TAX HAVENS: THREAT OR ENHANCEMENT TO COMMERCE

By Ingrid Ulloa

A haven is defined as a shelter or place that provides safety. Tax haven is defined as a place where there is low or no taxes at all, thereby giving shelter and protection from the loss of money. This gives many advantages to companies and citizens of countries that charge high income taxes, but of course, it is disadvantageous to the nations that lose these tax revenues. These nations obviously are totally opposed to tax havens and claim that there is unfair tax competition, money laundering and lack of transparency, among other arguments. But are these arguments valid, or is this just a matter of competition?

The existence of tax havens is inherent in that there are specific benefits which countries gain for creating them. One reason for becoming a tax haven is that some economies simply find that to sustain their budgets there is no need to charge as big amounts of taxes as some industrialized countries. Others put specific conditions, such that the company must set up a division in their country, in this way creating job for their population and development for their nation. Some want to capture new skills within their population that can be developed by attracting foreign companies through low taxes. While others simply can't compete in any other sector internationally and find their comparative advantage in the taxing/banking sector. In this way these economies become tax havens and start up international competition in taxes.

The creation of tax havens has been very beneficial to the development of many countries and to the distribution of wealth from developed countries to developing countries. Lower taxes provide incentives for people to save, invest and innovate, which will increase productivity and wealth in an economy. A clear example of this is Ireland whose GNP per capita in 1970 was 40% of Germany's and in 1996 increased to 79%. (Around the World in 80 Ideas, 2002). Jobs have increased in Ireland and the population has a better quality of life. Luxemburg, which is an onshore tax haven, whose asset value in the banking sector in 1995 was 587% of its GDP, this is another example of how this regime can bring development to an economy. Also the Channel Islands, the Isle of Man, the Portuguese island of Madeira, Malta and Cyprus, among others, are examples of growing economies based on tax competition.

So, specifically what is tax competition? It is the practice under which some countries reduce the personal and/or corporate income tax rates in order to attract foreign direct investment and high value human resources into their country. Is this bad? Does it increase money laundering and many other financial crimes that some claim? The Financial Action Task Force (FATF) published in 2000 a so called blacklist of countries that were not cooperating with the efforts to eradicate money laundering and among it, at that time, some tax havens appeared like the Cayman Islands, Cook Islands, Marshall Islands, Liechtenstein and Nauru. Specifically at that time, 15 countries were named and only these 5 were openly considered tax havens; nowadays there is no on the list. Despite this, Jeffrey Owens, head of Fiscal Affairs at the OECD, wants tax havens to implement some measures so that other countries will be able to tax the incomes that are being kept in these havens. He affirms that the OECD as an organization is not against tax competition and states that the mission is not to restrain competition, but rather to restrain "harmful tax practices that erode the tax bases of other countries" (Owens, 2000). This statement follows arguments similar to those made by economists of the early mercantilist theory, where exports were encouraged, and imports were discouraged. This theory has been proved to be detrimental to world economic development, and the theory of comparative advantage has shown that with trade, actually all countries involved benefit with specialization. If we are talking about a world living in the era of globalization where every country is exporting all the goods and services at which they have advantage with respect to other countries, it would be a contradiction to say that competition is harmful. If these tax havens have an advantage on offering services at a low tax rate while other countries cannot, then tax havens should specialize in these services (as they are doing) and the other countries instead of crying foul (like in the earlier times of trade), should try to keep up with the pace and reduce their taxes too.

In fact there is already some evidence of the good effects tax competition can bring to the world economy. Once one country lowers its tax rate, the other countries which feel threatened may opt for one of two possible strategies: 1) begin to make propaganda selling the idea that it is unfair or 2) lower their tax rates too and truly compete with tax havens. And in a world moving further towards free markets, the second option should be the one adopted. Actually the wave in the reduction of tax rates had already started in 1980 in Britain when Margaret Thatcher cut corporate tax rates. Afterwards, other European countries such as Denmark, Sweden, Norway and Finland cut rates going from 60% to 28%!! (Mitchell 2007). In fact these countries made the reforms to attract back multinationals that had gone out of their countries because of the high taxes they had to pay. Therefore, opting for the strategy of claiming unfair tax competition is showing an inability to compete in this sector. This is proven by the fact that not all countries agree which economies/countries are tax havens and which are not. A clear example of this is when the UK claimed that Ireland was a tax haven and imposed restrictions for income going out to Ireland and meanwhile the neither the US nor the European Union thought Ireland was a tax haven. Countries accuse other countries of unfair competition for their convenience and not always based on solid facts.

Jeffrey Owens also talks about tax competition as being open and transparent. So, let’s examine what he refers to. He talks about lack of effective exchange of information; he claims that the tax havens should at all times report all of the incomes that enter their boundaries so that the other countries can tax it and control the foreign activities of their residents (2000). But then, where is the sovereignty of the tax havens? The OECD countries are asking others basically to report all that is being done in their land. Why would they do this? No country is above another, so no country should give reports to any other about the activities done within its boundaries as long as it doesn’t affect human rights.

