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The Adverse Impact of Tax Harmonization and Information Exchange on the U.S. Economy

The United States is the world's biggest beneficiary of jurisdictional tax competition. A modest tax burden, combined with advantageous tax and privacy laws for nonresident aliens, has helped attract more than \$9 trillion of foreign investment to the U.S. economy. This translates into more jobs and higher incomes for American workers. European-sponsored tax harmonization initiatives would undermine this competitive advantage. At the behest of uncompetitive nations like France, international bureaucracies want to give high-tax governments the power to tax income earned in low-tax jurisdictions. This is a direct threat to America's economic interests. Tax harmonization proposals such as "information exchange" would make America much less attractive to the world's investors and likely would result in a significant loss of capital.

By Daniel J. Mitchell

Tax competition occurs when governments are unable to increase tax rates because economic activity can shift to lower-tax jurisdictions. To stop this process, the Organization for Economic Cooperation and Development (OECD), the European Union (EU), and the United Nations (UN) are advocating tax harmonization.¹ In some cases, the international bureaucracies want to rig tax rates at high levels. In other cases, they want to give nations the power to tax income on a "worldwide" basis so that taxpayers face home-country tax rates regardless of where they work, save, or invest.

There is widespread agreement among American policy makers that tax harmonization is a bad idea. But there also is a temptation to ignore these bureaucratic initiatives. After all, America need not participate in any global tax cartels, so it is thought that these schemes pose no danger to America's economic interests. Yet, as the matrix on page 3 indicates, this optimistic attitude is a major mistake. The United States is the world's biggest beneficiary from international tax competition – and this makes America the biggest target for tax harmonizers.

¹ The OECD is a Paris-based bureaucracy representing 30 industrialized nations. Most of its members are high-tax European nations. The OECD's report, "Harmful Tax Competition: An Emerging Global Issue," can be found at http://www.oecd.org/daf/fa/harm_tax/Report_En.pdf. The European Union is a Brussels-based bureaucracy representing the 15-member European Community. A description of the European Union's "Savings Tax Directive" can be found at http://europa.eu.int/comm/taxation_customs/publications/official_doc/IP/ip011026/memo01266_en.pdf. The United Nations is based in New York and it professes to represent the entire world. The UN's proposal can be found at <http://www.un.org/esa/ffd/a55-1000.pdf>.

The tax burden in the United States is low compared to other industrialized nations. Equally important, America has attractive tax and privacy laws for nonresident aliens that help attract trillions of dollars from foreign investors. These pro-growth policies have enabled America's economy to easily out-perform the tax-crippled economies of Europe's welfare states.

European high-tax nations are the driving force behind the OECD, EU, and UN proposals, and politicians from these uncompetitive countries understand that their tax harmonization initiatives will fail unless the United States is pressured to change its laws. Trying to create a tax cartel without U.S. participation, after all, would be like trying to set up a hardware store cartel without Home Depot or a software cartel without Microsoft. That is why all three of the tax harmonization initiatives are designed – at least in part – to slowly but surely pressure U.S. policy makers into sacrificing America's fiscal sovereignty.

The stakes in this battle are immense. The market value of foreign investment in the U.S. economy at the end of 2000 was almost \$9.4 trillion.² Most of this investment currently is protected from foreign taxation, but the tax harmonization proposals of the OECD, EU, and UN would allow foreign governments to tax that U.S.-source income. For instance:

- American institutions, both banks and non-banks, held more than \$1.8 trillion in deposits from overseas at the end of 2000.³ Tax harmonization schemes would enable foreign governments to tax the interest on these deposits.
- Foreign investors owned nearly \$1.4 trillion of corporate and agency bonds at the end of 2000.⁴ Tax harmonization schemes would permit foreign governments to tax interest on these bonds and to tax capital gains if the bonds are sold.
- Overseas investment in U.S. stocks reached nearly \$1.6 trillion by the end of 2000.⁵ Tax harmonization schemes would allow foreign governments to tax dividend payments and to tax capital gains if the stocks are sold.
- Foreign direct investment in the United States climbed to more than \$2.7 trillion by the end of 2000.⁶ Tax harmonization schemes would allow foreign governments to more easily tax a portion of the income generated by those investments.

