Chapter 2

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.

Like other forms of competition, fiscal rivalry generates positive results.

Tax competition exists when people can reduce tax burdens by shifting capital and/or labor 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, and 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 scares government officials from high-tax nations, who vociferously condemn tax competition and would like to see it reduced

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or eliminated. Working through international bureaucracies like the European Union (EU), 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]

Fiscal rivalry among governments has produced an amazingly desirable impact on fiscal policy in the past 25 years. For instance:

- Nations across the globe felt compelled to lower personal income tax rates following the Thatcher and Reagan tax rate reductions.
- Tax competition has helped drive down corporate tax rates in Western Europe's welfare states.
- Numerous nations in the former Soviet bloc have enacted flat taxes, a process greatly aided by tax competition.

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, EU, 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 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 inhibiting 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.

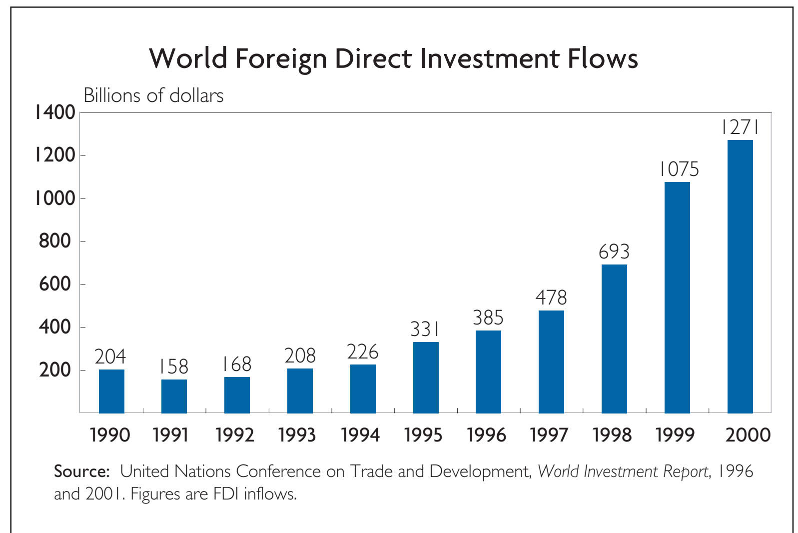
Tax competition is just one slice of this competition among countries, but it is increasingly important because of the growing mobility of capital and labor. Workers and people with money to invest want to obtain the best after-tax reward (or rate of return), and their search for profitable oppor-

tunities 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.

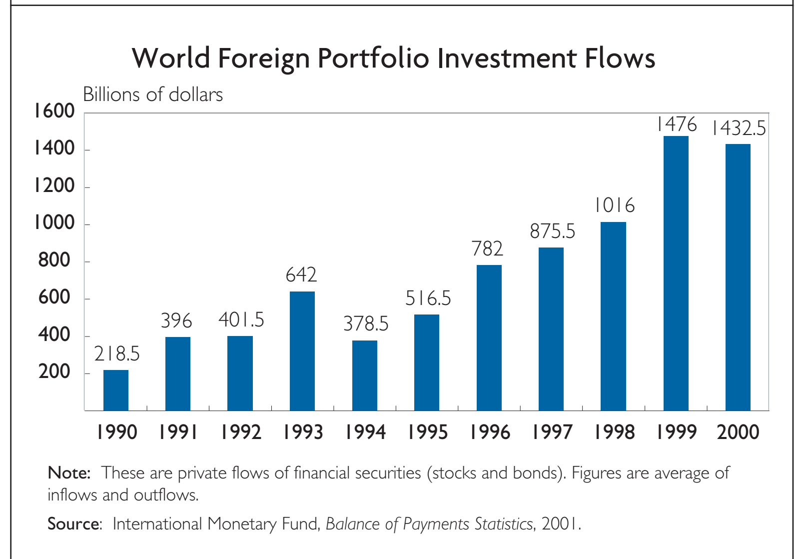
No wonder politicians from high-tax nations dislike tax competition. Fiscal rivalry restricts their ability to overtax (and therefore overspend). Just as the owner of a town's only gas station is unhappy when competitors set up shop, politicians do not like competitive neighbors who force them to behave 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 high tax rates or to impose discriminatory taxes on income that is saved and invested. The charts at right show 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 move to the lower-tax United Kingdom. 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.



Source: United Nations Conference on Trade and Development, *World Investment Report*, 1996 and 2001. Figures are FDI inflows.



Note: These are private flows of financial securities (stocks and bonds). Figures are average of inflows and outflows.

