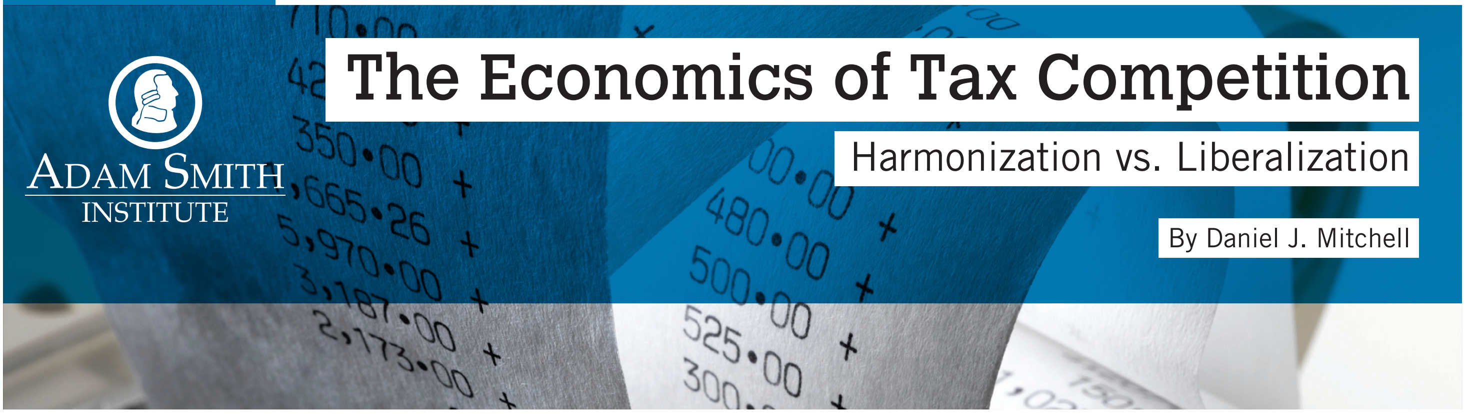
BRIEFING PAPER



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The Economics of Tax Competition

Harmonization vs. Liberalization

By Daniel J. Mitchell

An inquisition into every man's private circumstances, and an inquisition which, in order to accommodate the tax to them, watched over all the fluctuations of his fortunes, would be a source of such continual and endless vexation as no people could support.... The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour would necessarily be more or less diminished by its removal.

— Adam Smith, An Inquiry into the Nature & Causes of the Wealth of Nations, 1776.

Tax competition exists when people can reduce tax burdens by shifting capital and/or labour from high-tax jurisdictions to low-tax jurisdictions. This migration disciplines profligate governments and rewards nations that lower tax rates and engage in pro-growth tax reform.

Like other forms of competition, fiscal rivalry generates positive results. People get to keep more of the money they earn because of lower tax burdens. More important, from an economic perspective, economic performance is enhanced because of lower tax rates on work, saving, and investment. The capital mobility that defines tax competition also protects against government abuses. People can guard against corruption and protect their human rights more effectively when they know that they and/or their capital can flee across national borders.

The thought of losing sources of tax revenue worries government officials from high tax nations, who vociferously condemn tax competition (particularly the role of so-called tax havens) and would like to see it reduced or eliminated. Working through international bureaucracies like the European Commission (EC), the United Nations (UN), and the Organisation for Economic Co-operation and Development (OECD), high-tax governments are promoting various tax harmonization schemes to inhibit the flow of jobs and capital from high-tax jurisdictions to low-tax jurisdictions.

These proposals are fundamentally inconsistent with good tax policy. Tax harmonization means higher tax rates, but it also means discriminatory and destructive double taxation of income that is saved and invested. It also means extraterritorial taxation since most tax harmonization schemes are designed to help governments tax economic activity outside their borders.

Tax competition should be celebrated, not persecuted. It is a powerful force for economic liberalization that has helped promote good tax policy in countries around the world. Even OECD economists have admitted that, "the ability to choose the location of economic activity offsets shortcomings in government budgeting processes, limiting a tendency to spend and tax excessively."[1]

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Fiscal rivalry among governments has produced an amazingly desirable impact on fiscal policy in the past 30 years. For instance:

- Nations across the globe felt compelled to lower personal income tax rates following the Thatcher and Reagan tax rate reductions. The average top personal rate in industrialized nations has dropped from more than 67 percent in 1980 to less than 42 percent today.
- Tax competition has helped drive down corporate tax rates in Western Europe's welfare states. The average corporate rate in the developed world has plunged from about 48 percent in 1980 to less than 27 percent today.
- Numerous nations in the former Soviet bloc have enacted flat taxes, a process greatly aided by tax competition. The number of flat tax regimes has jumped from 3 in 1980 to more than 25 today.

Protecting and preserving the right to engage in tax competition should be a key goal for economic policymakers, particularly those interested in promoting economic development in poorer nations. If international bureaucracies succeed in destroying or limiting tax competition, governments will have much less incentive to behave responsibly. The absence of competition would undermine countries' opportunities for creative economic reform and reduce individual freedom.

