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The Taxing of Nations

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For the last decade, the high-tax countries of the European continent have been engaged in an aggressive and largely unknown war against low tax-rate countries around the world. This is not just a war of rhetoric, but one in which Continental governments are trying to destroy the economic livelihood and prospects of many smaller and poorer countries. The war has the goal of stemming the flow of savings and investment to low-tax entitiesfrom the high-tax countries.

These governments are using two basic strategies. The first is to try to force low-tax countries to raise their tax rates, particularly on capital--that is, taxes on individual and corporate income, including taxes on interest, dividends and capital gains. They argue that low-tax countries are economic free-riders, enjoying the protections of the welfare state paid for by higher-tax countries while avoiding taxing their own citizens at high rates. The second strategy is to make it difficult for savers and investors to move their capital freely around the world to its best use. To do so, high-tax countries are attempting to force their capital-friendly neighbors to report what funds they receive from citizens and companies of high-tax countries so they can be "properly" taxed--in their home countries.

Economists have long known that taxing capital is economically destructive. Nobel Prize-winning economist Robert Lucas, after carefully reviewing relevant economic studies, concluded in 2003 that reducing capital-income taxation from its current level to zero (using other taxes to support an unchanged rate of government spending) would result in overall welfare gains of "perhaps 2 to 4 percent of annual consumption in perpetuity." As a result of the accumulation of this and other economic evidence of the destructive effects of taxes on capital, countries around the world have been reducing their tax rates for the last couple of decades. The tax revolution started with Prime Minister Thatcher and President Reagan. Now, a quarter of a century later, some of the most aggressive tax-cutting states can be found in eastern Europe, where low-rate flat taxes have taken hold. The best economic performance the world has ever experienced has occurred during this period, in large part because of the global reduction in destructive tax rates. But France and Germany, with their high-tax, statist economic policies, have been trying to stop and reverse the tax revolution.

Europe is losing the economic race to the United States and Southeast Asia. Since 1982, the U.S. economy has been growing at a rate about 50 percent higher than Europe's. The French and Germans, having made great economic progress in the 1950s, 1960s and 1970s, are now keenly aware that they have been getting poorer in relation to Americans since the time of Ronald Reagan. Parts of Europe, most notably Ireland and to a lesser extent Britain, have pulled ahead of euro-zone countries like Germany, France and Italy.

Twenty years ago, the Irish were one of the poorest people in Europe. Now they have a per capita income that is higher than all of the major European countries. The British, as a result of Margaret Thatcher's economic reforms, have also done relatively well. In 1980 the per capita income in Britain was below that of the Germany and France. Now it is higher, making Britain (on a per capita basis) the wealthiest major European country. The Irish and the British succeeded by cutting tax rates and deregulating their economies. The supply-side revolution that changed America, Britain and Ireland for the better barely breached the shores of the Continent.

It is often said that demographics drive history and, to a considerable extent, the lower-than-replacement birth rates on the Continent are at the root of the tax-rate war. Starting in the 1960s, these countries built welfare states with generous retirement systems. Such systems are barely sustainable, even with rapidly growing populations. "Defined-benefit" systems are in essence Ponzi schemes that require the number of new workers to grow as fast, if not faster, than the retirees, because it is the taxes of the working population, not any sort of savings, that are used to finance the payments to retired workers. Europe is plagued with stagnant or falling populations, which means that the proportion of the elderly is increasing rapidly.

Many countries are moving to a "defined-contribution" system, much as Chile did a quarter of a century ago (and as President Bush is now advocating for the United States). In such a system, workers are required to invest a giv en percentage of their incomes in relatively safe investments, such as government bonds or high-grade corporate bonds and stocks. The Europeans have waited too long, however, to make the necessary changes without going through considerable pain. They cannot get out of the dilemma by raising taxes, because their current tax rates are already above the revenue maximizing point. Hence, any tax increase will further reduce economic growth. Because present growth is so low, tax increases will actually lead to less tax revenue over the long run. The European governments are then left with no alternative but to begin reducing real benefits. But the public is not yet willing to support politicians who tell them the unpleasant truth. As a result, reducing benefits is constantly postponed by the politicians.

