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In Praise of Tax Havens

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"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. . . . 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."
—Adam Smith, The Wealth of Nations, 1776

In May, President Obama declared war on Americans who shelter their money in low-tax jurisdictions overseas.

Meanwhile, at the behest of politicians from high-tax nations, international bureaucracies are persecuting these tax havens. The Paris-based Organization for Economic Cooperation and Development (OECD), for instance, blacklisted 41 such jurisdictions as part of its "harmful tax competition" project earlier this decade and is now trying to bully them into changing their attractive policies. The European Commission has several anti-tax-competition schemes, including a "saving tax directive" that seeks to coerce low-tax jurisdictions into helping Europe's welfare states track—and tax—flight capital. And the United Nations has a Committee of Experts on International Tax Matters whose objective is to impose global rules to hinder the flow of jobs and capital from high-tax nations to low-tax nations. As though this weren't enough, the G-20 communiqué last spring singled out tax havens for a crackdown.

The common theme of all these efforts is that politicians want to replace tax competition with tax harmonization. Tax competition exists when politicians feel pressure to improve tax policy so the geese that lay the golden eggs will not fly away. Ever since the Reagan and Thatcher tax-rate reductions began the process of tax competition, nations have been racing to lower rates in hopes of attracting—or retaining—jobs and investment. Since 1980 average top personal income tax rates in the developed world have dropped about 26 percentage points and corporate tax rates more than 21 points. And there are now 27 jurisdictions with flat taxes, an amazing development. No wonder the global economy—notwithstanding current turmoil—is so much stronger today than it was in the 1970s.

According to stereotypes, tax havens are little islands in the Caribbean, and indeed that's true of some of the world's premiere offshore centers. But to be more accurate, a tax haven is any jurisdiction that satisfies two criteria: First, its tax laws are attractive to global investors and entrepreneurs, and second, it protects its fiscal sovereignty by choosing not to enforce the bad tax laws of other nations, at least when they are trying to tax economic activity outside their borders. This means, of course, that individuals and businesses from high-tax nations have the option of using those jurisdictions as havens against excessive taxation.

Havens Are in The Nationality of The Beholder

So what are the tax havens? Places such as Liechtenstein and the Cayman Islands belong on the list, but so do many "onshore" nations. One of the world's leading experts on offshore issues, Marshall Langer, wrote in Tax Notes International that "the most important tax haven in the world is . . . Manhattan. . . . [T]he second most important tax haven in the world is London." The United States and United Kingdom are havens because the law enables foreigners to invest money and not report the income to their tax police. That's good for the U.S. and U.K. economies, and for foreign taxpayers.

By some counts there are more than 70 tax havens in the world, ranging from big nations like the United States to obscure, tiny jurisdictions such as Melilla, an autonomous part of Spain on the coast of Morocco, and Sark, a tiny British-controlled island off the coast of France. In some cases, such as the United States, the tax-haven

policies are designed to attract global capital and are only available to foreigners. In other cases, such as the Bahamas, the beneficial tax rules are open to both residents and nonresidents.

Tax havens are good for the global economy primarily for four reasons. First, they promote good policy around the world by pressuring politicians in high-tax nations to lower tax rates. The pro-growth changes noted earlier have been happening mostly because of tax competition, and tax havens are valuable precisely because politicians are less likely to be greedy when they know taxpayers have escape options. Remarkably, even OECD economists understand that tax competition is a pro-growth force in the world economy. They 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."

Tax havens have been especially helpful in convincing politicians to reduce the double taxation of income that is saved and invested. Many nations have lowered or eliminated death taxes and wealth taxes because the politicians have finally figured out that oppressive tax laws simply lead taxpayers to move their money to havens such as Luxembourg or Panama. Likewise, nations have reduced double taxation of dividends, interest, and capital gains. The politicians figure it's better to have a low rate and collect some money rather than to have a high rate and drive investment to Switzerland or Singapore.

From an economic perspective, these lower tax rates are critical because they reduce the tax bias against saving and investment. This encourages people to set aside more of today's income to finance tomorrow's growth—and even socialist economists agree that capital formation is the key to long-run prosperity and rising living standards.

Second, tax havens generate high living standards. According to World Bank data, nine of the world's 13 richest jurisdictions are tax havens. Not surprisingly, academic researchers have confirmed that tax havens grow faster and create more prosperity for people than higher-tax areas. This is especially important in the developing world, where poor nations that become tax havens enjoy big reductions in poverty.