People throughout the world should be allowed to benefit from lower tax rates. The OECD, EC, and UN should not limit the options of investors and workers by creating a cartel that benefits high-tax nations. An "OPEC for politicians" would insulate government officials from market discipline, and the resulting deterioration in economic policy would slow global economic performance.

What is tax competition?

When a town has only one gas station, consumers have very little leverage. In the absence of competition, the monopoly gas station is much more likely to charge high prices, maintain inconvenient hours, and provide inferior service. But when there are several gas stations, their owners must pay attention to the needs of consumers in order to stay in business. This means market prices, better hours, and improved service.

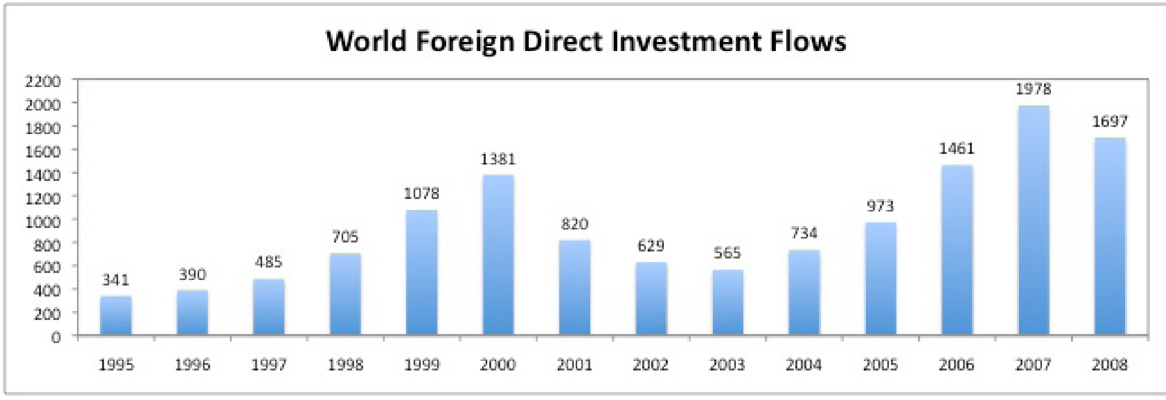
More important, competition enhances economic performance. Businesses of all kinds — if they face competitive pressure — are constantly driven to improve quality and offer new products in order to attract and hold the interest of consumers. Competitive pressure encourages better allocation of resources and boosts economic efficiency. This is why market- based economies tend to grow faster and provide higher living standards.

Competition between governments has similarly desirable economic effects. Nations with less punitive policies will enjoy more job creation and investment, much as gas stations with better service and prices will attract more motorists. But jurisdictional competition is not just about tax policy. Regulatory policy, monetary policy, trade policy, and legal policy can also erect roadblocks that affect the flow of jobs and capital across national borders.

Tax competition is just one slice of this competition among countries, but it is increasingly important because of the growing mobility of capital and labour. Workers and people with money to invest want to obtain the best after-tax reward (or rate of return), and their search for profitable opportunities is not limited by national borders. Not surprisingly, investors and workers tend to leave (or avoid) nations with punitive tax burdens and onerous tax codes. Instead, these resources gravitate toward nations that reward private-sector wealth creation — much as motorists gravitate to gas stations that provide good value for the money.

No wonder politicians from high-tax nations dislike tax competition. Fiscal rivalry restricts their ability to overtax (and therefore overspend). Just as the owner of a town's only gas station is unhappy when competitors set up shop, politicians do not like competitive neighbours who force them to behave responsibly in order to attract economic activity — or to keep economic activity from fleeing to a lower-tax environment.

The tax competition battle revolves largely around the tax treatment of capital. Investment funds can cross national borders at the click of a mouse, and this mobility makes it very difficult to maintain excessive tax rates or to impose discriminatory taxes on income that is saved and invested. The chart below shows the dramatic increase in cross-border capital flows in recent years. This also helps explain why high-tax governments are so eager to get the ability to track — and tax — fleeing capital. Where borders are relatively open for immigration, the taxation of workers and entrepreneurial talent is beginning to attract more attention from greedy governments.



Many French professionals have moved to the lower-tax United Kingdom (though this could change as the UK implements its new 50% tax rate on high earners). People from Canada move to the United States, as do many talented professionals from Third World nations. And similar tax-motivated migrations take place in other parts of the world. The phenomenon of workers "voting with their feet" has caused considerable angst among high-tax nations and has even led to proposals that would give governments permanent taxing authority over their citizens no matter where they live.

What is tax harmonization?

Tax harmonization exists when taxpayers face similar or identical tax rates no matter where they work, save, shop, or invest. Harmonized tax rates eliminate fiscal competition, much as a price-fixing agreement among gas stations destroys competition for gasoline.

Tax harmonization can be achieved two different ways:

Explicit tax harmonization occurs when nations agree to set minimum tax rates or decide to tax at the same rate. All European Union nations, for instance, are required to impose a value-added tax (VAT) of at least 15 percent. The EU also has harmonized tax rates for fuel, alcohol, and tobacco, and there are ongoing efforts to harmonize the taxation of personal and corporate income tax rates.

