



# ‘Harmful’ tax competition and the future of offshore financial centres, such as Vanuatu

Terry Dwyer

Offshore financial centres are coming under increasing pressure from both the OECD and the European Union. They are seen by many bureaucrats and politicians in OECD countries as facilitating criminal activities such as laundering drug money as well as tax evasion and tax avoidance by residents of high-tax welfare states. While there are good reasons for nation states to cooperate to suppress criminal activity, this is not true in relation to tax competition. The notion that by engaging in ‘harmful’ tax competition, offshore financial centres are damaging the legitimate interests of OECD nations has no sound foundation in economic theory. Competition in tax matters is beneficial and world welfare enhancing. Governments of offshore financial centres serve their own and the world’s interests by providing zero or low tax environments for global business and investment and they are right to insist that treaties on criminal matters not be used to enforce other countries’ tax claims.

**Terry Dwyer** is a Visiting Fellow at the National Centre for Development Studies, Asia Pacific School of Economics and Management, The Australian National University.

## History of tax havens

In 1970, the then British administrators of the Condominium of the New Hebrides introduced Banking Regulation no. 4 of 1970. That regulation introduced offshore banking to Vanuatu and led to the development of Vanuatu’s offshore financial centre. Later legislation provided for trust companies, insurance and exempt company laws. The development of Vanuatu’s financial services industry was not a casual decision on London’s part. Britain recognised that its

responsibilities to a post-colonial country required it to think about what industries could generate income for the Vanuatu economy and its efforts met with the endorsement of its then French government partner in the Condominium. In view of more recent OECD and European Union views on tax havens, Vanuatu might find it worthwhile to remind the former colonial powers of the parentage of its offshore financial sector.

Tourism and financial services are natural complements for a small South



Pacific economy as part of its development strategy. A country's development strategy has to focus on attracting locationally mobile industries to raise the productivity and wages of its people. In any case, a country such as Vanuatu with pristine coral reefs might be expected to prefer clean industries like financial services to dirty factories which might damage its tourism income (as well as the environmental amenity enjoyed by its citizens).

If you have a largely subsistence agricultural sector and virtually all your revenue is raised by indirect taxes or resource rents, you do not need income taxes, capital gains taxes, withholding taxes or death duties. If you do not have these taxes, there is no need to enter into tax treaties. Vanuatu is thus a natural tax haven. An absence of taxes, like an absence of war or internal violence, is something a country can turn to its advantage. It is understandable that Vanuatu continued the policy of developing its financial sector after independence in 1980. The presence of an offshore financial sector can provide collateral spin-off benefits for the rest of the economy. It may gradually lead to funds being lent to or invested in developing the domestic economy and it may assist in developing the legal expertise necessary for a market economy to work. These are no small things when one observes the problems faced by some Eastern European economies in transition. Educating people on how money and finance work in a market economy is an important part of development.

Notwithstanding the logical reasons which might favour Vanuatu developing its offshore financial sector, Vanuatu's existence as a tax haven has not been welcomed by all people. In particular, it would be surprising if the Australian Treasury welcomed its emergence after closing down Norfolk Island as a tax haven. It is therefore perhaps not surprising that the OECD (in whose Committee on Fiscal Affairs Australia plays

an active role) has launched an attack on 'harmful' tax competition from tax havens.

Indeed the history of offshore financial centres reflects the historical evolution of the tax systems of major countries, notably the United States and United Kingdom. When Lloyd George and his Treasury officials refused the request of the Vesteys that UK taxation not be extended to overseas income in World War I, the Vesteys decided on self-help. Their overseas income eventually flowed to the trustees of a settlement based in Paris at a time when France did not seek to tax overseas gains. Given the current attitude of France as an OECD member to offshore financial centres, it is worth noting that France was one of the first offshore financial centres.

After World War I, as tax rates rose in the United States and the United Kingdom, both countries sought in the 1930s to attack the transfer of assets abroad. The United Kingdom legislated against offshore schemes based in Canada and the United States legislated against offshore pocketbook companies held by US millionaires in the Bahamas.

For the vast majority of taxpayers in industrial countries, tax havens held little interest. With onshore tax havens such as life insurance, pension or superannuation funds available, only the very wealthy found much need to consider the use of offshore tax havens. In the United Kingdom, the combination of a still-wealthy upper class facing extraordinarily high marginal tax rates, a tradition of overseas investment and the unique circumstances of offshore tax havens within the then exchange control area meant the British were leaders in tax haven development. To these were added after World War II the multinational corporations which found that the services of tax havens were essential in overcoming the problems created for international business by inconsistent tax treaties or dual claims to income.



It is not generally recognised by most economists that without tax havens, multiple national taxation would still exist and pose enormous difficulties for mutually beneficial trade and commerce.

As public expenditure rose, notably on expanding welfare states, and as onshore tax shelters or tax havens were attacked, one after the other, by treasuries in industrial countries, the demand for the services of offshore tax havens rose. No longer were offshore tax havens merely of interest to major multinational corporations or the super-wealthy. With high postwar income tax rates and death duties and a widespread legacy of colonies which had inherited the common law and the law of trusts, the British led the offshore migration. The Americans were not slow to patronise the British-developed Caribbean jurisdictions and to take advantage of common law legal systems with which they were familiar.

The Europeans with a tradition of territorial taxation and civil law systems had less need to patronise Anglo-Saxon tax havens with whose legal systems they were less familiar. However, as European countries moved to wind back the scope of exemptions for extra-territorial income, it was no longer enough merely to have undisclosed bank accounts in Switzerland or Luxembourg. By the 1980s the gradual removal of capital controls in the United Kingdom and the European countries opened the way for further European patronage of places such as the Channel Islands.

The consciousness of European treasuries was raised after Germany failed in an attempt to impose an interest withholding tax in the face of a flight of capital. It now seemed clear to the treasuries of ageing welfare states that tax competition, when combined with freedom of capital movement, was a threat to their ability to raise further revenue. European writers increasingly recognised that the emergence

of a global capital market set limits to the redistributive financing of welfare states (Frenkel, Razin and Sadka 1991:213:4; Schjelderup 1993:377).

Since the 1980s, there has been the adoption generally within Europe of controlled foreign companies legislation as well as other anti-avoidance legislation. More significantly, the OECD report on harmful tax competition and its cognate report on tax sparing (OECD 1998), together with EU initiatives, have seen the emergence of a multilateral attack on tax havens or offshore financial centres (OECD 1999).<sup>1</sup> The OECD Council is expected to consider a list of tax havens at its meeting in June 2000. In particular the United Kingdom has clearly come under pressure from its European partners to 'do something' about its dependent territories. The first example of this was the UK Edwards report (Edwards 1998) which examined the Channel Islands and the Isle of Man and which has now been followed by the White Paper on the overseas territories (UK 1999).

The Edwards report, which, in the method of its inception, broke long-established constitutional usages governing the relationship between the United Kingdom and the Crown's offshore islands, did not recommend wholesale elimination of the offshore tax havens. Indeed the Edwards report was surprisingly fair, given its genesis, but it did foreshadow substantial inroads on client privacy in the interests of overseas regulators and tax collectors.

