feature article

The New Fiscal Imperialism

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The OECD's 'harmful' or 'unfair' tax initiative is little more than a smear campaign against low-tax jurisdictions.

In recent years, there has been a great deal of demonising of tax havens or offshore financial centres (OFCs). They are seen by many bureaucrats and politicians in the Organisation for Economic Cooperation and Development (OECD) and the European Union as facilitating criminal activity such as laundering drug money as well as tax evasion and tax avoidance by residents of high-tax welfare states. Underlying these attacks is a common theme of moral complaint, be it on tax, money laundering or misuse of corporate structures. Yet users of offshore financial centres and those countries whose OFCs provide employment and income should not be condemned as immoral merely because they seek or offer some kind of economic freedom or financial privacy. Just as patriotism can be the last refuge of a scoundrel, OECD appeals to morality can mask a ruthless pursuit of economic self-interest by OECD bureaucracies.

What the OECD wants

Developed countries impose income taxes to pay for high spending on age pensions and welfare recipients. But income taxes on capital income are hard to enforce if capital can flee across borders. Competition from low-tax jurisdictions, when combined with freedom of capital movement, is a threat to the ability of the treasuries of ageing welfare states to raise further revenue. Their labour income taxes are already high and facing shrinkage as populations age and people retire from the workforce. It is therefore not surprising that Japan, the most rapidly ageing OECD country, instigated the OECD work against tax havens and tax competition in 1995.

The OECD maintains that offshore financial centres or 'tax havens' help OECD taxpayers avoid taxes on capital income which rightly belongs to the OECD home country. It wants offshore financial centres to amend their domestic laws so that records are created and maintained of beneficial ownership or control of OFC companies or trusts (transparency). It also wants tax collectors in OECD countries to be able to obtain information on demand from citizens or residents of those countries (information exchange or, more accurately, inspection at will). Such changes in the laws of OFCs would assist OECD countries in enforcing civil and criminal tax liabilities against OECD residents who may have assets in tax havens.

The reason the OECD wants to force OFCs to impose such obligations on their own citizens and residents is that OECD countries have difficulty enforcing taxes on OECD residents in relation to income earned by offshore entities. While it is relatively easy to tax dividends or interest received from overseas in an OECD country, it is more difficult to tax income which remains offshore in foreign companies or trusts. For that reason many OECD countries adopted deeming provisions in their tax laws which treat the income of

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certain foreign companies or trusts as the income of OECD residents who may be shareholders or beneficiaries in such companies or trusts. These deeming provisions are presented as a necessary part of residence-based income tax systems under which a country taxes its residents on both their domestic and foreign source income. In practice, they often involve legal fictions under which OECD resident taxpayers are expected to pay tax upon income which is not legally theirs and which may never be theirs.

It is remarkable that an unelected international secretariat of OECD bureaucrats should seek to dictate to sovereign countries the duties and obligations to be imposed upon their citizens and residents, even to the extent of overriding domestic constitutional or other legal protections for citizens' privacy. As far as international law is concerned, the collection of taxes or tribute is a sovereign act. Historically, only vassal or subordinate polities have collected taxes for a superior power. Sovereign countries do not collect other countries' taxes, for taxation is fundamentally a matter of national sovereignty on which countries can and often do disagree.

Tax competition is a healthy economic process that weeds out stupid or inefficient taxes.

The benefits of tax competition

Tax competition is a healthy and natural economic process that weeds out stupid or inefficient taxes. OECD fears that tax competition will lead to a loss of domestic revenue do not amount to an argument that tax competition is unfair. 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. Offshore havens may serve as an economic and political safety valve, forestalling the physical emigration of talented labour and capital or the emergence of violent protest movements (oppressive taxes have created more than a few rebellions and revolutions).

Tax competition also acts as a check on high-taxing governments. Thanks to tax competition, some countries have reduced their company tax and top marginal personal income tax rates, and 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. Thus economic freedom and international tax competition, far from hurting the OECD, are nudging some OECD countries towards optimal tax policies which are in the best interests of their citizens.

Liberty versus uniformity

There is nothing inherently wrong in countries competing with others to provide investors with a choice between differing legal systems. Ultimately, an individual's ability to choose the laws of one jurisdiction over another involve considerations of individual freedom as well as national sovereignty. If a significant number of individuals or entities choose an offshore jurisdiction, the home country may well have reason to revisit its own taxation policies as part of a self-critical examination in the light of tax competition, rather than attack offshore jurisdictions.

In essence, the OECD is saying 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. Offshore financial centres could do worse than remind Europeans and Americans that European civilisation rose to greatness not from the slavish Imperial uniformity of the later Roman Empire but from competition between the nation states which succeeded it. 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.

Federations such as the United States and Australia have lived with tax competition for decades without disintegrating. A New Hampshire or a Queensland has not only served its own interests by following a low tax policy but, 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 US is an offshore banking tax haven while the UK rules granting the remittance system to non-domiciled residents has meant that London has been a tax haven for many wealthy expatriates. Why should offshore financial centres in small Caribbean or South Pacific countries with few resources forgo any chance of

maintaining the living standard of their citizens by imposing OECD tax rates which would drive away business and employment?