Under this *direct* form of tax harmonization, taxpayers are unable to benefit from better tax policy in other nations, and governments are insulated from market discipline.

Implicit harmonization occurs when governments tax the income their citizens earn in other jurisdictions. This policy of "worldwide taxation" requires governments to collect financial information on nonresident investors and to share that information with tax collectors from foreign governments. This "information exchange" system tends to be a one-way street since jobs and capital generally flow from high-tax nations to low-tax nations.

Under this *indirect* form of tax harmonization, just as under the direct form outlined above, taxpayers are unable to benefit from better tax policy in other nations, and governments are insulated from market discipline.

Both forms of tax harmonization have similarly counterproductive economic consequences. In each case, tax competition is emasculated, encouraging higher tax rates. This hinders the efficient provision of capital and labour, slowing overall economic performance.

The attack on low-tax jurisdictions

Currently, international bureaucracies are pursuing three major tax harmonization initiatives:

1. The Paris-based **Organization for Economic Co-operation and Development** launched a "harmful tax competition" initiative in the late 1990s, identifying more than 40 so-called tax havens.[2] The OECD is threatening these jurisdictions with financial protectionism if they do not agree to weaken their tax and privacy laws so that high-tax nations could more easily track — and tax — flight capital. Ironically, the OECD did not initally blacklist any of its member nations even though at least six of them — Switzerland, Luxembourg, the United States, Austria, Belgium, and the United Kingdom — qualified as tax havens according to the OECD's own definition.

As the OECD has expanded its campaign and built alliances with other multilateral entities such as the G-20, the project has broadened and now seeks to dictate "standards" in all jurisdictions. In October 2009 the OECD released a progress report on tax standardization in jurisdictions that were deemed in need of change (from the perspective of high-tax nations). This list covered a total of 57 countries and included both the UK and the US. There were still 21 jurisdictions classed as 'tax havens' that had yet to act upon previous agreements.

2. The **European Commission** is a major advocate of tax harmonization, and the Brussels-based bureaucracy has had some success. Value-added taxes, energy taxes, and excise taxes all have been subject to some level of direct harmonization among EU nations. The EC's major 'success' is the "savings tax directive," an indirect form of tax harmonization that requires member nations either to impose a withholding tax on interest paid to nonresidents or to collect information about the investment earnings of nonresidents and forward it to their respective governments, which would then tax the income. This agreement has been signed by all 27 member nations as well five other European countries, including Switzerland.

3. The **United Nations** has created a "Financing for Development Office" that calls for the creation of an International Tax Organization. This new bureaucracy could supposedly have the power to override the tax policy of sovereign nations and could be specifically responsible for curtailing tax competition. Equally worrisome, the UN proposes to give nations the power to tax emigrant income, which would have particularly adverse effects nations such as the United Kingdom and the United States that attract large numbers of skilled immigrants.[3]

Previously these tax harmonization schemes had been stymied. The OECD did convince many jurisdictions on its original blacklist to sign so-called commitment letters, which ostensibly obligate low-tax governments to obey OECD dictates, but most of these letters included "level playing field" clauses stating that the blacklisted nations have no intention of emasculating their tax and privacy laws unless all OECD nations agree to impose the same misguided policies. However, in the aftermath of the financial crisis this level-playing-field strategy has backfired since all OECD member nations have agreed to the misguided principles of the Paris-based bureaucracy. All jurisdictions have now agreed to sign tax information exchange agreements, which necessarily erodes the privacy of their banking systems.

The EU savings tax directive, by contrast, is not nearly as extensive as originally proposed and is widely seen as ineffective. The watered-down directive, which came into being in July 2005, is subject to numerous loopholes and only applies to EU members states and their oversears territories, plus Andorra, Lichenstein, Monaco, San Marino, and Switzerland. So far the EU has been unsuccessful in persuading other countries — like the United States — to sign up to their cartel. They do, however, look set to keep trying.

The United Nations, meanwhile, continues to play only a minor role. Notwithstanding grandiose schemes for an international tax organization, as well as the existence of a so-called Committee of Experts on International Cooperation in Tax Matters, the UN has not played a meaningful role.

Benefits of tax competition

Tax competition is desirable for a number of reasons. Most important, it facilitates economic growth by encouraging policymakers to adopt sensible tax policy. Tax harmonization, by contrast, usually is associated with higher fiscal burdens.[4] For all intents and purposes, advocates of tax harmonization are seeking to stop the downward pressure on tax rates that is caused by competition.

The history of corporate tax rates in the European Union is a good example. As early as 1962 and 1970, official reports were calling for harmonization of corporate tax systems. In 1975, the European Commission sought a minimum corporate tax of 45 percent. This initiative failed, as did a similar effort in the early 1990s to require a minimum corporate tax rate of 30 percent.[5] Today, the average corporate tax rate in the European Union is less than 25 percent.

