

Simply stated, governments that over-tax and over-spend cause “capital flight.” Investors and entrepreneurs do not like to keep their money in places like France where the tax burden is confiscatory. Instead, they shift their money to places like Switzerland, Hong Kong, Bermuda, and the United States. This mobility of capital—the ability of money to cross national borders—is a constraint on big government. When oppressed taxpayers have the ability to shift resources from high-tax nations to low-tax jurisdictions, politicians begin to realize that it is not smart to abuse the geese that lay the golden eggs.

This process is known as tax competition. But many politicians—especially in Europe—despise tax competition. These Socialist lawmakers rely on class warfare and the politics of envy to win elections. They

one gas station. The owner of the gas station can charge high prices and offer poor service. But what happens if a couple of new gas stations open up? All of a sudden, the consumer is in charge. The gas stations must compete to attract business. Prices fall and service improves.

The same thing happens with governments. If politicians know that taxpayers have no escape, they are much more likely to impose excessive tax burdens. Indeed, this happened in many nations after World War II. Marginal tax rates often reached 70 percent and higher, and other taxes—such as levies on corporate income, capital gains, and death —reached similarly confiscatory levels.

These oppressive tax laws—and the concomitant economic damage they caused—led to tax revolts. In some nations, the tax

# ENDING THE TAX HARMONIZATION THREAT

by *Daniel J. Mitchell*

promise to pillage a tiny minority of “the rich” so that they ostensibly can redistribute the money to the “masses.” But the folly of this destructive approach quickly becomes apparent when money flees to safe havens.

This is why politicians from high-tax nations want to end tax competition. They want to stop taxpayers from shifting their funds to places with better tax systems. And if they cannot stop the flow of funds, they want to track the money so they can continue to tax it—even when it is invested in another nation and subject to the tax laws of that other nation. This tax harmonization policy is known as “information exchange,” and it would create a tax cartel—an OPEC for politicians.

**Tax harmonization is bad tax policy.** This is basic economics. As every Economics 101 student understands, competition is good. Imagine, for example, that a town has only

revolt took place underground as taxpayers shifted their money to Switzerland, Hong Kong, and the Caribbean. In other countries, such as the United States and United Kingdom, the tax revolt became an expression of popular will as voters elected leaders who promised to slash tax rates.

**These tax revolts facilitated tax competition,** and the results were an unqualified success. Most importantly, Margaret Thatcher and Ronald Reagan slashed tax rates 20 years ago. This put tremendous pressure on other governments, and almost every other nation was compelled to reduce marginal tax rates to limit the flow of jobs and capital to the United States and United Kingdom.

Individual income tax rates have fallen dramatically in many nations, but tax competition has had a salutary effect on other taxes as well. Corporate tax rates have

dropped so much that the United States—which used to be a low-tax nation for business—now has the fourth highest corporate tax rate in the developed world. Tax burdens on capital gains also have fallen around the world, as have death tax rates.

It is worth noting that very few nations were lucky enough to have leaders like Thatcher and Reagan. Governments in these nations reduced tax rates because of competition, even though the political elite in these countries harbored socialist inclinations. Many Scandinavian countries, for instance, now have flat rate taxes on capital income. This is a spectacular change, but one that would have been inconceivable 20 years ago.

The Reagan and Thatcher tax rate reductions may have triggered the global revolution in free-market tax policy, but “tax havens” are now the driving force for supply-side economics. These jurisdictions, many of which impose no income taxes, encourage market-oriented reforms and give taxpayers a refuge when fiscal policy in a country becomes too oppressive. One can only imagine, for instance, how bad France’s tax system would be if the government did not have to worry about competition from Switzerland, Luxembourg, and the Channel Islands.

Not surprisingly, the political elite despises tax competition because fiscal rivalry reduces the power of government. Politicians from high-tax nations and international bureaucrats want us to believe that low-tax jurisdictions are illegitimate. Playing into the stereotype created by John Grisham novels, they claim that “tax havens” are sinister places that facilitate shady activity.

