International Tax Competition: Harmful or Beneficial?

'A response to the OECD report *Harmful Tax Competition: An Emerging Global Issue*'

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Introduction – advent of the OECD Report

The OECD Report *Harmful Tax Competition: an Emerging Global Issue* was presented to Ministers of the OECD countries at their meeting on 27–28 April 1998. The Report summarises itself as follows:

> 'Globalisation has had positive effects on the development of tax systems and has encouraged countries to engage in base broadening and rate reducing tax reforms. However, it has also created an environment in which tax havens thrive and in which governments may be induced to adopt harmful preferential tax regimes to attract mobile activities. Tax competition in the form of harmful tax practices can distort trade and investment patterns, erode national tax bases and shift part of the tax burden onto less mobile tax bases, such as labour and consumption, thus adversely affecting employment and undermining the fairness of tax structures.
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> The Report emphasises that governments must intensify their cooperative actions to curb harmful tax practices. To achieve this, OECD Member governments have developed "Guidelines on Harmful Preferential Tax Regimes". These Guidelines will discourage the spread of harmful preferential tax regimes and encourage countries with such regimes to eliminate them. To counteract both tax havens and harmful preferential tax regimes, Member governments have also agreed to pursue vigorously the implementation of the other Recommendations in the Report, including entering into a dialogue with non-member countries.'

Thesis of the Report

The central thesis of the Report can be expressed as follows:

> 'In a world moving towards a global free market, the factors capital and

labour are increasingly mobile. Such factors will tend (other things being equal) to be attracted away from countries with high tax burdens to countries with low tax burdens.

The Report concedes that tax competition can be beneficial, in stimulating the simplification of tax systems and reduction of tax rates. What it objects to is what it terms "harmful" tax competition. However, when tax competition ceases to be beneficial and starts to be harmful is not clear, and is essentially subjective. This is one of the weaknesses of the Report.

What the Report identifies as "harmful" effects of tax competition are two things. First, as mobile capital and labour leave a taxing jurisdiction, in the absence of any reduction in public spending, there will be an increasing burden on the less mobile labour and capital remaining in the jurisdiction, and on local consumption. This is considered to be unfair. Secondly, the Report objects to countries which specifically target mobile labour and capital in other countries to attract them away, either by operating as a "tax haven", or by offering a "preferential tax regime"[1] to overseas individuals and businesses. This is referred to by some jurisdictions as "poaching the natural tax base" of other countries.

It might therefore have been more accurate to have titled the Report: "Global Erosion of National Tax Bases – an Emerging Issue". Had the Report been so titled, it might have changed the terms of the debate. Global erosion of tax bases is a major problem for the OECD countries because of the nature of the tax base they have chosen.'

Response to the problem

There are a number of ways in which the OECD countries could have responded to the problem. One is by a radical reassessment of what an efficient and just tax system would look like, with consequent purely domestic changes to their tax laws and a transition to a largely immobile tax base. Another, and the one actually chosen by the OECD, is by seeking international co-operation from other countries in the enforcement of taxes overseas. However, some countries may have an incentive to offer such co-operation, while others may not. The latter are most likely to include the so-called 'tax havens'.

Many 'tax havens' are simply taxing jurisdictions that have no 'direct' tax

1 The preferential tax regime is sometimes ring-fenced to isolate it from the local economy. A long standing example is the UK's preferential treatment of foreign domicilaries who are resident in the UK. They are taxed only on a 'remittance' basis, ie on income and gains they bring into the UK. This regime is the cause of many offshore UK tax planning structures.

system,[2] ie no taxes on income or capital gains[3] of individuals or corporations and no taxes on the ownership, gift or inheritance of wealth. Most jurisdictions with a direct tax system (including the OECD countries) seek to charge taxes on the overseas income and assets of residents and locally headquartered businesses (and, in the case of the USA, citizens). It is because of this that double taxation treaties are needed, to relieve the taxpayer from being taxed twice by different taxing authorities.[4] It is also because of this that the problem arises of international co-operation in the enforcement of taxes outside the territory of the taxing jurisdiction.

The sovereignty issue

Only the government or state[5] in any jurisdiction has the authority to tax. It is a purely sovereign power. Under public international law, the sovereignty of a state is recognised as territorial in scope. Because of this the traditional rule and practice has been that no state will assist a second state in levying taxes within the first state's territory. Accordingly, tax judgments obtained in one jurisdiction are not customarily enforceable in another.