The European Union's treatment of Ireland also bolsters the view that tax harmonization is a one-way street designed to keep tax rates high. In an unprecedented move, EU finance ministers voted in 2002 to reprimand Ireland for its fiscal policy — even though Ireland at the time had the EU's biggest budget surplus, second lowest amount of debt, greatest reduction in government debt, lowest level of government spending, and lowest total tax burden.[6] Most observers felt that politicians from other nations were upset that Ireland's 12.5 percent corporate tax rate was putting pressure on them to implement similar reforms. Interestingly, there has never been a reprimand for a country because its taxes were too high.

The benefits of tax competition can be appreciated by looking at tax policy changes that have swept the world in the past three decades. Obviously, tax competition should not be seen as the only factor leading to the following tax changes. In some cases, it may not even be the driving force. But in each case, tax competition has encouraged the shift to tax policy that creates more growth and opportunity.[7]

The Thatcher–Reagan Tax Rate Reductions. Margaret Thatcher became Prime Minister of the United Kingdom in 1979, and Ronald Reagan became President of the United States in 1981. Both leaders inherited weak economies but managed to restore growth and vitality with free-market reforms.

Sweeping reductions in personal income tax rates were a significant component of both the Thatcher and Reagan agendas. The top tax rate was 83 percent when Thatcher took office, and she reduced the top rate to 40 percent.[8] The top tax rate in the United States was 70 percent when Reagan was inaugurated, and he lowered the top rate to 28 percent.[9]

The United Kingdom and the United States both benefited from tax rate reductions, but other nations also profited because they were compelled to lower tax rates — and this shift to better tax policy is an ongoing process. Appendix 4 shows the sweeping tax rate reductions that have occurred since 1980.

Tax competition surely played a role in this global shift to lower tax rates, and lower tax rates unambiguously have helped the world economy to grow faster. Even the OECD, which is hardly sympathetic to pro–growth tax policy, has estimated that economies grow one-half of 1 percent (0.5 percent) faster for every 10-percentage-point reduction in marginal tax rates.[10]

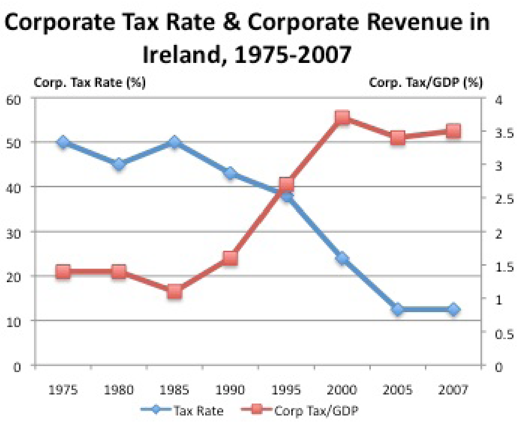
Corporate Rate Reduction. In addition to reductions in tax rates on personal income, tax competition has helped to encourage lower tax rates on corporate income. The Reagan and Thatcher tax rate reductions once again deserve credit for starting the process, and Appendix 5 demonstrates that corporate tax rates have fallen dramatically since 1995.

But Ireland offers perhaps the most impressive evidence of how tax competition advances good tax policy. Less than 30 years ago, Ireland was an economic "basket case" with double-digit unemployment and an anemic economy. This weak performance was caused, at least in part, by an onerous tax burden. The top tax rate on personal income in 1984 was 65 percent, the capital gains taxes reached a maximum of 60 percent, and the corporate tax rate was 50 percent.[11]

Although these rates were slightly reduced later in the 1980s, the top rates in 1991 were still very high: 52 percent on personal income, 50 percent on capital gains, and 43 percent on corporate income. At this point, Irish leaders decided that tinkering with the tax code was not a recipe for success. Over the next 10 years, tax rates — especially on capital gains and corporate income — were slashed dramatically.[12] Today, the personal income tax rate is 42 percent, the capital gains tax rate is 20 percent, and the corporate income tax rate is only 12.5 percent. These aggressive "supply-side" tax rate reductions have yielded enormous benefits.

The Irish economy responded with the strongest growth of all industrialized nations, expanding at an average of 7.7 percent annually during the 1990s.[13] The late 1990s were particularly impressive, as Ireland enjoyed annual growth rates in excess of 9 percent.[14] In a remarkably short period of time, the "sick man of Europe" became the "Celtic Tiger." Unemployment dropped dramatically, and investment boomed.[15]

The financial crisis and a collapsed real estate bubble have since tarnished some of these achievements, but the Irish people have been big winners. Once a relatively poor nation, Ireland came to enjoy the second highest standard of living in the European Union. Even the government has reaped benefits. In the mid-1980s, when the corporate income tax rate was close to 50 percent, it raised revenue barely in excess of 1 percent of gross domestic product (GDP). As the chart on the next page illustrates, however, as of 2007 Ireland's 12.5 percent corporate tax raised revenue totaling nearly 4 percent of GDP.[16] It will be interesting to see, of course, what happens in Ireland once the global downturn ends.



