GLOBAL TAX REVOLUTION

The Rise of Tax Competition and the Battle to Defend It

CHRIS EDWARDS
DANIEL J. MITCHELL

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CATO INSTITUTE
WASHINGTON, D.C.

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Library of Congress Cataloging-in-Publication Data

Edwards, Chris (Chris R.)
Global tax revolution : the rise of tax competition and the battle to defend it / Chris Edwards, Daniel J. Mitchell.
p. cm.
Includes bibliographical references and index.
ISBN 978-1-933995-18-2 (hbk. : alk. paper)
1. Taxation. 2. Fiscal policy. I. Mitchell, Daniel, 1958– II. Title.

HJ2305.E28 2008
336.2--dc22 2008029685

Cover design by Jon Meyers.

Printed in the United States of America.

Cato Institute
1000 Massachusetts Ave., N.W.
Washington, D.C. 20001
www.cato.org

To our children—Anna and Sophia Edwards, and John, Kelsey, and Adam Mitchell—whose generation will face a mighty struggle taming the federal tax burden.

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Acknowledgments

The authors would like to acknowledge the support of the Vernon K. Krieble Foundation and the Charles E. Holman Foundation.

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1. Introduction

A fear is haunting big governments around the world—the fear of rising tax competition. As globalization advances, individuals and businesses are gaining greater freedom to work and invest in countries with lower taxes. That freedom is eroding the monopoly power of governments and forcing them to reform their tax systems and restrain their fiscal appetites.

Many governments have responded to globalization with tax cuts designed to improve competitiveness and spur growth. Individual income tax rates have plunged in recent decades, and more than two dozen nations have replaced their complex income taxes with simple flat taxes. At the same time, nearly every country has slashed its corporate tax rate, recognizing that business investment and profits have become highly mobile in today's economy.

That is the good news. The bad news is that some governments and international organizations are trying to restrict tax competition. A battle is unfolding between those policymakers wanting to maximize taxation and those understanding that competition is leading to beneficial tax reforms. If plans to stifle tax competition gain ground, growth will be undermined, governments will grow larger, and economic freedom will be curtailed.

In this book, we chronicle the rise in tax competition, which was spurred by the unleashing of international capital flows beginning in the 1970s. We survey the exciting tax reforms that are taking place around the world and explain how these reforms benefit average workers and families. We also examine the backlash against tax competition and describe why the arguments of the critics are mistaken.

The concluding chapter discusses reform options for the United States. In many ways, America has fallen behind on tax reform and now its climate for investment is inferior to that of other major countries. As tax competition intensifies, it is crucial to overhaul the federal tax code to ensure America's continued prosperity and leadership in the world economy.

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Globalization Advances and Tax Rates Retreat

Globalization is transforming separate national economies into a single world economy. That process is occurring through rising trade and investment, migration of workers, and transfers of technology. International investment flows have increased roughly tenfold since 1990 as corporations and investors have sought new opportunities in foreign markets.[1]

The world economy is becoming "flat," as *New York Times* columnist Thomas Friedman discussed in a bestselling book of 2005.[2] That means that businesses can locate just about anywhere and ship products to their customers around the globe. Investors can search for opportunities abroad from their desktop computers. And entrepreneurs can raise capital, hire workers, and build factories in any of hundreds of hospitable investment locations.

Friedman skillfully analyzed these trends focusing on technology, skilled workers, and education. But Friedman's book largely ignored the globalization of capital and the importance of America creating a receptive climate for investment. Friedman focused on labor, but mainly overlooked capital.

Friedman also missed the growing importance of tax competition. Yet rising tax competition is a direct result of the flat world economy. As individuals and businesses have gained freedom to take advantage of foreign opportunities, the sensitivity of economic decisions to taxation has increased. Chapter 2 explores how labor, capital, and profits are much more mobile today than just a few decades ago. This mobility is creating increased pressure on countries to reduce tax rates.

As economic mobility has increased, tax rates have tumbled, as we discuss in Chapter 3. Following Britain's lead in the mid-1980s, all major economies have cut their corporate tax rates. Just since the mid-1990s, the average corporate tax rate in the 30-nation Organization for Economic Cooperation and Development has fallen from 38 percent to 27 percent.[3] During the same period, the average rate in the European Union plunged from 38 percent to 24 percent.

Since 2000, corporate tax cuts have included Austria (34 to 25 percent), Canada (45 to 34 percent), Germany (52 to 30 percent), Greece (40 to 25 percent), Iceland (30 to 18 percent), Italy (41 to 31 percent), the Netherlands (35 to 26 percent), and Portugal (35 to 25 percent).[4] But corporate tax cuts have spread beyond the OECD

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countries. This decade, there have been cuts in far-flung places such as Albania (20 to 10 percent), Egypt (40 to 20 percent), Mauritius (25 to 15 percent), Romania (25 to 16 percent), and Russia (35 to 24 percent).

Individual income tax rates have also been cut sharply. The average top rate in the OECD has plummeted 26 percentage points since 1980.[5] Again the trend is global, with the average top rate falling by a similarly large amount in Africa, Asia, Europe, Latin America, and North America. In addition, 25 nations have scrapped their multirate income taxes and installed flat taxes. The average individual tax rate in this "flat tax club" is just 17 percent.

Most countries have also cut tax rates on dividends and capital gains. Many countries have cut or eliminated taxes on estates and inheritances, and many have abolished annual taxes on wealth, which used to be popular in Europe. Further, withholding taxes on cross-border investments have been cut sharply around the world. All these types of taxes have mobile tax bases, and policymakers figured out that imposing high rates would cause domestic investment to decline and tax bases to shrink dramatically.

The international tax landscape has become remarkably dynamic. After reforms in 1986, the United States had one of the lowest corporate tax rates. But since then, U.S. policymakers have fallen asleep at the switch as other countries have continued to cut. The United States now has the second-highest corporate tax rate in the world. In today's global economy, if a country stands still, it falls behind.

Consider tax rates on dividends. The average tax rate in the OECD—including the burden at both the individual and corporate levels—fell from 50 percent in 2000 to 43 percent in 2007.[6] That means that the U.S. rate of 49 percent is now substantially higher than the average as a result of recent tax cuts abroad. Even worse, the U.S. tax rate on dividends is scheduled to rise to a stunning 64 percent in 2011, which would be easily the highest rate in the world.

Tax Competition in Action

Tax competition is broadly defined as the tax-cutting influence that countries exert on one another. That influence operates through many channels. Policymakers worry that the tax base will shrink if they do not respond to foreign tax reforms, and businesses lobby governments for tax cuts to remain competitive. Scholars examine

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foreign tax reforms for good ideas, and citizens hear about foreign tax cuts and demand the same at home.

Tax competition has been driven by a handful of leading countries, which have inspired others to pursue similar reforms. In the 1980s, Britain and the United States led the way with large cuts to individual and corporate tax rates. In the 1990s, Ireland's rock-bottom business taxes created an investment boom that has been hugely influential in Europe. More recently, it has been flat tax nations such as Estonia and Slovakia that have inspired other countries to pursue reforms.

Let us take a quick tour of tax competition in action around the globe. We can begin with the rivalry between Singapore and Hong Kong. In 2007, Singapore cut its corporate tax rate to 18 percent, which matched Hong Kong's low corporate rate. But Hong Kong responded and quickly cut its rate to 16.5 percent. *Tax Notes International* reported that the tax cut is "widely seen as a move to preserve Hong Kong's status as Asia's top financial center and to fend off competition from Singapore and Shanghai."[7]

Hong Kong abolished its estate tax in 2005 to ensure its top position as a haven for entrepreneurs and investment. The Hong Kong government explained: "A number of countries in the region, including India, Malaysia, New Zealand, and Australia have abolished estate duty over the past 20 years. Hong Kong must not lose out in this race."[8] Hong Kong's action helped prompt Singapore to abolish its own estate tax in 2008 to create "a more attractive place for Singaporeans and foreigners to invest and build up wealth."[9]

Shifting to Europe, Britain had been a tax reform leader, but countries such as Ireland are now surpassing it. The opposition Conservative Party has pushed for corporate tax cuts with party spokesman John Redwood arguing, "Ireland shows that if you cut capital taxes and business taxes, you create more jobs and generate more revenue."[10] The governing Labour Party enacted corporate tax rate cuts in the late-1990s and added a further cut to 28 percent this year. But in a new report, Britain's largest business organization argues that the corporate rate needs to be cut further to 18 percent for Britain to remain competitive.[11]

In the financial services industry, Britain is feeling tax competition pressure from countries such as Ireland, the Netherlands, and Switzerland. In 2007, the British government proposed to increase taxes on private equity firms, but that resulted in Switzerland's "stepping

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up an aggressive campaign to attract London-based financial services firms."[12] This year, the government increased taxes on wealthy residents who are foreign citizens, but that is creating a huge problem for the financial industry, which employs large numbers of foreign professionals.[13] Hedge fund managers and other financial leaders are starting to pack their bags and move to Switzerland.[14]

For Germany, it is the lower-tax nations of Central and Eastern Europe that are posing a major competitive challenge. The Czech Republic, Hungary, Poland, Slovakia, and other nearby countries have much lower corporate tax rates. Germany responded this year by cutting its corporate rate from 38 percent to 30 percent. The *Wall Street Journal* reported that the cut "was triggered by the [European Union's] addition two years ago of eight Eastern European countries with corporate tax rates as low as zero."[15] Germany's finance minister said the tax cuts would ensure that the country is "internationally competitive."[16]

Ironically, before the recent tax cuts, the same German finance minister was complaining that a corporate rate cut in Austria to 25 percent amounted to "fiscal dumping" and an "ambitious and aggressive attempt to get companies to come to Austria."[17] But that is how tax competition works in Europe: countries gripe about unfair tax cuts in other nations, and then they turn around and enact tax cuts at home.

Lower tax rates in Austria and Ireland were on the minds of Dutch policymakers when they reduced their corporate tax rate from 35 percent to 26 percent.[18] The Dutch Finance Ministry described the reason for the tax cut:

> The tax cuts for business are essential to improve the attractiveness of the Netherlands as a business location. A reduction in corporate tax is required in the near future to attract foreign investment. Domestic companies also need a reduction in corporation tax to make them more competitive compared with competitors from countries with lower taxes. . . . Reducing corporate tax . . . will create jobs. According to the Netherlands Bureau for Economic Policy Analysis, cuts in tax on profits result in more growth in the long term than cuts in any other taxes.[19]

Western European countries are being nudged into tax reforms by the former communist countries of Central and Eastern Europe,

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which seem determined to outcompete them. This region is the epicenter of the flat tax revolution, which we discuss in Chapter 4. The revolution was put into motion by Estonia, which installed a flat tax in 1994 and saw its economy transformed from a basket case to a booming Baltic Tiger. Today, there are 25 jurisdictions in the "flat tax club," and they are virtually all enjoying economic booms.[20]

Slovakia enacted a 19 percent flat tax on individuals and businesses in 2004. The country's finance minister argued that the flat tax "does not encumber production too much and thus it is an important [stimulus] for investment and the creation of new jobs. It is definitely the best way to catch up to the living standards of the most developed countries."[21] Slovakia's economy has grown at more than 7 percent annually since the flat tax was enacted.[22]

The flat tax nations are the most ambitious tax reformers anywhere. In Macedonia, the finance minister recently boasted, "For over a year now we have put all our efforts into improving the country's business climate . . . [and we have] the most attractive tax package in Europe, with a flat tax rate of 10 percent on corporate and personal income and a zero-percent tax rate on reinvested profit."[23] In Bulgaria, the economics minister noted that the country's new 10 percent flat tax "will undoubtedly encourage foreign capital and bring to our country more jobs and higher incomes."[24]

Elsewhere in the world, another reformer is South Korea's new president, Lee Myung-bak. He is pro-market in his policies and this year cut the federal corporate tax rate from 25 percent to 22 percent, with more cuts planned. Lee declared, "It is time to overhaul our tax system in order to save our economy."[25] While some critics in Korea worry about a loss in government revenue from the tax cut, Lee's government contends that "as time goes on, investments will soar and tax revenues will increase."[26]

In some countries, parties on both the political left and right support tax rate reductions. In Canada, the prior left-of-center government cut the corporate tax rate, arguing: "Canada needs a business tax system that is internationally competitive. This is important because business tax rates have a significant impact on the level of business investment, employment, productivity, wages and incomes."[27] The current Conservative government followed up this year with further cuts to the corporate tax rate.

Even socialist Sweden is responding to global tax competition. In 2007, the nation abolished its wealth tax, which had long driven

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millionaires and their assets out of the country. "The big winners," said the Swedish finance minister, "are all Swedes, because we need to have the conditions for jobs and companies necessary to match global competition."[28]

Tax competition is even influencing policy in Africa. In 2005, Egypt slashed its top individual and corporate tax rates from 40 percent to 20 percent to reduce tax evasion and increase foreign investment.[29] In 2007, Mauritius enacted a 15 percent flat tax on individuals and corporations. And in Namibia, a recent speech by the central bank governor called for tax rate cuts: "High taxes can impact negatively on investments and therefore contribute to low growth. . . . It will be necessary to gradually bring our tax regime in line with the region in order to be competitive in terms of attracting foreign investment."[30]

Labor and Capital

Much of this book focuses on mobile corporate investment, which is a key driver of tax competition. But skilled workers, wealthy individuals, and private savings are also part of the tax competition story. In Chapter 5, we discuss how the migration of brains and wealth is partly driven by taxes. The emigration of engineers, scientists, and other highly skilled workers is often called "brain drain." We discuss how countries are retooling their immigration and tax policies to attract skilled workers, and we argue that the United States lags in both these areas of reform.

The wealthy also have more flexibility about where to reside and where to invest their capital. We discuss some of the famous entertainers and athletes who have discovered the benefits of lower-tax jurisdictions. English music stars, German racecar drivers, Italian tenors, and many others are taking advantage of globalization to escape punitive tax burdens.

More importantly, entrepreneurs are increasingly footloose and are decamping from countries such as France and Sweden that have high tax burdens. The Swede Ingvar Kamprad, founder of IKEA, is the world's seventh-wealthiest person and he lives in Lausanne, Switzerland.[31] Like many wealthy entrepreneurs, Kamprad is frugal and he likes to save money on his taxes. What is important for policymakers to consider is that today's wealthy are typically self-made and entrepreneurial—they are not simply passive inheritors

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of wealth.[32] That means that the wealthy are an important dynamo for growth, and it makes sense to put out a low-tax welcome mat for them.

In Chapter 6, we move from the topic of mobile labor to mobile capital, focusing on U.S. multinational corporations. This chapter is a challenging read, but because large corporations are central to economic growth it is important to understand the complex tax rules that they face. U.S. multinational corporations account for most U.S. merchandise exports and for the bulk of private research and development in the United States.

The issue of corporate taxation is not just about profits and shareholders, it is about the living standards of average Americans. In a globalized economy, the burden of the corporate income tax falls mainly on workers in the form of lower wages. If corporations are not building factories and investing in the United States due to high taxes, labor productivity will fall, and that will drag down American wages. As such, corporate taxation should be front and center in debates about workers, jobs, and economic growth.

Backlash against Tax Competition

The global tax revolution has been a supply-side revolution. Supply-side tax cuts are those that reduce the costs of productive activities, such as working, investing, and starting businesses. If the costs of production are reduced, output will increase and incomes will rise. Tax competition does not result in cuts to every type of tax, but instead creates pressure to cut precisely those taxes that are the most damaging to the economy. More tax competition means more productive economies and higher living standards.

Alas, many politicians and pundits do not see it that way. We examined the various objections to tax competition and boiled them down to two main claims. The first claim is that tax competition causes distortions in the private sector. The idea is that if investment flows are driven in any way by taxation, it is "inefficient" for the world economy. Ireland is receiving "too much" investment because of its low business taxes, for example.

The second claim is that tax competition creates distortions in the public sector. Any reduction in government revenue that results from capital and labor's emigrating to lower-tax nations is supposed to be an inefficient "fiscal externality." Government revenues will

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fall below the supposed optimal amount as a "race to the bottom" in tax levels ensues.

In Chapter 7, we discuss the theoretical flaws in these arguments. For one thing, they are premised on the "public interest theory of government," the idea that government officials always act for the general welfare of citizens. We argue that it is naive to assume that if policymakers had monopoly fiscal power without tax competition, they would set tax rates at the optimal level for the good of the people.

At a practical level, there has not been a race to the bottom in tax revenues around the world, as the critics fear. We wish that there had been, but tax competition has not yet "starved the beast" of bloated government. However, in most advanced economies, tax revenues as a share of gross domestic product have leveled out in recent years, and even declined in some places. We also think that governments would have grown larger without the rise in tax competition.

Looking ahead, tax competition will impose a valuable barrier against government growth. In coming decades, the rising costs of retirement and health programs for the elderly in the United States and elsewhere will generate huge pressures to increase taxes. It would be nice if policymakers proactively pursued reforms to cut bloated entitlement programs. But if they do not, vigorous tax competition will be a crucial defense against rising government spending and a tool to preserve limited government in the 21st century.

Supporters of big government know that expansive welfare states are in jeopardy from tax competition in coming decades, and that is why they are trying to limit it any way they can. As we discuss in Chapter 8, their strategy is to forge international agreements to equalize tax rates, to harmonize tax bases, and to share information about each other's taxpayers. In effect, tax competition opponents want to create an international tax cartel, akin to the infamous oil cartel, the Organization of Petroleum Exporting Countries. Just as OPEC works to keep the price of oil high, limits to tax competition would keep the price of government—in the form of taxes—high.

Efforts are under way through the European Commission, the United Nations, and the Organization for Economic Cooperation and Development to control tax competition and eliminate downward pressures on tax rates. There are also proposals to create a permanent

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world tax organization, which would help enforce limits to competition. Some experts have even proposed the creation of global taxes, which would force taxpayers from every nation into a one-size-fits-all straightjacket.

Ironically, the efforts to squelch tax competition are in sharp contrast to the stated aims of governments with respect to trade. With trade, governments sign agreements to reduce tariffs and other trade barriers in order to promote globalization for the benefit of individuals. Indeed, that is the primary mission of the World Trade Organization. But trade barriers are similar to taxes, and thus efforts to promote trade liberalization are similar to efforts at cutting taxes.

Yet organizations such as the OECD try to impede globalization by blocking tax competition and taking actions against low-tax jurisdictions. Rather than focus on the benefits of tax competition to individuals, tax competition opponents focus on the supposed losses to governments. We think that tax competition deserves the same respect as trade liberalization. After all, the goals are the same: greater economic freedom, reduction in government burdens, and higher standards of living for average citizens.

A key mistake of tax competition opponents is to think of tax competition as a zero-sum game. As with trade liberalization, it is not. Tax competition drives down tax rates on the most inefficient types of taxes and thus helps expand the global economic pie. All nations that enact supply-side tax reforms can reap greater economic growth. Countries are not competing to divide a fixed pie, but to create the least burdensome government and the most prosperity for citizens.

In Chapter 9, we discuss how the efforts to restrict tax competition also raise privacy and human rights concerns. A key goal of tax competition opponents is the adoption of extensive sharing of personal financial information between countries. Such “information-exchange” policies are troublesome for those who believe in defending privacy in the digital age. Governments have a very poor record on keeping personal data private, as a recent British scandal drove home. A low-level tax official lost two computer disks containing the detailed tax, financial, and banking records of 25 million Britons.[33] The disk was sent by courier and then disappeared, and has not been found.

When less savory governments are involved, the issues can be even more serious. Overseas Chinese in places like Indonesia use tax

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havens to protect themselves from ethnic persecution. Businessmen from Latin America put their money in tax havens to protect their families from kidnapping and extortion. Many people will be at risk if governments create a global network of tax police to collect and swap personal financial information.

Unfortunately, jurisdictions that have low taxes and strong privacy laws are being pressured by groups such as the OECD to make sweeping policy changes. We argue that those demands run roughshod over the freedom of countries to set their own economic course, and for the misguided end of helping high-tax countries enforce their inefficient tax systems.

America's Challenge

The United States used to dominate the world economy. America is still the largest economy, but it is not the wealthiest on a per-capita basis and it is far from the fastest growing. The number of U.S. industrial corporations in the world's top 100 fell from 64 in 1970 to 38 today.[34] The U.S. share of the world's high-technology exports has fallen from 30 percent in 1980 to 16 percent today.[35]

In his book, Thomas Friedman argues, ''The assumption that because America's economy has dominated the world for more than a century, it will and must always be that way is a dangerous illusion.''[36] He is even more pointed in saying, "So many American politicians don't seem to have a clue about the flat world."[37] This book is our contribution to fix that knowledge gap, at least in tax policy.

America's relatively diminished position not only reflects the rapid growth in other economies, but also the dearth of domestic reforms in recent years. U.S. economic policy has fossilized, while many other countries are advancing. In taxation, the last major federal reform was in 1986, which is prehistoric given the fast pace of the modern economy. Also, recent tax cuts enacted in 2001 and 2003 are scheduled to expire at the end of 2010. The United States still has important tax advantages, but it also has a growing number of disadvantages. On the plus side, America has:

- A lower burden of taxes as a share of the economy than many countries. Federal, state, and local taxes consume 27 percent of GDP in the United States, which compares with an average 36 percent in all 30 OECD nations.[38]

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- A top individual income tax rate that is about average in the OECD, but which kicks in at a higher income level than in most countries, and thus penalizes fewer people.
- No value-added tax. In every other major country, VATs impose a substantial tax burden in addition to income and payroll taxes.

On the minus side, America has:

- The second-highest corporate tax rate in the world at 40 percent, which includes the 35 percent federal rate plus the average state rate. By contrast, the average corporate rate in Asia is 29 percent, in Latin America 27 percent, and in Europe 24 percent.
- Complex and uncompetitive business taxation. The World Bank ranks the United States 76th on having a low burden of business taxes and tax compliance costs.[39]
- The eighth-highest dividend tax rate in the OECD.
- The third-highest estate or inheritance tax rate in the OECD.
- One of the highest tax rates in the world on corporate capital gains.
- Tax rates on individual income, capital gains, dividends, and estates that are scheduled to rise in 2011 when current tax cuts expire.
- State-level corporate tax rates that have not been cut in decades.

In sum, the overall tax burden in the United States is lower than in many other nations. However, other countries rely more heavily on consumption taxes, which generally cause less economic damage than income taxes. Consumption taxes represent 17 percent of tax revenues in the United States and 32 percent in Europe.[40] The United States imposes more punishing taxes on savings and investment than many advanced economies.

These problems are well known to economists, but business leaders are also speaking out about the uncompetitiveness of America's tax policies. The chairman of Intel Corporation, Craig Barrett, testified before Congress:

> Many countries compete intensely to attract Intel's facilities. . . . More nations very intent on attracting high-tech state-of-the-art factories, such as Intel's, now also have the requisite infrastructure and well-trained workforce they lacked in years past. Many countries offer very significant incentive packages and have highly favorable tax systems.[41]

Intel argues that tax costs are higher in the United States than in other countries, which influences where it locates new semiconductor facilities.[42] The company recently announced that it would build a $2.5 billion chip plant in China, and company leaders pointed to both the business advantages of China and its tax advantages over the United States.[43] In 2006, Intel announced that it would build a $1 billion semiconductor plant in Vietnam. On this investment, Intel will pay no corporate taxes for the first four years and will enjoy a 50 percent tax break the following nine years.[44]

The *Wall Street Journal* reported recently that "manufacturing conglomerate 3M Co. plans to move more of its operations to low-tax locations overseas in coming years as it attempts to reduce its overall tax rate."[45] The company's effective tax rate of 33 percent is higher than its competitors. By moving some operations abroad, it can save hundreds of millions of dollars in taxes.

International investment decisions, such as those by Intel and 3M, are driven by many factors in addition to taxes. Unfortunately, America falls short in other policy areas as well, which compounds the competitiveness problem. A study by KPMG, for example, looked at 27 business costs in nine different countries. The United States had the third-highest overall costs of the countries examined.[46]

One problem area is the efficiency of America's international trade. The World Bank ranked the United States just 14th on the efficiency of trade logistics, behind countries such Canada, Germany, and Japan.[47] And America's seaports are not as efficient as many ports in Europe and Asia. A government report noted that "American ports lag well behind other international transportation gateways such as Singapore and Rotterdam in terms of productivity."[48] Why locate a factory in the United States if it would face these problems on its trading, as well as being burdened by high corporate taxes?

The competitiveness of America's financial markets has also been a concern. Employment in New York's financial industry has stagnated in recent years, whereas employment in London's industry has grown.[49] In 2007, the value of initial public offerings on the London Stock Exchange was double the combined value on the New York Stock Exchange and NASDAQ.[50]

A study by McKinsey & Company in 2007 found that New York financial markets excelled in some areas, but performed poorly with respect to the regulatory regime, legal environment, and corporate

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taxation.[51] A survey of executives by the City of London in 2008 looked at the tax competitiveness of major financial centers. New York City scored poorly: "New York was seen to be an uncompetitive centre with high taxes, a particularly aggressive tax authority, and a fragmented, difficult regulatory structure."[52]

The head of the London Stock Exchange gave some advice to American policymakers: "Rather than navel-gazing based on the dubious premise that the U.S. is 'the home of capitalism,' they might be better served by accepting that the flow of capital is global and will seek out the most efficient and effective marketplaces."[53] She is right—rather than complain about the global economy, Americans need to enact reforms to take advantage of it.

America is no longer a unique free-market island in a sea of socialism. The latest *Economic Freedom of the World* report ranks the United States the fifth-freest economy in the world, tied with Canada and the United Kingdom, but behind Hong Kong, Singapore, New Zealand, and Switzerland.[54] According to the study, America's economic freedom has remained fairly steady in recent years, but other countries have had large improvements, thus reducing America's advantage.

We think that the United States should be number one in economic freedom, number one in tax competitiveness, and number one in prosperity. To that end, we propose major federal tax reforms in Chapter 10. Individual income tax rates should be cut to 15 and 25 percent and narrow tax breaks abolished. The corporate tax rate should be cut from 35 percent to 15 percent. Those reforms would be big steps toward the goal of a simple flat-tax system that would treat taxpayers equally and maximize investment and growth.

For citizens worried about America's economic future, this book describes the role that tax policy plays in competitiveness and living standards. For policymakers, this book provides advice on how America can catch up to exciting tax reforms being enacted abroad. For all readers, we hope the book spurs interest in a powerful aspect of globalization that is growing in importance every year.

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2. Capital Explosion

Globalization is bringing revolutionary changes to the economy. The Internet is connecting people in distant countries. Businesses are operating global supply chains. Consumers are enjoying a wider range of products at lower prices. And living standards continue to rise as resources are used more productively.

Another happy consequence of globalization is increased tax competition. As the world economy becomes more integrated, it is easier for workers and investment capital to move across national borders. That is pressuring governments to restrain tax levels and adopt pro-growth tax reforms. For citizens, tax competition holds the promise of disciplining fiscal policy and reducing the burden of government.

To understand the rise in tax competition, we need to look at the changes in the world economy that made it happen. Most people are aware of globalization because of rising international trade. Everyone consumes imports, and many people work for companies that export. Imports grew from 5 percent of the U.S. economy in 1970 to 17 percent by 2006, while exports grew from 6 percent to 11 percent.[1]

However, the growth in trade has been dwarfed by the growth in international investment. Whereas the value of global trade has tripled since 1990, the value of global investment flows has increased tenfold.[2] It is this explosion in investment that has been the main spur to tax competition.