Since before the American revolution, the United Kingdom has had a practice that British colonies with self government are entitled to administer their own taxation affairs.<sup>2</sup> No pressure from its European partners is likely to alter that position. Hence the UK government is proceeding to assuage its European partners by seeking more subtle methods of removing the attractiveness of its overseas territories as tax havens. The ostensible focus of its



initiatives is to ensure credible regulation of the offshore financial industry in each of its territories. The overseas territories, on the face of it, find it difficult to complain if the UK government insists that they cooperate in measures to afford mutual legal assistance to counter criminal activity and eliminate fraud.

But there seems to be an ulterior motive in this apparently beneficent activity. If measures introduced to secure the integrity of the overseas territories' financial sectors have the effect, if not the stated purpose,<sup>3</sup> of ensuring that the financial affairs of OECD investors in those territories are exposed to the gaze of OECD treasuries, then Britain will have pleased not only its own treasury but those of its European neighbours. Certainly there is no reason to think that even a 'Third Way' UK Labour government has much sympathy for tax avoidance through the use of offshore havens.

It is clear that a consensus is emerging among many OECD countries that tax competition is harmful<sup>4</sup> and measures need to be taken collectively to eliminate tax havens. This is not a universal OECD view. Switzerland and Luxembourg dissented strongly from the report on harmful tax competition (OECD 1998:73–81) while the United States has its own views on foreign sales corporations.<sup>5</sup>

Tax havens face the following international agenda

- tax competition is harmful
- it should therefore be suppressed
- national sovereignty means it cannot be directly suppressed
- therefore, financial threats or inducements or the use of ostensibly non-tax treaties must be employed for the explicit or ulterior purpose of eliminating tax havens. In the case of dependent territories of OECD members, such measures may carry the implicit threat of the governing power to override internal self-government.<sup>6</sup>

## Are offshore financial centres 'tax havens'?

So far I have used the terms 'tax haven' and 'offshore financial centre' interchangeably. In fact the offshore financial centres have in many cases progressed for reasons other than tax, though without beneficial tax regimes, they may not have progressed at all. Increasingly offshore financial centres are used for asset protection against the tort liability revolution.<sup>7</sup> Liberalised no-fault divorce laws which give spouses automatic claims to assets regardless of adulterous conduct do not meet with universal moral approval. In some countries, testators are denied freedom to dispose of their estates as they think fit and, increasingly in common law countries, legislation makes it easier for disappointed beneficiaries or others to challenge a will. Assets may be moved to vehicles in offshore financial centres to defeat such legislation.<sup>8</sup>

Sometimes governments themselves use offshore financial centres, for example, to trade with other countries when it is not politically correct to do so or to protect themselves against the possibility of sanctions being imposed, as when Iranian assets were frozen in the United States. Individual investors, such as Taiwanese investing in mainland China, may have similar motives to use offshore centres.

Offshore financial centres cater to expatriate investors who may be working in many countries over time and wish to manage their investments or pension arrangements from one centre. Prospectus requirements may influence investment managers in choosing to locate their operations in offshore financial centres. Onshore investors denied access to foreign company prospectuses or life insurance products, may seek to invest via offshore vehicles. Persons planning a company takeover on a stockmarket may not wish to alert the market. Multinational groups



seeking access to lower premiums through the reinsurance markets may choose to operate captive insurance companies in offshore financial centres.

Opinions may differ on the morality or otherwise of the use of offshore centres but they do emphasise that tax is not the only, or the most powerful, motivation for the use of offshore centres. For that reason, the term 'offshore financial centre' is more accurate than 'tax haven' as there is often more than one kind of perceived legal inadequacy or repression in the investor's home or target jurisdiction providing the impetus to locate assets in an offshore vehicle.

### The theory of 'harmful' tax competition

As the expertise of this writer is in economics, not international relations or political science, the rest of this paper addresses the OECD premise that tax competition is harmful. There is an assumption that the answer is yes. I argue that economic theory points to the opposite conclusion, namely that tax competition is a healthy and natural economic process which weeds out stupid or inefficient taxes.<sup>9</sup>

If I am correct, then the governments of offshore financial centres are entitled to take the view that they are not being bad international citizens in seeking to profit from the stupidity of treasuries of high-income countries. They are entitled to take the view that any form of international legal assistance should not extend, directly or indirectly, to the enforcement of other countries' tax laws, whether such assistance is by sought by way of debt recovery, insolvency proceedings, information exchange or evidence for tax prosecutions.

The OECD fear is that

[d]evelopments in communications technology, such as the Internet, raise a general risk to the forward estimates of revenue. Such developments may

allow the purchase or sale of an increasing number of goods and services—including the provision of labour services—in a way which could render traditional tax collection mechanisms unworkable, posing a major challenge for tax system design. The OECD is developing a taxation framework to apply to electronic commerce including 'place of taxation' rules for consumption taxes and measures to strengthen international cooperation in tax administration and collection. Australia is contributing actively to this work. The ATO has sought to raise awareness of the issue in its publication *Tax and the Internet* (Costello 1999:4–24)

Before accepting that tax competition can ever be harmful, one might ask some questions. How does tax competition differ from other competition?<sup>10</sup> What is wrong with general fiscal competition so that a low spending country can pursue a low or zero income tax policy?<sup>11</sup> What is wrong with not taxing income you would otherwise not gain?<sup>12</sup>

Fear that tax competition will lead to a loss of domestic revenue does not amount to an argument that tax competition is harmful either to one's own or other countries, no matter how unpleasant it may be for the treasury concerned.

Competition among countries for taxation revenue poses a significant threat to national revenue bases and effective tax rates. The OECD has recognised the danger that such competition will simply see an erosion of tax revenues without any benefit to individual countries in terms of greater investment. The analogy with the destructive tariff competition of an earlier era is clear (Ralph 1998:25 para 2.36).

Tax competition is seen as a 'race to the bottom' where there are no winners in the end. But the theory to support such a view is not presented. The analogy that international tax competition is potentially harmful in the



same manner as the tariff competition of an earlier era is false. Whereas tariff competition involved putting up taxes and destroying trade, tax competition involves driving down tax rates on mobile factors of production towards their optimal level. It is trade-facilitating rather than trade-destructive.<sup>13</sup>

## Defining 'harmful' tax competition

A basic problem in defining 'harmful' tax competition is to define who wins and who loses. Are the losers governments? Or some governments and not others?<sup>14</sup> Or are they the citizens of countries? Or is the world at large a loser?

The OECD Report argues that

tax havens and harmful preferential tax regimes, collectively referred to as harmful tax practices, affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally. Such harmful tax competition diminishes global welfare (1998:8 para 4).

This statement raises a multitude of questions. Apart from the circularity of referring to a harmful preferential tax regime as harmful, in what sense is it harmful for another country to be a tax haven? If the alleged harm is that tax havens affect the location of financial and other service industries, it needs to be observed that all taxes affect location decisions, including the taxes of the country allegedly harmed. If country A puts on taxes while country B does not, whose action causes financial and other service activities to relocate? Are not country A's taxes the ultimate reason for the erosion of its tax base? Is not the harm self-inflicted? As for distortion of trade and investment patterns, all taxes on labour and capital are distorting; only taxes on rent are non-distorting and there is no international law which prohibits countries from adopting rent

taxes.