For the purposes of this report, though, the key thing to understand is that Ireland's tax rate reductions have had a positive effect on the rest of Europe. The Irish example has motivated other EU nations to reduce their tax rates significantly in recent years. These lower tax rates will improve economic performance and should encourage European policymakers to make reductions in other tax rates as well.

Tax Reform in Eastern Europe. One of the most amazing fiscal policy developments is the adoption of flat taxes in former Soviet bloc nations. The three Baltic nations — Estonia, Lithuania, and Latvia — adopted flat tax systems in the 1990s, and tax reform in the Baltics triggered a virtuous cycle of tax competition. Russia followed with a 13 percent flat tax that took effect in January 2001. Ukraine approved a 13 percent flat tax, and Slovakia implemented 19 percent flat tax. This trend has moved eastward in recent years, as places such as Kazakhstan, Kyrgyzstan and Mongolia have embraced flat taxes. Many places now have tax rates as low as 10%. Bulgaria is one notable example.

These flat tax regimes, by themselves, will not solve all the problems that exist in post-communist nations, but the evidence already shows that good tax policy is having a desirable impact. The Baltic nations, for instance, are the most prosperous of the nations that emerged from the former Soviet Union.[17] The Russian Federation was the next to adopt a flat tax. Not surprisingly, it is the next most prosperous of the former Soviet "Republics."[18]

The evidence from Russia, where the 13 percent flat tax has produced dramatic results, is particularly striking: According to the World Bank, Russia's economy expanded by around 6.5% a year between 2000 and 2007. The Russian economy certainly has performed better than the U.S. economy and has easily outpaced the anemic growth rates elsewhere in Europe.

In addition to faster growth, Russia's tax reform has had a dramatic effect on tax compliance, something even *The New York Times* was forced to concede.[19] From 2001 to 2003, inflation-adjusted income tax revenue in Russia significantly increased, demonstrating that people are willing to produce more and pay their taxes when the system is fair and tax rates are low.[20]

Tax competition has played a role in each of these success stories. In some cases, the benefits accrue because policymakers want to mimic success in other nations. In other cases, governments enact good tax policy because they fear that jobs and capital will leave. Irrespective of motives, however, good tax policy in one jurisdiction has a positive spillover effect on other jurisdictions. It is also worth noting that tax competition is a successful tool for economic development.

Hong Kong is perhaps the best example. Extremely poor after World War II, Hong Kong used market-based policy — including a low-rate flat tax — to boost economic performance. The results have been dramatic: Hong Kong has been the world's fastest growing economy in the post–World War II era and currently ranks as the 16th richest jurisdiction, according to the World Bank.

The World Bank's rankings are in fact very instructive. Many of the world's wealthiest jurisdictions, including 8 of the top 16 (see table below), are "tax havens" based on the OECD definition. This raises an interesting question: If international bureaucracies are supposed to be promoting growth, would it not make common sense for them to publicize so-called tax havens instead of persecuting them?

World's Wealthiest Juridictions (Tax havens in bold)

1. Lichenstein	9. Sweden
2. Bermuda	10. Netherlands
3. Norway	11. Ireland
4. Luxembourg	**12. San Marino**
5. Channel Islands	13. Finland
6. Switzerland	**14. United States**
7. Denmark	**15. Cayman Islands**
8. Qatar	**16. Isle of Man**

Source: Gross national income per capita, 2008, Atlas Methodology, in World Bank, World Development Indicators, 2009

Poison pill for tax reform?

There is strong sentiment in the United States for fundamental tax reform. President George W. Bush's 2003 tax rate reductions moved the tax code in that direction by lowering rates and reducing double taxation of income that is saved and invested — policies which helped to make America a magnet for global capital.[21] The current administration is clearly less enthusiastic about reducing taxes — it has signalled its intention to let the Bush tax cuts expire in 2010 — but there continues to be strong grassroots support for fundamental tax reform, as illustrated by widespread coverage of the FairTax proposals during the US presidential primaries in 2007, as well as the recent anti-tax 'tea parties' which took place all over America.

It is worth bearing in mind that tax competition is completely consistent with fundamental tax reform. For instance:

- Tax reform envisions a system with low tax rates on productive behavior. Tax competition promotes tax reform by helping to drive down marginal tax rates.

- Tax reform envisions a system in which income is taxed only one time. Tax competition promotes tax reform by helping to eliminate double taxation of income that is saved and invested.

- Tax reform envisions a system in which governments do not tax income earned in other nations. Tax competition promotes tax reform by rewarding territorial taxation, the common-sense notion that governments tax only income earned inside national borders.

- The tax harmonization agenda, however, is a distinct threat to the right of nations to reform their tax codes and enact single rate, consumption-based tax systems.[22] The tax harmonization agenda certainly means that tax reform would be very unlikely.

- The flat tax, for instance, is a territorial system. Yet the OECD and other international bureaucracies believe that territorial taxation is a form of "harmful" competition. The flat tax also eliminates double taxation, but the OECD initiative is designed to help governments discriminate against income that is saved and invested.