² Harlan W. King, "The International Investment Position of the United States at Yearend 2000," Survey of Current Business, U.S. Department of Commerce, July 2001.

³ *ibid.*

⁴ *ibid.*

⁵ *ibid.*

⁶ *ibid.*

- Foreign-born residents of the United States, including both citizens and resident aliens, had \$593 billion of income in 1999.⁷ Tax harmonization schemes would allow foreign governments to tax a portion of that income.
- Private holdings of U.S. government securities by foreigners at the end of 2000 were nearly \$640 billion.⁸ Tax harmonization schemes would make it possible for foreign governments to tax interest on these bonds and to tax capital gains if the bonds are sold.

Why Some Believe America is Safe...	...But there is A Real Threat to U.S. Economic Interests
<p>The OECD is persecuting relatively powerless low-tax jurisdictions like Barbados, Andorra, and Mauritius. The United States is not on the OECD's list of so-called tax havens, so America has no stake in the outcome.</p>	<p>The OECD uses four criteria to define a tax haven, and a jurisdiction meets the definition if only two of the conditions apply. The United States clearly satisfies three – and probably four – of the criteria. The precedent created by the OECD's "harmful tax competition" campaign therefore can be used to undermine America's fiscal sovereignty and competitive advantage in the world economy.</p>
<p>The EU is a European bureaucracy. The United States, therefore, should not be concerned about EU tax harmonization and information exchange initiatives.</p>	<p>The EU's major tax harmonization initiative is the "Savings Tax Directive," a scheme that would enable high tax countries to impose their tax rates on any savings income their residents earn in a low-tax country. This proposal is contingent on American participation, and thus would significantly reduce the flow of international capital to the U.S. economy. The EU also is interfering with U.S. tax policy by asking the World Trade Organization to rule that provisions of our tax code, such as FSC, are impermissible.</p>
<p>The UN is an inconsequential institution with no power. And besides, the United States has veto power over all UN proposals.</p>	<p>The UN's "Financing for Development" proposal endorses much of what the OECD and EU are seeking, but also calls for the creation of an International Tax Organization that would have power to undermine tax competition. Even more worrisome, the UN proposes to give nations the power to tax emigrant income, a ploy that would have particularly adverse affects on America because of the large numbers of skilled immigrants.</p>

⁷ Bureau of the Census, *Current Population Survey*, March 2000.

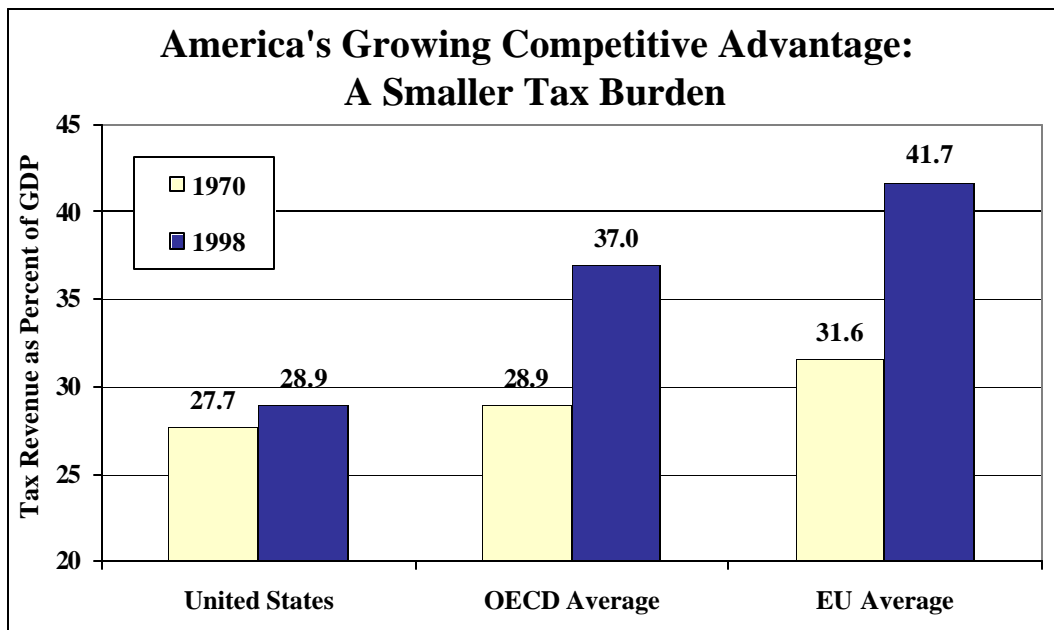
⁸ Harlan W. King, "The International Investment Position of the United States at Yearend 2000," *Survey of Current Business*, U.S. Department of Commerce, July 2001.