Governments inadvertently started the ball rolling for tax competition when they began to remove controls on capital movements in the 1970s. The deregulation of capital gave investors more freedom to diversify their portfolios and they ultimately purchased trillions of dollars of foreign securities. Meanwhile, corporations expanded their networks of affiliates worldwide. The result is that investors and corporations now look globally to maximize their returns and minimize their taxes, and governments have been forced to respond.

As global economic integration continues to increase, tax competition is likely to intensify further. That will encourage countries to

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pursue additional tax reforms, and it will spawn continued expansion in the world economy. In later chapters, we temper our optimism when we discuss some political initiatives aimed at stifling tax competition. But here we discuss the good news, the rise of capital mobility, and its far-reaching effects.

Unleashing Capital

Global capital flows have grown at an annual average rate of 15 percent since 1990, three times the nominal growth rate of the world economy of about 5 percent.[3] The explosion was set off by the removal of capital controls by major countries beginning in the 1970s. Capital controls are taxes and regulations that suppress foreign currency trading and cross-border investments. Most nations had tight controls on capital in the decades following World War II. Such controls made it very difficult, for example, for a British investor to purchase shares on the New York Stock Exchange.

During the Bretton Woods era of fixed currency exchange rates (1945–1972), governments needed capital controls to prevent private markets from putting upward or downward pressure on currencies.[4] Those controls aimed at allowing governments to run independent monetary policies while still enjoying the stability of fixed currency exchange rates.

Capital controls also made it easier for governments to maintain high tax rates on investment income, which was a popular policy in the mid-20th century. With capital controls, governments essentially built fences around the income and wealth of their citizens, and locked people into national economic prisons.

The Bretton Woods system worked to the benefit of governments, but it eventually became unstable. After the system broke down in the 1970s, many countries allowed their currencies to float, and that removed the need to restrict private capital movements. As countries adopted floating exchange rates, they could open their borders and allow free flows of investment capital. In this open system, inflows and outflows of capital are balanced by exchange rate movements, without the need for government intervention.

Some advanced nations, such as Britain, Germany, and Japan, removed capital controls during the 1970s. Others, such as Australia, France, and New Zealand, did so in the 1980s. Many developing nations followed suit in the 1990s, with Asian countries generally

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leading those in Latin America. In many countries, this was a gradual process with numerous fits and starts. But today, most nations allow residents to purchase foreign currencies and foreign securities. Most nations also allow foreign investors to acquire domestic securities and domestic businesses.

Governments unleashed capital, and then many factors helped propel capital flows ever higher. One factor is that most governments have run large budget deficits, and that has created large pools of debt securities for international investors to purchase. Indeed, one can view the liberalization of capital flows as a self-interested move by governments—it allowed them to spend with little constraint because they could run large deficits financed by borrowing abroad.

Another factor that has propelled capital flows is the deregulation of stock markets and financial industries around the world. That has made domestic securities more available to foreign investors. Investment opportunities have been expanded by the privatization of thousands of state-owned companies in Europe and Latin America since the 1980s. Today, privatization continues to draw investment into places such as Eastern Europe. *The Economist* reported recently that "foreign direct investment into eastern Europe hit a record $112 billion in 2006, putting the region ahead of Latin America and second only to Asia among emerging markets. Privatization was again a prominent driver."[5]

Political attitudes toward foreign investment have also changed dramatically. In past decades, many governments shunned investment inflows for nationalist reasons, and they passed laws blocking foreign takeovers of domestic companies. By contrast, most governments today encourage inward investment because they recognize that it creates jobs and growth. Canada, for example, used to have a government agency that blocked inward foreign investment, but today it has an agency that tries to attract it.[6]

A United Nations report noted that "as competition for foreign direct investment increases, countries worldwide are becoming more proactive in their investment promotion efforts."[7] Indeed, Britain has an "Invest in the United Kingdom" agency, Sweden has an "Invest in Sweden" agency, and Germany has an "Invest in Germany" agency.[8] These agencies might not have a large effect on investment, but they do illustrate the change in government attitudes toward globalization.

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Another spur to investment has been deregulation through bilateral treaties. A study by the United Nations found that more than 70 bilateral investment treaties (BITs) and double-taxation treaties (DTTs) have been signed every year in recent years.[9] These treaties generally reduce taxes and regulations on capital flows between pairs of countries. By 2006, there were 2,573 BITs and 2,651 DTTs in existence. While a few governments have taken steps to increase regulations on investment, the UN found that 90 percent of law changes for foreign investment since 2000 have been deregulatory in nature.

Trends in Portfolio and Direct Investment

Foreign investment is of two main types. *Foreign direct investment* (FDI) is equity investment that results in an ownership share of a foreign company, called an affiliate, of at least 10 percent.[10] FDI is used by corporations to expand their existing affiliates, establish new affiliates, or purchase other foreign companies. FDI is usually made with long-term investment goals in mind.

Foreign portfolio investment (FPI) includes investment in foreign debt securities, either private or government, and investment in foreign equities if the investor's ownership share is less than 10 percent. FPI is often undertaken with short-term investment goals in mind.

Let us look first at trends in portfolio investment. Figure 2.1 shows that average annual FPI increased from $170 billion in the 1980s, to $664 billion in the 1990s, to $1.9 trillion in the 2000s.[11] FPI reached a record $3.2 trillion in 2006. (We do not examine cross-border bank lending, but it is another type of financial flow that has soared in recent years).[12]

FPI has grown for many reasons. First, most governments run budget deficits, which has created a large pool of government bonds for international investors. Second, corporate debt has increased, and it has become increasingly securitized, which makes it easy to trade internationally.

Third, privatization of state-owned businesses has expanded the size of stock markets. And most countries have opened their stock markets to foreign investors. On the New York Stock Exchange, the market capitalization of foreign firms reached $10 trillion in 2006, or 40 percent of total market value, up from 25 percent a decade ago.[13]

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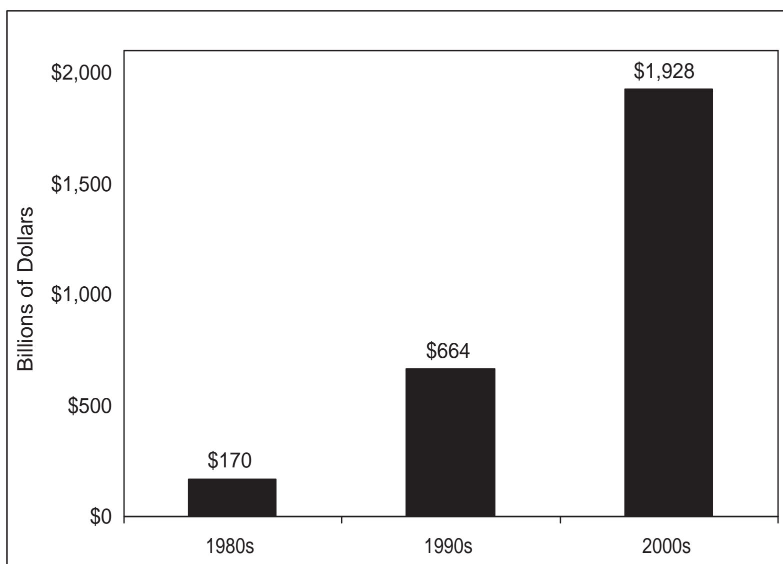
Figure 2.1
GLOBAL PORTFOLIO INVESTMENT FLOWS, ANNUAL AVERAGES BY DECADE



SOURCE: Authors' calculations based on International Monetary Fund, *Balance of Payments Statistics Yearbook*, various issues. These are flows of financial securities (stocks and bonds), averages of inflows and outflows. The 1980s are 1984 to 1989. The 2000s are 2000 to 2006.

Fourth, technology has helped boost investment flows, as it has since the 19th century. Beginning in the 1840s, the telegraph broadened Wall Street trading activity because it delivered real-time market information outside of New York for the first time. In the 1860s, the stock ticker was invented and a transatlantic telegraph cable was laid, which helped connect distant financial markets. As noted, investment flows were bottled up by governments during the mid-20th century. But today, deregulation combined with rising computer power and the Internet has driven international capital flows to new heights.

Finally, FPI growth is a byproduct of growth in the world's holdings of financial assets. The value of stocks, bonds, and bank deposits was $12 trillion in 1980, about the same size as world gross domestic

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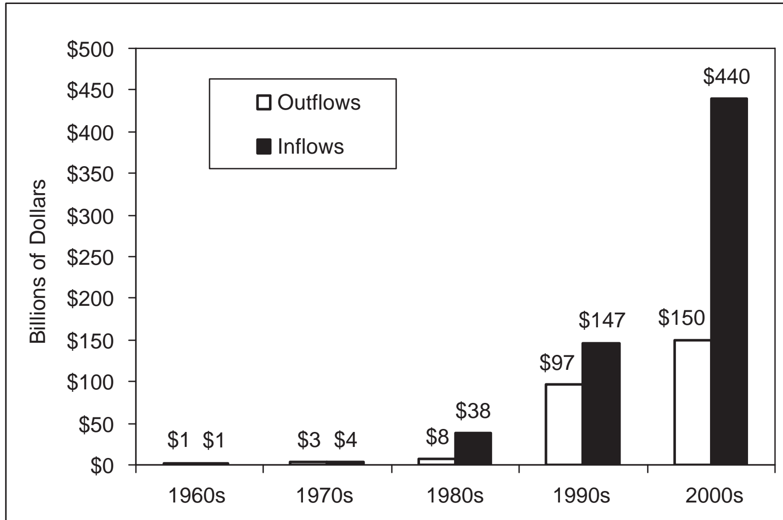
Figure 2.2
U.S. FOREIGN PORTFOLIO INVESTMENT FLOWS, ANNUAL AVERAGES BY DECADE



SOURCE: Authors' calculations based on U.S. Bureau of Economic Analysis, *Survey of Current Business*, various issues, Table F.2. The 2000s are 2000 to 2006.

product. By 1995, the value of these assets was $64 trillion, or about twice world GDP. By 2005, assets had reached $140 trillion, or three times world GDP.[14] A different data source puts the figure for 2006 at $190 trillion, or about four times world GDP.[15] Whatever the precise measure, there are clearly massive and growing pools of assets that can be moved around the planet seeking the highest after-tax returns.

The United States plays a large role in global investment flows. Figure 2.2 shows that U.S. inflows and outflows of portfolio investment have soared since the 1970s.[16] Inflows have been larger than outflows, and most inflows are in debt, not equities. One reason for that is ongoing borrowing by the federal government to finance budget deficits. During the last three years, 86 percent of portfolio inflows were debt and just 14 percent were equity.[17] By contrast, investments by Americans abroad are more evenly split between debt and equity.

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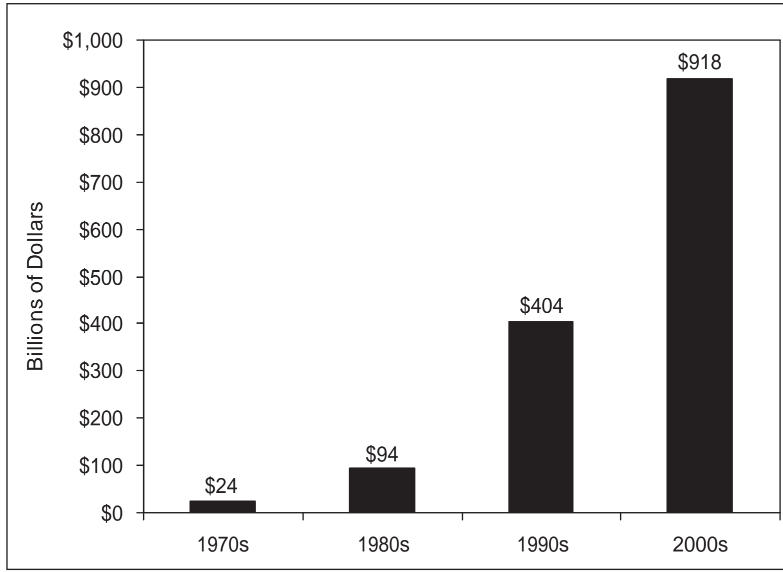
Figure 2.3
GLOBAL DIRECT INVESTMENT FLOWS, ANNUAL AVERAGES BY DECADE



SOURCE: Authors' calculations based on United Nations Conference on Trade and Development, *World Investment Report*, various issues. These are FDI inflows. The 2000s are 2000 to 2006.

As an inducement to foreign investors in U.S. debt, the federal government does not tax interest paid to foreigners, nor does it collect information about these investments to share with foreign governments. At the same time, the United States imposes a heavy tax burden on equity. In a recent book, Gary Hufbauer and Ariel Assa note that "the burden of U.S. business taxation clearly favors the foreign acquisition of debt securities rather than corporate equities or inward direct investment."[18] The authors propose reforms to correct that bias so that America can attract more equity investment.

Now let us look at trends in foreign direct investment. FDI has grown as explosively as FPI has. Figure 2.3 shows that global FDI flows averaged $94 billion annually in the 1980s, $404 billion in the 1990s, and $918 billion in the 2000s.[19] In 2006, FDI topped $1.3 trillion, which was triple the average level of the 1990s.

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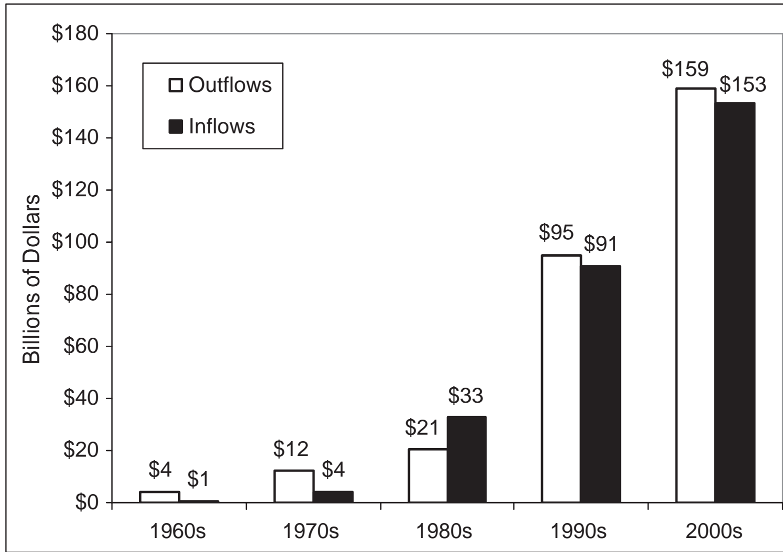
Figure 2.4
U.S. FOREIGN DIRECT INVESTMENT FLOWS, ANNUAL AVERAGES BY DECADE



SOURCE: Authors' calculations based on U.S. Bureau of Economic Analysis, *Survey of Current Business*, various issues, Table F.2. The 2000s are 2000 to 2006.

Figure 2.4 shows FDI inflows and outflows for the United States. FDI has grown rapidly, but relative to the size of the economy the United States attracts less FDI than other major countries. The stock of FDI in the United States represents 14 percent of GDP, compared with an average of 38 percent of GDP in European countries.[20] The United Nations publishes an index of FDI performance, which compares how much a country receives with its "potential." The United States ranks only 117th of the countries studied, and thus is said to be performing "below potential."[21]

Another way to appreciate the huge rise in international investment is by looking at growth in the number of multinational corporations. In 1990, there were 37,000 multinational parent companies in the world that owned 170,000 foreign affiliates.[22] By 2005, there were 78,000 parent companies and 780,000 foreign affiliates.[23] The sales

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of all these foreign affiliates are about twice as large as the total value of world exports.[24] Multinational corporations are the glue that holds the world economy together.

Despite huge increases in international investment in recent decades, there is no upward bound in sight. FDI still represents a fairly small fraction of total investment in advanced nations.[25] And with regard to FPI, world financial markets are still far from fully integrated. Among advanced nations, for example, only about one-quarter of debt securities and one-fifth of equities are owned by investors outside the countries of issue.[26] Investors have "home-country bias," partly because they have less information about foreign markets.[27] But this bias is falling over time, and investors are steadily increasing the foreign investment portions of their financial portfolios.[28]

In sum, we are only partway along the process of global integration. Market forces and technologies will continue to drive investment flows higher. Unfortunately, U.S. policymakers have spent little time focusing on this reality, and they have made few reforms to ensure that America can meet the globalization challenges ahead.

Why Invest Abroad?

There is much concern in the United States about the foreign investment activities of multinational corporations. People fear that large companies are relentlessly moving jobs offshore at the expense of U.S. workers. They wonder how any industrial production can remain in the United States if such low wages are being paid abroad.

Let's take a closer look at multinational corporations to understand how tax competition fits into such debates about American competitiveness. There are two sorts of factors that influence decisions about foreign investment: business opportunities and government policies. Government policies, including tax policies, can attract or repel investment, but they augment more fundamental business goals of foreign investment.

Data on foreign investment from the U.S. Bureau of Economic Analysis are revealing. They show that 81 percent of the production of all U.S.-owned foreign affiliates is in "high-income" countries.[29] Similarly, 77 percent of the value of U.S. direct investment is in high-income countries.[30] The biggest locations for U.S. foreign investment are, in order, Britain, Canada, and the Netherlands.

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U.S. investment in low-income countries is a small share of the total. It is not the main investment goal of U.S. companies to set up factories in low-wage countries and ship goods back to America. BEA expert Ralph Kozlow notes that the data help "refute one of the major fallacies about multinationals, which is that the most important determinant of the location of their overseas investment is access to low-wage labor."[31]

Investments in China, for example, represented just 1 percent of the total U.S. FDI stock in 2006.[32] And the purpose of much of that 1 percent is to penetrate China's growing market. For example, Ford Motor Company opened its second major automobile assembly plant in China in 2007 with an investment of $500 million.[33] With the Nanjing plant, Ford will increase its Chinese production to 410,000 cars annually for the rapidly expanding Chinese market. Ford also invested $500 million in India in 2007 to double its local automobile production capacity to serve the growing Indian consumer class.[34]

The main reason that U.S. corporations invest abroad is to penetrate lucrative and growing foreign markets and to expand global sales. Most U.S. FDI is in high-income countries such as Britain because that is where companies can sell the most products. In other words, U.S. corporations mainly invest abroad to sell products abroad. The BEA's Kozlow concluded that the most important determinant of FDI location is access to large and prosperous markets.[35] BEA data show that 90 percent of the sales of U.S. foreign affiliates are in foreign markets, and only 10 percent were sales to the United States.[36]

Moreover, U.S. foreign investment drives U.S. exports. In 2005, U.S. multinational corporations were responsible for 54 percent of all U.S. exports of goods.[37] Former presidential candidate Ross Perot talked about a "giant sucking sound" caused by open borders' supposedly damaging the economy. In reality, that sound is U.S. foreign affiliates sucking exports out of U.S. factories and into foreign markets. The Organization for Economic Cooperation and Development found that every dollar of outward FDI from a country is associated with $2 of additional exports from that country.[38]

Here is the key point: foreign investment by U.S. corporations mainly *complements* domestic investment, it does not *substitute* for it. The expansion of U.S. corporations abroad often means a complementary expansion in the U.S. operations of those companies.[39] Consider research and development spending. The larger the global

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sales of a U.S. corporation, the more profit it can earn by investing in R&D.

And where do U.S. corporations do their R&D? They mainly do it in the United States. In 2005, 86 percent of the R&D performed by U.S. multinational companies was in the United States.[40] And the U.S. R&D of these companies accounted for 79 percent of R&D performed by all U.S. businesses. Further, the BEA data show that as the global sales of U.S. multinational companies have grown in recent years, the number of U.S. R&D jobs in multinational companies has increased sharply.[41] Thus, the global growth and profitability of U.S. multinational companies are crucial to the future of private-sector innovation in the United States.

Consider Intel Corporation, the world's largest semiconductor company. In 2006, it had revenues of $35 billion, of which 84 percent came from outside the United States.[42] Yet, more than half Intel's 94,000 employees are in the United States. And, importantly, four-fifths of the firm's $5 billion in annual R&D occurs in the United States.

Twelve of Intel's 16 semiconductor fabrication plants are in the United States, with the foreign plants in Ireland, Israel, and soon China. Thus, most of the company's high-value operations are still in the United States. Nonetheless, taxation does affect the company's decisions on where it will expand, as it did for these foreign chip plants. The president of Intel, Paul Otellini, says that he is "lobbied relentlessly to locate factories in various countries."[43]

Or consider another globe-spanning U.S. company, Dow Chemical. Dow is the second largest chemical company in the world after Germany's BASF. Dow's revenues in 2006 were $49 billion, of which 63 percent came from outside the United States.[44] The firm operates 150 manufacturing sites in 37 countries, but 55 percent of the firm's capital assets and half its 43,000 employees are in the United States. It has 5,600 people engaged in R&D, and 67 percent of them are located in the United States.[45]

By expanding abroad, knowledge-based companies such as Intel and Dow can maximize sales of technologies developed in the United States. The more that such companies expand their global sales, the more likely they are to invest in domestic activities such as R&D. In testimony to Congress on tax competitiveness, Dow Chemical said of its operations that a "loss of business opportunities to foreign

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competitors affects not just foreign operations but also operations at home."[46] Thus, if U.S. tax policies result in Dow's, say, losing business in Brazil to a German company, Dow might hire fewer scientists in the United States.

As U.S. companies expand abroad, they usually strengthen their headquarters activities in the United States. Headquarters activities are often high-skill and high-pay, such as finance, planning, and R&D. Glenn Hubbard, former chief economics adviser to President Bush, noted that "where a firm chooses to place its headquarters will have a large influence on how much that country benefits from its domestic and international operations."[47] For this reason, government policies should try to create a favorable tax climate for corporate headquarters, but U.S. policymakers are doing just the opposite, as we discuss in Chapter 6.

We are not suggesting that the government artificially promote investment, either domestic or foreign. But policymakers should aim to reduce all investment barriers, recognizing that both inflows and outflows promote economic growth. How can that be the case? Remember that the first law of economics is that voluntary transactions are mutually beneficial. U.S. shareholders gain when American companies make profitable investments abroad. As it turns out, U.S. foreign investments tend to pay high returns to investors.[48] On the flip side, the United States also benefits from inflows of investment from foreigners. When foreign companies invest here, they often bring innovations that help improve U.S. productivity, as we have seen with foreign-owned automobile plants in the United States.

The problem with the U.S. tax system is that certain features distort both inflows and outflows of investment, thus undermining economic growth. The corporate income tax, for example, discourages investment in the United States, puts U.S. firms at a disadvantage in foreign markets, and artificially encourages U.S. companies to retain their earnings abroad. The current corporate tax makes no sense, as we discuss in later chapters, and it needs to be reformed to meet the realities of the global economy.

The World Is Flat

Why is tax competition becoming more intense? To answer that, we will borrow *New York Times* columnist Thomas Friedman's phrase "the world is flat." Flatness essentially means that more countries

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are becoming good places to do business—they are becoming more stable, open, and market oriented. Individuals and businesses can produce and trade products with growing ease in most places on the planet.

There are three main flatteners of the world economy. First, as Friedman stresses, new technologies are helping equalize business environments across countries. The Internet provides instant and detailed communications across the globe. Containerized shipping and lower-cost airfreight have allowed companies to create efficient global supply chains.[49] Wherever production is located today, products can be shipped more quickly and cheaply to final markets.

The second flattener is the increasingly mobile nature of industry. In the past, a key reason corporations invested abroad was to gain access to natural resources, such as mineral and oil deposits, which are in fixed locations. If companies wanted gold or copper, they had to invest in certain countries. That meant that firms were stuck paying whatever level of taxes those countries demanded. Even today, the United Nations reports that government taxes, charges, and royalties on foreign investments in oil, gas, and mining range from 25 to 90 percent of revenues generated by such projects.[50] That is a huge government grab, which is only possible because such resources are in fixed places.

However, most industries today are footloose, and production can be located anywhere that has an inviting tax and regulatory environment. While 6 percent of U.S. direct investment abroad is in mining and petroleum extraction, 21 percent is in manufacturing and 23 percent is in financial services.[51] Many countries have implemented policies to lure investments in these latter two sectors. As an example, pro-market reforms and low corporate tax rates have helped the Czech Republic, Poland, and Slovakia attract Asian and German automobile factories.

No manufacturing activity is more prized than semiconductor production. Intel's chairman, Craig Barrett, described the increased mobility of his industry: "With the global nature of Intel's business, a preference to locate production facilities near markets, and the increasing number of countries capable of meeting Intel's operating needs, considerable business reasons exist for locating a number of our wafer fabrication facilities in foreign locations."[52] The flatness of the world was highlighted with Intel's announcement in 2006 that it would invest $1 billion in a semiconductor facility in Vietnam.[53]

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Financial services are even more mobile than manufacturing. Insurance, banking, and other activities can be done anywhere that there are smart people and a good telecommunications infrastructure. In a 2007 study, McKinsey and Company found that the world is becoming much more competitive in financial services: "As technology has virtually eliminated barriers to the flow of capital, it now flows freely to the most efficient markets, in all corners of the globe. Today, in addition to London, we're increasingly competing with cities like Dubai, Hong Kong, and Tokyo."[54]

The McKinsey study asked financial industry executives about the most important factors in selecting locations for investment.[55] Access to skilled labor and various regulations were the most important items, but those factors were followed by corporate taxes. What that means is that if two cities both have skilled workers and similar regulations, taxes would tip the balance for the chosen investment location.

And note that access to skilled workers, in itself, depends on taxes. A recent story in the *International Herald Tribune*, for example, discussed how Denmark's high individual income tax rates are driving high-skill workers from that country:

> Lars Christensen is co-chief executive of Saxo Bank, a Copenhagen financial services firm specializing in currency trading and retail brokerage services. . . . 'The high tax rate is the No. 1 problem we have,' Christensen said. 'It's that simple.' Christensen said about 150 positions at Saxo Bank had been created outside Denmark because filling them at the home office would have been either prohibitively expensive or simply impossible. Finding people at its offices in Britain, Switzerland and Singapore, where tax rates range from 19 to 40 percent, proved easier.[56]

Another footloose financial industry that has been responsive to tax competition is reinsurance. The United States has sharply declined as a preferred location for this industry in recent decades.[57] The global reinsurance industry has been gravitating toward low-tax jurisdictions. The biggest American reinsurance company, Berkshire Hathaway, ranks just 10th largest in the world. Three of the top 10 companies are in low-tax Bermuda and one is in low-tax Switzerland.

Intellectual property is perhaps even more mobile than financial services. An increasing share of product value in many industries is

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in the form of trademarks, patents, and copyrights. These intangible assets, and the large profits that they often generate, can be moved fairly easily across international borders to low-tax locations.

A final flattener of the world economy is that more countries are instituting the policy fundamentals needed to attract investment and achieve growth. Those fundamentals include reliable legal rules, a stable currency, and free trade. Such reforms have reduced investment risks for multinational corporations, and allowed them to locate production in a broader array of countries. Cuts to trade barriers have allowed companies to choose the best locations for production and then ship goods to their final destinations with fewer hurdles.

The Fraser Institute's *Economic Freedom of the World* provides a measure of progress in global economic reforms.[58] For more than 100 countries, the institute tracks changes in "economic freedom" based on 42 variables. Global economic freedom has steadily increased since 1980. The institute has also found that those countries with greater economic freedom tend to attract more foreign investment.[59]

Economic freedom took a leap—and the world economy became flatter—when dozens of socialist countries in Asia, Eastern Europe, and Latin America embraced markets during the 1990s. In Eastern Europe, many countries have become champions of tax reform and adopted flat income taxes. In much of Western Europe, the adoption of the common euro in 1999 eliminated currency risks for businesses, which spurred rising investment flows.