Which path for Europe?

High-tax European welfare states are the biggest supporters of tax harmonization. Germany and France even want European wide taxes imposed and collected by Brussels, and the new President of the European Council has openly stated his support for such a scheme. Along with a handful of additional nations, they also advocate harmonization of personal and corporate income tax rates. Other European nations are not quite so anxious to harmonize rates, but they certainly seem sympathetic to indirect forms of tax harmonization such as the EU savings tax directive.

The outcome of the push for a further expansion of the savings tax directive could determine whether Europe's high-tax nations are able to cripple tax competition. If the EU is able to broaden the directive, persuade other countries to sign up to it, and make it apply to a broader range of assets (all of which are currently on Brussels' agenda) then it will certainly be more difficult for taxpayers in high-tax nations to benefit from better tax regimes outside their borders.

At this stage, it is not clear whether the EU will succeed. Jurisdictions such as Hong Kong and Singapore have already refused to join the EU-cartel, essentially saying that they have no interest in underming their competitive positions to prop up Europe's welfare states. Switzerland, meanwhile, is highly unlikely to accept a savings tax directive that was broadened to cover a wider range of financial instruments.

In any case, Europe's high-tax nations may be fighting a losing battle. In May 2004, 10 new nations joined the EU. These countries included many jurisdictions with tax laws that are designed to boost growth and attract economic activity, as well as a number of governments that are considerably more sympathetic to free markets and competition than their counterparts in 'Old Europe'. As a result, the political culture in Brussels may be less collectivist in its orientation.

Even more importantly, it is much harder for the EU to pursue additional tax harmonization schemes now that they need to get all 27 member states to agree to their cartel policies. It was difficult enough when there 15 EU members. Now that pro-market countries like Slovakia and Estonia have a veto on tax matters, it may prove impossible. This will remain the case so long as the unanimity requirement for tax policies is not eroded as part of the EU's constitutional deliberations.

Conclusion

The battle between tax competition and tax harmonization is really a fight about whether government will control the factors of production. Supporters of tax harmonization would like to hinder the flow of workers and investments from high-tax nations to low-tax nations. The debate has focused primarily on capital, particularly on whether governments can track — and tax — flight capital; there are, however, even proposals that would allow government to tax the other factor of production — labour — when it crosses national borders.

Some assert that tax harmonization policies are needed to reduce evasion, but there are two ways to improve tax compliance. The international bureaucracies want to create a system of automatic and unlimited information exchange among governments — a system that former House Majority Leader Richard Armey (R–TX) said would create a "global network of tax police".[23] Fundamental tax reform, by contrast, would reduce incentives to evade while simultaneously reducing opportunities to evade (because capital income would be taxed at the source).

Ironically, the OECD's staff economists know the answer. They write that "legal tax avoidance can be reduced by closing loopholes and illegal tax evasion can be contained by better enforcement of tax codes. But the root of the problem appears in many cases to be high tax rates."[24]

Ultimately, this is a debate about the size of government. Harmonization means higher tax rates and bigger government. Freed from the rigour of competition, politicians would cater to special interests and resist much-needed fiscal reforms. This is why the residents of high-tax nations have the most to lose if governments create an "OPEC for politicians".

Tax competition is the only realistic hope for German taxpayers, French taxpayers, and Swedish taxpayers. It is quite likely that politicians from those nations will be fiscally responsible only if they know that labour and capital have the right to escape fiscal oppression.

Daniel J, Mitchell is a Senior Fellow at the Cato Institute in Washington, D.C. An earlier version of this paper was published by the Heritage Foundation as part of their *2004 Index of Economic Prosperity*. It has been updated with reference to his new book, *Global Tax Revolution: The Rise of Tax Competition and the Battle to Defend It*, which can be purchased online at www.cato.org.

Endnotes

1 Organisation for Economic Co-operation and Development, Economic Outlook, No.63 (June 1998).

2 Many people assume that so-called tax havens are money-laundering centers. Several government agencies and one international bureaucracy, however, have analyzed the problem of money laundering and have concluded unambiguously that low-tax jurisdictions are neither the source nor the destination for a disproportionate share of the world's "dirty" money. See Daniel J. Mitchell, "U.S. Government Agencies Confirm that Low-Tax Jurisdictions Are Not Money Laundering Havens," Journal of Financial Crime, Vol. 11, No. 2 (Fall 2003).

3 For more information on the UN scheme, see Daniel J. Mitchell, "United Nations Seeks Global Tax Authority," Prosperitas, Vol. I, No. II (August 2001),

4 It is possible that harmonization could be used to limit tax rates. In the European Union, for instance, value-added taxes may not exceed 25 percent.

5 European Parliament, "Personal and Company Taxation, "Fact Sheet No.3.4.8, October 19, 2000.

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18 Ibid.

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20 Alvin Rabushka, "The Flat Tax at Work in Russia: Year Three, January–June 2003," The Russian Economy, August 13, 2003.