As regards the fairness and broad social acceptance of tax systems, it is curious that revenue collectors who traditionally insist in the Courts that taxes must be collected according to law—without regard to fairness—should raise this issue. The obvious point is that many citizens in high-taxing countries do not accept their tax systems as 'fair' and, failing to obtain equity from their political systems, do what they can to protect themselves and their families. Their responses can range from simple legal tax planning such as deductible pension fund contributions, or geared investments or income splitting to more complex tax planning or avoidance and even to minor or massive<sup>15</sup> unlawful evasion.

While one can understand why a high-tax country's tax administrators would view all such responses by its citizens as 'harmful' to revenue collections, that does not mean taxpayer responses to high tax burdens are necessarily always harmful to the country itself. In the case of onshore havens such as pension funds, the capital accumulated may increase investment and productivity while reducing future demands on the treasury from an ageing population. In the case of offshore havens, similar responses by citizens may have similar if more attenuated benefits and may serve as an economic and political safety valve,<sup>16</sup> forestalling the physical emigration of talented labour and capital or the emergence of violent minority political movements.<sup>17</sup> In an ideal society, people would want to pay their taxes or be unable to avoid them, but only benefit taxes or taxes on economic rent are likely to approach such an ideal. With other taxes, it is moderation in their levels and administration which best promotes their acceptance and mitigates avoidance and evasion.

It is therefore impossible to assume that tax competition harms the country losing revenue. It is even more difficult to conclude that 'harmful' tax competition diminishes



global welfare, unless one can show that the gains to the competing country and its clients from the revenue-losing country plus gains to third countries are less than the losses to the beneficiaries of the revenue-losing country's taxes and the marginal deadweight losses of those taxes. Nowhere does the OECD Report attempt such a demonstration.

The difficulty of defining 'harmful' tax competition is further exemplified by the OECD concession (1998:8 para 6) that: 'Tax incentives designed to attract investment in plant, building and equipment have been excluded at this stage...' The focus of the OECD Report is on tax competition for mobile financial capital or services. It seems to be assumed sometimes (or for the time being?) that competition for financial capital is harmful but competition for physical capital is, so far, legitimate.

But physical and financial capital are not so neatly distinguished and tax competition affects labour mobility as well. It seems odd to complain that tax competition for location of financial capital or regional headquarters is harmful while tax competition for factories and jobs is not. As Bracewell-Milnes (1980) and Keen (1993) have pointed out, paper tax avoidance, which means a factory continues to operate and create jobs in a high tax country, may be seen as less harmful than the tax avoidance involved in closing down the factory, sacking workers and setting up in a developing country which grants tax incentives for plant and equipment.<sup>18</sup>

The OECD (1998:17 para 34)

recognises that some investors may seek to invest in a location with lower rates (and greater after tax return) even if only low public services are available...but these genuine location decisions have to be distinguished from the type of behaviour which is the focus of this Report.

Again, the OECD Report gives no criterion by which any such decisions can be

distinguished from any other economic decision. Nor is it satisfactory to define 'harmful' tax competition as that which is 'designed' or 'intended' as tax competition.

Is it harmful tax competition if you intend to poach another country's tax base but not if you pursue a domestic policy which merely has that effect? Such a definition is nonsensical.<sup>19</sup> It would mean that Hong Kong, which pursues a low tax policy assisted by land revenues, is a 'non-harmful' tax haven competitor but Singapore, which is a higher tax jurisdiction, with specific incentives for international business, is a 'harmful' tax competitor. Curiously, it would also mean that the classical tax havens, Jersey, Guernsey and the Isle of Man, were not engaging in 'harmful' tax competition as their tax haven features grew out of domestic policy decisions and long-established tax practice.

Many tax havens have evolved their own tax systems without any particular interest in the wider world, yet the OECD Report recommendations clearly conclude by focusing on the effects of tax competition on the revenue-losing countries more than any intentions on the part of tax havens. In the end, the OECD sees all tax competition as harmful to the interests of revenue-losing tax authorities, regardless of whether it is intended and whether it operates on physical or financial capital or on labour. As Mason Gaffney (1999) has pointed out, the OECD report has not been accurately titled. It should have been called 'tax competition: a problem for high tax countries'.

## Defining 'fair' tax competition

The difficulty of defining 'harmful' tax competition is paralleled by the difficulty of defining 'fair' tax competition. The OECD argues that 'the proposals set out in the Report will reduce 'the distortionary influence of taxation on the location of mobile financial and service activities, thereby



promoting fair competition for real economic activities. If governments can agree that these location decisions should be driven by economic considerations and not primarily by tax factors, this will help move towards the 'level playing field' which is so essential to the continued expansion of global economic growth (1998:9 para 8).

What is a 'real' and 'unreal' economic activity. Is banking unreal? Is insurance unreal? Is e-commerce unreal? Is the Internet unreal? And why is tax not an 'economic' consideration? The House of Lords, the Australian High Court and the United States Supreme Court have taken it as axiomatic that taxation is a normal part of any business decision-making when dealing with cases of alleged tax avoidance.

If the concern is with whether a country's tax regime induces economic activity to shift, then all tax competition is necessarily 'harmful'. The only way to prevent tax-induced changes of investment location would be for all countries to adopt the same tax system and the same tax rates.

The inference from the OECD report is that all low tax countries are engaging in 'harmful' tax competition and the Report evinces in its recommendations an intention to eliminate all forms of tax competition as harmful, no matter how arising.

## The 'harm' caused by tax competition

More insight into what the OECD sees as 'harmful' tax competition comes from its description of the harm caused by tax competition. If tax competition shifts the tax burden from mobile to relatively immobile factors, it is doing the world a service. Economic theory has always held that, from an efficiency point of view, taxes should be laid on things which are inelastic in supply (of which the prime example is land rents). As for progressive marginal tax rates and

income redistribution, there are many economists who would argue that both are economically inefficient, especially when it is sought to finance redistribution by high marginal tax rates on labour and capital incomes as opposed to land rents.<sup>20</sup> It is also odd that a report which complains (OECD 1998:15 para 25) that tax havens are 'free riders' accepts as given the 'free riding' implicit in redistributive taxation (OECD 1998:14 para 23).

## Should tax systems be the same?

Who is to define internationally accepted standards? Should it be internationally unacceptable for a country to raise its revenue entirely from land taxes or resource taxes (for example, oil royalties) and have no taxes at all on capital or labour? If it is to be unacceptable, why should that be so, given the obvious efficiency benefits of such a tax regime and, if, on the other hand, it is to be acceptable, how can one logically object to tax competition? If a zero tax rate on capital and labour income is acceptable to the OECD why does the OECD have any concerns about tax competition? The OECD report seems designed to dissemble the real objective of an OECD-led global tax cartel with worldwide enforcement powers.

## A global tax cartel?

The OECD response to tax competition is to try to organise a tax cartel.<sup>21</sup> The OECD argues that all countries can benefit by joining a global tax cartel.