International tax harmonization schemes would mean pervasive erosion of U.S. fiscal sovereignty. This would have profound economic consequences. A substantial portion of foreign investment in America is driven by tax considerations. America is a safe haven, a place for people fleeing fiscal oppression. With few exceptions, the U.S. government does not tax the investment income of nonresident foreigners. And since foreign governments are not told about this income, it is very difficult for them to tax it either. This combination of low taxes and financial privacy means America is a tax haven.

The American economy will suffer if foreign governments get the power to tax income earned in the United States. Investors from overseas, seeking to protect their assets, will shift their money to other jurisdictions. This means less investment in the American economy, fewer jobs for American workers, and substantial declines in financial markets. The United States is the world's biggest beneficiary of international tax competition, so it should come as no surprise that America would suffer the greatest damage if tax systems are harmonized.

Low Taxes: America's Competitive Advantage

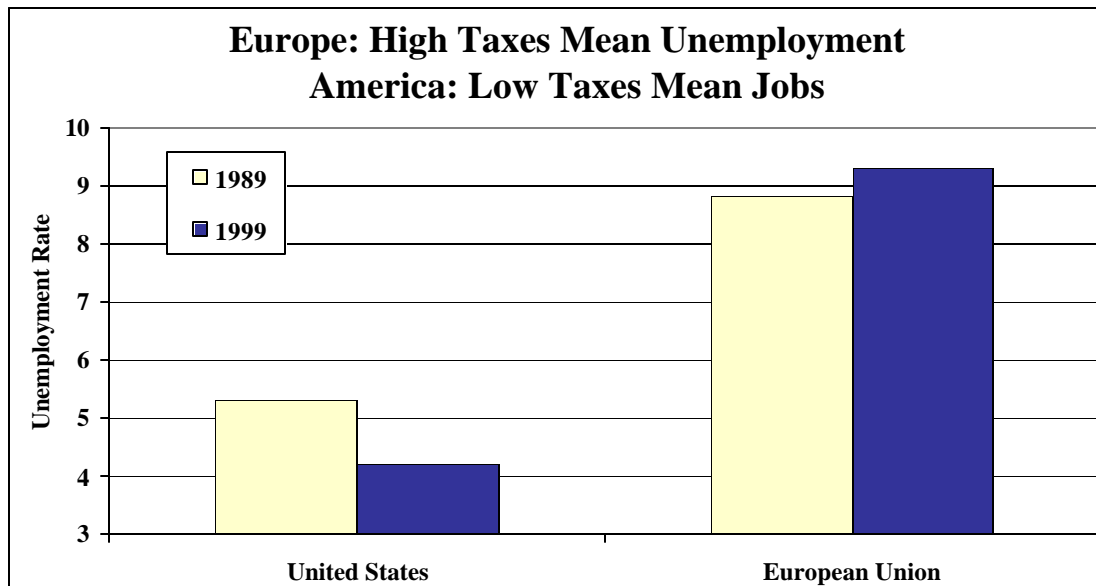
Compared to other industrialized nations, the United States has a modest tax burden. As the attached chart illustrates, taxes consume a relatively small share of national economic output. Perhaps even more importantly, this comparative advantage has increased significantly in the last thirty years. In 1970, the United States had a relatively small advantage over the European Union countries. Today, by contrast, the tax burden in the EU is nearly 50 percent higher than it is in the United States.