Third, tax havens promote better governance. One of the problems plaguing the developing world is the lack of sound institutions. Property rights, the rule of law, and sound money are the indispensable building blocks for wealth creation and economic growth. Two academics, James Hines and Dhammika Dharmapala, found that the desire to become a tax haven leads nations to improve their institutions for the simple reason that global investors don't want to place their money in poorly governed jurisdictions. And the World Bank's governance indicators find that tax havens rank very high. This is something that should be applauded not assaulted.

Fourth, tax havens promote economic activity in high-tax nations. This seems paradoxical, but most countries, even high-tax nations, generally have more favorable tax rules for inbound investment than for their citizens' economic activities. Politicians figure their own citizens are captive customers who can be overtaxed, but they understand that they have to compete for global investment. Moreover, academic experts have found that citizens in high-tax nations often take advantage of this preference and use a neighboring tax haven as a platform to invest in their own country. This additional investment, which otherwise would not have taken place, increases the prosperity of the high-tax nation.

The case for tax competition also is bolstered by Nobel laureates who recognize that competition between nations is a critical force for better policy. To cite just three examples, James Buchanan wrote that "tax competition among separate units . . . is an objective to be sought in its own right," and Milton Friedman noted that "Competition among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or enterprises in the goods and services they offer for sale and the prices at which they offer them." Gary Becker, meanwhile, wrote that "competition among nations tends to produce a race to the top rather than to the bottom by limiting the ability of powerful and voracious groups and politicians in each nation to impose their will at the expense of the interests of the vast majority of their populations."

Shelter From Persecution

Low-tax jurisdictions also offer a safe haven for people subject to persecution. The vast majority of the world's population lives in nations where governments fail to provide the basic protections of civilized society. Indeed, in many cases governments are the problem since ruling elites use their power to exploit people. Corruption often is rampant, expropriation common, and crime endemic. There is also widespread persecution. Not surprisingly, people with money are common targets of oppression —particularly if they are members of religious, political, ethnic, racial, or sexual minorities.

Tax havens protect people from venal and incompetent governments by providing a secure place to invest their assets. A Jewish entrepreneur, for instance, would be foolish to keep his money in a local bank when the government is controlled by anti-Semites. Indeed, Switzerland's admirable, centuries-old human-rights policy of protecting financial privacy was strengthened in the 1930s to protect German Jews who wanted to guard their assets from the Nazis.

Many groups in the world face discrimination and hostility, often from government. The ethnic Chinese in nations such as Indonesia and the Philippines frequently are resented by the local population. The same is true for people of Indian descent in East Africa. When people belong to groups that are unpopular and susceptible to being targeted by the government, it makes sense for them to protect their families' interests by putting money someplace like Hong Kong, where the politicians from their country have no feasible way to find out about it. The same financial-privacy laws that make tax havens so attractive to French families and Swedish entrepreneurs who want to escape oppressive taxation also protect other people from different forms of persecution.

Tax Hypocrisy, Not Harmonization

It is worth noting that even the international bureaucracies acknowledge the valuable role of tax havens and financial privacy. The UN, for instance, admitted in a 1998 report that "For much of the twentieth century, Governments around the world spied on their citizens to maintain political control. Political freedom can depend on the ability to hide purely personal information from a Government." The leader of the OECD's anti-tax-competition campaign, Jeffrey Owens, admitted to the U.K.-based Observer that "tax havens are essential for individuals who live in unstable regimes."

The campaign against tax havens interferes with the right of jurisdictions to pursue pro-growth policies, which is especially discriminatory against poor nations. Having "no or low taxes" is the main criterion for being listed as a tax haven by the OECD. Yet most OECD nations did not have income taxes during the 1700s and 1800s, when they climbed from agricultural poverty to middle-class prosperity. We should all be offended that such nations now want to deny that same opportunity to poor nations. It is rather unseemly for powerful white-governed nations in Europe, which control the OECD and European Commission, to target less powerful nonwhite jurisdictions in places such as the Caribbean.

Another issue is the OECD's hypocritical treatment of capital compared to labor. The Paris-based bureaucracy is upset that investment funds are flowing to low-tax jurisdictions, many of which are in the developing world. But OECD nations are big beneficiaries of a "brain drain" from developing nations. This flow of talent is beneficial to "labor-inflow" nations, just as global financial flows are beneficial to "capital-inflow" nations. Yet the OECD is not suggesting that developing nations have the right to tax emigrant income earned in OECD nations. So why should OECD nations be allowed to tax flight capital in non-OECD nations?