Individually, most Europeans understand the reality they are facing. Thus, we find that Europeans save much of their income. The problem is that Europeans have few profitable domestic investment alternatives available to them--given that tax rates on capital income often approach or even exceed 100 percent when an adjustment for inflation is made. (For example, if you are a French investor who received 4 percent on a capital investment before taxes, but are subject to a 50-percent-plus tax rate on that investment, while the inflation rate is 3 percent, the actual after-tax return is negative 1 percent.)

What do rational people do when faced with confiscatory tax rates on saving? They cease saving and increase their consumption, or reduce their incomes by working less, or move their savings out of the country to places where investment income is better treated. Many Europeans (both individual citizens and businesses) have chosen the last alternative--moving much of their capital out of high-tax countries.

In the view of much of the political class in these countries, if they could somehow force productive capital to remain at home rather than flee, they would have more money for both domestic investment and funding the welfare state and pensions. Thus, politicians ignore the inconvenient fact that if individuals and businesses cannot get acceptable returns on their savings and investment, they will choose not to save and invest, and consume all of their income instead.

Following the initial successes of Reagan and Thatcher's tax reforms, the Continental governments were left in the difficult position of trying to resist tax cuts as tax-cutting fever swept the globe. Politicians in individual high-tax countries realized that they were almost powerless to stop tax competition by themselves. They needed collective action. The Paris-based Organization for Economic Cooperation and Development (OECD) seemed to be the ideal vehicle. It had originally been set up by the thirty major industrial countries to promote economic cooperation and trade and to collect statistical data. The OECD had a reputation for reliable work, and it was viewed as non-political. But the French and their allies convinced the other members of the OECD in May 1996 to utilize the Fiscal Affairs Committee to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases." In April 1998 the OECD issued a report entitled, "Harmful Tax Competition: An Emerging Global Issue." In the report, the OECD argued that it was necessary for collective action to stop "harmful tax competition." A country was considered engaged in "harmful tax competition" if it had low or zero income taxes, allowed foreigners investing in the country to do so at favorable rates, or afforded financial privacy to investors or citizens.

The OECD identified 41 countries (mostly in the developing world) as having "harmful tax regimes" and demanded that they either raise taxes and engage in routine and comprehensive disclosure of individual citizens' confidential financial information, or be blacklisted. Blacklisted countries would be punished by a variety of economic and financial measures, incl uding termination of tax treaties and corresponding banking relationships.

To reinforce the efforts of the OECD, UN Secretary General Kofi Annan appointed a panel in December 2000 to look at "Financing for Development." The panel published its report in 2001. The report called for the establishment of an International Tax Organization (ITO). This body would allow every UN member government to have unqualified access to the financial information of all citizens of UN member states. It would also, among other things, provide for the taxation of emigrants, prohibit "unfair tax competition", and tax carbon emissions. Not surprisingly, the proceeds of the various taxes would go directly to the UN, bypassing national governments.

Similar steps were taken by the European Union. From the time of the formation of the EU, a debate had been ongoing about how much information the members should share about movements of capital between the associated states. The capital-exporting countries, such as France and Germany, desired more information in order to tax their citizens on income earned on capital beyond their borders. Capital-importing countries that had a tradition of financial privacy, such as Luxembourg and Austria, resisted information-sharing. In 2000 the EU proposed the European Savings Tax Directive, which would require countries to automatically exchange information on the investment earnings of foreign investors. For the measure to have its desired effect of reducing capital outflow (particularly non-taxed capital outflow), it was obvious that not only would the EU members and their off-shore dependencies need to be included, but also at least the United States, Switzerland, Liechtenstein, Andorra, Monaco and San Marino. This was clearly not in the cards. But it was agreed that, at least temporarily, Austria, Belgium and Luxembourg could apply a withholding tax on savings held by residents of the member states, eventually rising to a 35 percent withholding rate. The European Savings Tax Directive has been in an almost constant state of revision since it was first proposed, and a greatly watered-down version is now supposed to go into effect in July. This is at least a partial victory for the high-tax countries.