The assumption that all countries could be better off by joining a tax cartel depends, first, on all countries joining the cartel and, second, on a fixed worldwide supply of the factor sought to be taxed. While some countries may be tempted to join such a cartel if promised a share of the tax revenue, others





will observe that, the larger the cartel, the greater the profits to be secured by those remaining outside it. Apart from the improbability of all countries joining a tax cartel, since the rewards for staying out are increased as more join, the key assumption is that the worldwide supply of capital or labour would not be reduced if all governments colluded to increase tax rates. That this assumption is false is suggested by declining savings rates, labour force participation and birth rates in high tax countries. Even in a closed economy, high taxes on labour and capital have negative consequences.

Such considerations do not appear to deter the OECD from planning the means to enforce a tax cartel. The OECD notes 'Some progress has been made in the area of access to information, in that certain tax haven jurisdictions have entered into mutual legal assistance treaties in criminal matters with non-tax havens that permit exchange of information on criminal tax matters related to certain other crimes (for example, narcotics trafficking) or to exchange information when criminal tax fraud is at issue. Nevertheless, these tax haven jurisdictions do not allow [other countries'] tax administrations access to bank information for the critical purposes of detecting and preventing tax avoidance which, from the perspectives of raising revenue and controlling base erosion from financial and other service activities, are as important as curbing tax fraud' (1998:24 para 54). The OECD goes on to assert 'In an era of globalisation and increased mobility for taxpayers, traditional attitudes towards assistance in the collection of taxes may *need* to change. The purpose...is to encourage countries to review the current rules...with a view to encouraging the enforcement of tax claims of other countries' (1998:52 para 137).

The implications of this OECD bureaucratic view for both OECD and non-OECD countries are that there is to be no distinction drawn between legal tax

avoidance and illegal evasion.<sup>22</sup> It means international crime fighting is being used as a stalking horse to attack so-called tax crimes.<sup>23</sup> It means the destruction of sovereignty and the principle of no extra-territorial enforcement of other countries' taxes. It means the complete destruction of privacy as a social value in OECD societies, notwithstanding its status as a human right under some Constitutions, for example in the United States.<sup>24</sup> Non-OECD countries are expected to legislate to force their citizens to divulge information to OECD authorities not merely for the purpose of prosecuting common criminals but for the purpose of preventing both evasion and avoidance of OECD countries' taxes.<sup>25</sup> No decent person wishes to support drug cartels but many would feel that the loss of all personal financial privacy is too high a price to pay for their elimination.

Just as modern Western states are imitating the later Roman Empire in their population decline, so they are imitating it in their increasingly punitive approach to taxation enforcement as their labour tax bases shrink. Tax defaults are increasingly being criminalised and attempts are being made successfully to prosecute tax evasion as if it were common law fraud (even though taxes—originally called aids or subsidies—are a creature of statute alone and not known to the common law). The great tactical advantage of this confusion of the sources of legal obligation is that the authorities in the OECD country can then seek to use treaties on mutual legal assistance to pursue tax collection outside their borders by claiming they are pursuing criminal acts rather than seeking extra-territorial tax enforcement. There is little point to offshore financial centres saying they will cooperate with OECD measures against illegal tax evasion but not against lawful tax avoidance, if the OECD countries are determined to confound the two: offshore centres have in effect only one choice regarding exchange of tax



information—to force their citizens to provide information to OECD countries for all tax purposes or for none. Governments of offshore financial centres will doubtless study more closely the precise wording of legal assistance treaties to ensure such indirect attempts to erode their sovereignty do not seriously undermine their own revenues.

In essence, the OECD is arguing that the rest of the world should be forced to design their legal and administrative systems to facilitate the application of residence-based income taxation by OECD countries. Even in the heyday of colonialism, imperial powers tended not to make such demands of their colonies. Faced with the prospect of such drastic abuse of legal assistance treaties, one suspects that some non-OECD countries will reach the view that legal assistance treaties are not in their national interest and should be denounced or amended. It would be unfortunate if the unbridled demands of OECD tax bureaucrats were to trigger a decline in international cooperation against real criminality, under which tax offences are not necessarily included by most of humanity.<sup>26</sup>

Just why some countries should be made to enforce other countries' tax laws when it is not in their interests to do so, nor in the interests of world economic growth, is not explained. The radical assault on sovereignty implicit in such sentiments should cause observers to ask what is wrong with the OECD tax systems that they need such drastic extraterritorial enforcement.<sup>27</sup> Territorial income tax systems, or land taxes, do not require such extraterritorial assistance.

### **The problem of trying to tax mobile factors of production**

The real problem the OECD is grappling with is trying to tax what can run away. Tax policy is really quite simple. There are only three sources of income to tax—land, labour

and capital—and only one of them cannot flee. Capital can flee at the speed of light today and it can stop replenishing itself as people either stop saving or investing. Like water, capital can evaporate or leak away from an open economy. Labour has a harder job escaping tax burdens, but it can stop working, shift to the black economy, emigrate (especially if it is skilled)<sup>28</sup> or stop breeding. Only land (which includes all scarce natural resources) can command a true economic rent which cannot be diminished by taxation.<sup>29</sup>

There is no reason why reduced taxes on mobile capital could not be financed by increased land taxes within the OECD countries.<sup>30</sup> If they choose to tax their workers more rather than land, that is their domestic political decision, just as it was a domestic political decision for many OECD countries, notably in Europe, to embark on high welfare spending programmes which necessitated high taxes on labour and made them internationally uncompetitive. Having made those decisions, they should not blame the rest of the world for the logical economic consequences.

Just why small countries, for example the Pacific island countries, should be expected to provide a 'level playing field' for OECD countries by embarking on similar high-tax, high-spending, policies is not explained. Why should places such as Vanuata with few resources be expected to forgo any chance of maintaining the living standards of their people by imposing OECD tax rates which would drive away business and employment? To blame emerging economies in the Asia Pacific for the economic woes of European welfare states may be good domestic politics in Europe but it is bad economics, both for Europe and the world at large.

The argument that tax competition is harmful, implicitly rests on the assumption that there are only two factors of production, labour and capital, and these are fixed in their total worldwide supply. Both assumptions are quite false.



From the point of view of national economic welfare, the view that tax competition is harmful is correct only if there are no immobile tax bases available. Where there are mobile tax bases (for example, capital) and immobile tax bases (for example, land), tax competition can force a country to shift its tax base from mobile capital to immobile land. Such a shift is, in fact, a shift to a more efficient tax base, one conforming to the general Ramsey efficiency rule of taxing more those things which are less elastic in supply. Tax competition may thus be efficiency enhancing and no bad thing for a country, even if its tax administrators or politicians find it uncomfortable.

The economic theory underpinning the concept of 'harmful' tax competition is essentially non-existent. The theoretical models employed in the economic literature to show harmful effects from tax competition and a loss of collective revenue are essentially based upon models which assume a fixed worldwide supply of capital. In those models, tax competition is a 'beggar thy neighbour' policy whereby the gains of financial centres or tax havens must be at the expense of tax revenue in the capital exporting countries. Obviously, if the world conformed to such models, if there were a fixed world stock of capital, governments could collect more tax by operating a tax cartel. It would be in their collective interest to eliminate tax competition. In such models, it would make sense for a UK government to pressure its dependent territory governments to put up their tax rates and compensate them for any revenue lost by paying subsidies (increased foreign aid) out of the increased revenue generated by driving capital back to the United Kingdom.