The United States enjoys a significant competitive advantage because tax levels in Europe are so oppressive. This explains why global capital and entrepreneurial talent are shifting to America. This translates into higher levels of prosperity and more jobs, which

the European Union was forced to acknowledge in a recent report on competitiveness.⁹ Economic growth in the United States over the last ten years, for instance, has averaged 3.3 percent annually, more than fifty percent faster than the anemic 2.0 percent average growth in the European Union.¹⁰ These results are particularly amazing considering that America was a richer country at the start of the decade. Indeed, per capita GDP in America is now more than 50 percent higher than it is in the European Union.¹¹

Chart 2 shows that tax policy has a big impact on the job market. Entrepreneurs and investors have created millions of jobs in the American economy. As a result, the U.S. unemployment rate has been about 5 percent, even falling slightly over the last ten years. In the high-tax European Union, by contrast, there is very little private-sector job creation and unemployment rates have climbed to near-double digit levels. Even more stunning, nearly 50 percent of the unemployed in Europe have been jobless for more than one year, compared to less than 7 percent in America.¹² Similar differences show up in youth unemployment figures. Fewer than 10 percent of Americans under age 25 are jobless, compared to nearly 20 percent of Europeans in the same age range.¹³



U.S. is a tax haven

According to the OECD, there are four conditions that can be used to define a “tax haven.” The most important criterion – the one that a jurisdiction must meet to get on the OECD blacklist – is to have “low or no taxes.” This is the ultimate sin according to the Paris-based bureaucracy.

⁹ European Union, *European Competitiveness Report 2001*, Brussels, November 2001. Available at http://europa.eu.int/comm/enterprise/enterprise_policy/competitiveness/doc/competitiveness_report_2001/index.htm

¹⁰ Organization for Economic Cooperation and Development, “OECD in Figures,” 2001.

¹¹ *ibid.*

¹² *ibid.*

¹³ *ibid.*

But in order to be labeled a tax haven, a low-tax jurisdiction also must satisfy one of the remaining three criteria.¹⁴ Most importantly, the OECD is willing to forgive a nation for the sin of low taxes if that jurisdiction will divulge details about the private financial affairs of foreign investors (the OECD calls this “information exchange” even though the low-tax jurisdiction gets nothing from the deal). High-tax nations want this information, not surprisingly, so they can then tax their residents on the income they earn in the low-tax jurisdiction.¹⁵

How High-Tax Nations Define a “Tax Haven”

- 1) The regime imposes low or no taxes, particularly on the investment income of nonresidents;

And the jurisdiction must satisfy one of the following conditions:

- 2) Financial privacy laws make it hard for foreign governments to tax income earned in the low-tax jurisdiction; or
- 3) The regime offers special tax breaks; or
- 4) Residents pay higher tax rates than foreigners.

These rules were devised to attack powerless low-tax jurisdictions like Mauritius, Barbados, and Andorra, but the world’s biggest tax havens actually are OECD member nations. Countries like Switzerland, Luxembourg, and the United Kingdom qualify as tax havens according to the OECD’s definition.

The biggest tax haven of all, however, is the United States. America satisfies every single criterion. Most importantly, American lawmakers quite deliberately have chosen not to tax the bulk of the investment income earned by nonresident aliens. Combined with the fact that the U.S. government generally does not require this income to be reported – either to the Internal Revenue Service or to a foreign tax authority, this makes America a safe repository for international flight capital. This tax haven status is widely recognized among leading international tax scholars.¹⁶ Indeed, it is even recognized by the United States Congress. A report on international taxation published by the Joint Committee on Taxation noted (emphasis added):¹⁷

¹⁴ Organization for Economic Cooperation and Development, “Towards Global Tax Cooperation,” 2000. Available at <http://www.oecd.org/pdf/M000014000/M00014130.pdf>

¹⁵ The practice of taxing income earned by residents in other countries is known as “worldwide” taxation. The preferred approach – when a nation taxes only income earned inside its borders – is territorial taxation.