In fact, in order for a country to cooperate with another, there are two basic conditions that have to be met in the prosecution of criminal activity: 1) “Nations are not obliged to put other countries’ laws above their own. 2) Nations generally must respect the due process safeguards and constitutional protections of other countries.” (Mitchell, 2003). Therefore, low-tax countries do not cooperate with high-tax countries because these high-tax countries are trying to tax income that is earned and kept inside the boundaries of others and going against the tax system of these low-tax countries. In other words, “tax havens are sovereign and their tax laws apply to acts done in their territory” (Dwyer, 2002). Besides, groups like the CIA, the FATF and the US State Department have independently concluded that the so called tax havens have better track records of the money held in their jurisdiction than the high-tax nations (Mitchell, 2003).

Putting these restrictions on the income that is kept in tax havens is actually a trade barrier. Applying them will probably take away the advantage that the tax havens have over these services they are offering, and also they would deter these countries' economies and that would actually be unfair. In fact Mr. Owen contradicts himself in the interview cited because he says that countries are free to implement whatever tax system they think is ideal for their economy (2000), but on the other hand is restricting this freedom by asking these countries to report all the income that they are receiving.

The fact is that countries like those members of the OECD are worried because they are not competitive in terms of taxation, and capital is flowing out from these countries into tax havens. The OECD member countries want to hide this lack of competitiveness by claiming that tax havens are not transparent and they use this argument to implement a service trade barrier against the tax havens, in other words, it is just like a subsidy to their ineffectiveness in terms of taxes.

In fact, studies done by the US State Department, the CIA and the FATF have shown that the number of high-tax nations that are considered to be vulnerable to the practice of money laundering clearly outweighs that of low-tax nations (Mitchell, 2003). The problem is not in the tax havens like the OECD claims, but within the high-tax countries and especially in the USA. Daniel J. Mitchell also names several studies that show that almost 50 % of the world's dirty money is originated in the USA and that among the ten top jurisdictions where dirty money is invested there is only one tax haven. Portman said the problem is at home (2003), the USA must not blame other countries for its own system faults; instead it must try to eradicate the problem within its own boundaries first.

Another fact that clarifies that tax havens are not making it easier for criminals to wash their money is that the Internal Revenue Service (IRS) which is an institution that determines "whether a jurisdiction has effective know-your-customer laws when deciding to grant 'qualified intermediary' (QI) status to foreign financial institutions … (showed that) 21 of the jurisdictions named as tax havens by the OECD have received the agency's blessings, with many others awaiting approval" (Mitchell,2007). Although one might think that it is not convenient for tax havens to ask for information when investors are putting their money in these economies, the truth is that these economies are complying with the international standards and there is no reason for them to give more than what international institutions, like the one just cited, ask for.

In addition to the above arguments, what the OECD is proposing, that is, more transparency and almost unlimited access to all the financial information of their citizens, is also a threat to the development of the capital market. In fact, countries like the United States which is running a large current account deficit and thus is relying on the capital market to finance it, should think more closely about supporting these ideas of the OECD, which in the case of being applied, would deteriorate the capital inflows that it is receiving. On the other hand, many of the OECD countries, "as a 'source of income' countries, their national interests do not lie in helping 'residence of recipient' countries negate their attractiveness as investment destinations"(Dwyer,2002).

Just like Adam Smith said, "the proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country" (Dwyer, 2002), thus he does not have to provide any information to any country in specific; he is free and has the right to privacy, the state is not owner of the citizen. Smith says that setting up barriers to this proprietor would hurt the nation in which he keeps them in many important ways. When he decides to remove his stock away it will also take away all of the industry it has created leaving many workers unemployed and land uncultivated. It will harm the economy more, than what it will probably earn by charging taxes.

Because of the side effects that this would bring and also because of the current difficulty to get information and to actually know what an individual has in income, economic theory states that the optimal tax a nation can impose is on immobile factors such as land. Thus it would be completely inefficient to try to tax mobile factors, such as capital, like the OECD is trying to do. Also, "a country can protect itself from tax competition by taxing immobile factors" (Dwyer, 2002). Trying to impose a tax on income is the same as taxing workers, and it will bring undesirable side effects which will be only the governments' responsibility.

Also, Dwyer points out two important points in taxation that the OECD apparently is not taking into account. "(1) The optimal principle of international taxation is the residence principle, that is non-residents should not be taxed on their capital income by the source country. (2) The optimal tax rule for a country that cannot enforce taxes on foreign source capital income is to abstain entirely from taxation of domestic source capital income as well". Therefore following these principles we get to our later conclusion that the OECD should not tax income that is being held in the tax havens.

Also, we can see that for the tax havens it is not optimal to charge taxes on foreign income because this would drive out these investors to another country where they would not tax them, deterring their capital inflows by themselves.

The bottom line is that the OECD tends to forget that international commerce would not probably exist without privacy. It is one of the imperatives for transactions to be done through internet or other technological means. The truth of this situation is that actually almost all offshore centers, or tax havens, do cooperate with defeating money laundering and other financial crimes. But still they are not willing to harm their own economic infrastructure and their citizens, by imposing barriers, such as taxes, which is what the OECD is asking them to do. “Economic freedom and international tax competition are world welfare enhancing. Far from hurting the OECD, it is nudging OECD countries towards optimal tax policies which are in the best interests of their citizens” (Dwyer, 2002).

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