Behind the tax haven taboo

Too much sloppy thinking concerns itself with evasion. Low-tax and no-tax environments offer many social benefits, writes Daniel J Mitchell.

So-called "tax havens" have been mercilessly attacked in recent years by both national governments and international bureaucracies. These tax-efficient jurisdictions have been accused of facilitating tax evasion, but that is just the tip of the iceberg. According to critics, tax havens are responsible for everything from money-laundering to financial instability. Representing the interests of 30 industrialised nations, the Organisation for Economic Co-operation and Development (OECD) even issued a black list of selected low-tax jurisdictions in 2000, threatening them with financial protectionism if they did not change their laws to make it easier for high-tax nations to track – and tax – flight capital. Other international bureaucracies, including the European Commission and the United Nations, also have anti-tax haven initiatives.

Depending on the specific accusation, the attacks against the offshore world are hypocritical, misguided or inaccurate. The OECD's assault against about 40 offshore regimes is a good example of hypocrisy run amok. Officials at the Paris-based bureaucracy get tax-free salaries, yet these are the people leading the charge to condemn some jurisdictions for having supposedly inadequate levels of taxation. But this is a trivial example of hypocrisy. The bureaucracy's black list is a much more important example of double standards, since only non-OECD jurisdictions were targeted, even though nations such as the United Kingdom and the United States also qualify as tax havens.

Creating an unbiased list of tax havens would reduce hypocrisy, but the more fundamental issue is whether such jurisdictions should be persecuted or celebrated. There have been dramatic tax rate reductions around the world in recent decades – reforms that have improved global economic performance and lowered world poverty.

Tax havens almost certainly played a key role since politicians were motivated, at least in part, by a fear that punitive tax rates were driving money offshore. Similarly, many nations have deregulated financial markets – reforms that enhanced the efficiency and affordability of credit. Once again, tax havens were valuable players since politicians were at least somewhat motivated by a need to respond to competition from offshore financial centres. But this is not just a fiscal policy issue.

Tax havens also play a critical role in protecting people victimised by crime, corruption, expropriation and mismanagement, as well as those subject to ethnic, religious, political, racial and sexual discrimination.

Notwithstanding demagoguery from politicians, tax havens are good for the global system. Whether they are onshore or offshore, these jurisdictions expand global commerce, boost economic performance, discourage bad government policy and protect human rights.

World's biggest tax havens

Writing for *Tax Notes International* in 2001, Marshall Langer, one of the world's leading offshore experts, noted:

"It does not surprise anyone when I tell them that the most important tax haven in the world is an island. They are surprised, however, when I tell them that the name of the island is Manhattan. Moreover, the second most-important tax haven in the world is located on an island. It is a city called London in the United Kingdom."

Langer then cited policies in both the United States and United Kingdom that made them attractive to tax-savvy non-resident investors. Other experts have confirmed Langer's diagnosis, including the International Monetary Fund, which just published a study identifying the UK as an offshore centre, and the US Government Accountability Office, which issued a report on state-level tax haven policies in America.

Even the OECD, for all intents and purposes, admits that the US and UK are tax havens. In a 2006 report, it confessed that both the US and UK allow bearer shares and bearer debt instruments. Moreover, the OECD report admitted that neither nation collects the company ownership information needed to help enforce foreign tax law. Other policies, which the OECD neglected to mention in the report, include the US practice of not collecting information about certain types of interest and capital gains paid to non-resident aliens and the UK policy of offering favourable "non-domiciled resident" tax status to wealthy foreigners.

These policies are all important because a tax haven is a jurisdiction with policies that (either deliberately or unintentionally) make it difficult if not impossible for another jurisdiction to enforce its tax law. The OECD's definition of a tax haven specifically focuses on the collection and sharing of information about the activities of foreign nationals. The United States and United Kingdom clearly qualify, though neither nation was added to the OECD's black list.

But the US and UK are not the only onshore tax havens. Switzerland and Luxembourg are among the world's premier financial centres for non-residents. Yet, because they are OECD members, they also dodged the black list. Belgium, Austria and The Netherlands also qualify as tax havens, but their OECD membership resulted in a free pass as well.