¹⁶ Marshall Langer, “Harmful Tax Competition: Who are the Real Tax Havens?” *Tax Notes International*, December 18, 2000. Available at <http://www.freedomandprosperity.org/Articles/tni12-18-00.pdf>.

¹⁷ Joint Committee on Taxation, “Description And Analysis Of Present-Law Rules Relating To International Taxation,” June 30, 1999. Available at <http://www.house.gov/jct/x-40-99.htm>

- “The United States generally **does not tax** capital gains of a foreign corporation that are not connected with a U.S. trade or business.”¹⁸
- “Capital gains of a nonresident alien individual that are not connected with a U.S. business generally are subject to the 30-percent gross-basis tax **only** if the individual was present in the United States for 183 days or more during the year (sec. 871(a)(2)).”¹⁹
- “For example, interest from certain deposits with banks and other financial institutions is **exempt from tax** (secs. 871(i)(2)(A) and 881(d)).”²⁰
- “Original issue discount on obligations maturing in six months or less is also **exempt from tax** (sec. 871(g)(1)(B)(i)). An **additional exception** is provided for certain interest paid on portfolio obligations (secs. 871(h) and 881(c)).”²¹

As these citations indicate, the United States government imposes “low or no tax” on the investment income of nonresidents. The United States government also does not require information on foreign investors to be reported (with the exception of Canadians). In addition, the United States government satisfies the other two “tax haven” criteria. American citizens, for instance, do have to pay tax on their investment income. And one need only review the special deals that states offer companies in exchange for building factories to understand that tax rates in the United States can be negotiable.

America’s economy benefits from tax competition

Contrary to OECD and EU admonitions, being a low-tax jurisdiction is not a bad thing. America’s modest tax burden, combined with very attractive tax and privacy laws for foreign investors, has been a tremendous boon to workers and the economy. More jobs are created, incomes are higher, and wealth is created.

Every economic theory – even Marxism – agrees that capital formation is the key determinant of long-term growth and rising wages. Simply stated, workers can produce more and earn more when they work with modern technology and newer plant and equipment. This explains, for instance, why American farmers produce more and earn more than farmers in the third world. Farmers in the U.S. are not smarter, and they do not worker harder. Instead, they utilize modern equipment and technology to produce much more per acre and much more per hour worked. This makes them – and the country – wealthier.

There are two sources of capital. The traditional source of capital is the savings and investment of a nation’s people. In the modern economy, however, capital markets are not constrained by national borders. A nation with a pro-growth, competitive tax