However, the implicit assumption of the OECD model is wrong. The world 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. Once this fundamental error of the harmful tax competition model is grasped, the concept collapses.

### **The zero optimal tax rate on capital**

A key question is whether all forms of income should be taxed equally. Leaving aside ethical views in favour of graduated income taxes,<sup>31</sup> the answer depends on how responsive different parts of the tax base are. Income is not a homogeneous tax base.<sup>32</sup> It is not sensible to tax all forms of income at the same rate if the factors of production generating the income are not all equally mobile. In particular, it does not make sense to tax mobile capital, especially capital supplied by foreigners, at the same tax rate as income arising from land or immobile labour tied to the jurisdiction. Though not essential to the case against the OECD's views on harmful tax competition, it is reasonable to suggest that the optimal tax rate on capital income is zero.<sup>33</sup>

The fundamental Ramsey principle of taxation is that taxes should be levied on those activities which are least responsive. One would not tax a factor of production which was in perfectly elastic supply. This has profound implications for internationally mobile capital. Theoretical models of optimal taxation produce three broadbrush results (Frenkel and Razin 1996:chap 14).

- the optimal principle of international taxation is the residence principle; that is, non-residents should not be taxed on their capital income from a country
- the optimal tax rate on capital income from all sources is zero
- the optimal tax rule for a country that cannot enforce taxes on foreign source capital income is to abstain entirely from taxation of domestic source capital income as well.

Even in a closed economy, it may be efficient to exempt capital income from tax in the long run (Chamley 1986; Correia 1996).



The intuition behind these conclusions is not difficult to understand, even though the policy implications are dramatic.

One would not tax non-residents on their capital income because that drives up the cost of capital to the local economy—non-residents can take their mobile capital and invest it elsewhere. By driving away mobile capital, the tax becomes an inefficient tax on immobile factors of production, such as immobile labour or land (Kopits 1992:5, 15; Head 1997:86). One should not tax the capital income of non-residents just as one does not outlaw foreign investment. One wants foreign capital to increase the productivity and wages of the local population.

Just as capital can flow across borders, so capital can evaporate over time. Hence, in the long run, the optimal tax rule is not to tax capital income at all. Taxing the return on capital lowers the capital intensity of the economy and reduces the productivity and wages of labour. This is one of the major arguments for shifting from an income to a consumption tax base (although that can be done just as—or more—easily by exempting capital income from tax).

The third principle states that if capital income is to be taxed without distorting the allocation of investment then, other things being equal, it is desirable to tax income from domestic and foreign investments equally. But if one cannot tax foreign income equally—and even with the most sophisticated legislation that is likely—then one should cut the rate of tax on domestic capital income.

### **Territorial revenues from land rents**

Hong Kong has made a policy of raising much of its public revenue from land rents, which has enabled it to keep its tax rates on capital and labour comparatively low. That policy attracts capital investment which in turn pushes up land rents and enhances the

(land) revenue base—a virtuous economic cycle. There is nothing to stop developed countries such as the United Kingdom, the United States or Australia pursuing similar policies if they wish. Rather than complaining about 'harmful tax competition' they would do better to emulate Hong Kong. For example, the United States economic revival owes much to President Reagan's tax cuts and it is notable that the United States is somewhat more comfortable than the European Union with economic competition (and internally has long lived with State tax competition).

Indeed, this leads to the logical point that international tax competition, by forcing governments to reduce tax rates on mobile capital income or mobile labour, is directing governments' attention to the desirability of shifting the tax base towards immobile factors (which includes full licence fees for natural monopolies such as the broadcast spectrum). Economic theory declares that the most desirable tax base is a tax on unimproved land values because it cannot be shifted and has no distorting effects on investment in physical capital or labour supply. The beauty of such territorial-based taxation is that it also solves the tax treaty issue—international double taxation becomes a non-issue and the OECD tax treaty network becomes unnecessary.

As countries have reduced their company tax and top marginal personal income tax rates, they have turned to value added taxes, user charges, expenditure copayments, social security levies and mandated social insurance because there is less incentive or ability for such tax bases to leave the jurisdiction. Thanks to tax competition, tax policies are *de jure* shifting taxes from capital towards labour income, from the more mobile towards the less mobile factor. This could be to labour's advantage as *de facto* shifting is eliminated and jobs and wages are nourished by increased investment.



But the process can—and should—go further than simply shifting taxes from capital to labour.<sup>34</sup> As Kopits (1992:5) notes, a country can use its resource rents to respond successfully to tax competition for mobile capital. Although there does not seem to have been an international trend to shift taxes from capital income to land (as opposed to labour, which raises its own problems), some observers have noted that Hong Kong and Singapore have been able to compete on their company tax rates because they have placed heavier reliance on taxing land.<sup>35</sup> Professor Martin Feldstein, former Chairman of the US Council of Economic Advisers, acknowledges a tax on unimproved land values ‘involves no distortion’ and is clearly efficient (Feldstein 1976:96).

So, economic freedom and international tax competition are world welfare enhancing. Far from hurting the OECD, it is nudging OECD countries towards optimal tax policies which are in the best interests of their citizens.

### **Who says what is a ‘level playing field’?**

Another key theoretical defect of the OECD report lies in its concept of the ‘level playing field’. It appears to be assumed that the optimal approach to maximising world economic growth consists of identical tax and regulatory systems. But why should this be so?<sup>36</sup> The absurdity of the proposition is immediately obvious if it were suggested to OECD countries that they should now harmonise on a Soviet style command economy system. If the countries of the world cannot all agree on the first-best taxation system of taxing land rents, is that any reason why some countries should not do so and become tax havens for the avoidance of other countries’ less efficient taxes? It might also be pointed out that OECD countries often cannot agree themselves on what the regulatory level playing field shall be. For

example, New Zealand has not taken the view that insider trading should be a criminal matter but treated as a civil law matter between a company, its employees and others having a fiduciary duty.

The reality is that, while comparative advantage is a basic source of gains from international trade and commerce, comparative advantage may be largely man-made. It may depend substantially on how countries tax and spend (for example, whether they spend on infrastructure or age pensions) and how they regulate or tax mobile business. Countries which are resource-rich are sometimes poor because of oppressive government and oppressive taxation while countries which have little by way of natural resources (for example, Switzerland, Singapore and Hong Kong) have sometimes become rich by pursuing policies of good government and lower business taxation. A perfect identity of regulatory systems in search of a level playing field can destroy the gains from trade and deny the world the beneficial demonstration effects of genuine free market economies. The offshore financial centres could do worse than remind Europeans and Americans that European civilization rose to greatness not from the slavish Imperial uniformity of the later Roman Empire but from the competition between the nation states which succeeded it.<sup>37</sup> It was the ability to cross a frontier or cross the Atlantic and escape from tyranny which protected the vitality of Western culture and enterprise. The Anglo-American tradition is one of liberty rather than uniformity.