21 For more information on tax reform, see Daniel J. Mitchell, "Jobs, Growth, Freedom, and Fairness: Why America Needs a Flat Tax," Heritage Foundation Backgrounder No. 1035, May 25, 1995.

22 For a comprehensive analysis of this issue, see Daniel J. Mitchell, "Tax Reform: The Key to Pre-serving Privacy and Competition in the Global Economy," Institute for Policy Innovation, Policy Report No. 171, February 7, 2002.

23 Letter to Treasury Secretary Paul O'Neill, March 16, 2001.

24 Organisation for Economic Co-operation and Development, Economic Outlook, No 63 (June 1998).

Appendix 1: Worldwide taxation vs. Territorial taxation

Direct harmonization of income taxes is not the biggest threat to the global economy, even among European Union nations.[1] Instead, the threat to tax competition comes from the indirect harmonization proposals being advanced by the OECD and EU. This is why the issue of worldwide taxation vs. territorial taxation is so important. "Worldwide taxation" undermines the flow of resources from high-tax nations to low-tax nations by preventing the taxpayers in one jurisdiction from benefiting from lower tax rates in another jurisdiction. Worldwide taxation occurs when a government taxes the income its citizens earn in other nations (often referred to as foreign-source income). Foreign governments, of course, have the primary right to tax income earned inside their borders. A government that imposes worldwide taxation therefore generally allows taxpayers to reduce their tax bills on foreign source income by subtracting — using a foreign tax credit — taxes paid to the foreign government.

Worldwide taxation forces taxpayers to pay the highest possible tax rate when engaging in cross-border economic activity. If a foreign government has a higher tax rate than their domestic government, for instance, taxpayers must pay that high rate on their foreign-source income. (The foreign tax credit should cancel any domestic liability on that income.) But if a foreign country has a lower tax rate than their domestic government, taxpayers are required to pay the foreign tax — and then to pay more tax to their own government until the overall tax is equal to their domestic tax rate.

In other words, taxpayers face a "heads-you-win, tails-I-lose" situation. Countries that impose worldwide taxation also put their companies at a competitive disadvantage, as seen from the table below, which compares the tax burden on companies from three nations competing for business in Ireland.

Territorial taxation occurs when governments tax income only that is earned inside national borders. Territorial taxation respects sovereignty and automatically reduces conflicts between governments. It is good tax policy, and it rewards nations that enact policies that encourage economic growth. Territorial taxation dramatically reduces complexity and allows more privacy for law-abiding people.[2]

	Profit	Irish Tax	Extra Tax	Total Tax
U.S. Company	$100	$12.5	$22.50 to IRS	$35
Local Company	$100	$12.5	0	$12.5
Dutch Company	$100	$12.5	0	$12.5

1 Currently, EU tax harmonization proposals can be implemented only if all member nations agree. High-tax nations resent this "national veto" policy because nations like Ireland, Luxembourg, and England have attractive tax policies for certain forms of economic activity and generally use their veto powers to block further harmonization. High-tax nations continue to worry about the strong tax competition from the latest member nations to join the EU, particularly since many of these new member nations have relatively attractive tax systems. Uncompetitive nations such as France and Germany would like to abolish the national veto so that a mere majority of nations can impose tax harmonization policies on all EU nations, and the new constitution for the EU has created an opportunity to weaken or abolish the national veto.

2 For more information comparing worldwide taxation and territorial taxation, see Daniel J. Mitchell, "Making American Companies More Competitive," Heritage Foundation Backgrounder No. 1691, September 25, 2003.

Appendix 2: Frige Benefits of tax competition

Privacy. The indirect form of tax harmonization requires the automatic collection and unlimited sharing of personal financial information. This is a troublesome development for those who believe that individuals should have a presumptive right to keep their personal matters confidential. Equally troubling, the "information exchange" policies advocated by many high-tax governments would suspend many due process legal protections — including the right to be notified of government investigations, the right to contest government information requests, and the right to appeal government decisions.

Human Rights. For some people, the loss of financial privacy can be a matter of life and death. Many overseas Chinese in places like Indonesia use "offshore" financial centers to protect themselves from ethnic persecution. Many businessmen from Latin America put their money in tax havens to protect their families from kidnapping and extortion. Many citizens of repressive regimes use low-tax jurisdictions to protect themselves and their assets from oppression. All of these people will be at risk if governments create a global network of tax police to collect and swap private financial data.

Sovereignty. All forms of tax harmonization presume that there should be a one-size-fits-all Rule for tax policy. Low-tax jurisdictions are being told that they must make sweeping changes in their tax and privacy laws solely for the benefit of tax collectors from high-tax nations. These demands run roughshod over the rights of nations, especially smaller jurisdictions that are being bullied by the OECD. Another aspect of the sovereignty debate is whether nations are obliged to enforce the laws of other nations. Traditionally, jurisdictions are free to decide for themselves whether to help other jurisdictions. The United States, for instance, did not help China investigate and prosecute Tiananmen Square protestors. Likewise, many European nations refuse to assist the United States in cases that could result in the death penalty. As a general rule, under the "dual criminality" principle, nations do assist each other when an alleged offense violates the laws of both nations. The OECD and EU want to dismantle this sovereign right.