Source: International Monetary Fund, *Balance of Payments Statistics*, 2001.

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. The European Union, for instance, requires that member nations impose a value-added tax (VAT) of at least 15 percent.2 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.[3]

Under tax harmonization, 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 allocation of capital and labor, slowing overall economic performance.

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

1. The Paris-based Organisation for Economic Co-operation and Development launched a "harmful tax competition" initiative in the 1990s, identifying more than 40 so-called tax havens.[4] 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 blacklist any of its member nations even though at least four of them—Switzerland, Luxembourg, the United States, and the United Kingdom—qualify as tax havens according to the OECD's own definition.

2. The European Union 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 EU's current initiative is the "savings tax directive," an indirect form of tax harmonization that would require member nations—as well as six non-EU nations—either to impose a special tax on nonresident investors (and give the lion's share of the revenue to the investor's government) or to collect information about the investment earnings of nonresidents and forward it to their respective governments (which would then tax the income).[5]

3. The United Nations has a "Financing for Development" proposal that calls for the creation of an International Tax Organization. This new bureaucracy supposedly would have the power to override the tax policy of sovereign nations and would 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 on the United States because of the large numbers of skilled immigrants.[6]

As of this writing, all of these tax harmonization schemes have been stymied. The OECD did convince many blacklisted jurisdictions to sign so-called commitment letters, which ostensibly obligate low-tax governments to obey OECD dictates, but most of these letters include "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.

As originally conceived, with its automatic collection and sharing of information regarding nonresident investors, the EU savings tax directive would have created the "level playing field." The EU was forced to withdraw that proposal, however, and the replacement scheme clearly results in unequal treatment.

But this may be a moot point since the watered-down directive still faces a number of obstacles. Several nations—most notably the United States—have refused to join the EU's proposed cartel. This presumably is a death knell for the directive since it is predicated on unanimous participation from all 15 EU nations and six non-EU nations.

Finally, the United Nations' proposed International Tax Organization almost surely will never materialize. The right to tax—and the right to control the taxation of economic

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]

Worldwide Taxation Punishes U.S. Company Competing in Ireland

	Profit	Irish Tax	Additional 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 also worry that tax competition will become even stronger when 10 new nations join the EU in May 2004, 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 ongoing effort to create a 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.

Top Personal Income Tax Rates, 1980—2000

(Includes national and state/provincial taxes)

Country	1980	1985	1990	1995	2000	Change 1980-2000
Australia	62	60	49	47	47	-15
Austria	62	62	50	50	50	-12
Belgium	76	76	55	58	58	-18
Canada	60	50	44	44	44	-16
Denmark	66	73	68	64	59	-7
Finland	65	64	63	55	52	-13
France	60	65	53	51	54	-6
Germany	65	65	65	66	59	-6
Greece	60	63	50	45	43	-17
Iceland	63	56	40	47	45	-18
Ireland	60	65	58	48	42	-18
Italy	72	81	66	67	51	-21
Japan	75	70	65	65	50	-25
Korea	89	65	60	48	44	-45
Luxembourg	57	57	56	50	49	-8
Mexico	55	55	40	35	40	-15
Netherlands	72	72	72	60	52	-20
New Zealand	62	66	33	33	39	-23
Norway	75	64	54	42	48	-27
Portugal	84	69	40	40	40	-44
Spain	66	66	56	56	48	-18
Sweden	87	80	72	58	51	-36
Switzerland	31	33	33	35	31	0
Turkey	75	63	50	55	45	-30
United Kingdom	83	60	40	40	40	-43
United States	70	50	33	42	42	-28
Average for 26 OECD countries	**67**	**63**	**53**	**50**	**47**	**-20**

Note: Figures include the lowest state or provincial tax rate, as applicable.

Source: James Gwartney and Robert Lawson with Walter Park and Charles Skipton, *Economic Freedom of the World: 2001 Annual Report*(Vancouver: Fraser Institute, 2001); data retrieved from *http://www.freetheworld.com.*

activity inside national borders—is the very essence of national sovereignty, and it is very unlikely that powerful nations will ever surrender that right.[7]

The proposal to give governments permanent taxing authority over emigrants also faces daunting obstacles. Policymakers may not fully understand why it is misguided to tax flight capital, but they do seem to realize that it is wrong to tax flight labor.