Deutsche Post provides an illustration of changes in the world economy. Formerly a moribund government postal service, Deutsche Post was partly privatized in 2000, which allowed it to seek new markets and expand abroad. Today, Deutsche Post is a global corporation that operates package delivery and logistics services in 200 countries. It is currently building the world's largest logistics hub at the proposed world's largest airport in low-tax Dubai on the Persian Gulf.[60] Such investments serve to further integrate the world economy and spur rising tax competition.

As global integration increases, American companies are feeling greater pressures to reduce costs, including tax costs. Consider Dow Chemical's situation. It faces stiff competition from foreign firms such as BASF and Bayer in many foreign markets. Dow informed Congress that most of the production costs of chemicals are becoming equalized in the global economy, but tax costs still diverge

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depending on a company's location.[61] Indeed, Dow argues that the tax costs of a U.S. chemical company can be substantially higher than the tax costs of foreign competitors. The consequence of high U.S. taxes in a flat world is that Dow will lose customers: "As the economy becomes increasingly globalized, customers are becoming increasingly sophisticated and are taking advantage of more freedom to choose the lowest cost, highest quality supplier. . . . The cost of taxes is one of the deciding factors in determining which company will build the next production facility and thus be in a position to supply the next customer."[62]

To sum up, because of globalization, taxation is becoming increasingly important to every nation's competitiveness and prosperity. Individuals have growing pools of capital that they can invest abroad. Corporations have more foreign opportunities than ever before, and they are under great pressures to reduce costs. Most governments have responded to these changes with pro-market reforms, including substantial tax rate cuts, as we describe in the next chapter.

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3. Tax Cut Revolution

In the last chapter, we examined how more open borders and rising capital flows have transformed the global economy. Those changes helped launch a tax-cutting revolution that has swept the world. Since the 1980s, countries have cut tax rates on wages, business profits, dividends, interest, capital gains, and wealth. A European Parliament report noted that "a wind of tax reforms has been blowing through the European Union . . . [and] most reforms can be seen as supply-side oriented."[1] That supply-side wind has blown across Asia, Europe, North America, and many other places.

Supply-side tax reforms are those that reduce the costs of productive activities, such as working, investing, and starting businesses. If the costs of production are reduced, output will increase and wages and incomes will rise. Thus, tax competition has spurred the widespread enactment of tax cuts that have boosted standards of living worldwide.

Despite this good news, some policymakers are unnerved by recent changes in the world economy and are trying to block open markets and competition. In Latin America, some governments have nationalized businesses. In the United States, trade protectionism remains popular. And in Europe, some politicians are trying to stifle tax competition.

However, globalization and economic freedom remain ascendant. Many governments are continuing to make pro-growth reforms, such as privatizing businesses and reducing trade barriers. And, as we discuss here, the tax cut revolution is more than two decades old and is still going strong.

Taxes on Individual Income

Every major country has cut its top individual income tax rate in the last two decades. Figure 3.1 shows the average top tax rate for the 30 nations of the Organization for Economic Cooperation and Development, an organization in Paris established by governments

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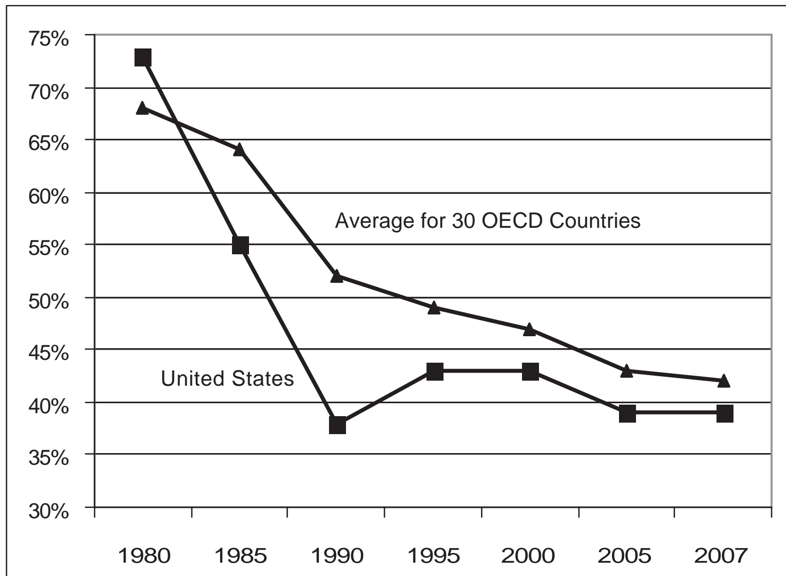
Figure 3.1
TOP INDIVIDUAL INCOME TAX RATES



SOURCE: James Gwartney and Robert Lawson, *Economic Freedom of the World* (Vancouver: Fraser Institute, 2007), as updated to 2007 by authors. Data include national and average subnational tax rates.

of some of the world's highest-income countries. The average top tax rate in the OECD plummeted from 68 percent in 1980 to 42 percent by 2007.[2] It is amazing that governments once imposed tax rates of 68 percent or more. However, before capital flows were liberalized, it was easier for governments to get away with such oppressive policies.

The figure shows that the top U.S. tax rate is below the OECD average. Tax rate cuts in 1981 and 1986 established the United States as a tax reform leader. However, America's lead has narrowed in recent years as other countries have been more aggressive at cutting tax rates. These data include each nation's federal rate plus the average of state-level rates where applicable.[3] (Table A.1. in the Appendix provides the details).

The top U.S. rate is 39 percent, based on a federal rate of 35 percent and the average of state rates.[4] State-level income tax rates range

from a high of 10.3 percent in California to a low of zero in the handful of states that impose no individual income taxes.

Figure 3.2 shows the top rates for OECD countries in 2007. These data are from a different source, using a different measure of state-level tax rates.[5] The OECD average rate is 43 percent by this measure, or slightly higher than the current U.S. rate of 41 percent. But note that the top U.S. rate will increase to 46 percent in 2011 if recent federal tax cuts are allowed to expire. Unless federal policymakers take action, the United States will move into the ranks of high-tax countries on this important measure of competitiveness.

We have looked at data for the 30 OECD countries, but the tax cut revolution has been a global phenomenon. So we examined a broader group of 79 countries that had data available for both 1985 and 2007.[6] Figure 3.3 shows that the average top income tax rate has plunged 21 percentage points or more on the four continents shown. The current top U.S. rate is higher than the average top rates for Africa, Asia, and Latin America.

Some of the more dramatic reductions in top rates between 1985 and 2007 include Brazil (33 points), the Dominican Republic (43 points), Egypt (45 percentage points), India (27 points), Italy (37 points), Morocco (43 points), Peru (35 points), the Philippines (28 points), Portugal (27 points), Spain (27 points), Thailand (28 points), and Zambia (50 points).

In most countries, tax rates have been cut on higher-income taxpayers as well as on middle- and lower-income taxpayers. However, when considering tax competition, tax rates on those with higher incomes are the most important. Higher-income taxpayers have the largest responses to tax changes, and they are increasingly mobile as we discuss in Chapter 5. Also, those with higher incomes often play crucial roles in the economy as executives, engineers, scientists, and entrepreneurs. Former prime minister Margaret Thatcher noted that her success at cutting Britain's top income tax rates in the 1980s "provided a huge boost to incentives, particularly for those talented, internationally mobile people so essential to economic success."[7]

In the 1970s, Thatcher spoke often about the damage caused by high tax rates at the top end. High rates were a "symbol of socialism" that she wanted to scrap.[8] In the current decade, the Thatcherite torch has been passed to the 25 nations that have enacted flat taxes. Flat taxes are a powerful symbol of the fairness and competitiveness

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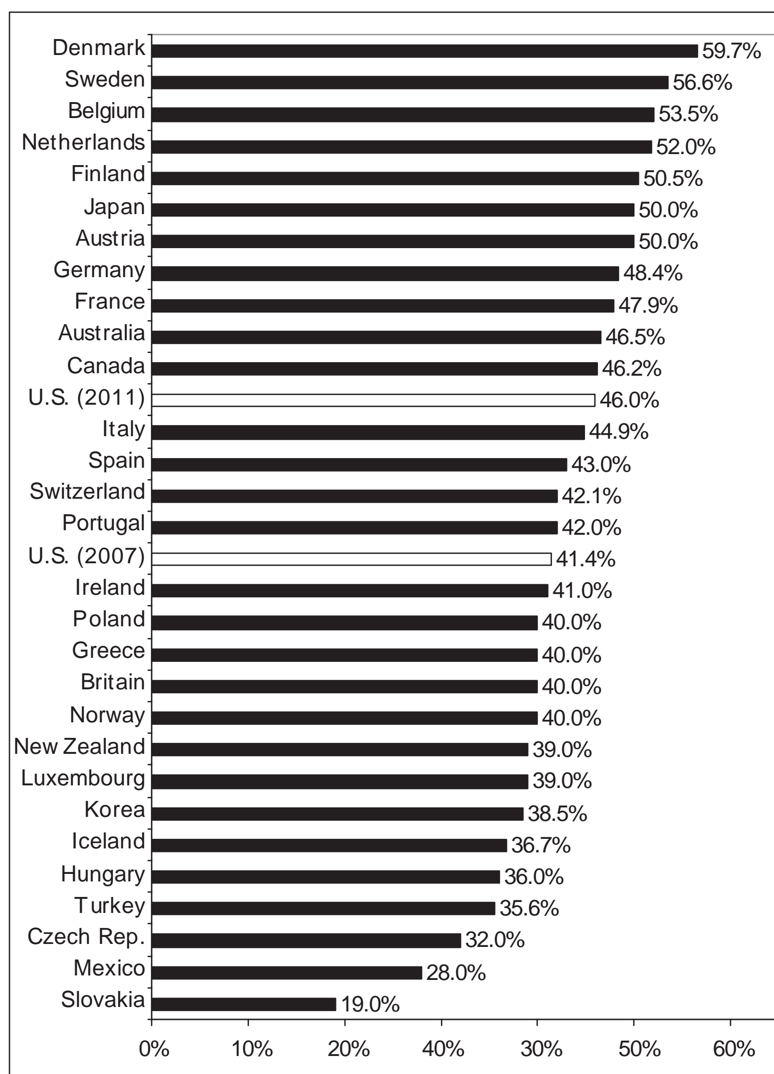
Figure 3.2
TOP INDIVIDUAL INCOME TAX RATES IN THE OECD, 2007



SOURCE: Organization for Economic Cooperation and Development, Tax Database, Table I.4. Updated by the authors to 2007. Includes national and subnational taxes.

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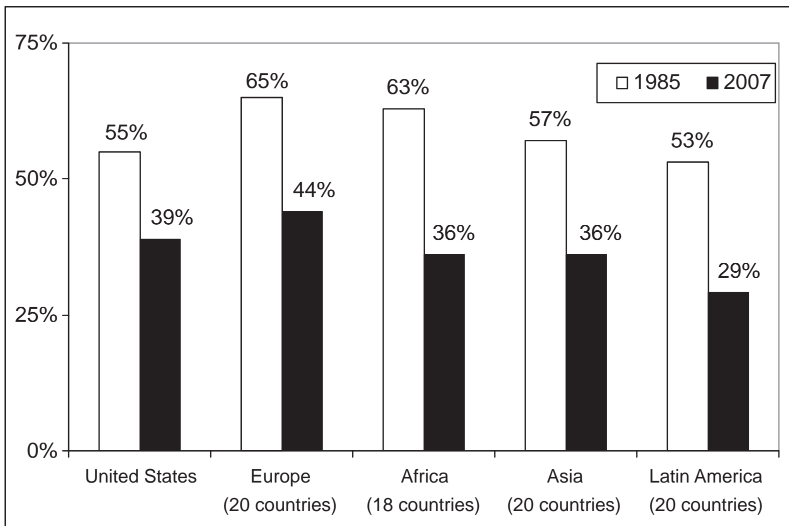
Figure 3.3
TOP INDIVIDUAL INCOME TAX RATES, AVERAGES BY REGION, 1985 AND 2007



SOURCE: James Gwartney and Robert Lawson, *Economic Freedom of the World* (Vancouver: Fraser Institute, 2007), as updated to 2007 by authors. Data include national and average subnational taxes.

of a country's tax system. Estonia launched the flat tax revolution in 1994, and other nations in Eastern and Central Europe have followed its lead.

Note that Figure 3.3 shows impressive tax cuts around the world, but the tax cut revolution is even more dramatic than the figure indicates because it excludes most of the flat tax nations, which were under communist rule in 1985. As we document in Chapter 4, the average individual income tax rate in the 25 flat tax jurisdictions is just 17 percent.

A final consideration when looking at income tax rates is to examine the income levels to which the top rates apply. The lower the income level to which a top rate is applied, the more taxpayers are hit and the more economic damage is caused. Denmark, for example, has a top tax rate of more than 50 percent and it affects a large share of Danish taxpayers because it kicks in at a fairly low level of income.

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"Bracket creep" also plays an important role in this regard. If tax systems are not indexed for inflation and income growth, bracket creep will push lower-income taxpayers into higher tax brackets over time. That is not a trivial matter. The 1970s were plagued by high tax rates and high inflation. The result was vicious bracket creep that helped destroy growth in many countries, including many poor countries in Africa and Latin America.[9] Fortunately, there is a solution to the problem of bracket creep: flat taxes. Flat taxes virtually end bracket creep because all taxpayers above a basic threshold face the same rate, even as income and price levels rise. We discuss the advantages of flat taxes in Chapters 4 and 10.

Taxes on Individual Capital Gains

The tax rates we have discussed so far are the general income tax rates, which mainly apply to wage income. But most countries apply lower rates, or other special rules, to dividends and capital gains received by individuals. One reason for special rules is that the income underlying dividends and capital gains is usually already taxed at the corporate level. Without special rules, dividends and capital gains would be double-taxed. By contrast, wage and interest income are taxed only at the individual level because they are deductible at the corporate level.

There is another reason most countries provide favorable treatment to capital gains and dividends—international tax competition. If a government today tried to tax investment income at the same high rates as wage income, the tax base would shrink dramatically and little revenue would be raised. This inverse relationship between tax rates and tax bases has been strengthened by globalization.

When countries cut their capital gains tax rates, they often find that revenues increase, not decrease, because the tax base expands so much. When Ireland cut its capital gains rate from 40 percent to 20 percent in 1998, it experienced a large increase in capital gains tax revenues.[10] A similar pattern followed U.S. capital gains tax cuts in 1997 and 2003—rates went down, capital gains realizations went up, and tax revenues increased.[11]

These results are dramatic examples of "Laffer curve" effects. In the 1970s, economist Art Laffer popularized the idea that tax rates, reported income, and tax revenues are related. That insight helped start the global tax cut revolution. Supply-side tax cuts cause tax

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bases to expand because they change taxpayer incentives. In most cases, the tax base does not expand enough to generate higher government revenue. But as globalization advances, the dynamic effects of tax cuts are becoming more important, particularly for taxes that have very responsive bases, such as capital gains taxes, wealth taxes, and corporate income taxes. When such taxes are cut, the expanding tax base partly offsets the fall in revenues from the lower rate. In such cases, the economy is better off and policymakers can take comfort that revenues do not fall as much as would otherwise be the case.

Figure 3.4 shows the tax treatment of capital gains for the 30 OECD countries.[12] Twelve OECD countries have general capital gains tax rates of zero, including the Netherlands and New Zealand. So do numerous non-OECD jurisdictions, such as Hong Kong and Taiwan. A zero rate means, for example, that if a Dutch person bought 100 shares of Royal Dutch Shell for €100 and sold them five years later for €150, he or she would have a gain of €5,000, but would owe no tax to the government.

Having tax rates of zero on capital gains may be surprising to Americans given the political battles that have taken place over cutting the federal capital gains rate. But our 15 percent federal rate is in the middle of the pack among major countries, as shown in the figure. Under current law, the federal capital gains tax rate is scheduled to rise to 20 percent in 2011, unless policymakers take action.

Capital gains taxation is a complicated issue, and there are caveats to the data in the figure. The rate shown generally applies to long-term holdings of portfolio stock investments. Capital gains on short-term holdings—often meaning less than a year—usually face higher tax rates. Also, some countries have restrictions on the types of investments that qualify for the lower rate. For example, the Dutch rate of zero applies only if a shareholder owns less than 5 percent of a company. Also note that numerous countries with nonzero rates in Figure 3.4—including Britain, France, Hungary, Ireland, Japan, and Korea—have special zero rates for small investors.

The bottom line is that virtually every country provides special treatment to reduce the distortions caused by capital gains taxation. Special treatment relieves the bias against investment under the income tax and minimizes the "lock-in" of share ownership, which

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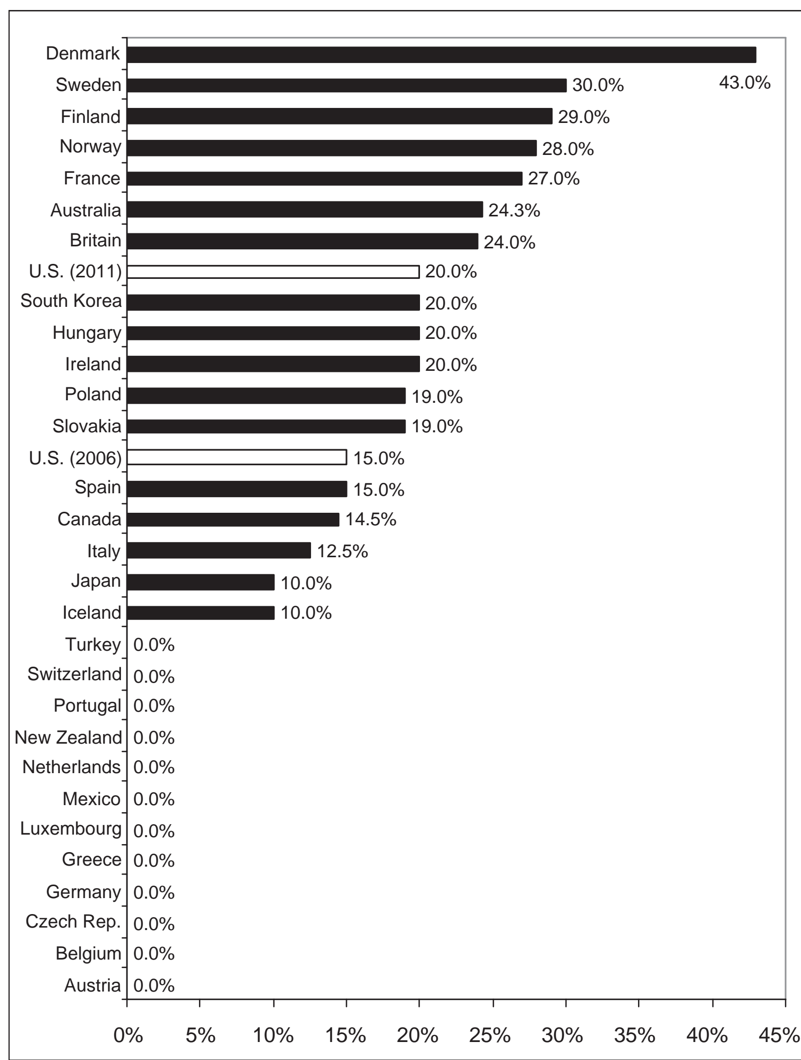
Figure 3.4
TOP INDIVIDUAL CAPITAL GAINS TAX RATES IN THE OECD, 2006



SOURCE: Authors' calculations, based on various sources, including Australian Government, Department of the Treasury, "International Comparison of Australia's Taxes," April 3, 2006. These are the rates on long-term portfolio holdings of equities. National government taxes only.

occurs when investors are reluctant to sell their shares for fear of the tax hit. Lock-in reduces capital market efficiency.

Another important reason to reduce or eliminate capital gains taxes is to spur growth in entrepreneurial companies. Low capital gains taxes generate more financing of young companies through angel investors, venture capitalists, and initial public offerings. Early investors in growth companies are taking big risks in the hope of capital gains. As such, cutting the capital gains rate directly affects the willingness of investors to place their funds in start-up and growth-oriented firms.

Consider Silicon Valley. The valley's technology firms and venture capital industry roared to life following a large capital gains tax cut in 1978.[13] During the 1980s and 1990s, many countries sought to emulate the success of Silicon Valley's technology companies and venture capital markets. That provided an important justification for many nations to cut their capital gains tax rates.

Taxes on Dividends

Figure 3.5 shows the top dividend tax rates for the OECD countries. Because dividends are corporate profits that are paid out to shareholders, the dividend tax rate includes both the corporate rate and the applicable individual rate. The top U.S. dividend tax rate is 49 percent, based on the federal corporate rate of 35 percent, the federal individual rate on dividends of 15 percent, and state-level taxes.[14] The U.S. rate is substantially higher than the average rate of 43 percent for the 30 OECD countries.

But there is more bad news for American taxpayers. The current 15 percent dividend tax rate for individuals is temporary. It expires in 2011 and jumps up to a remarkably high 40 percent. If policymakers allow that to happen, the combined U.S. rate would shoot up to 64 percent—easily the highest in the OECD. Having the highest dividend tax rate would be an extraordinary position for supposedly free-market America to be in.

Another interesting factor is that the average dividend tax rate in the OECD has fallen from 50 percent to 43 percent since 2000. Thus, if the United States let the current dividend tax cut expire in 2011, the country would not simply be going back to the status quo in 2000. The world has changed since 2000, and the United States would

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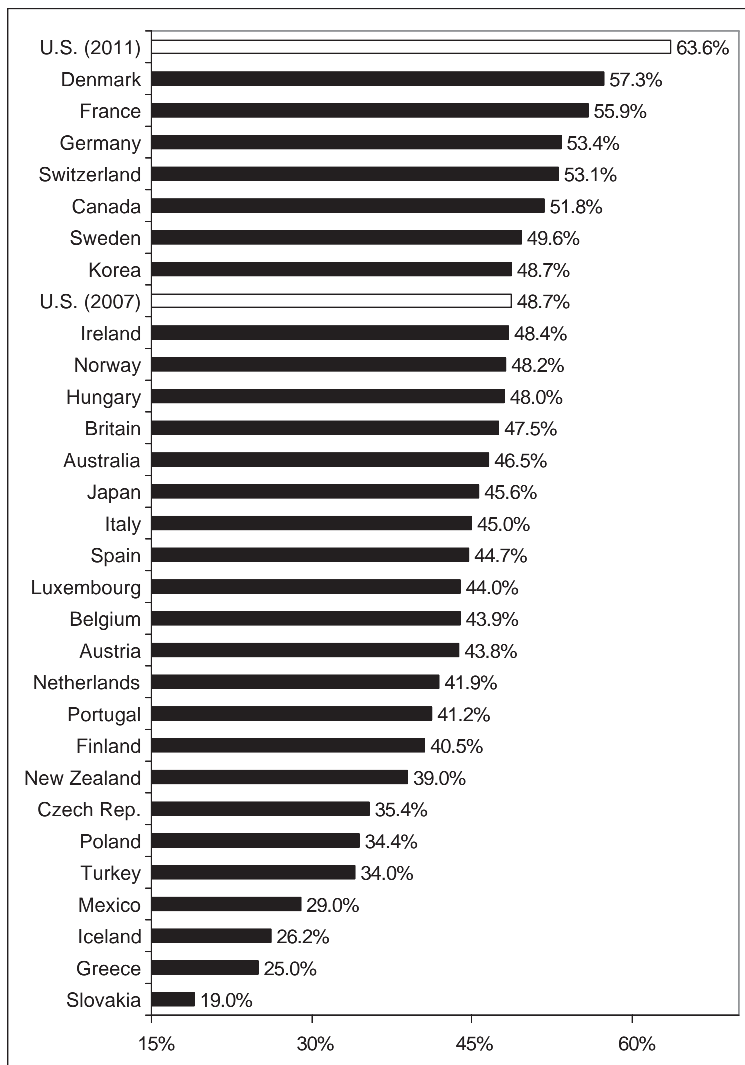
Figure 3.5
TOP DIVIDEND TAX RATES IN THE OECD, COMBINED INDIVIDUAL AND CORPORATE, 2007



SOURCE: Organization for Economic Cooperation and Development, Tax Database, Table II.4. Includes national and subnational taxes.

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be that much less competitive on dividend taxes compared with other nations.

As tax competition has spurred countries to reduce taxes on dividends and capital gains, some have installed "dual income tax" systems. These feature low, flat tax rates on individual investment income, but higher tax rates on labor income. Denmark, Finland, Norway, and Sweden implemented dual income tax reforms in the 1990s.[15] Other European nations, such as Austria, the Netherlands, and Spain have moved in that direction. A study by an OECD economist noted that these "moves toward a lower and flat tax on capital income have often reflected the need to remain competitive on international capital markets."[16]

Taxes on Wealth

Personal injury lawyers are infamous for going after individuals and businesses with deep pockets. Without tax competition, governments tend to do the same thing by applying punitive taxes on those with high earnings and wealth. Some countries even impose "wealth taxes" to hit pools of accumulated savings on an annual basis. Other countries impose "death taxes" in the form of either estate taxes or inheritance taxes. Fortunately, tax competition is promoting cuts and elimination of all these sorts of punitive levies on accumulated savings.

Let us look first at annual wealth taxes, which were once popular in Europe. They are imposed at a particular rate on the net assets of individuals above an exemption amount. Thus, in France, the "solidarity tax on wealth" imposes an annual tax with graduated rates from 0.55 percent to 1.8 percent on net financial assets and real estate, including primary residences, above an exemption of €760,000 (about $1 million).

Rising tax competition has convinced many countries to cut or eliminate these taxes. A survey of 19 countries found that the average wealth tax fell 40 percent during the 1980s and 1990s.[17] Many countries have completely abolished their wealth taxes in recent years, including Austria, Denmark, Finland, Germany, Iceland, Luxembourg, the Netherlands, and Sweden.

Sweden abolished its wealth tax in 2007 hoping to lure back the roughly $80 billion of funds that wealthy Swedes moved abroad to avoid the tax.[18] The tax was assessed at 1.5 percent annually on

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individual assets above an exemption of about $240,000. The Swedish finance minister said that the repeal would help create "the conditions for jobs and companies necessary to match global competition."[19]

In France, President Nicolas Sarkozy has promised to eliminate that country's wealth tax. Many French millionaires have pointed to the wealth tax as a key reason for their emigration to Belgium, Switzerland, and other places. The French wealth tax collects relatively little in revenue.[20] Indeed, it likely costs the government revenue because the income tax base shrinks as the wealthy flee to other nations.

Spain may also reform or abolish its wealth tax. The country has one of the most punitive wealth taxes in Europe, with rates ranging from 0.2 percent to 2.5 percent of assets above a modest exemption amount. Recently, Spain's ruling Socialist Party has vowed to eliminate the wealth tax.

The United States does not impose an annual wealth tax, but it does impose a one-time tax on wealth at death—the federal estate tax. Estate taxes are imposed on the value of estates at death. Inheritance taxes are similar, but are imposed on each heir's receipt of wealth from an estate. Estate and inheritance taxes have similar effects—they suppress savings and prompt wealthy individuals to put great efforts into tax avoidance. A Merrill Lynch report notes that very high income families often aim at a "tax-efficient transfer of wealth to the next generation" and they "place high importance on legacy planning for future generations."[21] Indeed, the report finds that many ultrawealthy families are creating "100-year plans" for optimal long-term wealth transfers.