With so many first-rate tax havens in its membership, it perhaps should not be surprising that the onshore community of OECD nations has captured 80% of the world's offshore market.

This raises a rather obvious question about what is really motivating the OECD's anti-tax competition project. Representatives from jurisdictions on the black list quite understandably suspect the effort is designed to squash competition in the financial services sector from smaller and less powerful nations. They argue that their governments should not be bullied into changing their laws unless OECD nations agree to the same rules.

This "level-playing-field" argument has proven quite powerful, and is one of the main reasons why the OECD's campaign against tax competition has been stymied.

But the big-states-persecuting-small-states hypothesis is probably not the full explanation. Critics of tax competition, including many politicians from high-tax nations, activists from radical organisations like the Tax Justice Network, and (almost certainly) bureaucrats at the OECD, want to curtail all tax-haven policies, but a wholesale assault on every nation's fiscal sovereignty would have been politically futile. This is why the OECD's campaign should be viewed as just the first step on a long march. The bureaucracy's black list was just a means of going after the supposedly easy targets first. The OECD anti-tax competition effort also should be recognised as being just one element of a multiprong effort. The European Commission has a number of proposals designed to hinder tax competition, and the United Nations also is pushing anti-tax competition schemes – including a proposed International Tax Organisation.

Opec for politicians

In other words, the OECD's actions reek of hypocrisy, but the bureaucracy's ultimate goal may be to create a level playing field. But the field would only be level in the sense that all governments agreed to participate in a cartel to constrain tax competition. From the perspective of taxpayers, the field would be dramatically tilted in favour of government.

This has dramatic – and unfortunate – implications for economic policy. As already noted, tax competition has helped encourage policymakers to lower tax rates and reform tax systems. The top personal income tax rate in developed nations, for instance, has dropped by 25 percentage points since 1980. The average corporate rate has dropped by 20 percentage points over the same period. There are now 17 flat-tax nations, with several more countries likely to follow suit in the near future. Other nations have eliminated death taxes, abolished wealth taxes and slashed tax rates on interest, dividends, and capital gains.

These reforms have yielded big benefits for the global economy. Lower tax rates on productive activity have unleashed a torrent of entrepreneurial activity. Citizens around the world are enjoying more prosperity and higher living standards. Tens of millions of jobs have been created and hundreds of millions of people have been pulled out of poverty. And even though politicians often did not like being pressured to cut tax rates, it is worth noting that tax revenues in almost every nation are at all-time highs because lower tax rates helped generate an increase in taxable income.

But imagine if politicians back in 1980 had agreed to block tax competition and instead decided to set up an "OPEC for politicians". Punitive tax rates would probably still exist and the global economy would likely be suffering from the stagnation and instability that characterised the 1970s. The regulatory burden would still be onerous, hindering the effective and affordable allocation of capital.

Tax haven critics doubtlessly will assert that it is unfair to link the anti-tax competition scheme with the economic misery of the 1970s, but OECD publications contain ideological statements that leave little doubt about the bureaucracy's mindset. A report in 1998 noted:

• Tax competition is "reshaping the desired level and mix of taxes and public spending"; and
• Tax competition "may hamper the application of progressive tax rates and the achievement of redistributive goals".

A follow-up report in 2000 echoed the same themes:

• Low-tax policies "unfairly erode the tax bases of other countries and distort the location of capital and services".
• "Tax should not be the dominant factor in making capital allocation decisions."

Pro-growth scenario

An overlooked aspect of the tax competition debate is the reliance of unilateral – and unsubstantiated – assumptions. The OECD, for instance, asserts that taxes should not be allowed to influence the allocation of resources, but the bureaucracy offers no evidence or data to justify this assertion (whereas evidence on the pro-growth impact of lower tax rates, often induced by tax competition, is abundant).

Having fabricated a problem that does not exist, the OECD then asserts that the solution is for low-tax nations to sacrifice their fiscal sovereignty and change their laws so that jobs and capital have less reason to escape high-tax nations.