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.[8] 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.[9] Today, the average corporate tax rate in the European Union is less than 30 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 two years ago 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.[10] 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.[11] 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 25 years. 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.[12]

■ **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.[13] The top tax rate in the United States was 70 percent when Reagan was inaugurated, and he lowered the top rate to 28 percent.[14]

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. The table on previous page 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.[15]

■ **The Irish Miracle and Corporate Rate Reduction in Europe.** In addition to reductions in tax rates on personal income, tax competition has helped to encourage lower tax rates on corporate income. The Reagan tax rate reductions once again deserve credit for starting the process, and the table on this page demonstrates that corporate tax rates have fallen dramatically since 1986.

But the Irish Miracle is perhaps the most impressive evidence of how tax competition advances good tax policy. Less than 20 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.[16]

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.[17] Today, the personal income tax rate is 42 percent, the capital gains tax rate is just 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 has experienced the strongest growth of all industrialized nations, expanding at an average of 7.7 percent annually during the 1990s.[18] The late 1990s were particularly impressive, as Ireland enjoyed annual growth rates in excess of 9 percent. [19] In a remarkably short period of time, the "sick man of Europe" has become the "Celtic Tiger." Unemployment has dropped dramatically, and investment has boomed.[20]

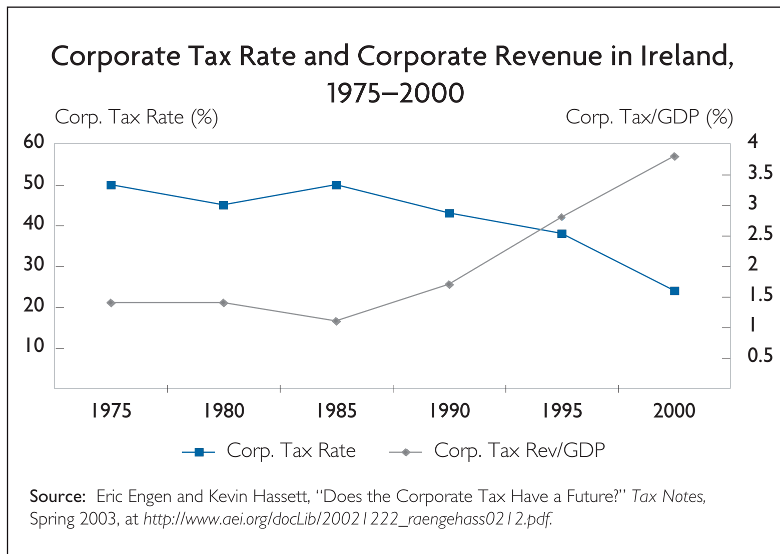
The Irish people have been the big winners. Once a relatively poor nation, Ireland now enjoys the second highest standard of living in the European Union. Even the gov-

Top Corporate Income Tax Rates, 1986—2000

(Includes national level taxes only)

Country	1986	1991	1995	2000	Change 1986-2000
Australia	49	39	33	34	-15
Austria	30	30	34	34	4
Belgium	45	39	39	39	-6
Canada	36	29	29	28	-8
Denmark	50	38	34	32	-20
Finland	33	23	25	29	-4
France	45	42	33	33	-12
Germany	56	50	45	40	-16
Greece	49	46	40	40	-9
Iceland	51	45	33	30	-21
Ireland	50	43	40	24	-26
Italy	36	36	36	37	1
Japan	43	38	38	27	-16
Korea	30	34	32	28	-2
Luxembourg	40	33	33	37	-3
Mexico	34	34	34	35	1
Netherlands	42	35	35	35	-7
New Zealand	45	33	33	33	-12
Norway	28	27	19	28	0
Portugal	47	36	36	32	-15
Spain	35	35	35	35	0
Sweden	52	30	28	28	-24
Switzerland	10	10	10	8	-2
Turkey	46	49	25	33	-13
United Kingdom	35	34	33	30	-5
United States	46	34	35	35	-11
Average for 26 OECD countries	**41**	**35**	**33**	**32**	**-9**

Source: Cato Institute based on OECD data.



Source: Eric Engen and Kevin Hassett, "Does the Corporate Tax Have a Future?" *Tax Notes*, Spring 2003, at *http://www.aei.org/docLib/20021222_raengehass0212.pdf.*

ernment 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 this page illustrates, however, today's 12.5 percent corporate tax raises revenue totaling nearly 4 percent of GDP.[21]

Thanks to tax competition, Ireland's tax rate reductions have had a positive effect on the rest of Europe. The Irish Miracle 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,[22] 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 recently approved a 13 percent flat tax, and Slovakia is implementing a 19 percent flat tax.[23] Even Serbia has a variant of a flat tax.[24]

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.[25] The Russian Federation was the next to adopt a flat tax. Not surprisingly, it is the next most prosperous of the former Soviet "Republics."[26]

The evidence from Russia, where the 13 percent flat tax has produced dramatic results, is particularly striking: Russia's economy has expanded by about 10 percent since 2001.[27] That may not sound like much, but it is rather noteworthy considering t e slowdown in the global economy. 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.[28] Over the past two and one-half years, inflation-adjusted income tax revenue in Russia has grown by about 60 percent, demonstrating that people are willing to produce more and pay their taxes when the system is fair and tax rates are low.[29]

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 15th richest jurisdiction, according to the World Bank.[30]

The World Bank's rankings are in fact very instructive. Many of the world's wealthiest jurisdictions, including 11 of the top 16

FRINGE 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.