Billions of dollars of assets are shifted from countries that have wealth, estate, and inheritance taxes to jurisdictions that do not. Hong Kong recently abolished its estate tax due to international tax competition. The *South China Morning Post* noted that the reform makes Hong Kong "an even more attractive option worthy of consideration by those seeking to secure their assets and protect them from unfair taxation."[22] In response, Singapore abolished its modest estate tax in 2008 to retain its competitive edge.[23] The Singaporean government "was aware that other jurisdictions, including Australia, Malaysia, New Zealand, and Hong Kong, had abolished estate duty in recent years."[24]

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Figure 3.6 shows that the United States has the third-highest estate or inheritance tax rate among the 30 OECD countries.[25] The U.S. rate of 45 percent is much higher than the average OECD rate of 17 percent. There are nine OECD countries that have no estate or inheritance taxes, including Australia, Canada, New Zealand, and Sweden. (Some countries, such as Canada, do impose capital gains taxes on unrealized gains at death.) Additionally, a PricewaterhouseCoopers survey of 50 countries found that 24 had no estate or inheritance taxes.[26] Another way to compare estate taxes is to look at estate tax revenue as a share of a country's gross domestic product. By that measure, the United States also has one of the highest burdens.[27]

U.S. policymakers have been considering eliminating the federal estate or death tax for years. There is a growing realization that the estate tax harms the economy by suppressing investment. The tax also generates huge tax avoidance. An industry of high-paid lawyers busies itself with paperwork, litigation, and creating schemes to minimize death taxes through trusts, life insurance, and other vehicles. This avoidance activity, and the negative economic effects of the estate tax, reduce taxable income under both the estate and income taxes. As such, many economists think that the tax raises no net revenue for the government.[28]

Congress enacted modest estate tax relief in a 2001 law. Bizarrely, this law repeals the estate tax fully in 2010, but then suddenly resurrects it in 2011 with a top rate of 55 percent. Everyone agrees that Congress needs to revisit this legislation, and so a permanent repeal may be in the works. That would be a win for all Americans—Harvard University's Greg Mankiw explains that "repeal of the estate tax would stimulate growth and raise incomes for everyone."[29]

Taxes on Corporate Income

Corporate tax rate cuts around the world have been just as dramatic as individual tax rate cuts. Corporate rate reductions began in the 1980s with cuts by Britain and the United States. Britain cut its corporate tax rate from 52 percent to 35 percent between 1982 and 1986. The United States followed by cutting its federal rate from 46 percent to 34 percent effective in 1987. Major rate cuts followed in Australia, Canada, France, Germany, Japan, and other countries.[30] The average corporate tax rate in major nations was above 40 percent from the 1960s to the mid-1980s, but has fallen rapidly since then.[31]

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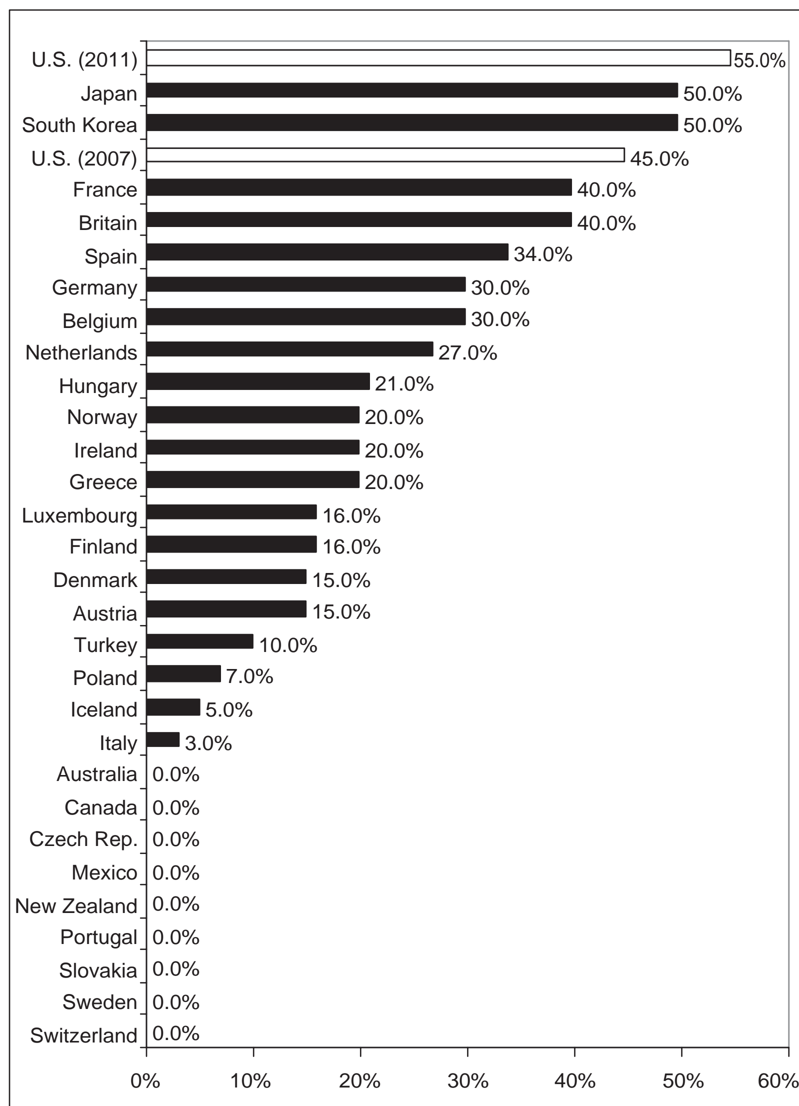
Figure 3.6
TOP ESTATE AND INHERITANCE TAX RATES IN THE OECD, 2007



SOURCE: Authors' calculations, based on various sources, including PricewaterhouseCoopers and the American Council for Capital Formation, "New International Survey Shows U.S. Death Tax Rate among Highest," July 2005.

This first round of tax cutting was driven by President Ronald Reagan and Prime Minister Margaret Thatcher and their personal beliefs in pro-market reforms. But their policy actions could not be ignored by other countries, and tax competition was kicked into high gear. Canadian policymakers, for example, knew that they had to respond to the U.S. corporate tax cut because of the huge size of America's economy. If they did not take action, U.S. companies could have simply drained profits out of their Canadian subsidiaries by shifting real investment and using various financial techniques. Canada moved quickly to cut its corporate tax rate to stop its tax base from shrinking.

Ireland was also a leader on business tax cuts, which helped transform the island from a backwater to the high-growth "Celtic Tiger." Irish incomes went from 30 percent below the European average in the 1980s, to 40 percent above the average today.[32] In 1980, Ireland enacted a corporate tax rate of 10 percent for manufacturing, and the low rate was subsequently extended to high technology, financial services, and other industries. More recently, Ireland established a 12.5 percent tax rate for all corporations, which is one of the lowest rates in the world. The Emerald Isle has enjoyed booming growth in computers, insurance, banking, pharmaceuticals, and other industries.

A second round of corporate tax cutting began in the mid-1990s and is still going strong. Figure 3.7 shows that the average corporate tax rate for the 30 OECD countries fell from 38 percent in 1996 to 27 percent by 2008.[33] The average rate will probably continue falling in coming years. Just this decade, 27 of 30 OECD countries have cut their corporate rates, with particularly large reductions in Canada, Germany, Greece, Iceland, Italy, Poland, Portugal, and Turkey.

The United States has completely missed out on this second round of corporate taxes, and now has the second-highest corporate tax rate in the OECD, indeed in the world. Figure 3.8 shows that the U.S. tax rate is 40 percent, which is now 13 percentage points above the OECD average. These data include both the federal and average state or provincial rates. Thus, the U.S. rate includes the federal rate of 35 percent plus the average state rate. The average corporate rate in the states is actually higher today than in 1980.[34] (Table A.2 in the Appendix has country data back to 1996.)

Thanks to vigorous tax competition, corporate tax rates have fallen particularly rapidly in the European Union. The average corporate

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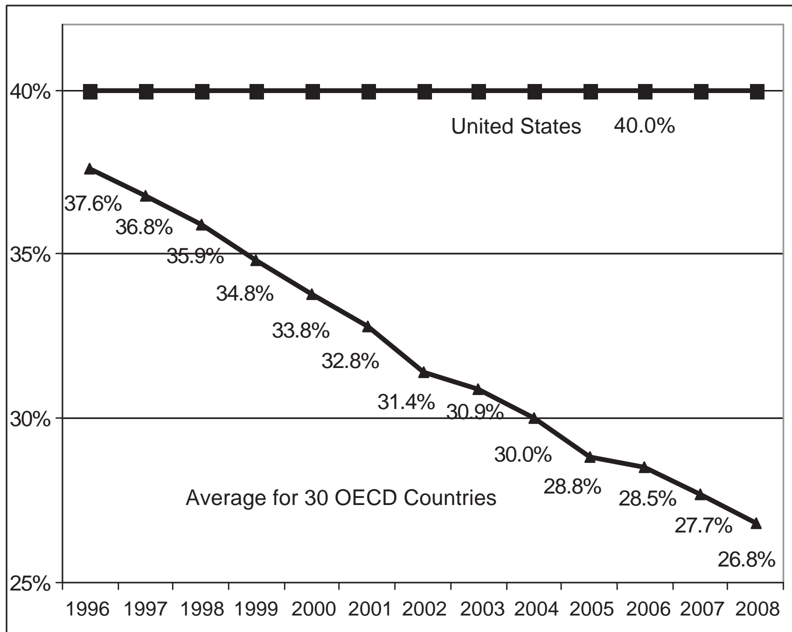
Figure 3.7
TOP CORPORATE INCOME TAX RATES



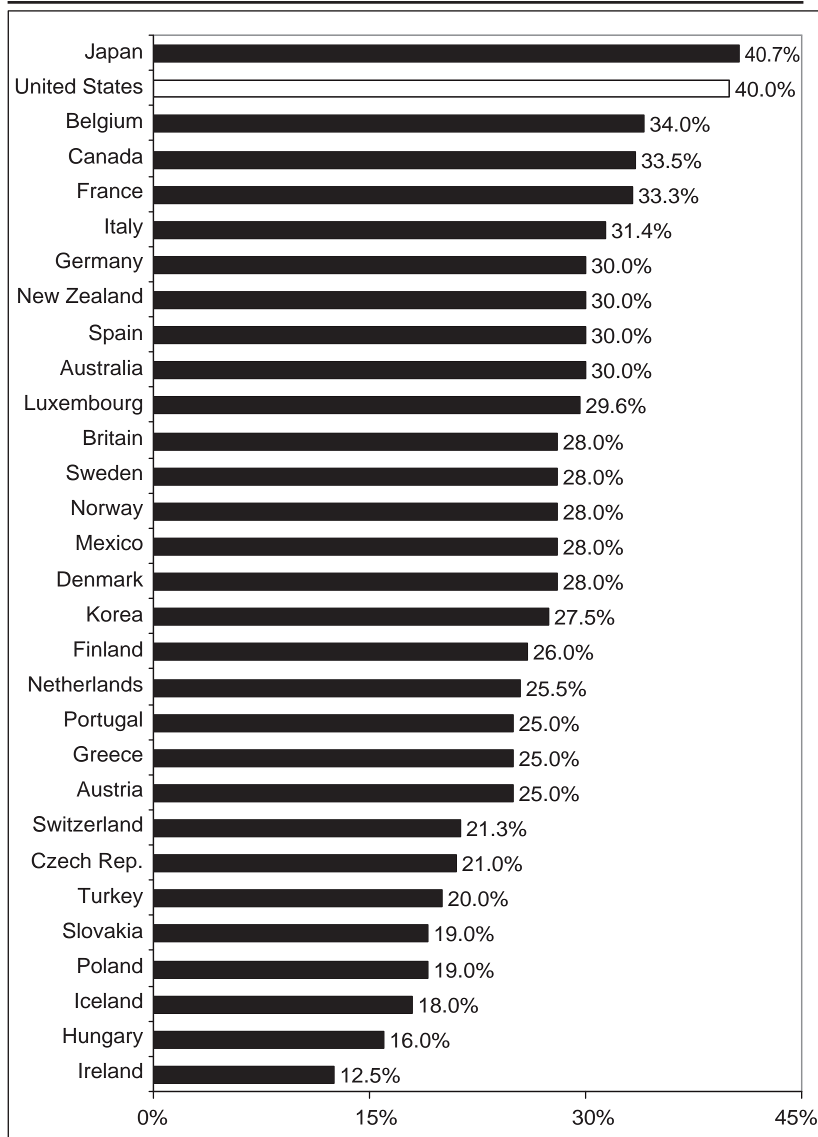
SOURCE: KPMG, "Corporate and Indirect Tax Rate Survey," 2007. Updated by the authors to 2008. Data include both national and subnational taxes.

tax rate in the EU fell from 38 percent in 1996 to 24 percent in 2007, or 16 points below the current U.S. rate.[35] The growing economic integration of the EU has put strong competitive pressures on its 27 member nations.

Corporate tax cuts are being announced so frequently that they are hard to keep track of. Here are some recent corporate tax cuts, and likely future cuts, in major economies:

- Germany cut its federal corporate rate from 25 percent to 15 percent effective for 2008. With municipal trade taxes and a solidarity surcharge, the total German corporate tax rate is now about 30 percent.[36]
- Italy cut its combined federal and regional rate from 37 percent to 31 percent for 2008.

Figure 3.8
TOP CORPORATE INCOME TAX RATES IN THE OECD, 2008



SOURCE: KPMG, "Corporate and Indirect Tax Rate Survey," 2007. Updated by the authors to 2008. Data include both national and subnational taxes.

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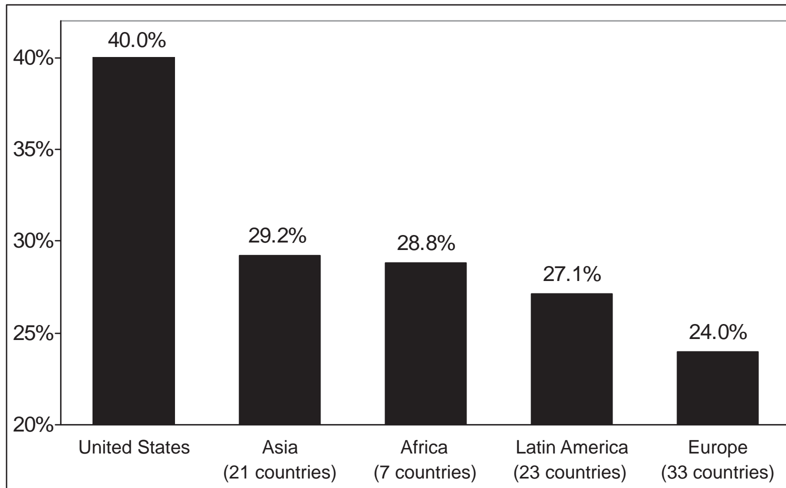
Figure 3.9
TOP CORPORATE INCOME TAX RATES, AVERAGES BY REGION, 2007



SOURCE: KPMG, "Corporate and Indirect Tax Rate Survey," 2007. Data include both national and subnational taxes.

- Canada is cutting its federal corporate rate from 21 percent to 15 percent over a period of years.
- Spain cut its corporate rate from 35 percent in 2006 to 30 percent in 2008.
- Britain cut its corporate tax rate from 30 percent to 28 percent in 2008.
- Korea's new president has cut that nation's federal corporate rate from 25 percent to 22 percent (not shown in figure 3.8).
- Indonesia cut its top corporate tax rate from 30 percent to 25 percent in 2008.
- Japanese policymakers have been actively discussing a corporate tax rate cut.
- French President Nicholas Sarkozy has proposed a corporate tax rate cut.

Corporate tax cutting is not just an OECD trend, but a global trend. Figure 3.9 shows average corporate tax rates on four continents.[37] The U.S. rate is far higher than the average rates in Africa, Asia, Europe, and Latin America. Just since 2000, the corporate tax rate

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fell from 36 to 29 percent in Israel, 37 to 30 percent in Panama, 35 to 24 percent in Russia, 26 to 18 percent in Singapore, and 33 to 28 percent in Vietnam. Kuwait cut its uniquely high 55 percent corporate tax to 15 percent, and Egypt cut its rate from 40 percent to 20 percent. Some other African countries have also cut their rates in recent years, including Ghana (33 to 25 percent) and Guinea-Bissau (39 to 25 percent).[38] America's high corporate tax rate is looking ever more antiquated in today's dynamic world economy.

Interestingly, numerous corporate tax cuts have been supported by left-of-center political parties and governments. That was the case in Sweden and Norway in the early 1990s, Britain in the late 1990s, and Germany and Canada this decade. Leftist politicians usually oppose cuts to top individual tax rates, but they often put their ideology aside with respect to corporate taxes because of their desire to improve economic competitiveness.

Tax reforms in some countries have aimed at equalizing top corporate and individual rates. In the past, Australia, Denmark, and other countries "reformed" their systems by increasing the top corporate rate to match the top individual rate. However, competitiveness has now trumped that goal and these countries have reversed course and cut their corporate rates.[39] Today, as corporate tax rates are falling, they are creating some pressure on countries to reduce top individual tax rates as well.

Thus far, we have looked at *statutory*, or officially listed, corporate tax rates. Those rates are just one measure of the corporate tax burden. Another measure is the *effective* tax rate, which measures taxes paid as a share of pretax profits. Taxes paid are determined by the statutory rate and the definition of taxable income, which is affected by depreciation deductions and other provisions. One type of effective tax rate, the *marginal effective* tax rate, measures taxes on an additional unit of investment.

As with statutory rates, effective corporate tax rates are falling.[40] In the 1980s, many countries cut statutory rates while broadening corporate tax bases, often by reducing depreciation deductions and thus increasing taxes on capital investment. As a result, effective tax rates fell only modestly. But since the mid-1990s, there has been much less broadening of tax bases, at least with regard to depreciation deductions.[41] The result is that effective tax rates have fallen along with statutory rates in recent years.

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The United States has one of the world's highest effective corporate tax rates. A 2007 study by tax scholar Jack Mintz compared marginal effective tax rates across 80 countries.[42] At 38 percent, the United States had the fourth-highest rate among the countries, and the highest among the subset of 30 OECD countries. There are various ways to measure marginal effective rates, but most studies of tax rates on equity-financed investment show the United States having one the most uncompetitive systems.

For tax competition, both statutory and effective tax rates are important because they both affect corporate decisionmaking. Generally, effective rates influence business decisions regarding capital investment. Scholars find that large and discrete investment choices, such as choosing the best country for a new factory, are driven by *average* effective tax rates, whereas smaller incremental decisions, such as buying a new machine, are driven by *marginal* effective tax rates.

Statutory corporate tax rates affect both investment decisions and tax avoidance decisions, such as the shifting of reported profits between countries. "Reported income of corporations can be highly elastic with respect to the statutory tax rate since income can be easily shifted from one tax jurisdiction to another without moving real assets."[43] Statutory rates are also important because they are highly visible symbols of a country's tax burden—when a country cuts its statutory rate, it sends a powerful "open for business" signal to global investors. We will discuss corporate tax rates and corporate tax avoidance further in Chapter 6.

Taxes on Corporate Capital Gains

An important, but often overlooked, aspect of corporate taxation is the tax rate on corporate capital gains. Corporate capital gains arise, for example, when companies sell shares they own of other companies. Consider a large company that invests in smaller companies to help them develop new technologies. If and when such venture investments are successful, the large company will usually want to sell its holdings and redeploy its funds into new investments. But the corporate capital gains tax stands as a barrier to such efficient redeployment of assets. As with individual capital gains taxes, corporate capital gains taxes create "lock-in" of share ownership, which reduces capital market efficiency.

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In the United States, the federal tax rate on corporate capital gains is the same high rate as the regular corporate tax rate of 35 percent. Unrealized corporate capital gains in the United States amount to more than $800 billion, suggesting that the inefficiency from this high rate and investment lock-in is large.[44] In addition to the problem of lock-in, corporate capital gains taxes discourage investment by adding an additional layer of tax on corporate equity. The high rate also prompts a great deal of wasteful tax planning by businesses to get around the tax.

The high U.S. tax rate on corporate capital gains contrasts with the much more favorable treatment found in most other countries. A recent study found that 16 of 27 EU countries provided full or partial exemption of capital gains taxes when companies sell shares of subsidiaries.[45] Countries that have full exemption include Germany, Ireland, the Netherlands, New Zealand, Spain, Switzerland, and the United Kingdom.[46]

Countries that do not tax corporate capital gains provide a good location for corporate headquarters. In such countries, corporations are free to restructure their affiliates with minimal tax consequences. Germany's tax reform of 2000 abolished the country's 50 percent corporate capital gains tax to encourage restructuring in German industry. Interestingly, those reforms prompted the European Union to express concern that Germany was practicing "unfair tax competition" because the reform would help the country attract greater foreign investment.[47]

Taxes on Cross-Border Investment

Global tax competition has driven down "withholding taxes" on cross-border investment. These are taxes placed on payments of interest, dividends, capital gains, and royalties to foreign individuals and businesses.[48] In the past, if a German investor bought a bond issued by Ford Motor Company, his receipt of interest payments would have been subject to U.S. withholding taxes. But such withholding taxes have fallen dramatically in recent decades.

Withholding taxes create a disincentive for investment because investors do not want to put their money into countries that have an "exit fee" on their repatriated earnings. Because investors have choice in today's global economy, even small taxes on cross-border financial flows drive away large amounts of capital. If the United

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States tried to place a heavy tax on German investors in U.S. bonds, those investors would simply move their funds to countries with lower taxes.

The United States has been a leader in reducing withholding taxes. Interest on U.S. bank deposits paid to foreigners has long been tax-exempt.[49] And portfolio interest paid to foreigners on government and private bonds was made tax-exempt in 1984. Today, a foreign investor who buys a federal government or Ford Motor Company bond pays no U.S. taxes on the interest. Interestingly, the 1984 law change was partly motivated by the federal government's needing to attract inflows of foreign credit due to the large budget deficits at the time.

The effect of the U.S. law change in 1984 was a classic example of tax competition. As one expert noted, "One after other, all the major economies abolished their withholding tax on interest for fear of losing mobile capital flows to the U.S."[50] Today, "most developed countries levy no withholding tax on interest paid to non-residents on bank deposits, government, or corporate bonds."[51]

Countries realized that taxes on cross-border interest would simply cause capital to flow to other lower-tax locations. Germany learned this lesson from episodes in the 1980s and 1990s. It tried to introduce withholding taxes on interest paid to foreigners, and there was a big response as investors withdrew their German deposits and shifted them to low-tax places such as Luxembourg.[52]

For the United States, the tax exemption on interest paid to foreigners has helped attract large capital inflows. There are more than $2.6 trillion in foreign deposits in U.S. banks today.[53] Miami has become a banking center for Latin America. Following the 1984 law change, about $300 billion worth of Latin American investments were moved to the United States.[54] Wealthy Latin Americans hold most of their financial assets abroad, which is not surprising since that region has a generally poor record on property rights and political stability.[55]

But Latin America has recently taken some tax steps in the right direction. Brazil eliminated its withholding tax on government bond interest paid to foreigners, and the country experienced a large surge of inward investment.[56] And Mexico eliminated withholding taxes on dividends paid to the United States to attract more investment.

In addition to the tax exemption on interest, U.S. capital gains paid to foreigners, except for gains on real estate, are exempt from

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federal taxation. Many experts think that the United States should also eliminate taxes on dividends paid to foreigners.[57] Currently, sophisticated investors can avoid dividend withholding taxes, and thus they raise little money.[58] Their effect is simply to deter valuable equity investment in the United States.

A tool for cutting withholding taxes has been the more than 2,000 bilateral tax treaties that are in place globally.[59] Tax treaties help ensure that cross-border financial flows are not double-taxed, as they usually cut withholding taxes on interest, dividends, and royalties. For example, a 2004 treaty between the United States and Japan cut withholding taxes on royalties and intercorporate dividends to zero. These reforms should lead to increased trade in technology goods and increased two-way investment. U.S. tax treaties often drop the tax rates on cross-border royalties and interest to zero, while sharply cutting or eliminating taxes on intercorporate dividends.[60]

The tax cuts in treaties have encouraged global integration, while benefiting savers and investors worldwide. In 2007, Canada and the United States signed a tax treaty that reduced the withholding tax on interest payments from 10 percent to zero. Washington tax treaty specialist, Carol Dunahoo, noted, "Any time governments agree to lower withholding rates, it will encourage cross-border trade and investment and, in the case of interest, lower the cost of borrowing, both for businesses and consumers."[61]

Inefficient Tax Competition

Thus far, we have given the good news regarding how tax competition is spurring sensible pro-growth tax reforms. But tax competition is a little messier than that. Aside from simple rate cuts, tax competition has prompted countries to offer narrow credits, tax holidays, and other special breaks. One survey found that 103 countries offered various special breaks to foreign companies.[62] These sorts of breaks have become more popular in recent years, particularly among developing countries.[63]

Consider India. Most news reports of that nation's booming technology industry focus on the large pool of inexpensive and well-educated engineers and scientists. But another reason why India has attracted large high-tech investments is that it gives special tax breaks to software and Internet companies. India recently created

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special economic zones that offer 15-year tax-free holidays and exemptions from import duties.[64]

Multinational companies often negotiate with nations such as India to provide them with a package of special tax breaks. Intel Corporation argues that it costs $1 billion more to build and operate a semiconductor plant in the United States than abroad.[65] Most of that extra cost is "directly attributed to tax benefits or the lack thereof in the United States relative to what's being offered elsewhere," says Intel Chief Executive Officer Paul Otellini.[66] Intel pays lower statutory rates abroad, but it also receives special tax breaks, such as tax holidays, in places like China, Israel, and Malaysia. State and local governments in many countries also provide special tax breaks.

Economists generally disapprove of narrow incentives and special breaks because they cause distortions. Targeted tax breaks also add complexity to tax codes and they increase opportunities for corruption. Besides, special incentives are often Band-Aids for fundamental policy problems in many countries. For example, India offers narrow tax incentives, yet it ranks 69th in the world on basic economic freedoms.[67]

Our advice for developing countries is to scrap the special tax deals, improve basic economic freedoms, and apply low tax rates all around. Hopefully, countries will move in that direction because as tax competition pushes down general corporate tax rates, the benefit of special loopholes is reduced. Corporate tax lobbyists will fight harder to get a narrow loophole in a tax system with a 35 percent rate than in a system with a 15 percent rate.

Some countries have moved in a reform direction and are reducing narrow corporate tax breaks. China has long offered tax breaks in special economic zones, such as Pudong and Shenzhen. But in 2008, China replaced most of those special breaks with a standard 25 percent corporate tax rate.

An even more dramatic reform was in Egypt. In 2005, that nation cut both its top corporate and individual rates from 40 percent to 20 percent, while eliminating a huge range of narrow tax incentives and holidays.[68] The head of Egypt's tax agency argued that the lower rates would be more effective at attracting foreign investment than the prior mess of special incentives.[69] The country's finance minister said that the system had been "almost as complex" as the U.S. system, but that with special breaks ended and rates slashed, the government

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has changed from one "that preys upon its citizens to one that supports them."[70]

Hopefully, other developing countries will end their special breaks while cutting their general corporate tax rates. Certainly, the United States should not offer narrow tax breaks. But U.S. policymakers do need to be aware of the wide range of tax benefits that are available to companies that locate abroad. A federal corporate tax cut is needed, not just to match lower rates abroad but also to help offset the special tax benefits offered by many other countries.