Meanwhile, there were also attempts to pressure the United States to take action. In 1984, Congress enacted a portfolio interest exception, which allowed interest received by non-resident aliens to be exempt from U.S. tax withholding, with the express goal of attracting foreign tax-flight capital. This exemption applied to interest on bank deposits and bonds. The interest earnings did not need to be reported to the U.S. government because there was no tax liability due on the money. EU member states lobbied the Clinton Administration to change the regulation to require tax-information reporting to foreign governments. A few days before the Clinton Administration left office, the Treasury Department issued a proposed regulation to require U.S. institutions to report interest income paid to non-resident aliens. This proposed interest-reporting regulation has never been implemented, but the Treasury has not withdrawn it.

In 1989 the Financial Action Task Force (FATF) was created at the G-7 summit to combat money laundering and financial crime. The FATF is staffed by bureaucrats from 31 countries (many of whom appear to have little regard for the right to financial privacy or protections from self-incrimination). It has put forth forty recommendations, ostensibly to fight financial crime. But they are in effect used by high-tax countries to coerce information-sharing from low-tax countries. Under the threat of international sanctions, these countries are pressured into abdicating their sovereign responsibilities to protect their own citizens.

Low-tax countries and their allies have not given up without a fight, however. In 1998, when the OECD came out with its demands to restrict tax competition and its proposed sanctions, many smaller low-tax jurisdictions were left in a state of shock and panic. Several countries and offshore jurisdictions indicated they would comply, although mostly out of fear of what would happen if they didn't. Fortunately, the Swiss took the lead in demanding changes in the proposals. Switzerland is big enough that it could not immediately be rolled over. The Swiss challenge gave cover to smaller countries and jurisdictions, so they were able to say they would only comply if Switzerland and other countries did so.

Meanwhile, a global coalition of public policy organizations concerned with economic growth and personal liberty formed to argue for tax competition and financial privacy. These topics became the themes of dozens of high-level policy conferences, primarily in Europe and the United States. By the end of 2004, scores of different think tanks located in two dozen countries had published papers or articles challenging the anti-tax competition and anti-financial privacy proposals being put forth by the OECD and its various institutional and national allies. The arguments in favor of tax competition were picked up and echoed by a number of writers in the leading papers of the global financial press. There is also considerable evidence that the papers and studies produced by the think tanks had a positive impact on policymakers, particularly in the United States and several central and eastern European countries.

The opponents of the OECD's anti-tax-competition proposals were bolstered when the Bush Administration took office in January 2001. The president's chief economic advisors--Larry Lindsey, head of the National Economic Council, and Glenn Hubbard, chairman of the President's Council of Economic Advisors--declared that the administration was in favor of tax competition and would not support the European Savings Tax Directive. Treasury Secretary Paul O'Neill and his successor, John Snow, later echoed that commitment.

The OECD was given a scare in the last months of 2004, when it almost lost its U.S. funding. Opponents of the OECD's anti-tax-competition efforts were able to get a number of key Senators to support a defunding proposal for the 2005 budget. It was only through direct lobbying by the State Department (with the help of the French ambassador) and an intervention by other Senators that senior officials of the OECD were able to succeed in obtaining the appropriation.

The high-tax advocates certainly have not won the war, but they have not necessarily lost it either. They have at their disposal tens of millions of dollars of taxpayers' money and an army of self-serving bureaucrats in government ministries. Their opponents, on the other hand, have only a handful of brave, responsible government officials in Switzerland, Luxembourg and a number of smaller low-tax entities, as well as a few courageous business people, some fine scholars, and public policy wonks at think tanks and universities, all operating with a fraction of the financial resources of the pro-tax crowd.