Note: 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, at *http:/www.freedomandprosperity.org/task-force-report.pdf*.

(see table at right), 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 sense for them to publicize so-called tax havens instead of persecuting them?

World's Wealthiest Jurisdictions

(Tax Havens in Bold)

1. Bermuda	9. Denmark
2. Luxembourg	10. Iceland
3. Switzerland	**11. San Marino**
4. Norway	**12. Cayman Islands**
5. Liechtenstein	**13. United Kingdom**
6. United States	14. Sweden
7. Japan	**15. Hong Kong**
8. Channel Islands	**16. Monaco**

Source: Gross national income per capita, 2002, Atlas Method, in World Bank, *World Development Indicators*, July 2003.

POISON PILL FOR TAX REFORM?

There is a strong effort in the United States to enact a flat tax, and President George W. Bush's 2001 and 2003 tax cuts move the tax code in that direction by lowering rates and reducing double taxation of income that is saved and invested.[31] These policies help to make America a magnet for global capital.

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 Consequences," 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.

Tax competition promotes tax reform by helping to drive down marginal tax rates.

Indeed, 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.[32] 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. 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 savings tax directive could determine whether Europe's high-tax nations are able to cripple tax competition. If the savings tax directive is implemented, it will be more difficult for taxpayers in high-tax nations to benefit from better tax regimes outside their borders—especially if the EU manages to convince the United States and Switzerland to participate in the proposed cartel.

At this stage, it is not clear whether the EU will succeed. Austria, Belgium, and Luxembourg probably would like the initiative to die. Switzerland has not embraced the pro-

THE SINGLE-MARKET TAX HARMONIZATION MYTH

European supporters of tax harmonization frequently assert that tax rates must be harmonized to permit the functioning of a single market. This is a rather odd claim. The United States has had a single market for more than 200 years, notwithstanding the vigorous tax competition that takes place between American states.

Critics may claim that state taxes are dwarfed by federal taxes, but this argument is not very convincing because states still account for one-third of government taxes and spending. Moreover, for much of U.S. history, the federal government was considerably smaller than the combined size of state and local governments.

Note: For more information, see Daniel J. Mitchell, "The Single-Market Tax Harmonization Myth," *Tax Notes International*, May 6, 2002, at *http:/www.freedomandprosperity.org/articles/tni05-06-02.pdf*.

posal, and the Bush Administration already has announced that the United States does not support the savings tax directive.

The EU has responded to these obstacles by weakening its proposal. To appease Switzerland, the EU has offered to permit withholding tax regimes instead of automatic information-sharing of tax data. The EU also has tried to sidestep U.S. opposition by asserting that America already is in compliance—a rather odd claim since interest and capital gains paid to foreigners are neither taxed nor reported.[33]

Europe's high-tax nations may be fighting a losing battle. In May 2004, 10 new nations will join the EU. These countries include many jurisdictions with tax laws that are designed to boost growth and attract economic activity. Some of these new member nations, such as Slovakia, Lithuania, Estonia, and Latvia, have (or will have) flat tax regimes. Other new members, such as Hungary, Malta, Cyprus, and Slovenia, have elements of their tax systems that are very attractive (such as Hungary's 18 percent tax rate on corporate income). And more changes are on the way. Poland has announced that it will reduce its corporate rate to 19 percent, and the Czech Republic plans to lower its corporate tax rate to 24 percent.

Once these new nations are part of the EU, the competitive pressure on Europe's welfare states will increase because many investors and entrepreneurs will shift economic activity to take advantage of more favorable tax laws. Equally important, it will be much harder for the EU to pursue additional tax harmonization schemes once 10 new nations have voting power. This is especially true if the national veto for tax matters 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—labor—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."[34] 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

The battle between tax competition and tax harmonization is really a fight about whether government will control the factors of production.

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."[35]

Ultimately, this is a debate about the size of government. Harmonization means higher tax rates and bigger government. Freed from the rigor 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 labor and capital have the right to escape fiscal oppression.

Endnotes

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