Tax Competition and the Size of Government

We have surveyed how tax competition has promoted cuts to individual income taxes, capital gains taxes, dividend taxes, corporate taxes, wealth taxes, and withholding taxes. Tax competition has given rise to dramatic pro-growth tax reforms across the globe.

Nonetheless, tax competition has not led to a reduction in overall tax revenues in most countries. Tax competition has yet to "starve the beast" of bloated government. Looking at the 30 OECD nations, the average ratio of taxes to gross domestic product edged up from 33.9 percent in 1990 to 36.2 percent in 2000.[71] In 2005, the ratio was still at 36.2 percent, and thus the upward drift seems to have halted. Across 25 European Union countries, the tax ratio peaked at 42.3 percent in 1999, and then declined to 40.9 percent by 2005.[72] The fear of tax competition's opponents—and the hope of its supporters—of greatly shrinking government has not yet been realized.

However, we suspect that many governments would have grown larger without the rise in competition. The growth in governments has slowed in the past 15 years or so. Many major economies show a pattern of large increases in taxes as a share of GDP between the 1960s and the 1980s, then a leveling off since then. That was the pattern, for example, in Belgium, Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, Spain, and Sweden.[73] In some countries, including Estonia, Ireland, and Slovakia, the tax share of the economy has actually declined substantially in recent years.

Underneath the overall measure of tax burdens are a lot of moving parts. As a share of GDP, average individual income tax revenues in the OECD fell from 10.5 percent in 1990 to 9.2 percent in 2005.[74]

Income taxes are substantially affected by tax competition. By contrast, consumption taxes rose from 10.5 percent to 11.4 percent during the same period. Consumption taxes are less affected by tax competition, although they are not immune.

Another major tax in most countries is a payroll or wage tax used to fund social insurance programs. Payroll taxes increased from 7.8 percent to 9.2 percent of GDP between 1990 and 2005 in the OECD, on average. Both payroll taxes and consumption taxes tend to have lower and flatter rate structures than income taxes, and thus are better suited for global tax competition. Also, payroll and consumption taxes are not imposed on savings and investment, and are thus more competitive and pro-growth than income taxes.

Corporate income taxes present a different situation. The corporate tax base is very mobile and responsive to tax competition, yet corporate tax revenues have soared in recent years in most countries. In the OECD, corporate tax revenues as a share of GDP grew modestly from 2.2 percent in 1965 to 2.6 percent in 1990.[75] Then in the 1990s—just as corporate tax rate cutting was kicking into high gear—corporate tax revenues started to grow rapidly. By 2005, corporate tax revenues hit 3.7 percent of GDP.

How could revenues rise sharply as rates were falling? In the 1980s, corporate tax bases were broadened in many countries to partly offset rate cuts. But there has been less base broadening in recent years. Instead, the main factor causing corporate tax revenue growth appears to be dynamic responses to tax rate cuts. As tax rates on corporate profits have been cut, more profits have been reported because tax avoidance has fallen and economic activity has increased. We examine the dynamic responses to corporate tax cuts further in Chapter 6, but here we conclude that tax competition and tax rate cuts have not yet starved the beast, although we hope that time will come.

In the next chapter, we turn to real-world experiments in dynamic pro-growth tax policy—the flat tax reforms of Eastern Europe. The World Bank noted: “Reducing tax rates has been a trend in Eastern Europe and Central Asia. Most reformers—Armenia, Bulgaria, Estonia, Kazakhstan, Slovakia, Russia—have seen tax revenues rise.”[76] The flat tax nations are enjoying soaring investment, falling tax avoidance, and rapid economic growth. They are the current vanguard of global tax competition.

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4. Flat Tax Club

In the 1980s, the big story in tax competition was the reduction in individual and corporate income tax rates in major industrial countries such as Britain and the United States. In the 1990s, tax rate cuts intensified and spread to a broader group of countries. In this decade, the most exciting tax competition story is the flat tax revolution. By 2008, 25 jurisdictions had adopted single-rate individual income taxes. This "flat tax club" is growing larger every year.

Ironically, it is the former communist world that is the hotbed of flat tax reforms. From the Czech Republic in the west to Mongolia in the east, 17 nations in the former Soviet bloc have joined the flat tax club. These nations have adopted flat taxes to spur growth, reduce tax avoidance, and attract foreign investment. Reform leaders, such as Estonia and Slovakia, inspired a broader group of countries to join the flat tax revolution. In numerous countries, flat tax reforms have been supported by political parties on both the right and the left.

Flat tax countries have made the choice to scrap multirate, or "progressive," income tax systems in favor of single-rate systems that have fewer deductions, exemptions, and credits. Today, the average individual tax rate in the flat tax countries is just 17 percent. Most of the flat tax countries have also cut their corporate tax rates, and the average corporate rate in those nations stands at just 18 percent.

In this chapter, we examine the structure of flat taxes and take a detailed look at reforms in the flat tax countries. The flat tax revolution will likely continue to spread, perhaps into Western Europe where countries are feeling competitive pressures from the flat tax nations to the east. The flat tax has been debated in Britain, Germany, and other countries.[1] Africa has its first flat tax nation thanks to reforms in Mauritius in 2007. And Asia may also be ripe for flat tax reforms. In 2007, Mongolia became the second Asian jurisdiction, after Hong Kong, to join the flat tax club. In the United States, the

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flat tax has been debated for years but not enacted. Hopefully, this discussion provides U.S. policymakers with the encouragement they need to jump on board the flat tax express.

What Is a Flat Tax?

A "flat tax" generally refers to a direct tax on individuals that has a single statutory rate. The flat tax concept also embodies the ideas that special tax preferences should be abolished, people should be treated equally, and income should be taxed only once. The ideal flat tax structure was described by Robert Hall and Alvin Rabushka of the Hoover Institution in a 1983 book, *The Flat Tax*.[2] The Hall-Rabushka flat tax was championed in the 1990s by then House majority leader Dick Armey and presidential candidate Steve Forbes. The Hall-Rabushka flat tax system would abolish the federal income tax and replace it with a tax system with three key features: a single flat rate, elimination of special preferences, and neutral treatment of savings and investment.

Single Flat Rate. The flat tax has a single statutory rate above a basic exemption amount. The goal is to treat taxpayers equally while bringing the tax rate down as low as possible to reduce economic distortions. Equality under the law is a bedrock principle of justice, and that is the promise of the flat tax. A low, flat rate reduces the tax penalty on productive activities and encourages tax compliance. In addition, a low tax rate is increasingly important to attracting labor and capital in the competitive global economy.

Elimination of Special Preferences. The flat tax eliminates provisions of the tax code that create special advantages for certain people and industries. By getting rid of deductions, credits, and other narrow benefits, economic growth is promoted by allowing resources to flow to the highest-valued uses, rather than to activities that have unwarranted tax advantages. Cleaning the special-interest provisions from the tax code would result in huge simplification, and it would reduce political corruption caused by the trading of campaign support for narrow tax benefits.

Neutral Treatment of Savings and Investment. The optimal flat tax would tax each source of income just once. By contrast, under the current U.S. income tax, some income is not taxed and other income is taxed multiple times. Under a well-designed flat tax, there would

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be no capital gains tax and no double taxation of dividends. A flat tax in the design of Hall-Rabushka would end the tax bias against savings and investment that occurs under the current federal income tax.

The countries we examine in this chapter have all adopted a single tax rate for their individual tax systems. That is the basic ticket to join the flat tax club. In addition, nearly all the flat tax countries have taken strides toward eliminating special preferences and loopholes in their tax codes. Finally, most flat tax countries have reduced the tax bias against savings and investment to create a more neutral and efficient tax code. No country has adopted the full Hall-Rabushka package yet, but flat tax countries have taken big steps toward simple, fair, and efficient tax systems.

The Rise of Flat Taxes

Flat taxes have long attracted interest from tax experts, but the challenge has been to convince policymakers to proceed with reforms. A flat tax is contrary to the interests of most politicians because it prevents them from micromanaging the economy through the tax code. Under a flat tax, politicians would not be in the business of offering narrow tax benefits to certain favored interests.

Another hurdle to reform has been that some experts and international organizations have argued that flat taxes are not practical in the real world. Hong Kong has had a flat tax since 1947, but that was considered to be a special case because of that jurisdiction's colonial status. There have been flat tax systems in Jersey and Guernsey, but those British territories are small and little known. And Jamaica has had a flat tax since 1986, but it has been overlooked perhaps because it had a high rate initially and Jamaica is a developing nation.

The Baltic nations of Estonia, Latvia, and Lithuania adopted flat tax systems in the 1990s, but critics downplayed those reforms because those countries were relatively small. This decade, Russia and other large Eastern European nations began adopting flat taxes, and commentators started to concede that flat taxes made sense, at least for transition economies.

However, some critics continued to dismiss the spread of flat taxes as if it were a temporary fad. An International Monetary Fund study in 2006 stated boldly, "Looking forward, the question is not so much

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whether more countries will adopt a flat tax as whether those that have will move away from it."[3] Yet a dozen more nations have joined the flat tax club since the IMF assessment, including the first mature and high-income economy, Iceland.

Every nation that has adopted a flat tax has kept it. In a few cases, governments that implemented flat taxes eventually lost political power, but incoming parties have not reversed course and repealed flat taxes. Perhaps some flat tax reforms will be reversed in the future, but the durability of flat taxes thus far is a testament to how well they work in practice.

Table 4.1 shows the world's 25 flat tax jurisdictions, in order of the year that the flat tax became effective.[4] Jersey was the first in 1940, whereas Bulgaria and the Czech Republic were the most recent to join the flat tax club in 2008. Most flat taxes have been enacted since the mid-1990s, and more nations are joining the club every year. Note that numerous jurisdictions, such as the Bahamas, impose no income taxes at all—they essentially have flat taxes of zero percent. But we stick to the countries that have replaced their multirate income taxes with simple flat taxes. Also, we found a number of countries that have tax systems that are close to being flat taxes, but they are not quite there.[5]

Here are some patterns we noticed in reviewing the history of flat tax reforms:

Flat Tax Rates Are Low. Nations are generally choosing flat taxes with low rates. Most flat taxes adopted this decade have rates of 15 percent or less. Low rates are important because the economic benefits of flat taxes increase as rates are reduced. Lower rates increase productive activities and they reduce unproductive activities, such as tax avoidance. The competitive spirit has prompted many flat tax nations to adopt lower tax rates than nearby countries.

Flat Tax Rates Are Falling. Flat tax rates have fallen in numerous countries. Estonia cut its flat tax rate from 26 percent to 21 percent, and the rate is scheduled to fall further. Lithuania cut its rate from 33 percent to 24 percent. Macedonia enacted a 12 percent flat tax in 2007, but it reduced the rate to 10 percent in 2008. Montenegro is scheduled to drop its flat tax rate from 15 percent to 9 percent in 2010. The Czech Republic's flat tax rate is scheduled to fall from 15 percent to 12.5 percent in 2009.

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Table 4.1
THE FLAT TAX CLUB: INCOME TAX RATES, 2008

Jurisdiction	Year Individual Flat Tax Adopted	Individual Flat Tax Rate	Corporate Tax Rate
Jersey	1940	20.0%	20.0%
Hong Kong	1947	15.0%	16.5%
Guernsey	1960	20.0%	20.0%
Jamaica	1986	25.0%	33.3%
Estonia	1994	21.0%	21.0%
Lithuania	1994	24.0%	15.0%
Latvia	1995	25.0%	15.0%
Russia	2001	13.0%	24.0%
Slovakia	2004	19.0%	19.0%
Ukraine	2004	15.0%	25.0%
Iraq	2004	15.0%	15.0%
Romania	2005	16.0%	16.0%
Georgia	2005	12.0%	15.0%
Kyrgyzstan	2006	10.0%	10.0%
Pridnestrovie	2006	10.0%	10.0%
Trinidad	2006	25.0%	25.0%
Iceland	2007	35.7%	18.0%
Kazakhstan	2007	10.0%	30.0%
Mongolia	2007	10.0%	25.0%
Macedonia	2007	10.0%	10.0%
Montenegro	2007	15.0%	9.0%
Albania	2007	10.0%	10.0%
Mauritius	2007	15.0%	15.0%
Czech Rep.	2008	15.0%	21.0%
Bulgaria	2008	10.0%	10.0%
Average of 25 jurisdictions		16.6%	17.9%

SOURCE: Authors' compilation. Estonia's corporate tax rate for retained earnings is zero.

The Flat Tax Is Resilient. No flat tax nation has reversed course and returned to a multirate tax system. Notwithstanding the lack of support for flat taxes from bureaucracies such as the IMF, flat tax nations are staying the course. There was a recent threat to the flat tax in Russia, but lawmakers ultimately rejected a scheme to create a multirate system with a top rate of 30 percent.[6] Slovakia elected

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a coalition of socialists and nationalists in 2006, leading many to conclude that the flat tax enacted in 2004 was in jeopardy. To the credit of Slovakia's leaders, they decided not to tinker with the goose that is laying golden eggs for the economy, and the flat tax is secure for the time being.

The Role of Tax Competition

How did an idea that many experts said was impractical, and that ran counter to the political impulses of many politicians, start sweeping the world in the 1990s? The answer was a combination of growing tax competition and the rise of market-oriented leadership in many former Soviet bloc countries. After the collapse of communism, nobody predicted that the flat tax would become ubiquitous in Central and Eastern Europe. By the early 1990s, tax competition was prompting many governments to cut tax rates, but the flat tax was unknown outside of academic circles.

Estonia had the breakthrough reform with the introduction of a 26 percent flat tax in 1994. Prime Minister Mart Laar, a former history professor, provided the visionary leadership. Laar was wondering how to rescue the floundering Estonian economy and recalled reading that economist Milton Friedman had advocated a flat tax. Laar wisely ignored the advice of establishment tax experts in Estonia and the international bureaucracies, and he introduced Estonia's flat tax as part of a broad reform agenda.

Estonia's dramatic tax reform made its Baltic neighbors, Latvia and Lithuania, take notice. Those countries quickly proceeded to adopt their own flat taxes. Although all three Baltic nations initially introduced flat taxes with fairly high rates, those rates have been cut in the years since.

The flat tax revolution went through a dormant phase in the late 1990s, but was revived by the most surprising reform of all. Russia, the former epicenter of communism, scrapped its complex and "progressive" tax regime, and adopted a 13 percent flat tax in 2001. Russia also cut its corporate tax rate. Decades of class warfare went out the window and equal tax treatment for all was introduced.

Much of the credit belongs to Andrei Illarionov, who was an economic adviser to Vladimir Putin. The combination of Russia's prominence and the low flat tax rate created huge interest. Another factor that generated wide notice was that Russia's tax revenue

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began rising sharply after the introduction of the flat tax as tax evasion fell and the economy boomed.[7]

In 2004, Slovakia joined the flat tax club. Slovakia's 19 percent flat tax was an important development because the reform was quite close to the flat tax ideal. The flat tax in Slovakia has been a huge success, and the country has attracted large inflows of foreign investment. Slovakia's reform played a key role in the subsequent decisions to adopt flat taxes in Romania, Bulgaria, and the Czech Republic.

Looking ahead, other nations in Central and Eastern Europe have cut their income tax rates substantially, and are good prospects for joining the flat tax club. Hungary has a corporate tax rate of just 16 percent, and it sharply cut its top individual tax rate during the 1990s. Poland cut its corporate tax rate from 38 percent to 19 percent over the last decade. Slovenia is currently cutting its corporate tax rate from 25 percent to 20 percent, and last year it cut its top individual income tax rate from 50 percent to 41 percent.

Leaders in all three of these countries have proposed flat taxes, and the countries are feeling competitive pressures. When the Czech Republic announced its 15 percent flat tax in 2007, it prompted a Polish paper to observe: "Poland is surrounded by countries with low, flat tax rates. If Polish governments refuse to grasp the nettle and lower tax, investment might just head abroad."[8]

The nations that emerged from communism's collapse are leaders in the flat tax revolution. People in those nations endured decades of socialist propaganda. Now that they are free, they apparently have little sympathy for tax systems based on resentment and class warfare. They understand the importance of equal treatment, and that is one reason why flat taxes are so appealing.

On a practical level, growth was virtually nonexistent during the communist years and living standards stagnated. People in the former communist nations are anxious to catch up to their neighbors in Western Europe. The flat tax is a way of jump-starting growth so that the income gap between Western and Eastern Europe is narrowed. Every time another nation adopts the flat tax and enjoys faster growth, it encourages other countries to follow suit.

A final selling point of the flat tax in many countries has been that it is the best way to encourage tax compliance. Tax evasion emerged as a major problem after the collapse of communism, particularly since the early postcommunist governments usually imposed

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high tax rates. Under a low-rate flat tax, there is much less incentive to hide income from the tax authorities.

In promoting his country's dramatic flat tax reforms in 2007, Albanian Prime Minister Sali Berisha said, "The flat tax is intended to simplify tax collection, encourage the legalization of the shadow economy, attract foreign direct investment, and make the economy more competitive."[9] Similarly, here is a news story about the recent adoption of a 10 percent flat tax in Bulgaria:

> Former Prime Minister Ivan Kostov voiced support for the legislation, saying it will help combat the shadow economy, which is estimated to account for as much as 30 percent to 40 percent of the economy. A flat tax system is the only way to make oligarchs and rich Bulgarians pay their taxes, said Kostov, leader of the rightist party Democrats for a Strong Bulgaria. It also appears that attracting foreign direct investment by using a strategy successfully implemented by other nations in the region played a role in driving the legislation.[10]

Looking ahead, one wonders whether the flat tax can cross from the former communist world into Western Europe. Many politicians in Western Europe have been hostile to flat taxes and complain about "unfair tax competition" from the east. Western European countries have made substantial tax rate cuts since the 1980s, but there is still ideological resistance to flat taxation, as there is in the United States.

That is why the recent enactment of a flat tax in Iceland is so interesting. Nordic nations are supposed to be hotbeds of socialist thinking, but Iceland scrapped its multirate tax system in 2007 and adopted a 36 percent flat tax. That is a high rate, but the system treats everyone equally and treats income from savings and investment very favorably. We also suspect that the rate will fall over time. Hopefully, Iceland's reforms will begin the spread of the flat tax revolution across the western half of Europe.

Variations in Flat Tax Reforms

While a single individual tax rate gains a country entry to the flat tax club, there are variations in the structures of flat taxes between countries. One variation is that individual and corporate tax rates have been equalized in some countries but not others. Equalized rates are simple and they reduce tax distortions. Table 4.1 shows

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that equalized rates are in place in about half the flat tax countries. For example, Estonia's individual and corporate tax rates are 21 percent, and Bulgaria's rates are 10 percent. Countries such as Russia would benefit by dropping their corporate rates to the same low level as their individual rates.

Other variations in flat tax systems involve the treatment of savings and investment. Optimally, savings and investment should not be disfavored compared with consumption, which is the case under most income tax systems. Steps toward that goal include eliminating capital gains taxes, ending the double taxation of dividends, and repealing estate and wealth taxes. Generally, the flat tax countries do not have fully neutral treatment of savings and investment, but some come very close.

The Czech Republic and Hong Kong, for example, do not tax capital gains. Slovakia applies just a single layer of tax to corporate dividends at 19 percent. Latvia exempts domestic dividends from individual taxation, such that corporate earnings face just the 15 percent corporate-level tax. Finally, Estonia applies a tax rate of zero to retained corporate earnings, and applies just a single tax layer to earnings paid out. In all these cases, the treatment of savings and investment is far superior to their treatment under the U.S. income tax.

Beyond different tax structures, the flat tax countries have widely varying economic environments. A flat tax is a leap forward in economic policy, but it is not a cure-all. To prosper, countries need to combine a flat tax with strong property rights, a stable currency, moderate levels of government spending, and other market-based policies. The benefits of flat taxes are maximized if countries have pro-growth economic climates. A low-rate tax will not attract investment if investors are worried that their assets will be expropriated.

We looked at how the flat tax nations ranked in the Fraser Institute's *Economic Freedom of the World* study.[11] The study ranks countries on 42 measures, including property rights, monetary policy, and openness to trade. Flat tax jurisdictions Estonia, Hong Kong, and Iceland are among the freest economies in the world. Others, such as Russia and Ukraine, are not so free, and would gain more benefits from their flat taxes if they pursued broader economic reforms.

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Table 4.2
FLAT TAXES AND ECONOMIC FREEDOM

Jurisdiction	Freedom Rank 2005	Freedom Score 1995	Freedom Score 2005	Change in Score 1995 to 2005
Hong Kong	1	9.1	8.9	−0.2
Estonia	8	5.6	8.0	+2.4
Iceland	11	7.4	7.8	+0.4
Latvia	22	5.1	7.5	+2.4
Lithuania	22	4.9	7.5	+2.6
Mauritius	22	7.4	7.5	+0.1
Slovakia	32	5.4	7.3	+1.9
Kazakhstan	32	n/a	7.3	n/a
Jamaica	38	6.5	7.2	+0.7
Georgia	44	n/a	7.1	n/a
Mongolia	44	n/a	7.1	n/a
Czech Rep.	52	5.8	7.0	+1.2
Bulgaria	56	4.6	6.9	+2.3
Kyrgyzstan	60	n/a	6.8	n/a
Montenegro	60	n/a	6.8	n/a
Trinidad	60	6.7	6.8	+0.1
Romania	82	3.8	6.4	+2.6
Macedonia	86	n/a	6.3	n/a
Albania	97	4.5	6.1	+1.6
Ukraine	112	3.4	5.8	+2.4
Russia	112	4.0	5.8	+1.8

SOURCE: Authors' calculations based on James Gwartney and Robert Lawson, *Economic Freedom of the World* (Vancouver: Fraser Institute, 2007). No data for Jersey, Guernsey, Iraq, and Pridnestrovie. n/a = not available.

The good news is that virtually all the flat tax nations have increased their economic freedom in recent years. Table 4.2 shows the most recent rankings of economic freedom in the left-hand column. The two middle columns show the economic freedom scores (out of 10) for 1995 and 2005. In every country that has data, except Hong Kong, economic freedom has increased since 1995. Some flat tax countries, including Estonia, Latvia, and Slovakia, have substantially cut the overall burden of taxation as a share of their economies.[12] In sum, while some flat tax countries are still lacking in

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general economic freedom, virtually all flat tax countries are moving in the right direction.

The Success of Flat Taxes

Before we describe reforms in individual flat tax countries, we can make some general observations. First, virtually every flat tax country has enjoyed strong economic growth in recent years, according to IMF data.[13] Most flat tax countries have made a range of economic reforms, so many factors have helped spur growth. However, these nations are clearly illustrating that low tax rates and high growth go hand in hand. Real economic growth in the three Baltic nations of Estonia, Latvia, and Lithuania, for example, has averaged about 8 percent annually since 2000.[14] Georgia is another success story. Since its flat tax went into effect in 2005, its real growth has averaged 10 percent annually.[15]

Second, many flat tax countries are attracting large inflows of foreign direct investment. For example, in Estonia and Slovakia the stock of FDI as a percentage of gross domestic product reached 77 percent and 55 percent, respectively, by the end of 2006.[16] By contrast, the average FDI stock in Europe is 38 percent of GDP, and the FDI stock in the United States is just 14 percent of GDP.

Third, flat taxes are raising plenty of revenue for governments because they spur economic growth and reduce tax evasion. Research by economist Alvin Rabushka has found strong tax revenue growth in most of the flat tax countries after reforms were enacted. In Russia, for example, he calculated that individual income tax revenues tripled, in real ruble terms, in the six years following adoption of the flat tax.[17] Rising tax revenues have allowed many flat tax countries to reduce their flat tax rates.

The following are descriptions of tax reforms in the major flat tax jurisdictions. The discussion goes chronologically from Hong Kong in 1947 to the Czech Republic and Bulgaria in 2008.

Hong Kong

Hong Kong has been an autonomous region of China since 1997, when it was handed over after more than 150 years of British rule. It has long had one of the world's most efficient tax systems. Low taxes, open trading, and good governance have created enormous prosperity for Hong Kong's 7 million residents. One of the premier

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trading and financial centers, Hong Kong is generally regarded as the freest economy in the world. The jurisdiction's "tradition of simple and low taxes, combined with a comparatively easy-going government . . . is widely seen as a main reason for its stunning rise to prosperity," noted *The Economist*.[18]

Hong Kong has an optional flat tax of 15 percent on individual income. Taxpayers can pay tax under a system with graduated rates up to 17 percent, or they can pay the 15 percent flat rate and forgo a large basic allowance. The corporate tax rate in Hong Kong is just 16.5 percent. The individual and corporate tax rates have fluctuated over the decades, but have always been less than 20 percent.[19]

Hong Kong's low tax rates provide assurance to those who work hard that the government will take just a small portion of their earnings. There is no income tax withholding in Hong Kong, so taxpayers write a check to the government for their entire tax liability. That has created a powerful restraint on government growth. Interestingly, despite the virtually flat income tax structure, the wealthy pay most income taxes in Hong Kong. About 60 percent of workers pay no tax on their wages, whereas the top 8 percent pay more than half the total tax burden.[20]

Hong Kong has remarkably low taxation of savings and investment. The general tax rates on individual capital gains, interest, and dividends are zero. The tax system is territorial, so there is no double taxation of income earned abroad. Hong Kong has no wealth tax, and it recently abolished its estate tax in fear that it might lose some of its tax competitiveness. As one Hong Kong tax expert put it, "Hong Kong isn't really into taxing people . . . particularly wealthy people."[21]

Hong Kong's low taxes, strong property rights, and advanced financial institutions have made it a tax haven. It has the good fortune of benefiting from pressure by the Organization for Economic Cooperation and Development to close down other tax havens. As we discuss in Chapter 8, the OECD has not blacklisted Hong Kong, and that has led investors to shift funds to Hong Kong to take advantage of the jurisdiction's low taxes.[22]

Other features of Hong Kong's fiscal system are also impressive. There are no social security payroll taxes in Hong Kong. Instead, workers put 10 percent of their income into private retirement accounts. There is also no general sales tax or value-added tax in

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Hong Kong. The entire tax code, even after being in place for 60 years, is only about 200 pages long. Hong Kong has a low overall burden of government, with revenues and spending of less than 20 percent of GDP.

Hong Kong began with no natural resources, just low taxes and good governance. But that was enough to make it one of the wealthier places on earth. Hong Kong's per capita income in 2007, based on purchasing power parities, was about $42,000.[23] That was ahead of France and Germany, and not far behind the United States at about $46,000. Hong Kong's chief executive, Donald Tsang, discussed Hong Kong's economic success in a 2007 interview:

> We have been the most attractive place for investment in Asia and that scenario is not likely to change. We have the freest economy in the world. We have the lowest taxation with the least government intervention in the economy. We have been appraised by most of the rating agencies as one of the most attractive places for investment. People are not moving elsewhere.[24]

Hong Kong's status as a low-tax refuge looked in doubt in 2006 when some politicians, including Financial Secretary Henry Tang, proposed enacting a new 5 percent tax on goods and services. Luckily, the plan was abandoned after it faced strong opposition from the public. Hong Kong residents seem determined to keep their home a beacon of freedom and prosperity for decades to come.

Estonia

Estonia gained independence from the Soviet Union in 1991. Before 1994, this small country of 1.3 million people had a corporate tax rate of 35 percent, a multirate individual tax with a top rate of 33 percent, and a high overall tax burden. The economy was in poor shape, and there was no sign that the country would soon become a "Baltic Tiger" with a booming economy.