Comparative advantage is not a static endowment

Comparative advantage is a basic source of gains from international trade and commerce. Sometimes comparative advantage may be largely man-made. It may depend substantially on how countries tax and spend and how they regulate or tax mobile business. Take Vanuatu as a case in point. Tourism and financial services are natural complements for this small South Pacific economy as part of its development strategy. A country like Vanuatu with pristine coral reefs might be expected to prefer clean industries like financial services to dirty factories which might damage its tourism income through negative impacts on the environment. Vanuatu is thus a natural tax haven, for if a country has a largely subsistence agricultural sector and virtually all its revenue is raised by indirect taxes or resource rents, it does not need income taxes or death duties.

No country *has* to tax capital income. Land, for example, is an immobile tax base: unlike capital, OECD countries could tax it without fear of it leaving. In economic theory, there are only three things you can tax—land, labour or capital—and only one of them cannot flee (or stop regenerating). The OECD has only itself to blame if OECD countries attempt to tax a mobile tax base like capital income instead of an immobile one like land. Besides, if the concern is with tax and tax fraud, taxes on land and natural resource rights make it harder for taxpayers to lie about what they own. Hong Kong has raised much of its public revenue from land rents, which has enabled it to keep its tax rates on capital and labour productivity low.

In any case, the term 'tax haven' is misleading. Many OFCs have progressed beyond beneficial tax regimes. Increasingly they are used for asset protection against the tort liability revolution. Liberalised no-fault divorce laws now give spouses automatic claims to assets regardless of conduct. In some countries, testators are denied the freedom to dispose of their estates as they see fit, and legislation now 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.

Multinational corporations have found the services of OFCs essential in overcoming the problems of inconsistent tax treaties or dual claims to income. Without OFCs, multiple national taxation would still exist and pose enormous difficulties for mutually beneficial trade and commerce. Similarly, expatriate investors may be working in many countries over time and wish to manage their investments or pension arrangements from one centre. Sometimes governments even use OFCs, 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 US.

For developing countries, the presence of an offshore financial sector can provide collateral benefits for the rest of the economy. It may gradually lead to funds being lent to it or invested in the domestic economy. It may also assist in nurturing 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.

The assault on financial privacy

The OECD demands on harmful tax competition originally fell into three groups—transparency, ring fencing and exchange of information (all subsumed under the idea of supposedly 'fair' tax competition). Demands to end ringfencing (no more preferential tax regimes for foreign investors) have waned since most OECD countries themselves could not conform to that original requirement.

The OECD demand for 'transparency' requires offshore centres to ensure that their domestic laws are altered to require creation and maintenance of records setting out the beneficial ownership or control of trusts and companies. In turn, these records will be available to answer enquiries from OECD countries. Although the requirement of transparency is generally thought of as appropriate to making *governments* accountable to their electors, the OECD requirement will be enforced upon the *private* sector in those countries. It does not matter if neither the private sector nor the government of an offshore country see any need to create or maintain such databases or wish to protect information under data or privacy protection laws.

The second demand is for so-called 'exchange' of information, 'so-called' because, in practice, information flow is almost certain to be virtually one-way—from the tax haven to OECD countries to allow them to tax their residents on their overseas interests or deemed interests. In terms of transparency, such a flow of information is akin to a one-way mirror, with transparency apparent to only one set of observers—

bureaucrats from OECD countries looking to spy on the private and government sectors in other countries.

Agreements for information exchange for tax purposes are normally found only in full double taxation agreements, which in turn are generally subordinated to the local legislation of each country as this does not require a jurisdiction to do anything beyond its normal legal or administrative processes. Thus, if a country has strict bank secrecy, such as Switzerland or Singapore, its local tax authority cannot provide more in response to a request for information from a treaty partner then it could obtain under local practices. Similarly, given that the United States Constitution prohibits unreasonable searches and seizures, a treaty partner of the United States cannot expect the United States Internal Revenue Service to provide information on request which it does not have and which would require a search warrant authorising activities outside the scope of US law and its Constitutional limitations.

Information is precious. No country agrees to force its citizens or residents to provide information to another country unless there is a significant benefit in doing so, a benefit which justifies overriding protection of the individual rights of owners of information, including data protection and privacy rights. The long history of negotiations since the 1920s on double taxation agreements show that most countries will only agree to exchange of information for tax purposes if they are assured of substantial concessions as a quid pro quo from the treaty partner. These concessions do not appear to be forthcoming from the OECD.

No country exists to enforce the laws of another country.

If an OFC were to agree to a full double taxation agreement with an OECD country it would need to seek some further concessions on tax sparing. There is not much point in offering tax incentives or being a tax-free jurisdiction if those tax exemptions are wiped out by other countries imposing taxes on the income which you have chosen not to tax. That is basically what OECD residence taxation does. Interestingly, around the same time as the OECD produced its report on harmful tax competition it also produced another report on tax sparing suggesting that OECD countries rethink their willingness to forgo taxation on income exempted from tax through incentives in developing countries, such as Malaysia and Singapore. Yet investors often place their monies in or through offshore financial centres because they want to take advantage of tax and regulatory competition. It is unrealistic for OECD countries to expect other countries to agree to information disclosure on such lax terms that the investment attractiveness of those non-OECD countries are destroyed.