Fortunately, the high-tax countries' argument against tax competition is now widely regarded as intellectually bankrupt. As a result, they are changing their rhetoric--using words like "distorting tax preferences"--to appear to have a different agenda. No doubt some politicians and members of the media will be fooled by this. But time is not on their side. They face a tax-cutting Bush Administration and a growing understanding of why lower taxes on capital are desirable across the globe. Most of the new entrants to the EU see Ireland as a better economic model than Germany or France. Hence, they are cutting their corporate tax rates and enacting low flat-rate personal income taxes, despite continued threats from Old Europe. Indeed, the effort by France and Germany is losing favor with most of the other EU members. The new president of the European Commission, Jose Manuel Barroso, attacked the French and Germans in January, saying: "Some member countries would like to use tax harmonization to raise taxes in other countries to the high-tax levels in their own countries. We will not accept that, and member states will not accept it."

One clear loser so far is the OECD. It was once a respected institution, but it has allowed itself to be captured by high-tax interests who have not only destroyed much of the OECD's credibility, but have also endangered its funding. And the UN's ITO effort is not taken seriously, except by a few utopian globalists. Furthermore, the UN's credibility has been badly damaged by the Oil for Food scandal and general mismanagement.

Unfortunately, the battle against financial information sharing has not gone as well as the battle against tax competition. On the positive side, the opposition of Switzerland, the United States and others derailed the tough early versions of the European Savings Tax Directive. The current version, slated to go into effect in mid-2005, will not have much economic impact--besides enriching the lawyers and accountants who will guide investors though the inevitable loopholes. But its very existence makes it easier to expand destructive provisions in the future.

Furthermore, the events of 9/11 have made it more difficult for the advocates of financial privacy to gain support. In the United States, the Patriot Act decreased financial privacy protections. Those within the Treasury and State Departments who had argued for the implementation of the Internal Revenue Service's interest-reporting regulation were able to use the War on Terror as an excuse for not withdrawing the proposal. Ironically, this regulation could make it more likely for sensitive personal financial information to get into the wrong hands. Given what many in the U.S. government saw as French duplicity (or even sabotage) in the run-up to the Iraq War, the Treasury Department displayed a remarkable amount faith in the French government, declaring, "we can trust the French with sensitive financial information on U.S. companies and individuals."

For years, those who were demanding more information-sharing for the wars on drugs, money laundering and tax evasion were making very slow progress, because civil libertarians around the world fought back. In the post-9/11 world, those fighting for financial privacy are often on the defensive. To be fair, some governments have made good-faith arguments for greater powers in tracing financial flows in order to fight terrorism. But terrorism has also provided the perfect opportunity to expand the scope of cross-border tax management. High-tax countries realize that if they place issues in the context of fighting terrorism, they have a winning hand. Though most Americans favor tax competition, as does the current administration and a clear majority in Congress, concerns about terrorism will swamp concerns about the erosion of financial privacy in the near term.

This raises a question: What can pro-growth economic forces do to reverse these trends? First, they must continue to be aggressive in challenging the concept of "harmful or unfair tax competition" whenever and wherever it is advocated, and clearly detail how it reduces economic growth, opportunity and job creation. Second, they need to do a better job articulating the dangers of unrestricted information-sharing and excessive financial regulation to both the pocketbooks and liberties of ordinary people. Third, efforts must be expanded to teach people why financial privacy is necessary for a civil society and, in turn, how a civil society is necessary to maintain a vibrant and growing economy. Finally, multinational institutions like the OECD that promote anti-economic growth policies should be defunded.

The little-known war for tax competition and financial privacy is likely to drag on for years. The high-tax forces have lost the intellectual battle, in that most economists view competition in a good light. Despite the loss of intellectual respectability, the high taxers keep coming up with new proposals. French President Jacques Chirac, in an address to the World Economic Forum in January, called for an "experimental" international tax to help fund the war against aids. He suggested taxing international financial transactions, and a tax on aviation and maritime fuel. Such proposals will face fierce opposition in the United States and elsewhere, but the high taxers do not appear anywhere near ready to give up.

The reality is that tax competition is continuing, despite the angst of the French and the Germans. Tax rates around the globe are likely to continue to fall. But the battle is slowly being lost as the opponents of financial privacy have been able to use the terrorism issue to further erode privacy protections. It is not yet clear if the privacy advocates will be able to acquire the necessary resources to stop this trend, let alone achieve a reversal. At the moment it looks like we are heading for a world of lower tax rates, but with less financial privacy.