Enter Mart Laar, a former history teacher. Laar's pro-market political party claimed victory in Estonia's 1994 elections, and Laar became prime minister. Tax reform was a main priority, and Laar launched the flat tax revolution in 1994 by instituting a 26 percent tax on individual and corporate income. By 2008, Estonia had trimmed the individual and corporate tax rates to 21 percent. The rates are scheduled to drop to 18 percent by 2011.

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Estonia has a uniquely pro-investment corporate tax system. After reforms in 2000, corporate retained earnings are not taxed at all. Corporate profits are taxed at 21 percent only when paid out as dividends. Thus, for all intents and purposes, Estonia has abolished its corporate income tax, thus also ending the double taxation of dividends. There are also no death taxes or wealth taxes in Estonia. All in all, Estonia has dramatically reduced the taxation of savings and investment.

Estonia does have an onerous 33 percent payroll tax, of which 4 percentage points go into private retirement accounts. It also has a value-added tax of 18 percent. But the government in Estonia is still much smaller than in most European nations. Indeed, between 1995 and 2005, Estonia dramatically cut its overall tax burden as a share of GDP from 38 percent to 31 percent.[25]

The results of these economic reforms have been impressive. Between 1994 and 2007, Estonia's real economic growth averaged more than 7 percent annually.[26] The unemployment rate was just 5 percent in 2007, and Estonia has become a magnet for foreign investment.

Some critics have argued that flat taxes will starve governments of revenue, but the opposite has happened after flat tax reforms in most countries. Estonia's government budget has been in surplus for years because tax revenues are rising rapidly.[27] One reason is that there has been a big reduction in tax evasion and avoidance. As Mart Laar notes: "People think a progressive tax system is fairer. But in the real world rich people find a way to avoid high taxes. With a flat tax, they stop worrying about sheltering their income or working in the gray economy."[28]

Estonia is perhaps the greatest economic success story of the post-Soviet countries. But Estonia's tax reforms may not be finished yet. The current government of Prime Minister Andrus Ansip has pondered cutting Estonia's flat tax rate further, and one leader in his party has proposed reducing the rate to just 12 percent.[29]

Lithuania

Following Estonia's lead, Lithuania adopted a 33 percent flat tax in 1994. Lithuania also cut its corporate tax rate to 29 percent. Although these reforms were significant, policymakers recognized in subsequent years that these tax rates were too high. Lithuania

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proceeded to cut its corporate rate a number of times down to its current 15 percent. Lithuania cut its individual flat tax rate to 27 percent in 2006, and further to 24 percent in 2008. Dividends and interest are taxed at just 15 percent. Between 1994 and 2007, Lithuania's real economic growth averaged more than 6 percent annually.[30]

Latvia

Latvia became the third Baltic country to enact a flat tax. It introduced an individual flat tax of 25 percent in 1995. The corporate tax rate was initially set at the same 25 percent rate, but has since been cut to just 15 percent. Domestic dividends are exempt from individual tax, and thus corporate earnings generally face just the 15 percent corporate-level tax. Individual capital gains are generally tax-free.

Latvia has experienced rapid economic growth in recent years. Between 1995 and 2007, Latvia's real economic growth averaged more than 7 percent annually.[31] As in other flat tax countries, tax revenues increased substantially following Latvia's reforms due to strong economic growth and reduced tax evasion. And like in Estonia, Latvia has been able to cut the overall size of its government. Between 1995 and 2005, Latvia cut its overall burden of taxes as a share of GDP from 33 percent to 29 percent.[32]

Russia

Following the collapse of the Soviet Union, Russia's tax code was complex and tax evasion was rampant.[33] Many wealthy individuals and businesses simply did not pay their taxes. Before 2001, Russia taxed individual income at rates of 12 percent, 20 percent, and 30 percent.

Newly elected President Vladimir Putin gave his support to scrapping the system in favor of an individual flat tax with a low rate of 13 percent. Putin said: ''We are making our economy more attractive. . . . We are going to keep pursuing our [classical] liberal tax policy. We have significantly alleviated the tax burden on our economy.''[34]

Russia's system is not a pure flat tax, as it retains some narrow provisions, but it is a dramatically improved system. Domestic dividends are taxed at just 9 percent. In 2002, the corporate tax rate was cut from 35 percent to 24 percent.

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Russia ranks very favorably on the *Forbes* Misery Index, which measures the burden of each country's corporate, individual, payroll, and wealth taxes on higher-income taxpayers.[35] Also scoring highly as places with taxes that are not very miserable are flat tax club members Bulgaria, Estonia, Georgia, Hong Kong, Latvia, and Lithuania.

Russia's tax reforms have been a big success. In recent years, the nation's economy has grown strongly. Between 2001 and 2007, real growth in GDP averaged more than 6 percent annually.[36] As the economy has boomed, and as tax evasion has fallen, tax revenues have soared. Alvin Rabushka has documented the dramatic rise in real income tax revenues in the years following the enactment of the Russian flat tax.[37] Russia's flat tax is an example of the Laffer curve in action.

Slovakia

Slovakia is another former socialist country that has found economic success with a flat tax. Before the flat tax, Slovakians were taxed under a five-rate structure of 10 percent, 20 percent, 25 percent, 35 percent, and 38 percent. The Slovakian system had a multitude of complex deductions and exemptions, and was a confusing mess.

Under the leadership of Prime Minister Mikulas Dzurinda and Finance Minister Ivan Miklos, Slovakia scrapped that system in 2004 and adopted a 19 percent flat tax. The flat tax has a large basic exemption and few special preferences. The tax bias against savings has also been sharply reduced. Individual dividends are generally exempt from tax. The death tax was abolished. There is also no wealth tax in Slovakia. As under other flat tax reforms, income tax revenues came in higher than expected following reforms as tax evasion dropped and the economy expanded.[38]

Slovakia has radically cut its corporate income tax over time. The rate was cut from 45 percent in 1992, to 25 percent in 2002, to 19 percent in 2004. The low corporate tax rate has helped create an investment boom in Slovakia. The country is being called the "Detroit of Europe," and is home to factories of automobile giants Volkswagen, Peugeot, Kia, and Hyundai. On a per capita basis, the country is the world's leading producer of automobiles.[39] Slovakia's overall economy has grown strongly. Between 2004 and 2007, real growth in GDP averaged more than 7 percent annually.[40]

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The bad news is that Slovakia has a fairly high value-added tax burden and also high payroll taxes, which are used to fund pensions and health insurance. Counting both employee and employer shares, the payroll tax rate is nearly 50 percent, though there is a cap on the amount of income subject to payroll taxation.

Nonetheless, as the economy has boomed, Slovakia has dramatically cut the overall size of its government. Between 1995 and 2005, Slovakia cut its burden of taxes as a share of GDP from 40 percent to 29 percent.[41] That is the largest cut in taxation in a relatively short period that we are aware of.

Finance Minister Ivan Miklos discussed the reasons for moving ahead with the flat tax reform: "I, and it is not just me, consider the tax reform an important part of the structural reforms that we are carrying out in Slovakia. It should mainly improve the business environment, support sustainable economic growth, create job opportunities, and motivate [people and businesses] to work and invest through the simplified tax system."[42] Slovakia has also moved ahead with other pro-market reforms, including personal retirement accounts, school choice, liberalized labor markets, and welfare reform.

Recently, there have been efforts in the parliament to cut the flat tax rate further, but those efforts have not yet been successful. Nonetheless, Slovakia's tax system is widely viewed as a model for other nations. One leading Slovak economist said that the "Slovak public finance reform will be studied in economic textbooks all over the world one day."[43]

Ukraine

In 2004, Ukraine replaced its individual income tax system, which had a top rate of 40 percent, with a simple 13 percent flat tax. The rate moved up to 15 percent in 2007, as called for in the original legislation. Ukraine also cut its corporate tax rate from 30 percent to 25 percent. After years of declining output and falling incomes in the 1990s, the Ukrainian economy is now expanding strongly. Between 2004 and 2007, real growth in GDP averaged more than 7 percent annually.[44]

Romania

After the fall of the Soviet Union, the Social Democratic Party in Romania instituted an individual tax system with five rates: 18 percent, 23 percent, 28 percent, 34 percent, and 40 percent. Corporate

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income was taxed at 25 percent.[45] The progressive tax system was a failure, and Romania had a high degree of corruption and tax evasion.

Reforms would come after the election in 2004 of Traian Băsescu to the presidency. One of Băsescu's top priorities was installing a flat tax, and he gained support from Prime Minister Calin Popescu Tariceanu. In 2005, Romania instituted a 16 percent flat tax for individuals. The corporate tax rate was cut from 25 percent to an equivalent 16 percent.

Romania aspired to join the European Union, but in a common ritual, officials at the EU and IMF criticized Romania's low tax rates. Both organizations noted that Romanian tax revenues as a share of GDP were lower than other EU states, and called for tax increases. Romania ignored those ideas and has kept its tax rates and tax burden low. It was admitted to the EU in 2007.

The Romanian economy has grown rapidly since the flat tax was installed. Incomes have risen, and unemployment has fallen. Foreign direct investment has climbed sharply in recent years.[46] Between 2005 and 2007, real growth in GDP averaged more than 6 percent annually.[47] Romania has many challenges ahead, but it has come a long way, sharply improving its economic freedom score, as shown in Table 4.2.

The results of the flat tax reforms were more positive than even government supporters, such as Prime Minister Tariceanu, expected.[48] Mugur Ibarescul, the governor of the Bank of Romania, found that tax revenues rose faster than anticipated under the flat tax, and he became a believer: "If it worked in Slovakia, why wouldn't it work here, too?"[49]

Georgia

In 2004, the Georgian parliament voted overwhelmingly to adopt a flat tax, replacing an income tax system with rates of 12 percent, 15 percent, 17 percent, and 20 percent. The new 12 percent flat tax went into effect in 2005, greatly simplifying the tax code for 4.5 million Georgians. Georgia also cut its social insurance tax rate from 33 to 20 percent, and reduced its value-added tax rate from 20 to 18 percent. Dividends and interest are taxed at just 10 percent.

In 2008, Georgia made further reforms. It combined its individual income tax (12 percent) and payroll tax (20 percent) into a single-rate tax of 25 percent, which represents a seven-point cut in the tax

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rate on wages. In 2008, Georgia also cut its corporate income tax from 20 percent to 15 percent.

Georgia's tax reforms are part of a broader drive toward free-market policies in the nation, including privatization. In 2004, the minister of the economy, Kakha Bendukidze, said that Georgia should sell "everything that can be sold, except its conscience."[50] In 2006, Minister of Economic Development Irakli Chogovadze summed up Georgia's reform goals: "The philosophy is very simple: what is good for business is good for the country. That is why we privatize, we reduce the taxes and we try to promote the emergence of new Georgian business,"[51] Georgia has substantially improved its international rankings on both corruption perceptions and economic freedom in recent years, and the economy is growing very strongly.[52]

Iceland

Iceland has joined a growing list of nations that have cut their corporate tax rates and adopted individual flat taxes. Individuals pay a flat rate of 23 percent of their taxable income to the central government, but local taxes of 13 percent push the total up to a flat 36 percent.[53] That is a high rate, but it has come down from a decade ago when the top rate was 46 percent. As with other flat tax countries, Iceland's system has a substantial tax-free threshold.

It is remarkable that a Nordic nation—nations that traditionally lean socialist—has abandoned multirate taxation. Iceland also significantly cut taxes on savings under the leadership of former prime minister David Oddsson. There is a very low tax rate of just 10 percent on dividends, interest, and capital gains. The death tax has been cut to 5 percent and the wealth tax has been abolished. Iceland has an onerous value-added tax at 24.5 percent, but payroll taxes are modest at just 6 percent.[54]

Iceland's most dramatic reforms are in corporate taxation. In 2002, Iceland cut its corporate rate from 30 percent to just 18 percent, which is one of the lowest among advanced economies. The rate cut has created a powerful increase in investment incentives and boosted economic growth. Rather than creating a revenue loss for the government, Iceland's corporate tax cuts have coincided with rapidly rising corporate tax revenues.[55] The government has proposed cutting the rate to 15 percent in 2008.

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In addition to tax rate cuts, Iceland has also adopted other market-based reforms, such as privatization of businesses and personal accounts for retirement. Iceland has one of the world's highest average incomes.[56] Unemployment is almost nonexistent at about 2 percent.

In sum, Iceland's flat tax has a high rate, but the country has very low taxation on savings and investment. From a political perspective, Iceland's reform is remarkable. It is the first time to our knowledge that an advanced Western nation has decided to scrap a "soak the rich" philosophy of multirate taxation and adopt a simple system that treats all taxpayers equally.

Macedonia

Devastated by war and the collapse of Yugoslavia, Macedonia's 2.2 million people struggled with stagnation and high unemployment for years. But in 2006, incoming Prime Minister Nikola Gruevski observed the flat tax revolution abroad and called for a Macedonian flat tax. Macedonia became a member of the flat tax club in January 2007, when Gruevski's government instituted a 12 percent individual flat tax. Macedonia's previous tax system had rates of 15 percent, 18 percent, and 24 percent. The government also cut the corporate tax rate from 15 percent to 12 percent.

In 2008, Macedonia's tax reforms continued. Prime Minister Gruevski and his party cut the individual and corporate tax rates to just 10 percent. Reinvested business profits are not subject to tax. The capital gains tax rate is just 10 percent. Macedonia is tied for first place with the lowest individual and corporate flat tax rates in the world.

With these reforms, Macedonia's leaders are seeking to increase foreign investment, spur job creation, and improve the transparency and efficiency of tax administration.[57] And as in other flat tax countries, the Macedonian government reported a marked increase in tax revenues after its tax rate cuts were enacted.[58]

Montenegro

Montenegro enacted a flat tax in 2006, which came into force in 2007.[59] The new 15 percent individual flat tax replaced a system with rates of 16 percent, 20 percent, and 24 percent. The flat tax rate is scheduled to fall to 12 percent in 2009 and 9 percent in 2010. The

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country has also cut its corporate tax rate to just 9 percent, from the previous rate of 20 percent. Individual long-term capital gains are generally exempt from tax.

Albania

Albania enacted a flat tax in 2007. Under the leadership of Prime Minister Sali Berisha, the government put in place a unified individual and corporate flat tax of just 10 percent. The individual flat tax replaces a system that had a five-rate structure. The corporate tax rate was cut in half from the previous 20 percent. *Tax Notes* reported that ''Albanian Prime Minister Sali Berisha said the flat tax is intended to simplify tax collection, encourage the legalization of the shadow economy, attract foreign direct investment, and make the economy more competitive.''[60]

Mauritius

Mauritius is a stable democracy with free elections, and has "attracted considerable foreign investment" while earning "one of Africa's highest per capita incomes."[61] Mauritius enacted a dramatic tax reform in 2007, which sharply cut both individual and corporate income tax rates.[62] A new individual flat tax of 15 percent was adopted, replacing a system that had a top rate of 25 percent. The corporate tax rate was cut from 25 percent to 15 percent.

Mauritius's Finance Minister Rama Sithanen discussed his reasons for adopting flat tax reforms: "Last year, I took bold steps to reform our personal and corporate income tax system. . . . Because of its numerous tax breaks and exemptions, the system had become very complex and offered vast opportunities for abuse and tax avoidance. It led to inequity and inefficiency and was biased against small enterprises. It was also hindering the emergence of a fully-integrated and competitive economy."[63]

Czech Republic

Under Prime Minister Mirek Topolánek and President Václav Klaus, the Czech Republic has enacted an individual flat tax of 15 percent. The flat tax came into force in 2008, replacing a system with four rates that topped out at 32 percent. The flat tax rate is scheduled to drop to 12.5 percent in 2009. The general tax rate on long-term capital gains is zero. The corporate tax rate has fallen over the years

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from 45 percent in the early 1990s to just 21 percent in 2008. The corporate tax rate is scheduled to fall to 19 percent in 2010.

Bulgaria

Bulgaria scrapped its multirate income tax, which had a top rate of 24 percent, and adopted a 10 percent flat tax in 2008. The reform was passed by a broad left-right political coalition with the aim of reducing tax evasion, eliminating narrow tax breaks, and increasing foreign investment.[64] This reform followed changes in 2006 that cut Bulgaria's corporate tax rate from 15 percent to 10 percent.

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5. Mobile Brains and Mobile Wealth

Migration is the original form of globalization. Long before capital flows, people moved great distances in search of economic improvement and better governance. Migration slowed in the mid-20th century, but has grown quickly in recent decades. The number of people living outside their countries of birth has doubled since 1980, rising from about 100 million to 200 million.[1]

Migration takes place for many social reasons, including political repression and family reunification. But migration is also driven by economics—people searching for higher wages, lower taxes, and more opportunity. Our focus is tax competition, and so the migration of highly skilled and wealthy individuals is of particular interest. These types of individuals respond strongly to taxation, and they also play a central role in economic growth.

The emigration of highly skilled and educated workers, such as engineers and doctors, is often called "brain drain." Countries fear losing their best and brightest, whether it is French entrepreneurs moving to London or Canadian computer experts moving to Silicon Valley. Historically, the United States has been a "brain gain" nation, a magnet for smart and productive people. But that may change if other countries continue to improve their tax and immigration policies, and succeed in attracting more of the world's mobile knowledge workers.

The wealthy also have increasing flexibility about where to work and where to invest their capital. Rich people today are mainly self-made and entrepreneurial, and are not simply passive inheritors of wealth.[2] Indeed, just one-fifth of the wealth of the world's richest individuals is inherited, and an increasing share stems from active business ownership.[3] That means that the wealthy are an important dynamo for economic growth, and thus it makes sense to adopt favorable policies to attract them.

Mobile Brains

In increasing numbers, citizens dissatisfied with their governments are emigrating in search of more favorable economic climates.

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The costs of migration are falling, and restrictions on migration have been eased in recent decades. Migration experts believe that the international demand for highly skilled workers has increased sharply.[4] The result is that global migration of skilled workers is rising.

For these workers, economic factors such as wages and taxes are important in their migration decisions.[5] Entrepreneurs, scientists, and executives have more choices than ever about where to work. More countries are politically stable and technology has helped flatten the global economy, as we discussed. Computer software experts can live just about anywhere, for example, and sell their products in foreign markets over the Internet. As a result of these changes, national differences in the taxes on high-paid and high-skilled individuals have increased in importance.

Let's look at the factors that have flattened world labor markets and spurred greater tax competition for skilled labor. First, emigration restrictions in many formerly communist nations have been eliminated, and that has increased the pool of potential migrants. Talented Russians and Eastern Europeans used to be imprisoned, but now they are free to emigrate, and many have done so. For example, about 1.5 million generally well-educated Jews emigrated from Russia to Israel and the West during the 1990s.[6]

Second, workers in advanced nations are more likely to change jobs than in the past because of the changing structure of the economy. The days of lifelong employment at one company are over. Traditional pension plans, which tied workers to their jobs, have been replaced by more portable savings plans. Salaries are increasingly based on skills rather than years of service in jobs. Newer industries do not have the rigid bureaucracies of older industries. All this has made workers more willing and more able to take employment abroad.

Third, falling travel and communication costs have made it easier for workers to find employment abroad. Cheap air travel has made emigration more affordable. The Internet has made vast information available to international job seekers and recruiters. The Internet and low travel costs have also made it easier for emigrants to maintain contact with relatives back home. The *Financial Times* noted that rising migration "is the result of the increase in global economic ties, cheaper flights, and better communications links. . . . Once those

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leaving their countries feared they were seeing their families for the last time. Today, they can talk to, and see each other, on Skype and fly home for reunions."[7]

A fourth factor causing the rise in skilled worker migration is the passage of trade agreements and other treaties. The European Union allows for the mobility of workers between member countries. The North American Free Trade Agreement allows for increased mobility of skilled professionals. Trade deals have also spurred migration as a side effect of greater trade and investment. In addition, hundreds of bilateral tax treaties have been signed in recent decades. These treaties often promote migration by including rules to reduce the double taxing of emigrants' income.

Competition for skilled labor has been highly visible in the EU after the removal of internal migration restrictions in the 1990s. Although there are still language and cultural barriers to migration within Europe, they have been reduced by the widespread adoption of English as the language of commerce. There has been an influx of smart, young people to cities such as London that have strong economies and moderate taxes, particularly in fields such as technology and finance. London's population is 31 percent foreign-born, up from 18 percent two decades ago.[8] About one-third of London's workers in health care, business services, financial services, and manufacturing are immigrants.[9] More than 150,000 Poles have moved to Britain in the last 15 years.[10]

The *International Herald Tribune* recently profiled the outflow of skilled workers from high-tax Denmark to booming London and other places:

> As a self-employed software engineer, Thomas Sorensen broadcasts his qualifications to potential employers across Europe and the Middle East. But to the ones in his native Denmark, he is simply unavailable. Settled in Frankfurt, where he handles computer security for a major Swiss corporation, Sorensen, 34, has no plans to return to the days of paying sky-high Danish taxes. . . .
>
> Young Danes, often schooled abroad and inevitably fluent in English, are primed to quit Denmark for greener pastures. One reason is the income tax rate, which can reach 63 percent.
>
> "Our young people are by nature international," said Poul Arne Jensen, chief executive of Dantherm, a maker of climate-control technology. "They are used to traveling and have studied abroad."

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> "They are no longer Danes in that sense—they are global people who have possibilities around the world," he said. . . .
>
> The problem [of skilled emigration] employers and economists believe, has a lot to do with the 63 percent marginal tax rate paid by top earners in Denmark—a level that hits anyone making more than 360,000 Danish kroner, or about $70,000. . . .
>
> The movement toward lower taxes passed Denmark by, even as it took root in much of Europe. Small East European countries, notably Estonia and Slovakia, started the trend by imposing low, flat taxes on income and corporate profits about five years ago. Those moves helped prod Austria, and eventually, Germany, to slash high marginal rates as well.
>
> Danish taxes also contrast sharply with those in nearby London, often jokingly referred to among Danes as a Danish town, because so many of them live there. Lower taxes on high earners have been a centerpiece of the policy mix that has fed the rise of London as a global financial center since the 1980s.[11]

A fifth spur to migration has been the enactment of policies designed to facilitate the hiring of highly skilled foreign workers. Such programs have been launched in Australia, Canada, Denmark, France, Germany, Ireland, New Zealand, and the United Kingdom.[12] Australia, Britain, Canada, and New Zealand have "points" systems, which tilt immigration toward those with advanced skills, education, and other beneficial traits.[13] One business group in New Zealand lauded that country's efforts to attract skilled immigrants: "There is a global war for talent and we need to change our tax, migration, and skills policies if we are to compete."[14]

The Organization for Economic Cooperation and Development notes that many nations "have been attempting to attract qualified human resources from abroad, which their increasingly knowledge-intensive economies need in order to sustain economic growth."[15] A United Nations report gave high scores to Australia, Britain, Canada, and New Zealand for policies to attract the highly skilled, but the United States received lower scores.[16] Australia and Britain have had the largest increases in skilled immigration in recent years.

A sixth cause of rising immigration among the highly skilled is the proliferation of special tax breaks to attract such immigrants. Some countries offer a tax-free status to skilled immigrants for a

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period of years. Other countries provide partial income tax exemptions for highly skilled immigrants, including Austria, Korea, the Netherlands, and Sweden.[17] Denmark allows highly skilled immigrants to pay a flat rate tax of 25 percent for the first three years, before making them pay the painfully high regular rates.

Policymakers are implementing such policies because they recognize that high-paid workers are sensitive to taxes. Most countries have graduated income tax systems, under which workers pay much higher rates at higher levels of income. A consequence is that high-income workers have the most to gain by moving from high-tax to low-tax countries. A British scientist, paying a top income tax rate of 40 percent, might not want to take a job in France, where the top rate is higher. France has partly recognized this problem and offers special tax benefits to foreign professionals who take French jobs.[18]

We would expect the most intense competition for skilled workers to occur between countries with similar cultures and language. The French move to Switzerland, for instance, and Canadians move to lower-tax United States. NAFTA liberalized immigration for skilled workers in North America, and that has intensified tax competition. As it has turned out, for each skilled American who has moved north under NAFTA rules, there have been six Canadians who have moved south.[19] The brain drain to the United States has been an important concern of Canadian policymakers, and the nation's technology companies have complained that some of their best workers have emigrated.[20] Canadians move south for the warmer climate, of course, but academic studies have also identified tax differences as an important factor in the brain drain.[21] More recently, the Canadian economy has boomed due to growth in the petroleum and mining industries, and that has likely slowed emigration for the time being.

Ireland is another interesting case study of taxes and migration. For decades, many English-speaking and well-educated young Irish sought better lives in Britain and the United States. But corporate tax cuts, followed by individual tax cuts, have reversed the Irish migration pattern over the last 15 years. Ireland has enjoyed large net immigration since the mid-1990s, as emigration has plunged and immigration has soared.[22] The age-old Irish brain drain was finally defeated by tax cuts.

Language and culture are becoming smaller impediments to migration, particularly among skilled and educated workers. As

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noted, English has become the international language of business, and culture is becoming globalized. The types of sophisticated amenities that high-income workers demand are available in hundreds of cities these days. Consider, for example, the fancy new facilities that Beijing is adding: "Norman Foster is behind the city's new $3.6 billion airport terminal, French architect Paul Andreu has created its National Grand Theatre, a futuristic, dome-shaped bubble, and Swiss architects Herzog & de Meuron are building the main Olympic stadium."[23]

Meanwhile, Abu Dhabi, part of the booming United Arab Emirates, has hired famed architect Frank Gehry to design the world's largest Guggenheim museum for that city's new Cultural District. With such amenities and rock-bottom taxes, the UAE may become a world-class business center. Whereas places such as New York used to have a near monopoly on high-end amenities, professionals and the wealthy can live very well in many cities today. New York's mayor Michael Bloomberg has said that his city's high taxes are not a problem because they are offset by unique amenities.[24] The mayor could not be more wrong.

A recent story in the *Times* of London highlighted the UAE's low-tax advantage for professionals. An expert at the executive placement firm Mercer noted: "We often find that the UAE's zero taxation is a strong draw for expatriates on short-term assignments. For three to five years, young professionals can fast-track their savings to afford a mortgage when they return home, while senior executives can maximize their savings potential ahead of retirement."[25] Another Mercer expert noted that taxation "has an obvious impact on take-home pay, and in some countries with low and zero tax rates, it is an important incentive for employees to work abroad."[26]

By the way, the UAE had the best score on the *Forbes* taxpayer Misery Index in 2007. The index measures the burden of each country's corporate, individual, payroll, and wealth taxes, and acts as a "proxy for evaluating whether policy attracts or repels capital and talent."[27] *Forbes* finds that tax differences between high-tax places, such as Denmark, and low-tax places, such as Singapore and the UAE, are huge.

How is the United States doing in this new world of labor mobility? The good news is that America is still a land of opportunity, and it has moderate taxes on individuals compared with most countries

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in Europe. While states such as New York score poorly on taxpayer misery according to *Forbes*, other states such as Texas have lower-than-average taxpayer misery.

