

TAX COMPETITION IS BENEFICIAL, NOT HARMFUL*

The drive by the Organization for Economic Cooperation and Development for “information sharing” between governments for tax collection purposes is akin to their campaign to eliminate “harmful tax competition.” Either proposal would enable high-tax countries to avoid capital flight.

In 1998, the Organization for Economic Cooperation and Development (OECD) published “Harmful Tax Competition: An Emerging Global Issue,” followed by “Towards Global Tax Cooperation” in 2000. In brief, these reports propose measures to counter global tax competition, which is deemed “harmful” because it affects the location of financial activities, distorts trade and investment patterns, and undermines national tax bases.

The OECD is an intergovernmental organization comprised of 29 industrialized countries. Its activities are carried out by more than 100 committees, which review specific issues and formulate policy recommendations. The organization has no specific power over sovereign nations but uses its influence over members to achieve desired goals. Its stated goals are: 1) To achieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and thus to contribute to the development of the world economy; 2) To contribute to sound economic expansion in member as well as non-member countries in the process of economic development; and 3) To contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

Ironically, these goals appear at the beginning of each report, despite the fact that each outlines corrective measures that ultimately would discourage capital formation, slow world economic growth, and impose discriminatory trade practices against uncooperative nations.

The latter report stresses that “the project is not primarily about collecting taxes and is not intended to promote the harmonisation of income taxes or tax struc-

tures within or outside the OECD.” However, a careful reading reveals that the goal is precisely this. The report frequently contradicts itself, sometimes within the same sentence. For example, one passage reads, “Countries should remain free to design their own tax systems as long as they abide by internationally accepted standards in doing so.” The first half of that sentence is negated by the second half. At bottom, the report calls for setting international standards that everyone must obey.

In the opening remarks of each report, the OECD emphasizes that taxes should not be a factor in making capital allocation decisions. The OECD seems to assume that an absence of taxes causes a capital distortion instead of the imposition of taxes causing the distortion. The way to have taxes and not distort the capital distribution is to force citizens to face the same effective tax rate regardless of where they invest. Given that the reports include a list of tax havens and not of excessive tax nations, it doesn’t take a rocket scientist (or an economist) to figure out that their goal is the harmonization of high tax rates around the world. In a particularly telling section, one report laments that the existence of tax havens “may hamper the application of progressive tax rates and the achievement of redistributive goals.”

The reports go on to characterize harmful tax practices, produce a list of “tax haven” countries, and recommend a timetable for the elimination of these tax practices.

The factors that the OECD uses to identify harmful tax havens are: 1) no or low effective tax rates; 2) a lack of effective exchange of information; 3) a lack of transparency; and 4) an absence of a requirement of substantial activities. A total of 41 nations, mostly in the Caribbean, were classified as tax havens.

Being classified as a tax haven tends to reflect the geopolitics of the OECD as opposed to the strict application of a standard. For instance, research by tax attorney Bruce Zagaris has shown that the remedies the tax havens are asked to adopt in order to be removed from the list are not completely practiced by most of the OECD countries recommending them. According to an April 2, 2001 *National Review* article, Ireland, Switzerland, Austria, Singapore, and the U.S. met the OECD standards for tax ha-

vens but had not been included on the OECD’s list.

The reports called for countries failing to commit to reforms by July 31, 2001 to be listed as “Uncooperative Tax Havens.” At that point, OECD countries were to take a range of “defensive” measures, such as requiring comprehensive information reporting rules for transactions and “transactional” charges or levies.

In May, Treasury Secretary Paul O’Neill announced that “the U.S. does not support efforts to dictate to any country what its own tax rates or tax system should be, and will not participate in any initiative to harmonize world tax systems.” He criticized the current OECD project as “too broad and not in line with [U.S.] tax and economic priorities.” This development represents a significant setback for the OECD initiative.

Information Sharing Initiative

The OECD and the European Union (EU) are now pushing an information sharing initiative. After years of trying unsuccessfully to persuade Britain, Austria, Luxembourg, and other relatively low-tax EU members to create a withholding tax on all savings, the EU adopted a banking information exchange agreement last June. This agreement stipulates that EU countries must collect information on foreigners’ savings and send it to their home countries if they are also EU members. Once the home country has the information, it will be able to impose its own tax rate on these savings, thereby eliminating the incentive for its citizens to save in other EU countries for tax purposes. The lower tax countries agreed to the regulation under one condition: other havens such as Switzerland and the U.S. would have to follow suit.

The IRS is currently considering a regulation that would require U.S. banks to report interest earned on accounts held by nonresident foreigners. Such accounts are exempt from U.S. tax, but the information would be passed on to their home country where they could be taxed. Currently the U.S. does this only for Canada. If the U.S. adopts such a policy, it will be possible for the OECD and its allies to go ahead and pressure other tax havens to exchange information too. This will be just as effective in ending international tax competition as the OECD’s campaign which the U.S. rejected.

Some proponents of information exchange claim that the goal is to fight international criminal money laundering. However, nowhere in the combined 110 pages of the two reports is this implied.

