance.

Another critical omission is that Sullivan completely neglects the important role of tax havens for the oppressed people of the world. Americans sometimes do not realize how lucky we are. We may complain about our government — often with good reason — but our liberties and freedoms are largely intact. For a majority of the world’s population, this is not the case. There is still widespread persecution and discrimination targeting ethnic, religious, political, sexual, and racial minorities. For people who are potential or actual victims of state-sanctioned mistreatment, tax havens enable them to shelter their assets from corrupt and venal governments.

Similarly, there are people who live in countries with incompetent or despotic governments. A family in Venezuela almost certainly will put their money in New York, Miami, or the Cayman Islands because corrupt government tax officials would likely expropriate their assets or sell their confidential information to kidnappers. A rancher in Zimbabwe will put his money in London or the Channel Islands rather than let the thuggish Mugabe regime steal the funds. These issues are so important that even the OECD’s Jeffrey Owens was forced to concede that financial privacy is desirable. As reported by the U.K.-based Observer, “Owens . . . stressed that tax havens are essential for individuals who live in unstable regimes.” And Joe Guttentag, a former Clinton-era Treasury Department official who was closely involved with the OECD’s anti-tax-competition campaign, spoke at an American Enterprise Institute conference, where he admitted, “How far do we want to go with this information exchange, and the secrecy issues, the privacy issues, and so forth, which relates to the problems of corrupt governments, of danger to your children and to individuals? That subject should be discussed.”

Setting the Record Straight

The article also contains a few misleading (and unsupported) assertions. Sullivan writes that compliance rates for offshore accounts remain very low, but he bases that on nothing more than a shot-in-the-dark estimate from the IRS. But because the tax agency has an obvious incentive to exaggerate evasion to justify bigger budgets and more staff, this is hardly an unbiased source. The article also includes a chart showing the amount of money (other than bank-to-bank deposits) in Cayman banks, but these numbers tell readers nothing about evasion of U.S. tax law. The bulk of those deposits are probably institutional funds, with a good chunk also coming from non-Americans. Moreover, because there is a tax information exchange agreement between the Cayman Islands and the U.S., common sense tells us that very little of that money is hiding from the IRS. To Sullivan’s credit, at least he did not regurgitate the $70 billion offshore evasion figure concocted by a former John Kerry staffer, a number that was discredited when the former staffer admitted to the Congressional Research Service that — for all intents and purposes — the number was his personal guess.

Sullivan also links tax havens with money laundering and terrorist financing, but dirty money is much more likely to be found in “onshore” banks. There is not a single tax haven, for instance, on the Financial Action Task Force’s blacklist. Moreover, every major tax haven is a member of the Egmont Group, and membership in the international coordinating body for Financial Intelligence Units is not open for regimes with lax attitudes to money laundering. Additionally, all the major tax havens have received “qualified intermediary” status from the IRS, indicating high-quality anti-money-laundering laws. And even the State Department reports that “onshore” nations are more likely to be “major money laundering countries.” None of this should be surprising, especially since an overwhelming share of the world’s dirty money is obtained because of the drug trade in nations like the U.S. The notion that drug dealers and other criminals rely on offshore banks is rather fanciful since they can only wire money offshore if they first deposit it onshore. Yet if they get the money in an onshore bank, the laundering already has been successful, so why would they create additional risks and call more attention to themselves by sending it offshore (even the United Nations acknowledges that this would not make sense, because it raises a red flag for authorities)?

The article also errs by implying that the EU savings tax directive is a model for the type of automatic and unlimited information sharing desired by high-tax nations. At one point, proponents did hope that the savings tax directive would require the then 15 nations of the EU (as well as 6 non-EU nations, most notably Switzerland and the U.S.) to automatically collect financial data about nonresident investors and then share it with the tax authorities of other nations. But for several reasons — including America’s refusal to participate and Switzerland’s refusal to sign any agreement that would either violate its human rights policy regarding privacy or threaten its financial services industry — the directive that was implemented was a hollow shell of the original proposal. There is no requirement today for automatic information exchange, and no obligation for automatic information exchange in the future. Moreover, the directive applies only to interest paid to “natural persons,” which means that German dentists with accounts in Luxembourg and French entrepreneurs with accounts in Switzerland easily can structure their affairs to avoid what is called the “dummy tax.”

Sullivan also claims, with no evidence, that tax evasion results in higher taxes on the law-abiding taxpayer. This assertion naively assumes that tax levels are exogenous, yet even a cursory examination of fiscal data shows that the relentless rise in tax levels during the 1960s and 1970s came to a halt once globalization and tax
Thinking Outside the Code
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Last November, attorney David K. Colapinto, fresh off his astounding victory in *Marrita Murphy v. IRS*, No. 05-5139, Doc 2006-15916, 2006 TNT 163-3 (D.C. Cir. Aug. 22, 2006), told an assembly of tax attorneys and judges, in the course of discussing the meaning of the term "income" and his client’s success to that point, "You have to think outside the code!" (*Tax Notes*, Nov. 6, 2006, p. 521, Doc 2006-22442, 2006 TNT 213-1.)

In *Murphy*, the D.C. Circuit originally held damages for some nonphysical injuries not to be income. The circuit has since reversed itself and held the damages to be income. *Marrita Murphy v. IRS*, No. 05-5139, Doc 2007-15777, 2007 TNT 129-4 (D.C. Cir. July 3, 2007).

Colapinto’s statement sounds ridiculous. This article will show, however, that there is still a significant question regarding the term "income" and that we should not be content to think within the code only.

Recall that Article I, section 8 of the Constitution authorizes Congress to "collect taxes, duties, imposts, and excises." The limitation under Article I is that if the tax falls directly on the income-producing capital itself, the tax must be apportioned among the states.1

In 1913 the 16th Amendment to the Constitution was ratified, empowering Congress to "tax income without apportionment." The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”

Congress has relied exclusively on its authority under the 16th Amendment to tax income. The relevant legislative history explains: “Section 61(a) [of the Internal Revenue Code] provides that gross income includes ‘all income from whatever source derived.’ This definition is based upon the 16th Amendment and the word ‘income’ is used in its constitutional sense.”2

Neither the 16th Amendment nor section 61(a) of the code defines income. Section 61(a) merely gives examples.

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1U.S. Constitution, Article I, section 9, clause 4.