The bad news is that America's tax advantage, especially for high-income individuals, has narrowed, as we discussed in Chapter 3. Also, U.S. immigration policies are unfavorable toward skilled workers, compared with policies of some of our major trading partners. As a result, numerous countries attract relatively more highly skilled immigrants than does the United States. Immigrants with advanced degrees are 26 percent of U.S. immigrants, which compares with 42 percent in Australia, 41 percent in Ireland, 38 percent in Canada, 35 percent in Britain, and 31 percent in New Zealand.[28]

The United States operates the H1-B visa system to attract highly skilled professionals. However, that program is only for temporary workers and the annual quota for H1-Bs is very low at just 65,000 people.[29] By comparison, the total U.S. workforce is about 150 million people. The United States also has an employment-based green card program for skilled and permanent immigration, but there are serious limitations to that program as well. The chairman of Intel Corporation, Craig Barrett, recently warned that America is losing the global talent competition because of restrictive policies on skilled immigration. As a result, he warns, "the next Silicon Valley will not be in the United States."[30]

While the United States has restricted its highly skilled immigration, other countries have increased their efforts in this regard.[31] Britain's program for highly skilled workers attracts about 100,000 immigrants per year, which is impressive given that the UK's population is just one-fifth of the U.S. level.[32] The European Union recently launched an effort to provide temporary but renewable "blue cards" to attract highly skilled immigrants.[33]

In 2007, Microsoft Corporation announced that it was opening a software development center in Vancouver, British Columbia. The facility would be close to its Seattle headquarters, but would be able to take advantage of Canada's less restrictive immigration policies for highly skilled workers. Microsoft noted that Vancouver has a diverse population and the location would allow the "company to recruit and retain highly skilled people affected by immigration issues in the U.S."[34]

If the United States closes its borders to smart people, U.S. companies will hire them abroad. Bill Gates stated exactly that in 2008

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testimony to Congress: "Many U.S. firms, including Microsoft, have been forced to locate staff in countries that welcome skilled foreign workers to do work that could otherwise have been done in the United States, if it were not for our counterproductive immigration policies."[35]

Overall, the United States continues to be a net gainer from the migration of highly skilled people because U.S. emigration is very low. But federal policies need to be improved, given that other countries are not standing still—they are cutting income tax rates and enacting policies to attract the highly skilled. The OECD notes that "competition is keen among OECD member countries to attract human resources they lack and retain those who might emigrate. Many amended their legislation in the late 1990s to facilitate the entry of skilled foreign workers."[36]

Migration experts tell us that "international competition for talent is bound to increase" in coming years.[37] That is because many advanced nations have rapidly aging populations. In the United States, the ratio of those over age 65 to those of working age will increase from 18 percent today to 31 percent by 2030. The similar ratio in Western Europe will increase to 42 percent.[38] These changes will create a high demand for workers, prompting countries to redouble their efforts to attract the highly skilled.

The fastest-growing occupations over the next decade will be in health care, professional services, education, and financial services.[39] In health care, the growing number of elderly will create a huge demand for doctors, nurses, and other medical specialists. These same types of experts will be sought after in other advanced economies.[40] American industries may be hard-pressed to get the skilled workers they need, especially if federal policies prevent the importing of foreign talent.

Limits on skilled immigration already appear to be hurting the U.S. electronics industry. The industry needs talent, but current federal policies are "shunning" needed immigrants, according to one report.[41] And in financial services, a report by McKinsey & Company found that Wall Street is being damaged by immigration limits on skilled workers.[42] However, the economic slowdown in 2008 may change the situation in the short term.

Now consider California. In the past, immigrants made huge contributions to Silicon Valley's growth. A 2007 study by researchers

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at Duke University found that one-quarter of U.S. technology companies launched in the past decade had an immigrant founder.[43] Immigrants have started large numbers of semiconductor, software, and bioscience firms. The largest sources of these immigrant entrepreneurs were India, Britain, and China. The results of the Duke study were similar to a 1999 study that found that 24 percent of Silicon Valley firms were founded by Chinese and Indian immigrants.[44]

Foreign-born brains have been very important to the U.S. economy. One-quarter of U.S. residents holding PhDs are foreign-born.[45] And consider that a large and growing share of U.S. intellectual property is created by immigrant scientists.[46] The bad news is that America's historic brain gain may have peaked unless major policy reforms are pursued.

A recent Kauffman Foundation study raised the alarm regarding a coming American brain drain.[47] Tight immigration restrictions will cause potential immigrants with skills to look elsewhere for opportunities. Students and skilled workers in America from China and India may be drawn back to those booming nations rather than trying to deal with the hassles of U.S. immigration. The National Science Foundation has warned that skilled worker shortages are looming because of immigration restrictions and the "intense global competition" for highly skilled people.[48]

Immigration and tax policy reforms can help America respond to the growing competition for talent. We have focused on immigration because tax reforms will not attract more engineers and entrepreneurs to America if there are tight legal barriers to entry. Thus, a two-pronged strategy of income tax rate cuts and liberalization of skilled immigration rules is needed so that America can retain its leadership in technology and innovation.

Mobile Wealth

When we change our focus from the highly skilled to the highly wealthy, we see even more intense international competition. Merrill Lynch estimates that there are 9.5 million "high net worth individuals" (HNWIs) in the world, more than double the number a decade ago.[49] These are people who hold more than $1 million in net financial assets. In total, these millionaires own more than $37 trillion in financial assets.

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Financial millionaires can be found on every continent, but they are not distributed equally. The United States is estimated to have 2.9 million millionaires, or 31 percent of the world's total. Massive India and Indonesia have just 100,000 and 20,000, respectively, whereas tiny Hong Kong and Singapore are estimated to have 87,000 and 67,000 millionaires, respectively. These latter two jurisdictions have tax systems that attract wealth. Singapore, for example, is the world's second largest private banking center due substantially to its attractive tax regime.[50]

Merrill Lynch reports that millionaires are becoming more global in their outlook, and they are allocating a growing share of their investments to foreign markets.[51] The goal of HNWIs is to maximize their net after-tax returns while minimizing their risks. According to Merrill Lynch, the very wealthy—those with net financial assets of more than $30 million—have a high degree of "tax intelligence."[52] They perform complex transactions to defer and minimize taxes.

There are regional differences in the investment patterns of the wealthy. Asian and Middle Eastern HNWIs hold more than half their assets abroad, whereas the "overwhelming majority" of Latin American HNWIs hold much of their wealth in offshore tax havens.[53] Many Latin American governments show little regard for property rights, so it is not surprising that the wealthy there have moved their investments offshore.

American HNWIs are generally less diversified internationally than those in other countries.[54] Instead, they prefer to "take advantage of tax-efficient holding structures domestically."[55] The United States also offers domestic investors a huge internal market. But we suspect as the world economy becomes more integrated, Americans will follow foreign patterns and shift more of their assets abroad. The pace of that change will partly depend on the direction of U.S. tax policy in relation to progress on tax reforms in other countries.

In sum, the world's wealthy hold a huge pool of mobile investment capital, they are tax sensitive, and they are increasingly international in their outlook. In estate planning, *Tax Notes International* says that "one of the fastest-growing specialty practice areas focuses on high-net-worth families with assets and beneficiaries scattered around the world."[56] More than one-fifth of HNWIs have children living abroad, while one-half of the very wealthy have homes abroad.[57]

Consider Peter Nygard, a Canadian entrepreneur in the fashion business, who has a net worth of about $500 million. He splits his

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time between Canada, his New York City office, and the low-tax Bahamas, where he lives. He is currently battling the Canadian government over a $16 million tax bill relating to whether he is a resident of Canada for tax purposes.[58] Or consider entrepreneur and billionaire Joseph Lewis, who lives near Nygard in the Bahamas. Lewis moved out of then high-tax Britain in 1979 to the Bahamas, but also spends part of each year in Florida where he does business deals, and part of each year on his ranch in Argentina, where his son lives.[59]

Given this environment of the globalization of the business elite, America needs to consider its policies toward the wealthy. Wealth-friendly policies are important because investment capital is crucial for economic growth. Also, most millionaires today are self-made; they are not simply passive inheritors of wealth.[60] That means that they are often entrepreneurial—they start new companies, they fund venture capital, and they launch innovative charitable activities. If a country scares away these sorts of people with high taxes, it loses both financial wealth and entrepreneurial innovation.

How responsive are the wealthy to international tax differences? We know from news stories that at least one group of millionaires—celebrity musicians, actors, and sports stars—can be very responsive. Such entertainers are often shocked when they find out how much of their earnings disappear in taxes. George Harrison of the Beatles wrote the song "Taxman" in 1966 after he found out that most of the band's earnings would be confiscated by the British government. Fellow Beatle Ringo Starr currently lives in Monaco, where he avoids high taxes on his huge royalty income.

Entertainers probably spend little time thinking about taxes early in their careers. But as they start accumulating assets, they likely become more focused on the effects of income, wealth, and inheritance taxes. Many celebrities establish homes in low-tax jurisdictions and shift their wealth and intellectual property abroad.

Of course, for every celebrity we hear about engaging in active tax planning, there are many more entrepreneurs and professionals doing the same thing. Tax-motivated migration of brains and wealth is a major economic issue for some nations, and the following is a tour of some of the countries that are alternatively attracting or repelling productive people.

France

The wealthy have been emigrating from France for decades. Hundreds of thousands of French have emigrated to Belgium, Britain, Switzerland, and the United States in recent decades, in part to escape high taxes.[61] France's total tax burden as a share of the economy is high at 44 percent, and its individual tax rates are some of the highest among the major nations.[62]

Perhaps the main source of vexation for the wealthy is the French wealth tax. The "solidarity tax on wealth" was imposed in the 1980s under President François Mitterrand. It is an annual assessment on net assets above a threshold of about $1 million, and it has graduated rates from 0.55 percent to 1.8 percent.[63] It covers both financial assets and real estate, including principal homes. Originally, the wealth tax was supposed to be paid by just a small group of taxpayers, but it is currently paid by about 400,000 French residents.[64]

One of those hit by the wealth tax was Johnny Hallyday, a famous French rock star and friend of French President Nicolas Sarkozy. Hallyday created a media sensation when he fled to Switzerland in 2006 to avoid the tax. He has said that he will come back to France if Sarkozy "reforms the wealth tax and inheritance law."[65] Hallyday stated: "I'm sick of paying, that's all. . . . I believe that after all the work I have done over nearly 50 years, my family should be able to live in some serenity. But 70 percent of everything I earn goes to taxes."[66] A poll in *Le Monde* found that two-thirds of the French public were sympathetic to Hallyday's decision.[67] The commotion about Hallyday was reminiscent of the angst generated when French supermodel Laetitia Casta departed for Britain a few years ago.[68]

Many of the French wealthy have moved to Belgium, Luxembourg, and Switzerland because those are French-speaking countries with important tax advantages. Belgium, for example, is a high-tax country overall, but it does not have a wealth tax and it generally does not tax individual capital gains. About 150,000 French people have moved to each of Switzerland and Belgium.[69] Among the French tax exiles living in Belgium are the founders of the Carrefour supermarket chain, the former head of oil company Elf Aquitaine, and the Mulliez family, which was France's second wealthiest.[70] The Taittinger family, famous as champagne makers, have scattered to Belgium and Switzerland.

French emigrants in business, finance, and technology often move to lower-tax Britain and the United States. As many as 300,000 French

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citizens live in Britain.[71] A large share of France's engineering graduates leave the country each year, while tens of thousands of French technology workers have moved to Silicon Valley.[72] Claude Taittinger of the champagne family noted that "any Frenchman who wants to make money goes to Britain or America these days."[73] A recent *Reuters* headline captured that feeling: "Young French, Seeking Hard Work, Head for Britain."[74] A study by advisers to the French government found that about 10,000 business leaders have left France in the past 15 years.[75]

The *Washington Post* profiled one emigrant, a 34-year-old entrepreneur who built a French technology company and then decided to retire for a while and spend time with his family.[76] To his surprise, he realized that his plan was not feasible because he would be hit with an annual wealth tax of $2.5 million. His wealth was tied up in his business, and thus he could not access that much cash. As a consequence, he moved with his family to Belgium and has built a new business there. The bottom line: France's high taxes are causing a loss of investment capital and the entrepreneurship that goes with it.

Germany

Germany's high taxes are somewhat less oppressive than those in France, but they are nonetheless causing the skilled and wealthy to emigrate. A *Wall Street Journal* story summarized the problem: "Highly skilled workers, notably engineers and doctors, are fleeing Germany in record numbers. . . . High taxes, relatively low salaries, and inflexible working conditions are among the reasons 144,815 German citizens left the country in 2005."[77] Many wealthy Germans are moving to Switzerland.

The Swiss canton of Zug is a favorite destination for German sports stars and entrepreneurs because of its particularly low taxes. In the 1990s, tennis star Boris Becker claimed residence in Monaco, but was prosecuted by tax authorities who claimed he still lived in Germany. But he has since moved to Switzerland and brought his various business enterprises with him.[78]

Formula One racing star Michael Schumacher moved to Switzerland in 1996 to avoid Germany's high taxes. His brother Ralf is also a racing star, and German taxes prompted him to move to Monaco. Ralf later moved to Austria after cutting a deal with the Austrian government to minimize his taxes. In an interview, Ralf said: "Germany is simply a taxation jungle. . . . I don't feel like having tax

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collectors on my heels. I don't want to be hunted down like Boris Becker and Steffi Graf. That's why I used the chance to go abroad for tax reasons."[79]

Numerous German soccer players have moved to Britain. A key advantage for foreigners residing in Britain is that it does not tax the foreign income of foreign citizens who reside there, as discussed below. Thus, German soccer players can move their financial wealth and intellectual property, including their "image rights," to a low-tax country, and then move to Britain and be taxed just on their current salary.[80]

Italy

Italy has made some tax reforms, but it still suffers under a high overall tax burden at 41 percent of its economy.[81] The country's top individual income tax rate was cut during the 1990s, but it is still quite high. Italy's payroll taxes are very high. Italy abolished inheritance taxes in 2001, but then reinstated them in 2006.

The country is infamous for its rampant tax evasion, which is often called the nation's second most popular sport after soccer. One expert estimates that Italy's underground economy represents 26 percent of the nation's gross domestic product.[82] High taxes are one of the key causes of large underground economies.[83] Like France and Germany, Italy has had many famous tax exiles. Luciano Pavarotti, for example, moved to Monaco to avoid high Italian taxes.[84]

Italy's high tax problem has come to a head recently. The former prime minister, Romano Prodi, complained in 2007 that "a third of Italians heavily evade taxes."[85] He pointed out that less than 1 percent of the country's taxpayers reported income of more than €100,000 a year (roughly $150,000). Given that the comparable figure for the United States is roughly 5 percent, it does suggest large tax evasion by Italy's wealthy.[86] Interestingly, Prodi asked for help from the Catholic Church to crack down on tax evasion, but church leaders were hesitant because they knew that the country's tax system was widely viewed as being unfair.

Britain

Britain is both a "gain" and "drain" nation when it comes to the wealthy. Let's look at the drain first. Numerous millionaires have emigrated to lower-tax jurisdictions, including musician David Bowie and racecar driver Jackie Stewart.[87] Singer Phil Collins lives

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in Switzerland, as does popular British rock singer James Blunt, who moved there in 2007. Actor Roger Moore lives in Monaco. Margaret Thatcher's son, Mark Thatcher, moved to Gibraltar to minimize taxes on his $64 million fortune.[88] The low-tax Bahamas has also attracted wealthy Brits, including Sean Connery and Laura Ashley, the former British designer.

Britain's most famous entrepreneur, Richard Branson, apparently uses complex strategies to minimize his taxes. According to the *Times* of London:

> Sir Richard Branson has a complicated series of offshore trusts and companies that own his business empire. Branson, whose wealth is calculated at £3,065m, pays relatively little tax as his wealth is tied up in these companies. It means that when he retires, he could move abroad—to the island he owns in the Caribbean—and liquidate his assets virtually tax-free.[89]

For decades, the Rolling Stones have managed their affairs in sophisticated ways to minimize their tax burden. Since 1972, most of the band's income, including royalties, has been channeled through a company in the Netherlands. The Netherlands has very low taxes on royalty income. In 2005, the Stones paid tax of just 2 percent on their £81 million of royalty income (roughly $160 million).[90] The Dutch finance agency that handles the Stones' money is said to have designed a plan for band members to avoid estate taxes at their death.

The Stones' Keith Richards, who owns assets of about $180 million, has observed: "The whole business thing is predicated a lot on the tax laws. It's why we rehearse in Canada and not in the United States. A lot of our astute moves have been basically keeping up with tax laws; where we go, where to put it, whether to sit on it or not."[91]

To avoid being deemed British residents for tax purposes, emigrants need to ensure that their return visits to the island nation do not exceed a certain number of days in a year. In the past, bands such as the Spice Girls and the Rolling Stones have planned carefully to make sure that the British legs of their world tours stayed under the legal time limit.[92] Many wealthy tax exiles who live in places like the Channel Islands and Monaco travel to England to do business, but keep their stays under the limit.

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That's the brain drain part of British tax laws. The brain gain part is that the tax code is very attractive for wealthy migrants from abroad, or at least it was until recently. Seven of Britain's 10 wealthiest people are immigrants.[93] A recent *Wall Street Journal* story was entitled "Behind London's Boom, Billionaires from Abroad."[94] It noted that "behind the surge of money pouring into London is the globalization of wealth," with many people "drawn by a combination of low taxes, historical ties, and a geographical location that makes the city attractive for people doing business in Eastern Europe, Asia, and the Middle East."[95]

Britain's tax advantage has favorable rules for "nondoms," or foreigners residing there who are not "domiciled" there. Nondoms pay British tax on British earnings, but they do not pay tax on their foreign earnings that remain abroad. In other words, if you earned your wealth in another country and it stays abroad, you can move to Britain and pay no taxes on it. There are about 150,000 nondoms in Britain who have foreign income exempt from British tax.[96]

The nondom tax benefit has attracted 23 foreign billionaires to London.[97] The world's fourth-wealthiest person, Lakshmi Mittal, lives in Britain and is the Indian owner of the global steel company that bears his name.[98] If Mittal chose to live in the United States, he would have to pay taxes on his global income, but in Britain he does not.

Another billionaire resident in London is the Icelander Thor Bjorgolfsson, who runs a private-equity firm. Bjorgolfsson says that Britain's tax benefits helped entice him to move there. The country's "incredibly benign tax structure . . . that's the practical reason why everyone's here," he says.[99]

That tax structure has also recently attracted Israeli entrepreneur and diamond billionaire Lev Leviev. Leviev, who recently bought the most expensive new property ever in Britain, emigrated from Israel apparently to avoid that country's high taxes.[100] Leviev has launched businesses in London, including a new diamond store that competes with DeBeers. Leviev, Bjorgolfsson, and Mittal are joined in London by thousands of financial industry executives, oil millionaires from Russia and the Middle East, and Greek shipping tycoons. London is home to about 80 percent of Europe's hedge fund business, partly because of the nondom tax advantage.[101]

Yet in a dramatic example of killing the goose that laid the golden egg, Britain is moving forward with plans to greatly increase taxes

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on nondoms in 2008. The ruling Labour Party plans to enact an annual lump-sum tax on nondoms of £30,000 per person. Such a tax may be no big deal for a Mittal or a Bjorgolfsson, but most nondoms have more modest incomes. Many of them will likely leave Britain unless the new tax is withdrawn.

The nondom rule change could have a large effect on London's huge financial services industry.[102] Hedge fund managers are already pulling up stakes and moving to Switzerland.[103] And the *Financial Times* reported that most Greek shipowners were ready to flee Britain if the tax goes into place.[104] There are about 100 Greek shipping companies with London headquarters that together control about one-fifth of the Greek shipping fleet, which is the largest in the world. Clearly, imposing the nondom tax would be a serious blow because Britain has become home to a huge array of entrepreneurs who have made the nation's economy one of the most dynamic in Europe.

Ireland

Like Britain, Ireland is both a "gain" and "drain" country with respect to tax competition. Ireland is a huge gain country when it comes to business investment because of its low corporate tax rate. But for wealthy individuals, it has been more of a "drain" country. More than half of Ireland's 20 wealthiest individuals live outside Ireland, in places such as Monaco and Switzerland.[105] Ireland's top individual income tax rate is quite high, and the country also has an inheritance tax.

Popular destinations for wealthy Irish emigrants include Gibraltar, Monaco, Portugal, and Switzerland. Consider Tony Ryan, founder of budget airline Ryanair, who was worth $1.1 billion before he passed away in 2007. Ryanair is Europe's largest budget carrier and was "one of the greatest Irish economic success stories," according to the Irish prime minister.[106] Ryan had lived as a tax exile in Monaco, which is free of income taxes, wealth taxes, capital gains taxes, and inheritance taxes.

In 2006, Irish telecom billionaire Denis O'Brien established residence in Malta so that if he sells some of his assets, such as his Caribbean mobile phone company, he can avoid capital gains taxes, which would have been quite heavy at 20 percent in Ireland.[107] Malta is one of the most favorable locations in Europe from a tax

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perspective for such individuals because it does not tax foreign-source capital gains. O'Brien had previously moved to Portugal, also popular for some wealthy tax exiles because it does not tax capital gains.

Irish rock band U2 moved its music publishing business to the Netherlands in 2006, where the royalties earned by such businesses face very low taxes. In total, U2 earned €217 million in 2005, one-third of which was royalty income.[108] The band's guitarist The Edge said, "Of course we want to be tax-efficient, who doesn't?"[109]

One bright spot for Ireland might be if Britain succeeds in driving out "nondoms," as discussed. Ireland may be an alternative destination for wealthy foreigners, given that it has favorable rules for foreigners who are residents but manage to get themselves classified as nondomiciled.[110] For those individuals, non-Irish earnings are generally not taxed if not remitted to Ireland.

Sweden

Sweden's high individual tax rates are infamous. Its current top income tax rate is 56 percent, which provides a big incentive for higher earners to emigrate. Some of the members of the pop group ABBA have done their best to keep their huge earnings from the greedy hands of the Swedish state. Anni-Frid Lyngstad lives in Switzerland and has recently battled Swedish authorities over royalty income.[111] Björn Ulvaeus has "avoided paying taxes in Sweden on royalties from songs and musicals by funneling those revenues through offshore companies and financial institutions."[112]

Perhaps Sweden's most famous tax exile is Ingvar Kamprad, founder of furniture company IKEA. Kamprad, the world's seventh-wealthiest person, lives in Lausanne, Switzerland.[113] Like many wealthy people who have built businesses, Kamprad is famously frugal, and that frugality extends to his belief in reducing taxes. IKEA is privately held, and Kamprad has created a complex tax structure to ensure that taxes on the company's earnings are minimized.[114] A Dutch nonprofit foundation is the parent entity of a Dutch private company that actually operates most IKEA stores worldwide. IKEA's intellectual property is owned by a company in Luxembourg, which receives income from the franchised stores.

Policymakers in Sweden have made some tax reforms. In 2007, the country abolished its wealth tax, which will create an incentive

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for wealthy Swedes to bring their offshore assets back home. The problem with democracies, however, is that they have trouble creating stable tax rules over time. *Tax Notes International* reports that "the left opposition parties have indicated that the net wealth tax will be reintroduced if they win the 2010 election. That might discourage Swedes who have hidden their capital outside the country from repatriating their assets."[115]

Switzerland

Switzerland is a magnet for investment capital and industrious people seeking a stable, free, and lower-tax economy. For decades, Switzerland has provided a model for nations trying to improve their international competitiveness and living standards. One measure of Switzerland's attraction is that about one-quarter of the population was born abroad, the second-highest ratio in the developed world.[116] From entry-level jobs to top executives, Swiss immigrants see the nation as the best place to climb the economic ladder.

Switzerland's success is due in part to tax policy. The nation enjoys a much lower overall tax burden than France, Germany, Italy, and other nations in Europe.[117] Tax rates are also significantly lower than the European average, and citizens in nearby countries see Switzerland as a fiscal refuge.

Switzerland's decentralized federation helps keep tax burdens low because strong tax competition takes place between the regional governments, known as cantons. High-income residents and businesses choose their canton carefully to minimize their taxes, which has created pressure for all cantons to cut taxes. Regarding recent business tax reforms by some cantons, the accounting firm PricewaterhouseCoopers noted, "It is likely that further cantons will join the trend towards lower corporate tax rates and so intensify the location competition further."[118]

One factor that sets Switzerland apart is a deliberate policy of opening the doors to the world's most successful people. The policy of "taxation according to expense" enables wealthy people from other nations to move to Switzerland and be fully exempt from income and wealth taxes. Instead, they pay a lump-sum tax based on their expenses in Switzerland. The tax is calculated based on the rental value of a resident's home or other related measures.

Individual cantons decide whom this special tax status should apply to, and they limit the eligibility. But the small number of

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people attracted by this favorable tax policy includes some of the world's wealthiest individuals. One expert noted:

> For a very long time Switzerland has seen itself as a refuge for persecuted people around the world, not least for victims of confiscatory taxation in neighboring countries with predatory socialist governments. In parallel, because of the high level of safety and quality of life generally available in Switzerland, the country attracts wealthy individuals from industry, sport, or the arts who choose it as a permanent residence.[119]

Switzerland's low-tax policies are good for Switzerland because they attract many skilled and wealthy people. But there are also spillover benefits for taxpayers in other countries. Governments in neighboring European nations are more likely to restrain their tax rates if they know that their high-end taxpayers could decide to escape to Switzerland.

Challenges for the United States

The United States has not had a large exodus of the wealthy, as some European countries have. Nonetheless, some celebrities and business leaders have escaped to low-tax jurisdictions. Music divas Diana Ross and Tina Turner live in Switzerland. John Templeton, a mutual fund entrepreneur and billionaire, famously gave up his U.S. citizenship and moved to the Bahamas in 1968. From there, he avoided U.S. taxes while handing out large portions of his wealth to worthy causes. Hundreds of other millionaires and billionaires have followed Templeton's path, some associated with well-known business names, such as Campbell Soup, Dart Container, and Carnival Cruise Lines.[120]

Aside from military personnel, there are roughly 6 million Americans who live abroad, but there is no official count. The State Department has put the figure at 4 million, but that figure is known to be underestimated.[121] Some American emigrants are tax exiles, but we do not know how many. We do know that the number is probably increasing as globalization advances.

Let's look at how U.S. taxation might affect migration. U.S. income tax rates on high earners are a bit below average among major economies, and top rates generally kick in at higher income levels

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than elsewhere. Also, the United States does not have a value-added tax, which creates a large burden in most other countries.

The result is that there is no American brain drain to places such as France. But there is also no big tax advantage for the foreign wealthy to migrate to the United States, as there is to Britain or Switzerland. Perhaps America's biggest hurdle to increased immigration of the wealthy is the federal estate tax, which is scheduled to feature a steep 55 percent top rate after 2010. The U.S. tax situation, combined with the growing numbers of countries that offer low taxes, political stability, and a warm climate, suggests that America is becoming a less attractive place for wealthy immigrants.

Now let's look at the emigration side of the equation in more detail. Like many countries, the United States taxes individuals on their foreign investment income. However, the United States has uniquely aggressive rules for taxing Americans who reside abroad.[122] It is one of the few countries that taxes on the basis of citizenship, not residency. That means that Americans must file federal income tax returns even if they live abroad permanently. Above an exemption amount, Americans living abroad may be liable for paying U.S. taxes on top of foreign taxes.