¹⁸ *ibid.*

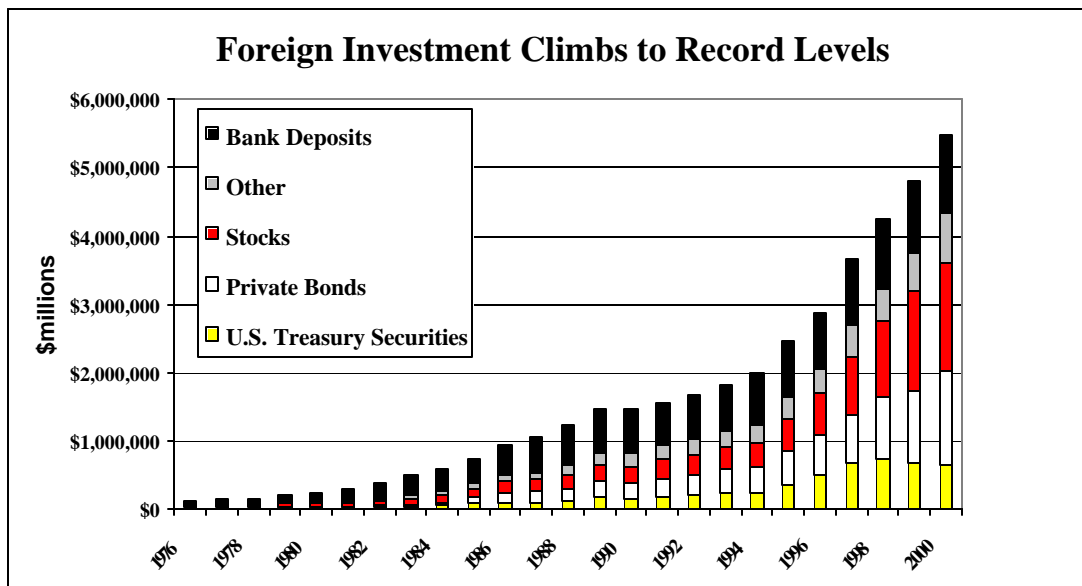
¹⁹ *ibid.*

²⁰ *ibid.*

²¹ *ibid.*

system can augment domestic sources of savings and investment by luring capital from around the world.

Some countries benefit from this process and some countries do not. America is the world's largest recipient of international capital flows. As the attached chart illustrates, global capital has poured into America during the last twenty years. This money has helped finance America's spectacular economic performance.



In addition to capital flight, America also benefits from what some countries call "brain drain." Many highly educated people from developing countries emigrate to America in search of economic opportunity. In some cases, these ambitious people are drawn by America's prosperous market economy. In other cases, they simply want to escape oppressive policies that stunt economic development. Regardless, the result is the same. The United States is a magnet for bright, hard-working people. And according to the latest available Commerce Department figures, foreign-born workers earned nearly \$600 billion in 1999.²²

The tax harmonization threat

Tax harmonization, particularly the indirect form known as "information exchange," is a form of capital control. High-tax nations are seeking to reduce capital flight by acquiring the information needed to tax their citizens and residents on the income they earn in other nations. Under this system of "worldwide taxation," a taxpayer has little reason to shift economic activity to lower-tax jurisdictions. An overburdened French taxpayer, for example, would have scant incentive to shift money to a lower-tax jurisdiction if France is able to tax any resulting income at French tax rates.

²² Bureau of the Census, *Current Population Survey*, March 2000.

As the world's largest recipient of flight capital, the United States would suffer economic harm if tax competition is curtailed. The economy would lose a significant amount of investment if foreign governments were given the ability to tax income earned in America. It would seem that opposing tax harmonization should be a "no-brainer" for U.S. policy makers.

Unfortunately, this issue is not fully resolved. The Bush Administration has forced the OECD to substantially curtail its so-called "harmful tax competition" initiative, but the Paris-based bureaucracy still is seeking U.S. support for a scaled-back form of information exchange. The European Union, meanwhile, has asked the United States to participate in its proposed "savings tax directive" cartel.

There are two reasons why American policy makers are reluctant to summarily reject international tax harmonization initiatives. They are:

1. **The United States has a "worldwide" tax system.** More than most nations, the United States seeks to tax income earned in other nations. The internal revenue code, for instance, applies to individual investment income earned abroad. This is misguided, but not very unusual since many European nations have the same approach. What makes the United States unique – also in a bad way – is the decision to tax other forms of foreign income. Notwithstanding the adverse impact of U.S. competitiveness,²³ American companies must pay taxes on the income they earn abroad. The United States even taxes the overseas labor income of American citizens, a policy practiced by only a handful of the world's nations.

Because of this worldwide tax system, tax authorities in the United States generally favor "information exchange." It is difficult to enforce worldwide taxation, they argue, without knowing the overseas investment income, labor income, and business income of U.S. taxpayers.

This myopic perspective, however, fails to consider the costs and benefits of "information exchange." Yes, it is quite possible that such a policy would help the IRS collect a few \$billion of extra tax revenue every year.²⁴ But this "benefit" must be weighed against the likely cost. Information exchange would require the United States to divulge the U.S.-source income of nonresident aliens.

