



## **Strategic Memorandum**

**Date:** August 27, 2009

**To:** Supporters of tax competition, fiscal sovereignty, and financial privacy

**From:** Dan Mitchell

**Re:** Protecting Good Tax Policy

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### **Feeding Your Leg to a Crocodile Doesn't Turn Him into a Vegetarian**

The past several months have witnessed an unfortunate setback in the fight for good tax policy. Bolstered by a shift in the U.S. position from benign neglect to active support, anti-tax competition ideologues have won a somewhat significant victory. Low-tax jurisdictions, faced with direct and indirect threats of sanctions from powerful nations, have been forced to weaken their human-rights policies by agreeing that privacy laws no longer protect foreign investors. Indeed, jurisdictions are being coerced to sign agreements to provide confidential data upon request to at least 12 of their high-tax brethren.

The campaign against tax competition now moves to the next step, beginning with the Organization for Economic Cooperation and Development's (OECD) Global Tax Forum in Los Cabos, Mexico, Sept 1-2. Dominated by European welfare states, the OECD has been working for more than 10 years to impose punitive international tax rules in order to prop up the inefficient policies of its member nations.

It is unclear whether high-tax nations see the meeting in Mexico as an opportunity to cement existing gains, or a springboard for further concessions, but that is just a matter of timing. The low-tax jurisdictions should realize that agreeing to a dozen information-sharing pacts does not buy them any good will. Instead, that merely encourages high-tax nations to up the ante with additional demands. There is an old saying among professional negotiators that "feeding your leg to a crocodile does not turn him into a vegetarian, it just means he'll be back for another meal later." The same is true in the battle over international tax policy.

#### **Why is this happening?**

The battle against tax competition is essentially an attempt to counter globalization. With advances in technology and reductions in the costs of cross-border economic activity, it is now increasingly easy for individuals and businesses to choose the location for economic activity. This is good news for the world economy, but it is not good news for power hungry government officials. More specifically, there are two reasons for this battle:

- Politicians in most high-tax nations have made unsustainable promises to give unearned benefits to ever-growing shares of their populations. This results in punitive tax regimes, which encourages the migration of productive resources to jurisdictions that have a welcoming (or at least more tolerant) attitude to wealth creation. But unwise fiscal policy is just part of the problem. Most of these nations also face daunting demographic trends. Low birth rates and rising life expectancies mean that the number of people lining up for government programs will continue to grow rapidly while the number of people available to finance a burgeoning welfare state – at best – will grow slowly. Assuming that governments do not reduce the size and scope of the public sector, this is a recipe for fiscal meltdown. And since politicians seem determined instead to expand the burden of government, they hope to delay the day of reckoning by inhibiting the ability of labor and capital to benefit from better tax policy in other jurisdictions.
- Opponents of tax competition are pursuing an ideological mission, guided by a theory that presupposes that tax policy should have no impact on economic decision making. Known in the academic literature as capital export neutrality (CEN), this theory usually is associated with statist tax law professors, and its central conclusion is that government policy should make it impossible for taxpayers to benefit from better tax policy in other jurisdictions because that will lead to economic inefficiency (sounds absurd, but I'm not making this up). This requires either direct tax harmonization (the same tax rates) or indirect tax harmonization (information sharing so a taxpayer is always subject to home-country tax rates). Not surprisingly, CEN has the support of a number of Treasury Departments and Finance Ministries in OECD nations. And these bureaucracies, of course, are the ones whose representatives comprise the OECD's Committee on Fiscal Affairs (the sub-bureaucracy that concocted the anti-tax competition project), which is why key elements of the CEN theory can be found in the OECD's 1998 and 2000 reports.

### **The Next Wave**

For all intents and purposes, the so-called tax havens have agreed to sign tax information exchange agreements (TIEAs) with their high-tax brethren. The bad news is that there is no "exchange" in these TIEAs. Low-tax jurisdictions agree to be tax collectors for nations such as France and the United States, but they get little or nothing in return. The good news, though, is that the information sharing is limited. High-tax nations can only request information on specific taxpayers, and (at least in theory) they must have some evidence of noncompliance to justify the request.