But if representatives of high-tax nations think that differences in tax rates truly are a problem, they could unilaterally solve the alleged problem by reducing their tax rates and reforming their tax systems. Indeed, nations such as Ireland and Estonia have moved in this direction, leading to faster growth and better tax compliance. But the nations that dominate the OECD, such as France and Germany, are resistant to economic reform. They want a level playing field, but only if it means that all parties agree to abide by rules that benefit high-tax nations.

The distinction between a level playing field that promotes growth and one that does not is insufficiently appreciated. Tax havens on the OECD black list have made “commitments” that they will adopt bad tax policy if the “onshore” tax havens do likewise. This is a smart tactic to win a battle, but it may be a poor strategy to win a war.

The level-playing-field condition has been a good short-term tactic because it exposed OECD hypocrisy and created a stalemate. But what would happen if the United States, the United Kingdom, Switzerland, and Luxembourg suddenly decided to eliminate their tax haven policies? Low-tax jurisdictions would then be in a bind since they based their strategy on a level playing field but allowed the OECD to define how it is achieved.

This scenario may seem unlikely, but political changes in OECD nations may create an opportunity for high-tax nations to regain the initiative.

In the UK, Gordon Brown is poised to become prime minister and he is to the left of Tony Blair on fiscal policy issues and has a long track record of undermining the interests of UK territories on the OECD black list. Both factors do not bode well for the tax competition debate.

In the US, it is quite likely that Democrats will control both Congress and the White House after the 2008 election. And it is worth noting that the US was an active supporter of the OECD’s “harmful tax competition” project during Bill Clinton’s presidency.

To be sure, political changes in the UK and US do not necessarily mean changes in the tax haven polices of the two nations. Moreover, the playing field would not be level so long as OECD nations such as Switzerland and Luxembourg kept their policies.

And there are other tax haven jurisdictions – such as Hong Kong and Singapore – that also would be required to change their laws for a level playing field to exist. While these are significant obstacles, the OECD has the luxury of a large staff and an extravagant budget. The bureaucracy can wage a relentless campaign to slowly but surely erode tax competition.

Benefits of financial privacy

The attack against tax havens has negative economic implications, but there are other compelling reasons to defend jurisdictions with financial privacy protections.

The vast majority of the world’s population lives in nations that fail to provide the basic protections of civilised society. Corruption often is rampant, expropriation is common, crime is endemic and there is widespread persecution of religious, political, ethnic, racial and sexual minorities. In such environments, people with money frequently are the targets of oppression.

But if such people have the ability to place their assets in a jurisdiction that protects financial privacy, they are much more likely to avoid persecution.

Likewise, people who live in regimes plagued by political instability or economic mismanagement are at great risk of losing all their assets and thus putting their families at risk. But if such people have the ability to use tax havens, they are much more likely to avoid financial calamity.

The United Nations has even admitted the need for individuals to be protected from oppression. A 1998 report published by the UN noted that “serious issues arise when Governments engage in human rights violations. For much of the 20th century, governments around the world spied on their citizens to maintain political control. Political freedom can depend on the ability to hide purely personal information from a government.”

Even the leader of the OECD’s anti-tax competition campaign, Jeffrey Owens, was compelled to recognise the role of tax havens as a bulwark for the protection of human rights. As reported by the UK-based *Observer*, “Owens... stressed that tax havens are essential for individuals who live in unstable regimes.” And a former Clinton-era treasury department official who was closely involved with the OECD’s anti-tax competition campaign admitted, “How far do we want to go with this information exchange, and the secrecy issues, the privacy issues, and so forth, which relate to the problems of corrupt governments, of danger to your children and to individuals? That subject should be discussed.”

Conclusion

Many “onshore” nations are tax havens, and this is a good thing. Tax havens, wherever they are based, promote good fiscal policy and protect human rights.

The anti-tax competition campaigns of international bureaucracies, by contrast, are based on bad economics and dubious morals. If high-tax nations want to reduce tax evasion, they should fix their tax systems.

Thanks to tax competition, this process already is under way, but many politicians from high-tax governments – particularly in Europe – are fighting to preserve their uncompetitive welfare states. The narrow and selfish agenda of these politicians should not be allowed to undermine the valuable role of tax havens in the global economy. ■