Yet, as discussed above, this would drive a substantial amount of capital out of the American economy. At a minimum, "information exchange" would drive several hundred \$billion out of the U.S. economy. The capital flight easily could exceed \$1

²³ For example, see Daniel Mitchell, "How the Johnson-Neal Bill Would Harm Competition and Tax Reform," *Backgrounder* No. 1469, The Heritage Foundation, Washington, September 5, 2001. Available at <http://www.heritage.org/library/backgrounder/bg1469.html>.

²⁴ According to many media reports, the IRS has estimated that it fails to collect \$70 billion in tax revenue each year because of "offshore" tax evasion. This is a bogus number. The IRS has never made such an estimate. A former staff assistant for a Democratic member of the U.S. Senate concocted the \$70 billion figure. When asked by the Congressional Research Service to justify that number, the former staff assistant refused.

trillion. This would wreak havoc with financial markets and dramatically weaken the economy's performance. Policy makers therefore must consider whether this level of damage is acceptable before acquiescing to European-led tax harmonization initiatives.

2. **The United States is subject to peer pressure**. It sounds absurd, but the American government is reluctant to disappoint politicians from other countries. The Kyoto Agreement is a good example. The proposal to reduce "greenhouse gases" would impose disproportionate damage to the U.S. economy. This led the U.S. Senate to vote, 95-0, for a measure signaling disapproval. This was followed by a presidential election where a candidate in favor of the agreement was defeated. Yet at no point has the United States government unequivocally stated that it wants no part of any further discussions.²⁵

The same process is at work in the area of tax harmonization. The United States easily could derail the OECD's so-called "harmful tax competition" initiative by announcing that it will never impose financial protectionism against nations simply because they have low tax rates.²⁶ Yet this type of statement is very unlikely because it would be perceived as "undiplomatic." Similarly, the United States could sink the EU's "Savings Tax Directive" by refusing to entertain any negotiations. Once again, though, this simple step is almost impossible because it would violate protocol.

Another part of the problem is that the career bureaucracy is ideologically predisposed to favor tax harmonization. Unfortunately, these career staffers are the ones who represent America at many of the international meetings and these people often conduct the initial negotiations when international issues are being discussed. This tends to constrain the actions of political leaders, most of whom do not wish to be attacked for "scrapping years of hard work" – even if the work product is bad policy.

The Right Way to Fight Tax Evasion

Tax harmonization would significantly harm the U.S. economy and undermine America's competitiveness. Yet current U.S. tax law assumes that the IRS should have access to information about the overseas income of U.S. taxpayers. This creates a quandary: How can the United States demand that other nations help the IRS enforce American tax law while simultaneously serving as a safe haven for international flight capital?

²⁵ Another good example was the United Nation's infamous "Law of the Sea" treaty. This scheme resulted from more than a decade's worth of meetings and negotiations. And even though the U.S. Senate never would have approved the treaty, it was not until Ronald Reagan's election that the American government finally pulled the plug on the ill-fated concept. The controversy surrounding this decision – like the controversy associated with the "global warming" issue, illustrates the supposed difficulty of permanently rejecting misguided international initiatives.

²⁶ This is the "stick" that the OECD is using to compel cooperation from low-tax jurisdictions. For more information on the OECD initiative, see Daniel J. Mitchell, "An OECD Proposal to Eliminate Tax Competition Would Mean Higher Taxes and Less Privacy," *Backgrounder* No. 1395, The Heritage Foundation, September 18, 2000. Available at <http://www.heritage.org/library/backgrounder/bg1395.html>.

Because America is a powerful member of the world community, it certainly is possible for the United States to maintain a double standard. Yet this approach is hypocritical and might be difficult to sustain over a long period of time. As a result, it is likely that policy makers will feel compelled to choose a different approach. For all intents and purposes, the debate may hinge on whether America shifts to a territorial tax system. The two choices are:

Alternative #1: Maintain worldwide taxation and participate in the global tax harmonization initiatives.