The offshore financial centres might also point out that federations such as the United States and Australia have lived with tax competition for decades without disintegration. A New Hampshire or a Queensland has not only served its own interests by following a low tax policy but also, by putting pressure on the tax policies of neighbouring states, has helped to keep



economic activity within the federation as a whole.

In the international sphere, the United States and the United Kingdom have long engaged in tax competition. The United States is an offshore banking tax haven<sup>38</sup> while the United Kingdom rules granting the remittance system to non-domiciled residents has meant that London has been a tax haven for many wealthy expatriates.<sup>38</sup>

Without a refund system for embedded State indirect taxes on exports and with a system of taxing worldwide income, the US stands to disadvantage itself uniquely by continuing to endorse the OECD attack on 'harmful' tax competition. Having felt the sting of international tax conformity in the form of the adverse World Trade Organization ruling on its foreign sales corporations, the US would do well to reconsider its support for the OECD and EU attacks on tax competition. The US Congress is starting to ask itself the right questions by examining a bill to implement a territorial system for taxing business income.<sup>40</sup>

## Conclusion

Because mistaken and unexamined OECD nostrums on tax competition are affecting world economic policies by appealing to the prejudices of EU and other politicians, offshore financial centres should undertake their own research to examine the 'harmful' tax competition issue so that the implicit errors of OECD policy reasoning can be debated openly and flushed out. They need to enter the global economic policy debate. Ideas matter!

The governments and citizens of offshore financial centres are entitled to resent strongly a situation in which they are being pressured (or pilloried) by the OECD on the basis of wholly incomplete economic theorising. They need to point out to the OECD that the remedy for the alleged 'harm'

of tax competition lies in the hands of OECD countries themselves. No offshore financial centre is preventing any OECD country from privatising or implementing 'user pays' for social insurance. No offshore centre is forcing any OECD country to have a bloated welfare state or impose high taxes on labour and capital. No offshore financial centre is preventing any OECD country from taxing immobile land and resource rents which are immune to tax competition.

Vanuatu and other offshore financial centres have no reason to cut their own incomes by winding back their services. As parts of Adam Smith's 'invisible hand' they serve not only their own, but the world's interests, by facilitating the freedom of trade and investment and the protection of property. Those who seek to eliminate offshore financial centres might do damage to their own countries were they to succeed.

No doubt, offshore financial centres should cooperate as good international citizens in combating common criminality. But they should politely decline any suggestions to harmonise taxes or to assist OECD tax enforcement directly or indirectly through any exchange of information. Perhaps some offshore financial centres may be coerced or bribed by the OECD to join its tax cartel, but, as with all cartels, the fewer there are outside the cartel the greater the profits to be had by them. Notwithstanding the current clouds over offshore financial centres, it is hard to see anything but increased demand for their services so long as there is scorn elsewhere for 'the obvious and simple system of natural liberty' which commended itself to the Physiocrats and Adam Smith (1776:687).

## Notes

- <sup>1</sup> These have included the United Nations report on *Financial Havens, Secrecy and Money Laundering*, the EU Code of Conduct on business taxation and the G7 initiatives



including the Financial Action Task Force (FATF). Money laundering legislation has moved well past drug trafficking to all kinds of 'economic crime' such as tax avoidance or evasion as well as securities law evasion or avoidance.

<sup>2</sup> See the Parliamentary speeches of William Pitt, 1st Earl of Chatham, 14 January 1766 and 20 January 1775.

<sup>3</sup> The metaphysical subtleties in distinguishing between 'purpose' and 'effect' is well understood by lawyers dealing with general anti-avoidance statutes.

<sup>4</sup> Curiously, Treasury officials have often downplayed the influence of taxation on investment decisions when arguing against the need for industrial countries to cut tax rates in order to compete on tax. Yet that has not stopped them from arguing that tax competition is a major concern (see Griffiths 1994). One might have thought that the two propositions were mutually inconsistent. The reality, and the commonsense, of the matter appears to be that taxation is a major, but not the only, influence on investment location decisions. It is generally agreed that taxation does affect business location (Papke 1987, 1991; Devereux 1992; Industry Commission 1996). Tax may not be the most important determinant—factories are not built on remote tax-free islands with no infrastructure and no workers—but tax will always be an important influence. As David Williams writes: 'Tax systems used once almost to be solely decided by a nation. Now even the biggest economies have tax systems which are part of the same world economy, and they are in competition together (1991:34).' There is increasing competition for international investment and, with improved real time communications and lower tariffs, an increasing ability to move operations offshore.

<sup>5</sup> The World Trade Organization has ruled that a US policy of granting special tax preferences to companies that export (foreign sales corporations or FSCs) is a violation of WTO rules. The United States has until 1 October 2000 to either change its tax laws or face retaliatory sanctions that could reach US\$6 billion annually. Daniel J. Mitchell, a senior

fellow at the Heritage Foundation, a Washington-based public policy research institute has written in the *Washington Times* (3 January 2000) that the United States could best respond to the WTO by repealing the US tax code's onerous foreign income provisions and instead shifting to a territorial tax system which would only tax income earned inside its borders, making US companies more internationally competitive.

<sup>6</sup> The threat is clear in Robin Cook's statement of 17 March 1999 to Parliament introducing the UK White Paper *Partnership for Progress*. He said '*we have to insist on the governments of the Overseas Territories fulfilling their [sic] obligations to meet the standards of international organisations in which the United Kingdom represents them. There are two issues which are of priority in meeting those obligations. The first is to match the best international standards in financial regulation... We will therefore be requiring all Overseas Territories, by the end of this year, to meet in full international standards on money laundering, transparency, cooperation with law enforcement authorities, and independent financial regulation. The globalisation of international finance means that we cannot tolerate a weak link anywhere in the chain without exposing investors everywhere to risk. The second area of priority is in human rights... Specifically, we require changes in the law in a minority of Overseas Territories which retain corporal punishment and criminalise consensual homosexual acts in private. Our strong preference is that the Overseas Territories should enact the necessary reforms themselves, but we are ready to make such reforms by Order in Council if they fail to do so.*' It seems the EU view is that there is a human right to privacy in sexual, but not financial, affairs. It is also interesting that in the Foreword to the White Paper, Mr Cook states 'It will ensure that we put up a common front against fraudsters, tax evaders, money launderers, regulatory abuse and the drugs trade. 'The order of listing seems to confirm more cynical views that, while drug trafficking has been a convenient excuse to elicit overseas cooperation, the emerging OECD



agenda is more tax-driven. Cynics will also note: 'In a recent communiqué, the G7 urged the OECD to give particular attention to the development of a comprehensive program to improve the availability of information to tax authorities to curb international tax evasion and avoidance through tax havens and preferential regimes. It also encouraged action to ensure that suspicious transaction reporting requirements apply to tax offences and for money laundering authorities to pass information to tax authorities in support of the investigation of tax related crimes in ways which would allow it to be shared internationally' (UK 1999:para 5.26).

<sup>7</sup> This certainly seems true of many Americans who suffer from a system of elected judges and tort juries plus a lot of lawyers searching for 'deep pocket' defendants.