Benefits of Tax Competition

Tax competition promotes low levels

* This article is by Benjamin Powell, a participant in this year’s AIER Summer Fellowship Program. For over half a century, this program has provided direct training and financial support to distinguished students who are pursuing graduate studies in economics in preparation for a teaching career. Our intensive 8-week program provides students with an alternative to the largely ahistorical, theoretically abstract mathematical approach fostered by most university graduate departments. By promoting procedures grounded in observation, we hope to encourage promising young economists toward more useful lines of inquiry.

of taxation and greater rates of economic growth. With tax competition, if one country raises its level of taxation too high, citizens shift some of their money to other, less confiscatory regimes. The ability of citizens to “vote” with their capital gives the home government an incentive to institute lower tax rates and to try to use the money it collects more efficiently.

Eliminating tax competition essentially eliminates the ability to avoid excessive tax regimes. Once there is nowhere for citizens to run to, governments will no longer have to fear driving away economic activity if they overtax their citizens. This is not to say that governments could tax at any rate they want. There will still be other checks on the level of taxation that a government can impose, such as fear of being voted out of office, but the removal of tax competition would lead to higher tax rates than would otherwise exist.

There is evidence of tax competition being effective at lowering rates in the past. After the Reagan and Thatcher tax-rate reductions in the 1980s, all but two OECD countries lowered their top marginal rates, income tax rates worldwide were lowered by up to 50%, and all but one EU country cut their corporate tax rates. The OECD’s own tax statistics show that the falling levels of income taxation and relative lower burden on corporate profits were a result of tax competition. The OECD acknowledged that, “This trend reflects in part an increasing erosion of the tax base as a consequence of widespread tax planning including the use of tax havens and intense tax competition among industrialized countries.”

These rate cuts do not mean that the OECD countries are now having a hard time raising taxes to fund government activities. During the past 20 years OECD countries have been increasingly shifting to general consumption or VAT taxes. In spite of the above tax cuts, not only have total taxes collected risen but the level of taxation as a percent of GDP in OECD countries has also increased. By the OECD’s own estimates taxes in OECD countries were 33 percent of GDP in 1980, 36 percent in 1990 and 37 percent of GDP in 1998. So the OECD drive to eliminate “harmful tax competition” is not about preserving the ability of the governments to raise a minimum amount of taxes. It is simply ever-greeder governments in OECD countries searching for ways to continue to impose higher taxes on their citizens.

It is almost universally accepted that low tax rates promote economic growth and high rates inhibit it. By promoting lower rates of taxation, tax competition helps to promote growth. The more mobile a resource is, the more it will respond

to tax competition. While there are many instances of people emigrating in order to have a lower personal tax rate, most people find the other associated costs too high to make it worthwhile.

In today’s global economy, savings and investments are so extremely mobile that they readily respond to tax competition. In many cases, this causes tax rates on savings to be quite low. Non-resident foreigners pay a 30 percent U.S. tax on dividends but pay no taxes on bank deposits or capital gains. The lower rates encourage savings and investment that are crucial to capital formation and economic growth. Dan Mitchell, an economist with the Heritage Foundation, notes that “The OECD mistakenly assumes that taxes on capital simply shift *where* investments take place. But as one tax scholar notes, the world’s 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.”

The Impact on the U.S. Economy

Disclosing financial information to other countries forces money out of the U.S. economy. The U.S. is a relatively low-tax nation that does not tax foreign bank accounts and does not disclose information to other countries, with the exception of Canada. The U.S. is far more politically stable than most island tax havens. Because of these factors, the U.S. attracts \$7 to \$8 trillion of foreign capital per year. This investment takes a variety of forms including checkable deposits, time deposits, corporate bonds, government bonds, corporate equities, and foreign direct investment. Foreign government investment is included in the \$7 to \$8 trillion dollars and would not be expected to change because of any tax or information changes. Unfortunately, since this money is not separated out of the data, it is impossible to precisely estimate how much foreign capital would be at risk with new regulations. Most foreign government savings in the U.S. is probably in the form of U.S. government bonds that comprise \$1.7 trillion of the \$7 to \$8 trillion owned by foreigners.

Foreign capital provides valuable services to our economy. It gives money to

small business, venture capital to high-tech startups, financing for further capital expansion in the manufacturing sector, and countless other businesses sectors. In short, it enables us to add to our capital stock and achieve greater rates of economic growth, higher worker productivity, and a higher standard of living. By adopting an information-sharing requirement, we would undermine our competitive advantages and risk losing some benefits foreign capital provides.

Not all of the foreign money in U.S. banks is here for tax purposes. Some would still come because of investment opportunities even if the home country could tax it. Some of the money, however, comes exclusively for the privacy that is offered. This is not to say that it is illegal money. Some nonresidents make deposits in the United States to avoid extortion and kidnapping in their own countries. Robert Brookes, president of Miami’s Eagle Bank, said, “The rule [information sharing] could prompt withdrawals of \$15 billion to \$20 billion by Latin American depositors in Miami alone.”

While adopting an information sharing regulation would not cause all foreign capital to flee the country, especially if the OECD could force other tax havens to adopt the same rule, it would still undermine our competitive advantage and risk losing significant amounts of capital. Because the U.S. is the world’s largest “tax haven,” it seems foolhardy for the U.S. to support any regulations that would endanger the competitive advantages that attract the foreign capital here.

Conclusion

The information sharing initiative supported by the OECD and EU is simply a continuation of their attempt to enable high-tax countries to raise tax rates and avoid capital flight. The effort to eliminate “harmful tax competition” was correctly seen as an attempt to collude and harmonize high tax rates around the world. While information sharing seems more innocuous, its result would be the same, the elimination of tax competition. This would cause tax rates around the world to rise and capital formation and economic growth to slow, with the loss of some foreign capital in the U.S. □

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