To be enforced effectively, worldwide taxation requires the IRS to know the overseas income of U.S. taxpayers. In order to get this information, though, the United States likely will need to provide other countries with similar information about the U.S.-source income of foreigners. This means America would have to participate in the OECD, EU, and UN tax proposals to exchange information and emasculate jurisdictional tax competition. This approach presumably means that the United States also would agree to impose sanctions against low-tax jurisdictions that do not wish to join the cartel. This approach might result in substantial capital flight out of the U.S. economy, but America no longer could be accused of having a double standard.

Alternative #2: Shift to a territorial tax system and protect tax competition.

The other way to eliminate the double standard is through tax reform. The United States could shift to a territorial tax system, meaning that the internal revenue code only would apply to income earned inside America's borders.²⁷ Such a system would protect America's competitive position, and it also would be sound tax policy. Every major tax reform plan, including the flat tax, envisions a shift to a territorial tax system. Some worry that territorial taxation would undermine the competitiveness of American financial institutions since taxpayers could avoid punitive U.S. taxes on capital income by shifting money overseas. But another feature of tax reform is that there no longer would be any double-taxation of income that is saved and invested. This means that U.S. banks and other financial institutions could compete on an equal footing with those located in low-tax jurisdictions like the Cayman Islands.²⁸

²⁷ For more information on territorial taxation, see Daniel J. Mitchell, "A Tax Competition Primer: Why Tax Harmonization and Information Exchange Undermine America's Competitive Advantage in the Global Economy," *Backgrounder* No. 1460, The Heritage Foundation, July 20, 2001. Available at <http://www.heritage.org/library/backgrounder/bg1460.html>. Also see Daniel Mitchell, "WTO Edict Requires Global Tax Repair," *The Washington Times*, July 31, 2001.

²⁸ A territorial tax system also is the correct way of dealing with the EU's WTO case against the "foreign sales corporation" provision of U.S. tax law. The "FSC" provision seeks to alleviate the anti-competitive impact of worldwide taxation by imposing a lower tax rate on profits from exports, but this almost surely violates WTO rules. For more information, see Daniel J. Mitchell, "WTO Verdict Requires Global Tax Repair," *The Washington Times*, July 31, 2000. Available at <http://www.heritage.org/views/2001/ed073101.html>.

Conclusion

Tax harmonization is a direct threat to America's economic interests. Because of appealing tax and privacy laws, the United States is a safe haven for global capital. This has helped attract more than \$9 trillion to the U.S. economy, and a big portion of that money is untaxed and unreported. Yet if the OECD, EU, and UN succeed, a substantial share of this investment would be subject to reporting and therefore would flow to other jurisdictions. This would mean fewer jobs and lower income for Americans.

Territorial taxation is a much better approach. This reform would protect America's economic interests while also reducing opportunities for tax evasion. Territorial taxation would help make American companies more competitive, and it also facilitates tax competition. This would lead to lower tax rates in other nations, and this would mean higher levels of economic growth around the world.

There is no legitimate reason for the U.S. to participate in a global tax cartel. Policy makers in Washington should forcefully announce that the United States is unalterably opposed to the OECD, EU, and UN schemes. This might ruffle some feathers in other nations, but this is a small price to pay for defending American jobs and American interests.

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August 2001, *Prosperitas*, Vol. I, Issue I, *Oxfam's Shoddy Attack on Low-Tax Jurisdictions*, by Daniel J. Mitchell. Web page link below:
<http://www.freedomandprosperity.org/Papers/oxfam/oxfam.shtml>

August 2001, *Prosperitas*, Vol. I, Issue II, *United Nations Seeks Global Tax Authority*, by Daniel J. Mitchell. Web page link below:
<http://www.freedomandprosperity.org/Papers/un-report/un-report.shtml>

October 2001, *Prosperitas*, Vol. I, Issue III, *Money Laundering Legislation Would Discourage International Cooperation in the Fight Against Crime*, by Andrew F. Quinlan. Web page link below:
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