<sup>8</sup> Contrary to David Ricardo's expectations, many British subjects have moved assets to offshore havens to escape new laws (whether arising from law reform or judicial activism) and enjoy old and familiar laws in present and former British possessions.

<sup>9</sup> I am not alone in this view. Sinn (1993:43–44, 70) also argues that tax competition is beneficial for the citizens of the 'losing' high tax country. It forces Leviathan governments to put their houses in order by cutting wasteful spending and shifting taxes from mobile to immobile factors of production. Breton (1996) explores how the collusive suppression of intergovernmental or political competition tends to make citizens worse off without making anyone better off, except the colluding politicians and bureaucrats.

<sup>10</sup> One can think of a sovereign competing for subjects and investment like any other economic agent maximising wealth, or of a democratic government maximising the wealth of its people. In either case, what is to be maximised is the country's welfare not some abstract concept of world welfare. If economists believe free competition maximises group welfare among self-interested individuals, one might expect a similar result in similar competitive processes.

<sup>11</sup> For example, it would be strange if a well-run country with no corruption, low spending and low taxes were seen as a more

'anti-social' world citizen than another with corruption, bloated spending and high taxes.

<sup>12</sup> From an individual nation's viewpoint, it is clearly welfare-improving to have something rather than nothing. Even Australia exempts bank interest derived through offshore banking units by non-residents and is, to that extent, a tax haven, though the policy amounts to little more than not taxing foreign source income of non-residents. What the critics of tax competition have to prove is that such actions are collectively welfare-reducing and that all nations could do better by not competing.

<sup>13</sup> Critics of tax competition may argue another, apparently, closer analogy: that tax competition is like competitive exchange rate devaluation. But tax rates distort the market equilibrium in the real economy and the reduction of tax wedges between pre and post tax rates of return on mobile capital reduces, rather than increases, distortions.

<sup>14</sup> Even from a narrow nation-state point of view, tax havens can be beneficial to a large power. For example, Hines and Rice (1994) point out that tax havens help US multinationals move profits back into US jurisdiction and the United States collects more tax in the end (at the expense of the source countries).

<sup>15</sup> Those who stripped companies with inchoate tax liabilities of their assets in the 1970s and sank documents into 'the bottom of the harbour' were the most extreme example Australia has seen of large-scale tax evasion.

<sup>16</sup> The late Professor Wheatcroft, an expert on the UK capital gains tax, is said to have remarked that: 'A tax system breathes through its loopholes'. That remark recognizes that all taxes on labour and capital are distorting and, if they can ameliorate the economic distortions created by taxation, taxpayers may be contributing to a more productive economy, for example, taxpayer self-help before imputation ameliorated the defects of Australian double taxation of income (Head 1997: 65).

<sup>17</sup> Note that this is only looking at some economic benefits from citizens' tax reduction activities. The economic benefits to a country from a citizen's 'tax reduction fund' may





depend more on such factors as whether it is onshore and invested domestically (Australian superannuation funds in the 1960s) or offshore and invested in another economy (Latin American flight capital in New York banks in the 1950s lent to US companies) than on whether the 'tax reduction' was obtained through legal tax avoidance or illegal evasion. That does not mean the distinction between legal or illegal activity is irrelevant, since increasing evasion may have a contaminating effect on public morals and respect for the rule of law, without which no economic activity is possible.

- <sup>18</sup> Bracewell-Milnes neatly controverts several conventional wisdoms, including the legal versus economic tax avoidance issue. After all, which is worse—the oft-deplored legal 'paper' avoidance which means a factory still operates, employing workers and generating PAYE and so on, or economic tax avoidance—closing down the factory and relocating in China? Why is the former denounced so strongly and the latter recognised as a legitimate business decision? And if both forms of avoidance are denounced with equal force, when will China, Hong Kong, Singapore and dozens of other countries be seen as anti-social economic threats to prosperity?
- <sup>19</sup> As equally illogical as to say that tax competition which poaches a tax base but not physical investment is 'harmful' yet tax competition which snares both is acceptable.
- <sup>20</sup> If a government wants to see income redistributed, a global graduated income tax is not necessary. A government can distribute the proceeds of resource revenues and can allow tax deductions for income transferred to low income relatives or to charity. Hong Kong has used low flat-rate taxes and land revenues to provide large subsidies to public housing.
- <sup>21</sup> The EU has tried to counter tax competition by prescribing minimum levels of corporate or value-added tax. Minimum withholding tax rates are under consideration. This is the action of a tax cartel and the OECD is clearly heading in the same direction.
- <sup>22</sup> The distinction between lawful tax avoidance and illegal tax evasion is basic to the rule of law. One of the most depressing features of

modern taxation systems is their tendency to corrupt basic legal principles. The British legal tradition held that all tax legislation is of its nature penal legislation which takes away common law rights. Since taxes were voluntary grants by Parliament to the Crown which derogated from common law rights, taxing statutes had to receive a strict construction. Increasingly, OECD countries have tended to rely upon statutory or judicial anti-avoidance doctrines which overturn the principle that the subject is not to be deprived of his property except by clear words (see Cooper 1997). The rule against self-incrimination is routinely ousted in tax administration. Retrospective tax liabilities are often created and the onus of proof increasingly reversed not only in civil tax collection but also in criminal prosecutions for tax fraud. Lawyer-client privilege is attacked and assets are seized without due process of law under a presumption of guilt. Even tax administrators themselves have sometimes anguished over the legal problems created by criminalising what was in the past a civil default (see Howard 1982). More recently, the US House Judiciary Committee and others have expressed concern over the abuse of forfeiture laws and asset freezing or confiscation ahead of conviction. The mere fact that OECD countries have increasingly abandoned basic legal principles and vital distinctions between legal and illegal or civil versus criminal acts is no reason why offshore financial centres should follow suit by allowing tax matters to come under treaties dealing with mutual assistance in criminal matters. On the contrary, this is a reason for stronger adherence to the traditional circumspection on enforcing foreign revenue laws (a circumspection which can also apply in federations—State death duties could not be enforced against executors in other States in Australia). Offshore financial centres and their citizens are simply not subject to the tax laws of the OECD countries, just as Americans are no longer subject to UK revenue laws nor under any legal or moral obligation to assist the UK Treasury.

- <sup>23</sup> This is particularly obvious in the United Nations Political Declaration and Action Plan



against Money Laundering adopted at the Twentieth Special Session of the United Nations General Assembly devoted to 'countering the world drug problem together' New York, 10 June 1998. Drugs are the ostensible focus of concern but the proposals on money laundering go much further. Offshore financial centres may rightly insist that any financial regulation or reporting they choose to implement be limited to international drug trafficking matters.

<sup>24</sup> Some (perhaps many) would argue that privacy, including bank secrecy or confidentiality of personal or business affairs, should given way to the need to investigate criminal activity.

<sup>25</sup> Australia pioneered instantaneous electronic reporting of financial transactions as part of law enforcement and made this facility available not just to police combating the drug trade but also to taxation officials. Several hundred public servants now have online access to the financial data of Australian residents. One suspects that allegations of Internet crime are going to be used (conveniently) to facilitate a further enhancement of bureaucratic powers in many countries.