The Paris-based Organization for Economic Cooperation and Development has led the attack against low-tax jurisdictions, accusing 41 so-called tax havens of “harmful tax competition” in 2000. But this was—and still is—a self-serving and hypocritical exercise by an international bureaucracy representing mostly high-tax European welfare states. But the OECD is only one of many bureaucracies pushing for tax harmonization. The European Union is actively pursuing tax harmonization, including a proposed “savings tax directive” that would compel U.S. financial institutions to obey foreign tax laws. The United Nations also has jumped into the

battle, seeking to create an International Tax Organization that would destroy the sovereign right of nations to determine their own tax policies.

These bureaucratic initiatives are a threat to good tax law, but this is not just an issue of tax competition. The attacks against low-tax jurisdictions are an assault against sovereignty. Tax havens are the main targets today, but Europe’s uncompetitive governments already are starting to argue that America’s comparatively low tax rates are a form of “unfair” competition. Indeed, the European Union already has dragged the United States before the World Trade Organization several times because, according to the Brussels-based bureaucracy, America does not impose a steep enough tax burden on export-oriented companies!

**Financial privacy is another key issue.** The OECD is trying to compel low-tax jurisdictions to dismantle legal and constitutional safeguards so high-tax governments can get the information needed to tax (usually for a second or third time) income that is saved and invested. Europe’s welfare states refer to this assault on privacy as “information exchange,” but the so-called exchange is really a one-way street. The high-tax nation gets the information on investment in the low-tax jurisdiction, but provides nothing in exchange (since most low-tax jurisdictions are not foolish enough to tax income earned outside their borders).

The European-led proposal for “information exchange” is best characterized as a form of fiscal imperialism. The high-tax nations are driving investors and entrepreneurs to shift their money to so-called tax havens. But rather than fix the misguided policy, the high-tax nations are seeking to turn the low-tax jurisdictions into fiscal colonies.

If the high-tax nations succeed, tax competition will be crippled. The OECD’s bureaucrats argue that “information exchange” is compatible with tax competition, but this is an outrageous deception. Tax havens might be allowed to exist in theory, but information exchange kills tax competition in practice since taxpayers from high-tax nations would be unable to escape bad tax law. Why would a French taxpayer shift investment funds to America, for instance, if the French government could

force the U.S. government to provide information that would enable the French tax authority to tax any income and assets at tyrannical French tax rates?

Recalling our “Economics 101” lesson above, imagine if new gas stations could enter a market, but customers still had to pay the monopoly prices of the gas station that used to control the market. Needless to say, there is no competition in this system. The original monopoly station would have no incentive to lower prices, and the new stations would have scant incentive to enter the market since they would have no ability to offer a more attractive pricing structure to customers. To make the analogy exact, they technically could charge lower prices, but they would be compelled to report customer purchases to the old monopoly station and that station would have a right to charge those customers the difference between the two prices. This sounds absurd, but this is what the OECD and EU are trying to impose on the world economy.

**Taxpayers have a big stake in this battle.** An OECD-instigated cartel will lead to higher tax rates and more punitive treatment of capital. The OECD’s tax harmonization campaign also could mean the death of tax reform. All proposals to simplify the tax code—such as the flat tax—are based on common sense principles such as taxing income only one time and taxing only income earned inside national borders. The OECD effort, by contrast, is designed to help governments impose discriminatory taxes on capital income, even if the income is earned in other jurisdictions.

We must fight against tax harmonization. Along with other think tanks, taxpayer organizations, free market legislators and friends in the government, we must protect our own fiscal sovereignty. Tax harmonization schemes would undermine competitive pressures to keep taxes low and severely cripple the liberalizing impact of tax competition on the global economy.

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**Tax Competition Between States**

Tax competition has a similar effect inside a nation. The fiscal rivalry between American states is a great example of the liberalizing impact of tax competition. California is suffering from fiscal mismanagement, leading many taxpayers and businesses to migrate to zero-income tax states like Texas, Florida, and Nevada. This punishes California politicians and encourages them to behave in a more rational manner. Likewise, politicians from Massachusetts have a hard time raising taxes since entrepreneurs and investors can flee across the border to New Hampshire.