This has made it difficult in the past for any country that levies taxes on a worldwide basis on its citizens, residents or locally headquartered businesses to enforce such taxes overseas. This, together with the relaxation of currency and exchange controls, has made it easy for people to avoid or evade (as the case may be) taxes simply by investing overseas. The taxing jurisdiction can always tax the domestic assets of the 'taxpayer', but may not be able to tax overseas assets. Instead, it may try to charge and enforce taxes against the taxpayer's domestic assets by reference to both the domestic and the overseas assets. This does not strictly involve any assertion of sovereignty overseas. Nor does it require any co-operation or enforcement from the overseas jurisdiction, provided the taxing jurisdiction has the requisite information to be able to calculate the tax payable.

This is where the problem with 'tax havens' is encountered. Many such countries have no direct tax system, and therefore no requirements to file accounts publicly or to report income or assets to the government. Moreover,

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[2] In this paper the phrase 'direct tax system' is used in its colloquial sense, meaning taxes levied on individuals or corporations according to their income and capital gains and on individuals according to gifts and inheritance of wealth. A more correct phrase would be 'in personam' taxes. These are to be contrasted with 'in rem' taxes, which conceptually are taxes levied on a thing itself (not a person or corporation), such as goods (charged to sales and excise taxes), land, documents (charged to stamp duty) or in the case of a corporation or business its seat of registration as a corporation or licence to carry on a certain, usually regulated, business.

[3] In the UK income tax and capital gains tax are separate taxes, whereas in the USA capital gains are viewed as 'income' and charged to tax under the income tax, albeit at a preferential rate different from other income.

[4] Typically the jurisdiction of situs of the asset or economic activity and the 'home' taxing jurisdiction.

[5] Including any subsidiary of the state on a local basis.

in some of those countries there are confidentiality laws which make it difficult for any third party to obtain such information.

'Tax havens', since they generally do not attempt to tax income or assets outside their territory, have no natural incentive to co-operate with countries that do try to tax on an extra-territorial basis. As a result, the sought-for 'co-operation' may be abandoned by taxing countries, to be replaced by some covert form of coercion.

The OECD Report requests the co-operation of countries which have 'harmful tax practices', but hints that if such co-operation is not forthcoming coercion may become necessary. At para 137 it explicitly states: 'In an era of globalisation and increased mobility for taxpayers, traditional attitudes towards assistance in the collection of taxes may need [sic] to change'.

International conformity through international pressure

One of the OECD's aims is to encourage the transition to a global free market and thus towards increasing mobility of capital and labour. This would certainly be compatible with advocating a transition to a tax system based on purely local and immobile factors of production (such as land and natural resources in the territory of the taxing jurisdiction). However, currently prevailing tax theory considers such a tax system to be discriminatory and unfair.

As a result, the OECD have had to seek a universal 'level playing field', which in their terms means a uniform tax system across the globe. If all countries adopted identical tax systems at identical rates, there would be no scope for tax competition between states. This, it seems, is also one of the goals[6] of the European Union.

Here, however, there is a form of ideological clash. Some countries are philosophically opposed to certain types of taxes. For example, some 'tax havens' are opposed to income taxes, even in the local economy. At the same time, other countries are wedded to certain types of taxes. For example, most of the OECD countries are wedded to income taxes, either because of ideology or because such taxes are needed to meet a large public expenditure burden, including the servicing of extensive public debt.

In this clash, there is significant inequality of negotiating power. The OECD Member countries are the most powerful countries in the world, who through the OECD are now acting in unison. By contrast, the 'tax haven' countries are small jurisdictions with little or no political coordination which are often the subject of vilification in the international media.

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6 Most commonly referred to as 'tax harmonisation'.

The irony is that the effects the 'tax haven' countries have on the OECD countries arise from the purely voluntary conduct of individuals and businesses internationally, responding to the attractive fiscal and legal environments of the 'tax haven' countries in an international free market. By contrast, the OECD countries are seeking to counteract these effects by essentially coercive action. In practice, this means applying political pressure and seeking to intervene in the internal affairs of other jurisdictions, which normally calls for some form of justification or defence on the grounds of public international law.

This seems to be the approach taken in the Report. At para 26 it states:

> 'The committee recognises that there are no particular reasons why any two countries should have the same level and structure of taxation. Although differences in tax levels and structures may have implications for other countries, these are essentially political decisions for national governments. Depending on the decisions taken, levels of tax may be high or low relative to other states and the composition of the tax burden may vary.'

The Report thus appears to concede that a jurisdiction should be free to devise its own tax system as it sees fit, as an essential matter of sovereignty. However, the paragraph goes on to state: 'Countries should remain free to design their own tax systems as long as they abide by internationally accepted standards in doing so'. There is no indication of what is meant by 'internationally accepted standards'.

