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In Defense of Tax Havens

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If the government suddenly said you would incur more onerous and expensive tax regulations and reporting requirements if you moved your business to a low-tax state such as Texas or Florida from a high-tax state such as New York or California, you would be justifiably outraged. Now substitute Switzerland and Bermuda for Texas and Florida, and France and Germany for New York and California, and you'll understand a new form of "tax protectionism" that is infecting Washington.

Several serious proposals are being floated in the nation's capital that would penalize Americans for investing in low-tax rather than high-tax jurisdictions. Proponents say the measures are needed to catch tax cheats -- but ignore the fact that most of the low-tax jurisdictions such as the Cayman Islands, Switzerland, etc., already have tax information exchange (for cases of probable cause), or tax withholding, agreements with the U.S. and other countries such as the U.K. and France.

Nevertheless, Sens. Carl Levin (D., Mich.), Bryon Dorgan (D., N.D.), and Max Baucus (D., Mont.), as well as officials of the Obama Treasury, want to make it more onerous and costly for American companies to do business around the world and for Americans to invest elsewhere. They would even make it more difficult for non-Americans to invest in the U.S.

Mr. Levin's bill is a hodgepodge of tax increases, more regulations and penalties on American taxpayers doing business in targeted low-tax jurisdictions. Mr. Dorgan's bill would prevent certain American companies that operate and are incorporated outside the U.S. from being treated as nondomestic corporations, thus denying them the right of tax deferral until their income is brought back to the U.S. Mr. Baucus, chairman of the Senate Finance Committee, is circulating a draft bill that, among other things, would extend the statute of limitations from three to six years for tax returns reporting international transactions. The Treasury Department is proposing expanded regulations on foreign financial institutions that bring needed investment funds into the U.S.

In addition to charges of tax evasion, some members of Congress -- echoing European politicians including France's President Nicolas Sarkozy and British Prime Minister Gordon Brown -- have even tried to scapegoat the low-tax jurisdictions as somehow being responsible for the global recession. They are demanding that the G-20 countries come up with action proposals against them at their meeting next month.

This is nonsense. The so-called tax havens are for the most part no more than way-stations to temporarily collect savings from around the world until they are invested in productive projects, such as building a new shopping center or semi-conductor plant in the U.S. This enables a better allocation of world capital, leading to higher, not lower, global growth rates.

Indeed, to the extent tax competition between jurisdictions holds down the increase in the growth of governments, citizens of all countries experience more job opportunities and higher standards of living. And to the extent that businesses and individuals are discouraged by taxes or regulations from investing outside their own jurisdictions, they may simply choose to work and save less, period.

Those who demand increased taxes on global capital often rail against financial privacy and bank secrecy -- forgetting they are necessary for civil society. It is true that not all people are saintly. But it is also true that not all governments are free from tyranny and corruption, and not all people are fully protected against criminal elements, even within their own governments. Without some jurisdictions in the world enforcing reasonable rights of financial privacy, those living in un-free and corrupt jurisdictions would have no place to protect their financial assets from kidnappers, extortionists, blackmailers and assorted government and nongovernment thugs.

It is a fool's errand to pass ever more laws against things that are already illegal, or to pass laws against people trying to protect themselves from rapacious and corrupt governments. Despite the hundreds of local, state and federal laws against financial fraud, and financial regulatory authorities like the SEC, Bernie Madoff was able to conduct the biggest ever Ponzi scheme for decades.

The chief tax writer in Congress, House Ways and Means Committee Chairman Charles Rangel, Treasury Secretary Timothy Geithner, and former Senate Majority Leader Tom Daschle apparently did not report all of their foreign-source income. Their actions tell us that either the tax law is too complex, or they thought the tax burden was excessive. Would their behavior and that of millions of others improve by making the tax law more complex and punitive?

U.S. companies are being forced to move elsewhere to remain internationally competitive because we have one of the world's highest corporate tax rates. And many economists, including Nobel Laureate Robert Lucas, have argued that the single best thing we can do to improve economic performance and job creation is to eliminate multiple taxes on capital gains, interest and dividends. Income is already taxed once, before it is invested, whether here or abroad; taxing it a second time as a capital gain only discourages investment and growth.

In fact, the U.S. does not tax most of the dividend, interest and capital gains' earnings of foreign investors in the U.S. -- which means, ironically, that the U.S. is the world's largest "tax haven" for non-U.S. citizens, and that we benefit from hundreds of billions of dollars of needed capital invested here. If the U.S. did not treat foreign investors better than its own citizens (who are double-taxed on most capital income), most of the "tax avoidance" problems critics complain about would disappear.

The proposals by Messrs. Dorgan, Levin, Baucus and the Treasury will almost certainly have the unintended consequences of driving more U.S. businesses elsewhere, discouraging foreign investment in the U.S., and actually encouraging more U.S. investors to move their funds (either legally or illegally) not only out of the country, but to places in Asia or the Mideast that tend to be less cooperative with U.S. tax authorities than are the European and British low-tax jurisdictions.

The correct policy for the United States to follow is to reduce its corporate tax rate to make it internationally competitive, and to move toward a tax system that does not punish savings and productive investment so severely. We know from the experiences of many countries that reducing tax rates and simplifying the tax code improve both tax compliance and economic growth. Tax protectionism should be rejected because it is at least as destructive to economic growth and job creation as are tariffs on goods and services.

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