<sup>26</sup> The attitude of most people may be close to Will Rogers' remark that the income tax has made more liars out of the American people than golf. There is a certain inconsistency sometimes observed in the attitudes of ordinary people. Small scale tax evasion through false declarations by ordinary people is commonly condoned while legal, but large scale, tax avoidance is commonly condemned. The inconsistency of moral judgment seems only explicable by the fact that most people consider taxation itself as often arbitrary, unjust and immoral. As Coffield (1970) points out, the growth of taxation tends to corrupt public morals, inflame envy and bring the law into disrepute. Nor does it seem to make much difference whether the tax laws are enacted by a monarchy or a democracy. No one who has taken notes of Cabinet deliberations would pretend that laws always reflect wisdom or justice. There are actions now

legal which used to be proscribed (adultery) and vice versa. The real reason for obeying positive law is often more a sense of moral self-respect, see Adam Smith's *Theory of Moral Sentiments*.

<sup>27</sup> A question not asked by Jeffery (1999).

<sup>28</sup> The post-War 'brain drain' to the United States from the United Kingdom cost the United Kingdom dearly.

<sup>29</sup> That economic rent can even be increased by taxation if the proceeds are spent on useful public works or to remove taxes on labour or capital which will move in to use the land. See Mieskowski and Zodrow (1989) on this 'Henry George' theorem, of which Hong Kong has afforded some demonstration (see Rabushka 1979:62).

<sup>30</sup> Australia and New Zealand pioneered taxes on unimproved land values. New South Wales shifted to unimproved land rating in 1906 and gradually overtook Victoria (which did not) in population and wealth. The Australian Capital Territory was established on a leasehold tenure basis so that it would be self-financing without taxes. But both countries have forgotten their history and their land taxes have been wound back in favour of higher income and consumption taxes. In the ACT, leases have been renewed for trivial payments and taxes put up instead. Australians never ask themselves why, with a resource endowment per capita among the highest in the world, they cannot successfully compete internationally on business taxes by shifting to land and resource taxes.

<sup>31</sup> The view that all income should be taxed at graduated rates regardless of its source is a common, if not the prevailing, view among economists. Despite its popularity, it is essentially an ethical, not an economic, view and only one of several possible ethical views. At bottom it rests on utilitarian concepts, whether expressed through social welfare functions, including Rawlsian maximin functions or through older ideas of diminishing marginal sacrifice. As an ethical view, countries and individuals are free to reject it in favour of what they might consider more compelling ethical views. For example, many offshore financial centres rely on import duties and tourist luxury taxes as a



mix of a basic flat rate tax on inhabitants plus a windfall from foreigners. But other ethical views are possible. One could, for example, take a natural rights view of revenue raising as did the French Physiocrats: one could argue that the sovereign should collect the rent of land as a method of discharging the Lockean proviso that land can only be appropriated by one man against another so long as the other is compensated. Thus a Henry George or even a John Stuart Mill might argue that he has no objection to media tycoons minimising their tax payments according to law but he would rather condemn any politician who chooses to endow any person with valuable common property such as spectrum rights without charging full market rental annually. A fair price, not a tax, would be the cry of such a natural rights theorist, and he would have the support of ancient Parliamentary tradition. But one does not have to agree with this ethical view, to realize that a Brunei or a Saudi Arabia is quite within its sovereign rights in raising revenue solely from selling or leasing its natural resources (after all, Adam Smith started his discussion of the sovereign's revenues with land). A policy of looking first to resources for revenue also happens to allow reduction of economic distortions since one can reduce labour and capital taxation: Hong Kong's low tax rates would not have been possible without its land revenues. But whatever ethical view one takes, the OECD cannot legitimately complain about countries which take a differentiated or schedular approach to income taxation (as have the Scandinavian countries). If, for example, Brunei does not collect a personal income tax for itself why should it be expected to assist other countries enforce their residence-based income taxes within Brunei's territory?

<sup>32</sup> In reality, there is no such thing as an income tax. As Adam Smith recognised, a tax on income is three taxes—a tax on the wages of labour, a tax on the rent of land and a tax on the profits of capital.

<sup>33</sup> By having a zero tax rate on interest income, Hong Kong to a large extent exempts that part of capital income which represents a riskless rate of return.

<sup>34</sup> The OECD complaint that tax competition forces a shift in tax burden from (mobile) capital to (immobile) labour not only ignores the possibility of taxing land or other natural resources but it also sounds rather odd coming from European countries which have willingly raised social security payroll taxes and value-added taxes to extremely high levels.

<sup>35</sup> *Australian Financial Review* editorial 30 June 1997.

<sup>36</sup> 'Arguments for creating a level playing field are troublesome at best. International trade occurs precisely because of differences among nations—in resource endowments, labour skills and consumer tastes. Nations specialize in producing goods and services in which they are relatively most efficient. In a fundamental sense, cross border trade is valuable because the playing field is *not* level... Taken to its logical extreme, the notion of leveling the playing field implies that nations should become homogeneous in all major respects... [but the] core of the idea of political sovereignty is to permit national residents to order their lives and property in accord with their own preferences.' Tanzi (1995, preface pxvii)

<sup>37</sup> Douglass North (1995:32) also argues that European development profited from institutional competition between competing nation states.

<sup>38</sup> The US exempts interest on bank deposits of non-resident aliens. Indeed, the US has served as a tax haven for capital from Latin America, see McLure (1989).

<sup>39</sup> For its part, Australia acknowledges that it cannot necessarily tax foreigners on their capital income and imposes no interest withholding tax on widespread foreign borrowings such as Eurobonds.

<sup>40</sup> Although it is treated as axiomatic by many writers that foreign income should be taxed, it is not clear that this is so. Suppose, for example, another country raises all its tax revenue through consumption or payroll taxes. The idea that a dividend from that country represents untaxed income is somewhat naive. Further, unless that foreign country supplies the same level of public services to an investor in return for low or



no taxes, one cannot assume that taxing the investor at home produces a neutral result. For example, a company operating in Liberia may pay no tax but would be spending considerable amounts of money on providing the sort of physical protection which home taxes would provide. There is thus both pragmatic and theoretical justification for the policy adopted by more than a few Asian, European and Latin American countries of excluding foreign income from the tax base. Interestingly, the US has spent the most effort over the years trying to tax foreign income, but at the same time invented foreign sales corporations to try to mitigate the adverse effects on American exports! The US may get no tax revenue from its foreign tax regime because the US credits foreign taxes and allows active income of subsidiaries to remain untaxed (Grubert and Mutti 1995). The use by US companies of low rate havens may even enhance US tax collections (Hines and Rice 1994). A territorial system of international taxation of business income has been suggested for the US (Hufbauer 1992:135–136). The tax-writing committee in the House of Representatives is considering a Bill to replace the corporate income tax (and the business parts of the personal income tax) with a business transfer tax that would be territorial. This may not happen, but the World Trade Organization decision that the US Foreign Sales Corporations were in breach of WTO rules has created a new US appreciation for territoriality (though part of the motive for the Bill is border-adjustability for indirect taxes).

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