Distortions caused by tax competition

The Report refers to the 'distortion' of trade and investment patterns. However, the use of the term 'distortion' in this context begs the question. A more balanced term would have been 'change' or 'alteration'. 'Distortion' implies that there is a natural state of affairs which is being bent out of shape.

The OECD's allegations of 'distortion' are problematic. It is actually in the nature of developed countries' tax systems to distort the natural trade and investment patterns that would exist in the absence of taxes, since the taxes that will become payable are anticipated by the participants in the market and consequently compensated for in the price-setting mechanism. What the Report really objects to is that some countries, such as 'tax havens', advocate totally free markets in capital and investment and are not willing to impose the same distortions as the OECD countries do through their tax systems.

Countries that operate as 'tax havens' or offer 'preferential tax regimes' to

overseas investors, businesses and labour eliminate the waste involved in raising taxes which are then spent in the form of subsidies. Moreover, they reduce the scope for 'free riders' who are net beneficiaries of government spending. (In most 'tax haven' countries subsidies for businesses and individuals are minimal.)

Politico-economic correctness of the Report

The Report seems to imply that the only natural and just politico-economic system is a mixed economy with a free market which is subject to bureaucratic regulation or direction (particularly on the subject of 'unfair competition'), direct state intervention in the form of subsidies and tax expenditures, a high direct tax burden and a welfare state, albeit leaving the precise mix of these elements to be determined by each individual state government.[7]

Such politico-economic correctness is evident in various passages in the Report.

In para 8 the Report states as an objective the intention of: 'reducing the distortionary [sic] influence of taxation on the location of mobile financial and service activities thereby promoting fair competition [note: not free trade] for real economic activities'.

In para 23 the Report states that:

> 'these schemes can erode national tax bases of other countries, may alter the structure of taxation (by shifting part of the tax burden from mobile to relatively immobile factors and from income to consumption) and may hamper the application of progressive tax rates and the achievement of redistributive goals. Pressure of this sort can result in changes in tax structures in which all countries may be forced [note the aggressive term – not "encouraged", "stimulated" or even "provoked"] by spillover effects to modify their tax bases even though a more desirable [from a dirigiste point of view] result could have been achieved through intensifying [sic] international co-operation [or coercion, if you are a "tax haven"].'

In para 29 the Report reasons that it is acceptable to devise one's own tax system, but not to:

> 'redirect capital and financial flows and the corresponding revenue from other jurisdictions by bidding aggressively for the tax base of other

[7] Some commentators call such a system 'socialist'; but as it does permit the ownership of private property, it may more correctly be termed 'dirigiste'.

> countries. Some have described this effect as "poaching" as the tax base "rightly"[8] belongs to the other country. Practices of this sort can appropriately [or pejoratively] be labeled harmful tax competition as [here comes the non sequitur] they do not reflect different judgments about the appropriate level of taxes and the public outlays or the appropriate mix of taxes in a particular economy, which are aspects of every country's sovereignty in fiscal matters, but are, in effect [sic], tailored to attract investment or savings originating elsewhere or to facilitate the avoidance of other countries' taxes.'

From this passage, the implication seems to be that the motives behind a country's tax system are relevant in assessing its justifiability. A country that is committed as a matter of principle and policy to low or no direct taxes across its economy[9] is free to adopt such a policy. On the other hand, a country that adopts a low or no direct tax system in order to attract investment and other economic activity that would otherwise occur elsewhere is engaging in 'harmful tax competition'. But the distinction is almost impossible to draw in practice. This passage also seems to imply that in evaluating the laws of a country it is relevant to consider the motives of the relevant legislators. Such an approach is unknown to the English common law system and the rule of law.

Paragraph 31 states: 'if the spillover effects of particular tax practices are so substantial that they are concluded to be poaching other countries' tax bases, such practices would be doubtlessly [?] labeled [note: not "described as"] "harmful tax competition"'. But this is to use the term 'harmful' in a metaphorical sense. Competition will often have a 'negative effect' on less competitive suppliers in a market, but the losses incurred by them while real are not 'harm' in the proper sense. In the same way, one can only be said to be 'poaching' something that belongs to another. Current suppliers in a market, who actually have no right (as such) to the future custom of their customers will often refer to the activities of new suppliers entering the market as 'poaching' their customer base.

Erosion of the rule of law

The Report uses (at para 42) a new term in the field of tax mitigation: to 'escape' taxes. One must reluctantly conclude from this that the difference between tax avoidance (which is lawful) and tax evasion (which is unlawful) is

[8] Quotation marks in the original.