For more information on issues of privacy, human rights and sovereignty, see Task Force on Information Exchange and Financial Privacy, Report on Financial Privacy, Law Enforcement, and Terrorism, March, 25, 2002. http://www.freedomandprosperity.org/task-force-report.pdf

Appendix 3: Harmonization does not mean more tax revenue

Even if the OECD, EU, and other international bureaucracies succeed in destroying tax competition, it is not likely that this will result in a surge of new tax revenue. Many taxpayers simply will shift resources to the underground economy. Indeed, the underground economy already accounts for one-fourth to one-third of GDP in many of Europe's welfare states.[1]

Interestingly, even the OECD recognizes that high tax rates are the real problem. Staff economists have written that tax evasion "can be attributed to higher tax burdens."[2] OECD economists have even outlined the solution, writing that "lowering statutory corporate tax rates and rates on personal capital income in countries where these are particularly high, may increase the domestic tax base as there are less incentives to shift taxable profits and capital income abroad."[3]

1 Friedrich Schneider and Dominik Enste, "Shadow Economies Around the World: Size, Causes, and Consquences," International Monetary Fund, Working Paper No. WP/00/26, February 2000

2 Organisation for Economic Co-operation and Development, Economic Outlook, No. 63 (June 1998)

3 Willi Leibfritz, John Thornton, and Alexandra Bibbee, "Taxation and Economic Performance," Organisation for Economic Co-operation and Development, Economics Department, Working Paper No. 176, 1997

Appendix 4: Top Personal Income Tax Rates, 1980-2007

Country	1980	1985	1990	1995	2000	2005	2007	Change 1980-2007
Australia	62	60	49	47	47	47	45	-17
Austria	62	62	50	50	50	50	50	-12
Belgium	76	76	58	61	60	53	53	-23
Canada	64	57	49	49	48	44	44	-20
Denmark	66	73	68	64	59	59	59	-7
Finland	68	67	60	57	54	53	52	-16
France	60	65	60	62	61	56	49	-11
Germany	65	65	53	57	56	44	47	-18
Greece	60	63	50	45	43	40	40	-20
Iceland	63	56	40	47	45	39	36	-27
Ireland	60	65	58	48	42	42	41	-19
Italy	72	81	66	67	51	44	44	-28
Japan	75	70	65	65	50	50	50	-25
Korea	89	65	64	48	44	39	39	-50
Luxembourg	57	57	56	50	47	39	39	-18
Mexico	55	55	40	35	40	30	28	-27
Netherlands	72	72	60	60	52	52	52	-20
New Zealand	62	66	33	33	39	39	39	-23
Norway	75	64	51	42	48	40	40	-35
Portugal	84	69	40	40	40	40	42	-42
Spain	66	66	56	56	48	40	39	-27
Sweden	87	80	65	50	55	56	56	-31
Switzerland	38	40	38	37	36	34	34	-4
Turkey	75	63	50	55	45	40	40	-35
United Kingdom	83	60	40	40	40	40	40	-43
United States	73	55	38	43	43	39	39	-34
Average for 26 OECD Countries	**68**	**64**	**52**	**50**	**47**	**44**	**43**	**-25**

Source: James Gwartney and Robert Lawson, Economic Freedom of the World (Vancouver: Fraser Institute, 2007). Data includes the national and average subnational tax rates.

Appendix 5: Top Corporate Income Tax Rates, 1995-2009

Country	1995	2000	2005	2009	Change 1986-2009
Australia	36	36	30	30	-6
Austria	34	34	25	25	-9
Belgium	40	40	33	33	-7
Canada	44	44	36	33	-11
Denmark	34	32	28	25	-9
Finland	25	29	26	26	+1
France	36	36	33	33	-3
Germany	59	51	38	29	-30
Greece	35	40	32	25	-10
Iceland	33	30	18	15	-18
Ireland	48	24	12	12	-36
Italy	53	41	37	31	-22
Japan	51	42	40	40	-11
Korea	n/a	30	27	24	-6
Luxembourg	40	37	30	28	-12
Mexico	34	35	30	28	-6
Netherlands	35	35	31	25	-10
New Zealand	33	33	33	30	-3
Norway	28	28	28	28	0
Portugal	39	37	27	25	-14
Spain	35	35	35	30	-5
Sweden	28	28	28	26	-2
Switzerland	28	25	21	21	-7
Turkey	44	33	30	20	-24
United Kingdom	33	30	30	28	-5
United States	40	40	40	40	0
Average for 26 OECD Countries	**37**	**34**	**29**	**27**	**-10**

Source: KPMG's Corporate and Indirect Tax Rate Survey 2009 & 2007, http://www.kpmg.com/Global/IssuesAndInsights/ArticlesAndPublications/Pages/KPMG-Corporate-and-Indirect-Tax-Rate-Survey-2009.aspx & http://www.kpmg.fi/Binary.aspx?Section=174&Item=3854 [PDF]