While a step in the wrong direction, this would be a tolerable conclusion to the tax competition battle. Limited information sharing reduces the pressure on governments to adopt good policy, but it does not eliminate it. Unfortunately, this is just the beginning of the fight. The proponents of statism have much more aggressive goals and they are quite open about their objectives. These four policies are probably the most important and/or imminent threats (and the first three are

most thoroughly discussed in the attached PDF from the most recent issue of *Offshore Investment*):

1. *Automatic Information Exchange* - Certain governments and left-wing interest groups are arguing that “upon-request” information exchange is inadequate and that all information about foreign investors should be immediately and automatically available. Indeed, the European Commission (EC) already has implemented a savings tax directive that requires all EU member nations (as well as their overseas and dependent possessions) and a handful of non-EU nations (such as Switzerland) to either levy a withholding tax or engage in automatic information sharing. The original directive already is being revised so that governments can extend double taxation to additional forms of capital income. Moreover, the EC wants to phase out the ability to choose a withholding tax. Ideally, governments should stop the punitive and destructive policy of double taxing income that is saved and invested. This would substantially improve economic growth and – by definition – make information exchange a moot issue since there no longer would be additional layers of tax on forms of capital income such as interest, dividends and capital gains. But that is not in the interests of the political elite. As such, once low-tax jurisdictions have been pressured into signing more information exchange agreements based on the “upon request” model, the international pressure will shift to automatic information sharing. It is quite likely that the OECD (and the high-tax governments it represents) will soon join the EC in pushing for automatic information exchange.

2. *Tax Monitoring of High Net Worth Individuals* – Governments are now beginning to target high net worth individuals (HNWIs) in hopes of restricting their ability to engage in international tax planning. The OECD, for instance, recently published “Engaging With High Net Worth Individuals On Tax Compliance,” which asserts that the international mobility of HNWIs makes them more likely to engage in tax avoidance or evasion. The bureaucrats argue therefore that these people require much more intrusive monitoring of their affairs, including so-called voluntary disclosure initiatives, where HNWIs are pressured to preemptively disclose more information about their cross-border economic activity. Ideally, nations should have territorial tax systems and only seek to tax income earned inside national borders. Unfortunately, governments will continue to target HNWIs and eventually tax collection agencies will begin to preemptively share information as part of a more aggressive campaign by governments to restrict tax planning.

3. *Corporate Tax Base Harmonization* – The European Commission would like to concoct a single definition of taxable income for companies, a project known as the Common Consolidation Corporate Tax Base (CCCTB). A CCCTB presumably would be accompanied by some form of “formula apportionment” to determine how much income a company earns in each nation based on sales, employment, and/or property. And while it does not eliminate tax competition, it does weaken the process. Simply stated, it becomes more difficult for a company to declare that it is earning a large share of income in low-tax jurisdictions, even if that is actually what is happening. The

formula apportionment rules compel companies to artificially shift some of their taxable income to other nations. Low-tax jurisdictions would lose in order to prop up the tax systems of less competitive nations. Moreover, it would create openings for further mischief on issues such as apportionment rules and transfer-pricing regulations. Governments could reduce compliance costs (the ostensible goal of harmonizing corporate tax bases) by allowing companies to use the definition of taxable income in their “home state,” but that would allow nations to compete – which is precisely what the EC wants to stop. As such, it is highly likely that high-tax nations will more aggressively seek to hamper businesses trying to conduct activity in low-tax jurisdictions. While this effort has been limited to the European Union, it is just a matter of time before low-tax jurisdictions in the rest of the world are pressured to participate. In the long run, of course, opponents of tax competition almost certainly will try to harmonize tax rates.

4. *Expanding the Tax Cartel to non-OECD nations* – There are 30 member nations, and the OECD predictably has focused on helping those nations prop up their bad tax policies. This is why the Paris-based bureaucracy’s short-term goal has been to compel low-tax jurisdictions to sign TIEAs with member nations. For both reasons of ideology and practical coalition building, however, the OECD intends to pressure low-tax jurisdictions to share information with non-OECD nations. This is troubling for all of the traditional reasons about economic efficiency, but it also raises enormous concerns about human rights. Most nations have very troubling records with regards to the treatment of political, ethnic, religious, racial, and sexual minorities. Many of the people targeted by oppressive governments utilize low-tax jurisdictions for privacy reasons rather than tax reasons. Similarly, many people live in regimes that are unable to provide the basic protections of a civilized society, meaning that investors and entrepreneurs are subject to kidnapping and other physical threats. These people also use low-tax jurisdictions – especially since rampant corruption means that tax bureaucrats often sell information to criminals. Last but not least, people living in nations governed by kleptocrats – such as Argentina, Zimbabwe, and Venezuela – need confidential jurisdictions to protect assets from seizure.

## **Conclusion**

Tax competition is good for the global economy but bad for politicians. This is why high-tax nations are working through the OECD and other international bureaucracies to create something akin to a tax cartel – sort of an “OPEC for politicians.”

The OECD meeting in Mexico is not the conclusion of a process. It is just the beginning of a never-ending attack on low-tax jurisdictions. Agreements to share information about foreign investors will merely whet the appetites of high-tax nations to demand further concessions.

Motivated by the perverse CEN ideology, and facing domestic pressures to find ever-growing amounts of money to redistribute, politicians will continue their attacks on low-tax jurisdictions.