[9] For example Hong Kong.

now a distinction which the OECD countries no longer wish to draw. The OECD countries seem to want to shrug off such traditional safeguards as the rule of law, and to be allowed to charge taxes retrospectively, if the government thinks it is fair and reasonable, or to achieve 'redistributive goals'.[10]

Among the factors to be employed in identifying a so-called 'tax haven' is 'the absence of a requirement that the activity be substantial'. This is a term of which governments are fond since it allows the government to impose its views on the citizen and undermines the rule of law and the citizen's ability, and right, to plan ahead. In a free market one is not required to carry out 'substantial' activities. One is simply free to act as one chooses, within the rule of law.[11]

Real versus virtual harm

The Report refers to certain aspects of tax competition as 'harmful', rather than simply adverse. The word 'harm' connotes damage or injury. Such harm is real. However, 'harm' can also be used in a metaphorical sense, for example where the current suppliers in a market refer to the entry of new suppliers into the market as being 'harmful' to them. What they really object to is that their expectations of the future are being frustrated. The phrase 'virtual harm' can be used to describe the harm that is alleged by someone whose expectation of something where he has no legal or political right to it is being frustrated.

Real harm occurs where one person inflicts injury or damage on another. It is a proper function of law to protect people from real harm, through laws of tort, breach of contract and crime. By contrast, it is not a proper function of law to insulate people from virtual harm. Lost opportunities to which one has no right in the first place are not harms suffered in anything but a metaphorical sense. If the current suppliers in a market have come to expect a certain level of custom from customers, and plan ahead accordingly, when new suppliers come into the market and receive some of the custom which the original suppliers had come to expect (but legally had no right to expect) the original suppliers may incur losses that are real. But they do not suffer any real 'harm'

[10] This again highlights a fundamental flaw in the whole Report. Man is the economising animal. He seeks to attain his objective with the minimum of expense. To want to minimise one's own personal tax bill is human nature. It is no different from minimising any other bill. People want to know the rules first, and be free to plan their actions accordingly. Tax planning or avoidance is a fact of life, because it is the rate of return after taxes that workers, investors and entrepreneurs want to maximise.

[11] The erosion of the rule of law in the field of taxation is growing. The UK and other OECD countries are considering the introduction of general anti-avoidance legislation, which will blur further the distinction between avoidance and evasion, while 'unacceptable tax avoidance' is steadily being criminalised onshore and offshore as 'money laundering'.

at the hands of the new suppliers.[12]

In this sense, lost revenue caused by capital and labour being attracted to jurisdictions with more attractive fiscal regimes is only virtual, not real, harm and is not something that countries are entitled to be protected against.

Non-tax measures

The final paragraph of the Report (para 171) states that: 'it is therefore worth exploring the possibility of addressing harmful tax competition using a wide range of non-tax measures'. The word 'measures' typically connotes something coercive or hostile. The report gives no indication of what 'measures' may be being contemplated. However, a foretaste is the new US rules relating to tax exiles.

The recommendation of non-tax measures confirms the essentially coercive strategy of the OECD countries.

Tax competition as a natural and beneficial process

It is actually in the interests of mankind as a whole that the natural tax competition that has existed up to now between states continues. OECD countries that modify their legal, fiscal and political systems may attract business, investment, residents and citizens they do not have. This would be the just and natural response. It would not involve any coercion or pressure on other countries that do not share their tax philosophy to introduce changes to their legal and fiscal regimes. Moreover, the changes do not even need to be coordinated. Each country and community can be left to evolve, grow and change as it wishes, without necessity to conform to an 'international standard' and threats if it does not. Under such a system the countries with the best fiscal environments start to win, others are encouraged to follow their example, and there is a 'race to the top'.[13] We are all better off as a result.

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[12] There is in the law a long-standing distinction between the situation where a new market supplier wins away custom from an original supplier, the opportunity for which is the essence of a free market, and the situation where a new market supplier induces the current customers or clients of an original supplier actually to terminate their existing contracts with the original supplier in breach of contract. The latter conduct is a legal wrong, at common law termed the 'tort' of 'interfering with a contract between others'. In this latter regard, there is a difference between encouraging someone to breach a contract he has entered into, and encouraging him to terminate a contract he has entered into, in accordance with its terms. The freedom to do the latter is a key aspect of a free market. A prohibition on the former is what distinguishes a free market from anarchy.

[13] See, for example, the article by Professor Gary Becker of the University of Chicago and winner of the 1992 Nobel Prize, 'What's wrong with a centralised Europe? Plenty', *Business Week*, 29 June 1998.

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