Another example of hypocrisy is that the United States, United Kingdom, Austria, Belgium, Switzerland, and Luxembourg are all OECD members and yet were not on the original OECD blacklist even though they are tax havens for foreign investors. (The list was later revised.) Only smaller less-powerful nations were subject to this form of discrimination. And of course the ultimate hypocrisy of all is that the bureaucrats who work at the OECD and UN all get tax-free salaries, yet they run around the world demanding that other nations raise taxes.

Politicians from high-tax nations and their agents at the international bureaucracies often admit that the moral issues are pertinent. But then they say that they are worried that havens enable some of their residents to avoid the tax net. But why is

that the fault of jurisdictions with better tax policy? If high-tax nations want better compliance, shouldn't they fix their tax systems instead of trying to bully other nations into surrendering their fiscal sovereignty and becoming vassal tax collectors? In any event, the notion that there are huge amounts of unpaid tax is just one of several myths disseminated by opponents of tax competition. Let's have a look at these myths.

Myths of Anti-Competition

Myth 1: Tax havens result in $100 billion of unpaid taxes. President Obama wants to dramatically increase the power of the Internal Revenue Service, claiming that this is the only way to collect the money that supposedly is hiding in low-tax jurisdictions. The number is phony. The IRS—which certainly cannot be considered a fan of tax havens—estimates that the overwhelming share of the so-called tax gap is the result of what happens in the United States. Part of the make-believe $100 billion apparently comes from a former John Kerry staffer, who concocted an estimate of $70 billion in unpaid individual income tax. But when the Congressional Research Service (CRS) asked for the method used to generate the number, the staffer confessed, for all intents and purposes, that he made it up. According to the CRS memo, he "was not able to send us a written discussion of his estimating procedure" and he "indicated that the estimate was an uncertain one." That's the understatement of the century.

Myth 2: Cracking down on tax havens is the best way to improve compliance. Politicians from high-tax nations and bureaucrats at the OECD claim that "offshore" jurisdictions deprive politicians of much-needed tax revenue. This assertion is rather strange since tax receipts were at record levels in OECD nations until the current downturn. But how best to improve tax compliance? Academic research strongly indicates that the biggest factor in tax compliance is tax rates. When tax rates are excessive, people are less likely to obey the law. And if they can't protect their income using tax havens, they'll use the domestic underground economy. Or they'll be less productive. The world's leading expert on the issue, Friedrich Schneider at the Johannes Kepler University in Austria, explains that income and payroll taxes are "the main causes for the existence of the shadow economy" and higher tax rates increase "the incentive . . . to work in the shadow economy."

Myth 3: Tax Havens Lead to Higher Taxes for ordinary people. One of the worst myths is that low-tax jurisdictions reduce taxes on sneaky people and this causes politicians to raise taxes on others to make up the difference. But if this were true, increasing amounts of money flowing to tax havens should be accompanied by higher tax rates in the outflow countries. Yet, as noted, the opposite has occurred. Politicians are lowering tax rates because of the competition from tax havens. This means that all taxpayers benefit because of the risks taken by those who invest in low-tax jurisdictions.

Myth 4: Tax havens are money-laundering centers. Contrary to this routine smear, all the objective evidence shows that they have the toughest rules against dirty money. Not a single tax haven is on the blacklist of the Financial Action Task Force. A few tax havens are considered money-laundering centers by the CIA, but there are far more non-havens on its list. The State Department says the same thing. It's also worth noting that every major tax haven has been cleared by the IRS for having good know-your-customer laws to hinder dirty money, and all of the major havens also are members of the Egmont Group, which is open only to jurisdictions that have effective financial intelligence units to fight dirty money. No wonder an Australian academic found it was much easier to launder money in onshore nations than in offshore jurisdictions.

When he was a senator President Obama sponsored legislation designed to persecute tax havens, and his chairman of the National Economic Council, Larry Summers, is a harshly ideological opponent of low-tax jurisdictions. Now Obama has made good on his word. That places the U.S. on the side of countries like France and Germany, giving the OECD's previously stymied tax-harmonization efforts new life.

Advocates of economic liberty need to resist these efforts. The Center for Freedom and Prosperity, which was founded in 2000 to help protect tax competition, has done an excellent job (I'm a board member, so perhaps I am biased). But preserving tax competition in the new political environment is going to be a major challenge.

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