Civil versus criminal law cooperation

Nations have traditionally cooperated on matters of common criminality. The basic rule of international law is that one jurisdiction may help another in a criminal matter where the alleged offence is criminal under both systems of law (the rule on dual or common criminality). The OECD, however, views the present rule on common criminality as too narrow and urges that, as a matter of comity between nations in a globalising world, it is now necessary for offshore financial centres to agree to information exchange for both civil and criminal law enforcement purposes, including both criminal and civil tax matters.

Such a position represents a drastic expansion of de facto extraterritorial law enforcement beyond the borders of OECD countries. Yet the traditional rule on common criminality makes perfect logical sense and ought not be set aside. The rule on common criminality as a precondition for mutual legal assistance or information exchange recognises that each sovereign country is master in its own house. No country exists to enforce the laws of another country. The OECD seems to be trying to undermine this fundamental international law objection by arguing that information disclosure from offshore financial centres upon request by OECD countries is necessary for them to prevent tax evasion according to their own laws. The reasoning is that tax evasion is fraud, fraud is criminal under most legal systems and therefore information exchange for tax purposes is justified on the basis that fraud is criminal everywhere.

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. The tactical advantage of this intellectual obfuscation by OECD bureaucrats (and their apologists) is that the authorities in OECD countries can then seek to use treaties on mutual legal assistance to pursue tax collection outside their borders by claiming that they are pursuing

criminal acts rather than seeking extraterritorial tax enforcement. There is little point to offshore financial centres saying they will cooperate with OECD measures against fraudulent tax evasion but not against lawful tax avoidance, if OCED countries are determined to confound the two.

Privacy and human rights

Why should anyone be obliged to help high-taxing OECD countries stop capital flowing to where taxes are less? The capital flowing away belongs to their citizens, not to OECD governments. Citizens of OECD countries are not slaves whose property belongs to their sovereign masters: private capital is not the property of OECD governments and other countries do no injury to anyone's rights if they make it welcome.

Hernando de Soto notes in his book *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* that a country can only develop and attract capital investment if it can offer secure property rights. A country cannot attract *private* investment if investors' affairs are to be made *public* to every inquisitive foreign bureaucrat. The recognition that privacy and private property go together is why many countries, including the United States, have constitutional protections protecting private citizens from arbitrary searches and seizures, preventing laws impairing the performance of contracts, guaranteeing privacy and preventing unjust taking of private property.

Privacy is both a human right and a property right. Governments exist to protect people's rights and to protect them in their life, limb and property. Once governments cease to do so and are perceived to prey upon private commercial interests, merchants and others seek to take their wealth elsewhere, since any form of information disclosure concerning the affairs of a private citizen is inherently a diminution of private property rights.

Modern economists and business people often take the legal foundations of a free society and a free market economy for granted, but the declaration of the rights of individuals evolved as concrete responses to abuse of state power. Adam Smith based his first objection to taxing capital on the intolerable vexation which an inquisition into every man's affairs would involve. This objection arose in the light of long historical experience in England. Since before the Magna Carta of 1215 through the Bill of Rights of 1688 to the present day, the sentiment of common law jurisprudence has always been that the subject is free and that the common law exists to protect his property and his privacy. It should be remembered that the common law traditionally presupposes the paramountcy of the liberty of the subject as against the power of the state, while Continental legal systems have traditionally typified the relationship of the state and the subject as one of subordination of the liberty of the governed to the requirements of the state.

If offshore financial centres wish to attract or retain private client business, it is essential that there be strong safeguards to any process of exchange of information from offshore financial centres to OECD or other countries. Information on private client affairs should only be supplied to other countries where genuinely required for investigation of common criminality and subject to the normal legal rules on warrants, immunities, admissibility etc. The risk is that if an OFC agrees to unrestrained information disclosure on the financial affairs of its private client investors to their home countries for all sorts of civil law, tax or other economic regulatory purposes, it will very soon be out of business. It will be throwing away the advantages of engaging in international commerce (which the Internet is now providing). It will be throwing away its sovereign right to seek prosperity by providing people from other countries with different choices of legal regime to govern their assets and business affairs. Paradoxically, there is also a risk for OECD countries. If offshore financial centres are shut down due to the unilateral actions of the OECD, the incentive arising from international taxation competition to create better, more economically efficient taxation systems will cease to exist. This will further harm domestic growth and prosperity for all nations, not just small developing countries.

Conclusion

Offshore financial centres have both the sovereign right and the moral right to insist that information exchange be limited to matters of common criminality and governed by due legal process for the protection of both their own residents and citizens and their own economic interests. There is nothing wrong or immoral about sovereign countries competing for investment by offering differing legal and economic regulatory systems. That is how human beings learn from each other. That is how the world discovered that communism was not such a good economic system. That is also perhaps how people will learn that OECD bureaucratic attempts to force an international groupthink (under the guise of internationally accepted standards) on matters of fiscal and economic regulation are not necessarily a good thing for human liberty or economic progress.