That policy has a number of effects. It is a hurdle for Americans who wish to move abroad temporarily or permanently, which constitutes a restriction on personal freedom. It also creates a competitiveness problem for U.S. companies. If Americans living abroad face a high U.S. tax burden, it pushes up the cost for American companies to hire them for foreign deployments. That makes U.S. firms less able to compete with foreign firms in international markets. Equipment maker Caterpillar Inc. employs about 1,000 people abroad to help it expand its global sales. Caterpillar says that the high U.S. tax burden on its foreign employees is a "barrier to competitiveness" for the company.[123]

The aggressive taxation of Americans abroad has prompted some people to expatriate, or to emigrate and renounce their U.S. citizenship. But Congress has enacted rules, most recently in 2006 and 2008, to restrict the ability of expatriates to escape Washington's global tax net. Expatriates who hold a certain amount of wealth are now generally liable to pay U.S. taxes for 10 years after renouncing their U.S. citizenship.[124] This attempt to make expatriates long-term tax slaves of the government is remarkable for an advanced nation.

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Rather than reduce expatriation, there is some indication that the new exit-tax rules have prompted increased expatriation.[125] Certainly, the new rules will lead to more sophisticated tax avoidance, and they may also cause more emigrants to simply stop paying U.S. taxes without formally dropping their U.S. citizenship.

Whatever the practical effect of these rules, we have come a long way since 1868 when the preamble to a U.S. law on emigrants declared that "the right of expatriation is a natural and inherent right of all people, indispensable to the enjoyment of the rights of life, liberty, and the pursuit of happiness."[126] Unfortunately, in today's policy debates, Congress rarely considers individual rights as an important constraint on legislation. But it seems to us that having federal tax police chase after ex-citizens living abroad is oppressive. After all, "exit taxes" have historically been imposed by tyrannical regimes, such as the Soviet Union and Nazi Germany. For the United States, a better way to respond to the increased mobility of the wealthy is to cut tax rates, thus encouraging Americans to remain resident.

Tax policy and migration may seem like an obscure issue because America has historically been a magnet for highly skilled workers and the wealthy. But that pattern may change in a big way because of the twin forces of globalization and the rapid aging of the population. The number of Americans aged 65 and older is expected to increase 84 percent by 2030, whereas the number of working-age Americans who can support them will increase just 10 percent.[127]

That demographic shift will put a premium on tax reforms that can expand the nation's pool of labor and capital. By spurring increased economic growth, tax reforms could make the cost burdens of the elderly easier to handle. And tax reforms could aid America in the growing global battle for skilled labor, which we have discussed.

The coming demographic shift also raises tax policy issues with regard to retirees. More than 4 million U.S. baby boomers will be retiring every year in coming years.[128] In the past, only a small fraction of retirees moved out of state each year.[129] But looking ahead, retirees are expected to be increasingly mobile for many reasons, including their higher education levels and typically greater wealth than in the past.[130] How many baby boomers will decide to retire abroad in places with sunny climates and low taxes?

Domestically, states such as Arizona and Florida have drawn retirees with a combination of sun, low living costs, and lower taxes

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than states such as New York. An expert at *Where to Retire* magazine notes that "the cost of living is a big factor . . . people particularly want to know about taxes, and not just sales and income taxes but also property and inheritance taxes."[131] *Kiplinger's* magazine regularly compares retiree tax costs in different locations.[132] For most retirees, the largest differences between locations are property taxes. Numerous states have launched programs to attract retirees and have enacted various tax incentives to that end.[133]

For wealthy retirees, estate taxes are very important. Many states have cut or eliminated their estate taxes in recent years in fear of scaring away upscale and increasingly mobile retirees. Academic studies have confirmed that wealthy individuals are tax sensitive in their interstate migration decisions.[134]

Americans are increasingly considering retiring abroad. The most discussed retirement destinations include Barbados, the Cayman Islands, Costa Rica, Mexico, and Panama. Central American governments are welcoming U.S. retirees and implementing incentive packages to attract them.[135]

American retirement abroad is starting from a small base, but there appears to be a strong trend upward. Many Caribbean and Latin American retirement spots have low living costs and low taxes. There are many more countries today that combine sun, beauty, and political stability than in the past. Cheaper air travel and the Internet have added to the attraction of retirement abroad.

Barron's reports that "real estate consultants and brokers report a sharp spike in retirees looking for foreign havens" in the Caribbean.[136] *Tax Notes International* reports that "international real estate developers who once catered exclusively to wealthy globetrotters . . . have recently set their sights on luring middle-income Americans weary of rising property taxes to fiscally friendlier shores."[137]

Mexico is getting the most interest, and we are probably at the beginning of a long boom in American retirement to its southern neighbor. A *San Francisco Chronicle* story focused on "boomer retirees invading Mexico."[138] The article says that the number of Americans living in Mexico has soared in the last decade from about 200,000 to 1 million.[139] Developers are building whole seaside villages in Mexico designed for American retirees.[140] The regions of Mexico attracting large numbers of Americans include Baja California, Puerto Vallarta, and San Miguel de Allende.

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One draw for retirees is that Mexico has low-cost health care. Are Americans willing to trust their health to foreign doctors? Apparently they are, as confirmed by the rapid growth in medical tourism. About 150,000 Americans travel abroad each year for cheaper surgery and dental care.[141] Top destinations are Brazil, India, Mexico, and Thailand. Hospitals in these countries offer procedures for a fraction of U.S. prices. A related attraction of Mexico is low-cost nursing homes.[142]

Mexico and other places to the south also have big tax advantages. Many countries, for example, don't tax foreign pension or investment income. Low property taxes can also be an important advantage of many retirement destinations. In Mexico, property taxes are very low—the country's property tax collections represent just 0.3 percent of GDP, or just one-tenth the level in the United States.[143] In Panama, retirees who build new homes are exempt from property taxes for 20 years.

Property taxes are an important expense for retirees because many of them have paid off their mortgages and thus are unable to deduct property and other state and local taxes on their federal tax returns. That means that a retiree paying a $6,000 annual property tax bill is taking the full hit of $6,000, without any federal offset. *Kiplinger's* is right in that "property taxes, not state income taxes, often turn into the tax Godzilla for retirees."[144]

For wealthy retirees, it is the federal estate tax that is the Godzilla. Under a bizarre provision enacted by Congress, the federal estate tax is eliminated in 2010, but is then reinstated in 2011 with a top rate of 55 percent. One doesn't have to be a tax expert to recognize that such a high rate will prompt an exodus of the wealthy and their wealth to low-tax havens abroad.

European countries with high taxes face similar challenges. A recent column in London's *Guardian* noted: "Offshore financial products are of interest to a very wide range of people nowadays. . . . Offshore investing is not just an activity for the super rich, with competitive products available for those with modest sums of a few thousand pounds to invest. . . . For people planning to retire to the sun in a few years time, it can also be useful to start moving their savings offshore in advance so they can take advantage of lower local taxes when they settle in their new location."[145] Three million Britons are said to invest their money offshore.[146]

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No doubt there is growing offshore investment by Americans, as the Internet has made it easy for people to shift their money abroad.[147] Many people may be shifting their financial assets offshore in advance of retirement in low-tax jurisdictions. The most effective policy response to these developments is to eliminate the estate tax and cut income tax rates, with the ultimate goal of joining the club of nations that have low-rate flat taxes.

Kenneth Rogoff, professor of economics at Harvard University and former chief economist at the International Monetary Fund, came to the same conclusion in a recent column:

> Many super-earners are also super-creative and bring enormous value. Places like the United Kingdom actively court wealthy foreign nationals through extraordinary preferential treatment of their investment income. The ultra-rich are an ultra-mobile group, too. If you are earning $540,000 an hour, it does not take too long to save up to buy an apartment, even in London. Anyway, there are limits to how much tax pressure the political system can apply to the ultra-rich. . . . Rather than punitively taxing wealth, globalization strengthens the case for shifting to a flat tax on income (or better yet consumption) with a moderately high exemption. Aside from the usual efficiency arguments, it is just going to become increasingly difficult and costly to maintain complex and idiosyncratic national tax arrangements.[148]

Calling the U.S. tax code "idiosyncratic" is far too polite. The federal income tax is an abomination of special credits, deductions, and high rates. Federal tax rules and regulations span 67,000 pages and create serious economic distortions.[149] In Chapter 10, we follow up on Rogoff's suggestion and describe the advantages of replacing the federal income tax with a flat tax.

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6. Taxing Businesses in the Global Economy

Globalization is affecting millions of American businesses. Large corporations and small businesses are facing rising competition from imports, and many companies are battling to expand their sales into foreign markets. Unfortunately, the complex and high-rate federal income tax creates a barrier for all types of businesses to compete effectively in the global economy.

U.S. multinational corporations are subject to particularly complicated tax rules that affect their ability to compete. These tax rules are important because U.S. multinational corporations are crucial to the nation's economic growth. They account for 52 percent of merchandise exports and 79 percent of all private research and development (R&D) in the country.[1] They invest about $500 billion annually in the American economy, and their global sales are about $12 trillion.

In this chapter, we focus on three realities of corporate taxes and the global economy that should help guide U.S. policymaking.[2] First, federal tax rules are based on an outdated 1960s' theory of taxation, which calls for taxing companies on a "worldwide" basis. That approach makes no sense in today's economy, and most countries have instead opted for "territorial" taxation as a more competitive strategy.

Second, the corporate tax base is increasingly mobile, which implies the need for a big reduction in the corporate tax rate. Unless U.S. taxation is competitive with our trading partners, businesses will move their real investment and reported profits abroad through myriad techniques. America's high corporate tax rate is a loser for the U.S. economy, and it is also a loser for the government because it creates administrative headaches and causes the tax base to shrink.

Third, corporate tax policy affects the living standards of average Americans. The burden of corporate taxes in the globalized economy mainly falls on average workers in the form of lower wages. If U.S.

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and foreign semiconductor and pharmaceutical companies are not building factories in America because of high taxes, it is American workers who lose. As such, corporate taxation should be put front and center in debates about U.S. economic growth, jobs, and incomes.

Approaches to International Taxation

How should the U.S. government tax companies, such as Intel or Dow, which are incorporated in the United States but generate most of their revenue and profits from their foreign operations? How should the government tax the thousands of other American companies that own production, sales, and research facilities abroad?

Consider a hypothetical Brazilian automobile company that is majority-owned by a U.S. parent corporation. The company is staffed by Brazilians, is partly financed by Brazilians, and makes cars for the Brazilian market. Surprisingly, the U.S. government asserts the authority to tax the profits of this company generated in Brazil mainly by Brazilians. This policy of "worldwide" taxation means that U.S. corporations that own companies in Brazil, Britain, or anywhere else must report the income of those foreign operations on their U.S. tax returns. Those operations are also subject to taxation in the country where they are located.

This worldwide approach to taxation is supported by a theory called "capital export neutrality." CEN posits that investors should face the same tax rate on investments wherever the investments are located—at home or abroad. If tax rates were not the same, international investment flows would be affected, and that would not be efficient, according to this theory. Thus, if Japanese companies paid a 41 percent tax on profits earned in Tokyo, but a 35 percent tax on profits earned in Texas, that would be inefficient because it would create a tax incentive for investment to flow to Texas.

The worldwide tax approach tries to eliminate this supposed inefficiency problem by denying companies the tax benefit of investing in foreign locations that have lower taxes. Under worldwide systems, the foreign income of companies is taxed, but companies are provided with a limited credit for taxes paid to foreign governments so that income is generally not double-taxed. The idea is to remove any tax advantages that companies might enjoy from investing abroad. But, as we discuss below, even if that goal were achieved, it would not create any benefits for the U.S. economy.

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Table 6.1
TYPES OF BUSINESS TAX SYSTEM

	Worldwide	Territorial
Basis of taxation	Residence of taxpayer (country of parent company)	Source of income (country where income generated)
Principle of taxation	Capital export neutrality (CEN)	Capital import neutrality (CIN)
Adopted in	9 of 30 OECD countries, including the United States	21 of 30 OECD countries

Unlike the United States, most countries do not have worldwide tax systems. Instead, they have "territorial" tax systems, under which foreign business income is generally not taxed, such that business income is taxed only in the country where it is generated. If our hypothetical Brazilian car company were owned by a French parent corporation, the French government would not tax the car company profits, even when the profits were sent back to headquarters in Paris. Territorial countries, such as Canada, France, Germany, and the Netherlands, have various different mechanisms to exempt the foreign earnings of companies from tax.

Table 6.1 shows the two basic approaches to taxing multinational corporations. Of the 30 industrial countries in the OECD, 9 including the United States have worldwide systems and 21 have territorial systems.[3] Outside of the OECD, most countries also have territorial tax systems.[4]

The territorial approach is supported by the theory of "capital import neutrality." CIN posits that investments in any particular country should face the same tax rate no matter where the investment comes from. CIN is violated, for example, when British companies pay a 28 percent tax on their British investments, but U.S. companies pay a 35 percent tax on their British investments. That happens because U.S. companies pay the 28 percent British tax plus a net tax of 7 percent to the U.S. government on their British investments because of the U.S. worldwide tax system.

CIN supporters argue that U.S. companies should instead pay the same tax of 28 percent that British companies pay on their British

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investments, else they will face a competitive disadvantage. That result would be achieved under a territorial tax system. As we will discuss, territorial systems reinforce international tax competition, but worldwide systems tend to stifle it.

The worldwide tax approach, which is followed by the United States, has become less popular over time. More countries are adopting territorial tax systems. The United States is an "outlier in the sense of imposing a heavier tax regime on foreign income than other countries do," notes the University of Michigan's James Hines.[5]

However, it is also true that most countries follow neither the worldwide nor territorial approach strictly. The United States developed its international tax structure around the CEN principle, for example, but it has added many complex and jerry-built features over the years that follow no clear principles.[6]

In the extreme, CEN suggests that the U.S. government should immediately tax all the foreign profits of U.S. companies when earned abroad. Some U.S. politicians favor that goal, but the United States has not gone that route because it would further hinder the ability of U.S. companies to compete in foreign markets. Under a pure CEN system, for example, a U.S. company would pay a 35 percent tax on profits at a factory it owned in Ireland. Meanwhile, a French company would pay only the 12.5 percent Irish tax on profits at a factory in Ireland because France has a territorial tax system. The effect would be that U.S. companies would face a severe disadvantage in the Irish market compared with companies from France and elsewhere.

As a result of this problem with the CEN approach, a compromise in the U.S. tax system allows "deferral" of tax on the foreign income of U.S. companies. That means that foreign income is taxed only when repatriated to the United States. Thus, profits earned in Ireland only face the high U.S. tax rate when sent home to America. However, deferral is provided only to "active" foreign income, such as income from a manufacturing plant. "Passive" foreign income, such as interest on a company's foreign bank account, is taxed immediately by the U.S. government.

The divide between active and passive foreign income has been battled over since the basic U.S. international tax rules were put in place in 1962. Congress has often sought to expand the types of income that get taxed immediately because that allows it to raise

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revenues while claiming adherence to CEN. But U.S. companies have fought back, arguing that limitations on deferral make it even harder for them to compete in foreign markets. The result of this battle is a hugely complex set of tax rules on foreign investment that encourage sophisticated tax planning.

There is growing agreement that the U.S. tax system is out of step with the realities of the global economy. For one thing, the worldwide nature of the tax system makes the United States a poor place to locate the headquarters of multinational companies. When the U.S. tax rules were written in 1962, the idea that corporations might not want to be headquartered in America was not a concern. Back then, 18 of the world's 20 largest companies were headquartered in the United States, but today there are only 8.[7] The United States also has fewer nontax advantages for hosting corporate headquarters than it used to in order to offset the large tax disadvantages.

Another negative effect of the U.S. worldwide tax system is that it discourages the repatriation of foreign earnings. When U.S. companies earn profits abroad, they enjoy deferral if the profits are reinvested abroad. But if earnings are sent back to the United States, they are hit with the 35 percent federal corporate tax. If you tax something, you get less of it, so it is not surprising that the current tax system suppresses repatriation, which it turn probably reduces investment in the United States.[8]

A final nail in the coffin of CEN is that even if it were a good idea in theory, the efficiency gains that it claims are not achievable in the real-world economy. James Hines notes that "the logic of capital export neutrality assumes that the United States is the only country in the world that does any investing, and that's simply wrong."[9] If the United States follows CEN taxation and other countries do not, there is no neutrality, and thus no advantages from it. In addition, the rise of portfolio capital flows has reduced the importance of corporate investment in determining the efficient global allocation of capital. Further, important features of the U.S. system, particularly deferral and limitations on the foreign tax credit, render CEN unable to create the supposedly efficient solution that it envisions.

Why then do some scholars and policymakers in the United States continue to support CEN? One reason is that people fear "offshoring." They are concerned that unless the foreign income of U.S.

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companies is heavily taxed, companies will move their production abroad to low-tax countries, such as Ireland.

The reality is that if there is an economic or tax reason for a factory to exist in Ireland rather than in the United States, that factory will get built. The only question will be whether a U.S. or foreign company will own it. If the United States taxes foreign affiliates heavily, U.S. companies will own fewer such foreign factories, which would likely cause the profitably of U.S. businesses to fall and U.S. investment to decline, as we discussed in Chapter 2.

A key political reason for the continued support of CEN is that it provides a convenient rationale for policymakers to raise taxes on corporations. Tax proposals from those claiming adherence to CEN usually involve expanding the corporate tax base to raise revenues. In a new book, Gary Hufbauer and Ariel Assa note that "the prospect of gaining more revenue for the U.S. Treasury has been a driving force in legislative episodes of trying to implement CEN theory."[10] It seems that advocates of CEN would be satisfied if every country had a worldwide tax system with a high corporate rate of 60 percent. That would be "efficient" to their way of thinking, but it would be devastating to the global economy because investment would plummet and income levels would fall.

There is much less support for CEN today than in the past.[11] A growing number of experts believe that the United States should scrap worldwide taxation and adopt a territorial system. Gary Hufbauer argues that "the worldwide tax approach is justified by emotion not logic."[12] He notes that the U.S. system begins with the pure CEN theory, which is impractical, and then adds an array of special rules to try to make the system work in the real world. The result is a complex mess. It would be better to begin with the territorial approach, as most countries have done.

Worldwide taxation makes all countries worse off because it tends to stifle tax competition and reduce the pressure to cut tax rates. The result is less investment and slower economic growth. For the United States, worldwide taxation adds complexity to the tax code, undermines the competitive position of American companies, and delivers no benefits to the economy.

Details of the U.S. Corporate Tax System

The U.S. corporate income tax is very complex, but we need to explore a little deeper to understand how it affects businesses competing in global markets. In this section, we discuss how foreign tax

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credits, deferral, expense allocation, and complexity all play roles in international tax competition.

As background, note that foreign affiliates of U.S. businesses are generally structured as branches or subsidiaries. Foreign branches of U.S. companies are not separately incorporated abroad, and the U.S. government immediately taxes their profits when earned. U.S. banks, for example, often structure their foreign affiliates as branches.

By contrast, foreign subsidiaries are separately incorporated abroad. Most are "controlled foreign corporations," which means that they are more than 50 percent owned by U.S. shareholders.[13] U.S. taxes are generally imposed on subsidiary profits when profits are repatriated, or sent home, to the U.S. parent company. Put another way, U.S. taxes on subsidiary profits are deferred until profits are repatriated.

Foreign Tax Credits

In addition to U.S. taxes, foreign affiliates of U.S. companies pay taxes in the host countries where they are located. To avoid or reduce double taxation, the United States provides a tax credit for foreign taxes paid. The tax credit is limited to the lower of the foreign tax rate and the U.S. tax rate. Thus, a U.S. affiliate in Japan pays a 41 percent Japanese tax, and then a 35 percent U.S. tax when repatriated, but receives an offsetting 35 percent tax credit. The net result is that U.S. affiliates in Japan and other high-tax countries pay the higher foreign rate, although few countries have higher rates than the United States anymore.

The situation for U.S. affiliates in low-tax countries is not symmetrical. Those affiliates are not allowed to simply pay the lower foreign tax rate. Instead, they must pay the U.S. tax rate on their foreign income. As we noted, U.S. affiliates in Britain pay the 28 percent British tax plus an added 7 percent tax to the U.S. government, bringing the total to the 35 percent U.S. federal rate.

In some cases, the U.S. tax system promotes tax competition. For example, the fact that the foreign tax credit is limited provides a basic incentive for U.S. companies to avoid high-tax countries such as Japan. In other situations, the U.S. system discourages tax competition. Suppose a U.S. company was considering expanding into Asia by building a factory in either a country with a 15 percent tax rate

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or a country with a 30 percent rate. In the first case, the company would pay 15 percent to the host government and 20 percent to the U.S. government. In the second case, it would pay 30 percent to the host government and 5 percent to the U.S. government. The total tax bill in both cases would be the same, and the company would be indifferent about where to invest.

Note in this example that the government of the higher-tax country benefits when other countries have worldwide systems because it can maximize its own revenues without deterring inward investment. If all countries had worldwide systems, governments would feel little international pressure to cut tax rates.

Corporate tax competition is, however, more complicated than that. Within limits, U.S. corporations can blend income from their affiliates in high-tax and low-tax countries to minimize their taxes. Corporations that mainly have affiliates in high-tax countries generate "excess foreign tax credits." To the extent that they can use those excess credits to offset U.S. taxes on profits earned in low-tax countries, they are not penalized for investing in high-tax countries. In this situation, the U.S. worldwide tax system takes the sting out of investing in high-tax countries while allowing companies to benefit from investing in low-tax countries.

By contrast, U.S. corporations with affiliates mainly in low-tax countries do not generate excess foreign tax credits. As a result, they may be less interested in making new investments in low-tax countries because they may be hit by the full U.S. tax rate on the profits earned. By deterring further investment in low-tax countries, the U.S. worldwide tax system in this situation stifles tax competition.

The point is that different companies are in different tax situations with respect to the foreign tax credit. That affects their incentives to seek further investments in low-tax or high-tax countries. In some ways, the current U.S. system promotes tax competition and in other ways it discourages it.

These effects can be illustrated by the Tax Reform Act of 1986. The act reduced the U.S. corporate tax rate from 46 to 34 percent, a rate below many other countries at the time. The tax cut was expected to push many U.S. companies into an excess foreign tax credit position, providing them an added incentive to invest in low-tax countries. U.S. foreign investment became more tax sensitive, and that prompted many foreign governments to cut their own tax rates.[14]

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A further complication of the foreign tax credit is that the ability to blend income from high- and low-tax countries is limited. Foreign income must be placed into different "baskets" that cannot be mixed, which can raise the tax burden on foreign income. However, a 2004 law crafted by former House Ways and Means Committee chairman Bill Thomas simplified the basket system, although it added some new complexities to the tax code as well.[15]

Deferral

Now we will look at deferral in more detail. As noted, the "active" income of foreign subsidiaries is generally not taxed by the U.S. government until repatriated. By contrast, "passive" foreign income, such as interest, is taxed immediately. For example, if a U.S. subsidiary in Ireland earned profits from a computer plant that it then deposited in a British bank, the interest earnings would be immediately taxed in the United States.

The primary U.S. anti-deferral rules, called "subpart F," were introduced in 1962.[16] In addition to covering passive income, these rules disallow deferral on foreign "base company" sales and services income, such as income from sales into third countries from certain U.S. subsidiaries. Thus, profits from export sales to Germany from a U.S.-owned Swiss subsidiary may be immediately taxable in the United States.

In 1986, deferral was ended on certain income earned abroad by U.S. financial services companies. That damaged the ability of firms such as American Express to compete in foreign markets. More recently, financial firms have won temporary reprieves from this punitive subpart F treatment. But if these reprieves expire as scheduled, U.S. financial firms would be put at a "tremendous competitive disadvantage" to firms in other countries, noted one accounting firm tax partner.[17]

Subpart F sounds obscure and abstract, but it can cause real damage. American Express gave an example of the damage in testimony to Congress:

> American Express purchased a Swiss bank in 1983. Its business operations were exclusively outside the U.S. and its customers were not U.S. persons. Its effective tax rate of about 9 percent increased to 40 percent in 1987 when the changes in the subpart F rules made its earnings subject to U.S. tax. Our subsidiary thus became subject to a much higher

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> tax rate than our foreign competitors solely because of its U.S. ownership. We disposed of our controlling interest in the Swiss bank in 1990.[18]

One dramatic example of the damage caused by subpart F regards the U.S.-owned commercial shipping fleet. Before 1975, taxes on foreign shipping income could be deferred until income was repatriated to the United States. But anti-deferral legislation in 1975 and 1986 made this income immediately taxable. The United States became the only country that taxed foreign shipping income in such a punitive way, and that gave foreign-owned shipping companies a large competitive advantage.[19]

The result was devastating. During the 1980s and 1990s, there was an ongoing transfer of U.S. ships to foreign ownership. Singaporean and Dutch companies purchased the largest U.S. shipping companies. Note that most of the world's commercial ships fly the flags of open-registry countries, such as Panama, but are owned elsewhere. The U.S.-owned share of this open-registry fleet plummeted from 26 percent in 1975 to just 5 percent by the late 1990s because of the increased U.S. taxation under subpart F.[20]

The effort by Congress to raise money from U.S. shipping companies ended up causing the opposite—it lost revenue because the tax base simply migrated abroad. Congress finally realized its error in 2004 and passed legislation to reinstate deferral for the shipping industry. There are already some signs that the U.S. shipping industry is reviving.[21] Ken Kies, former head of the Joint Committee on Taxation, concluded that the ''lesson learned from the shipping industry's experience is that U.S. businesses will surely be lapped in global markets when subject to taxes not borne by their competitors.''[22]

Although the rules for the shipping industry have been fixed, the U.S. anti-deferral rules are still considered to be the strictest and most complex in the world. The U.S. Council for International Business, which represents more than 300 large U.S. corporations, calls the broad sweep of subpart F rules "ill-conceived," "onerous," and the "most burdensome" among major nations.[23]

In a major report in 2001, the National Foreign Trade Council concluded that "U.S. anti-deferral rules have been the subject of constant legislative tinkering, which has created both instability and

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a forbiddingly arcane web of rules, exceptions, exceptions to exceptions, interactions, cross references, and effective dates, giving rise to a level of complexity that is intolerable."[24]

Expense Allocation

The tax rules for "expense allocation" create another anti-competitive burden on U.S. multinational corporations. These rules require companies to allocate a portion of certain domestic expenses to foreign income. The effect is to reduce allowable foreign tax credits and increase U.S. tax liability for some companies. The U.S. tax rules in this area are more onerous than those of other countries, and they often do not make economic sense. James Hines explains:

> Suppose that a firm spends $50 on domestic administration designed to improve domestic efficiency and thereby generate $55 of additional domestic output. From an efficiency standpoint this is clearly a worthwhile expenditure, since it produces more value ($55) than it costs ($50). If, however, the allocation rules require the firm to allocate $20 of this expenditure to foreign source, then the firm's foreign tax credit limit will be reduced. . . . and the firm will be obliged to pay $7 of additional U.S. tax on its foreign source income. As a result, the firm will have an incentive to forego the economically beneficial domestic efficiency improvement, since doing so triggers additional tax due on foreign income.[25]

The expense allocation rules for research and development are particularly damaging because they can effectively deny companies deductions for their U.S. R&D costs. If a company hires a scientist in the United States, some portion of his or her salary may, in effect, not be deductible. In that situation, the company might decide to hire the scientist at one of its facilities abroad and the U.S. economy would lose out.

These R&D tax rules are more punitive than the rules in other countries, and they illustrate how Congress often takes a legalistic approach to tax policy without regard to the economic consequences.[26] U.S. lawmakers seem transfixed by the goal of ensuring that absolutely no income ever escapes the federal tax dragnet. But from an economic perspective, if the expense allocation rules damage a crucial activity such as R&D, then it makes sense to relax the rules. It is more important for American companies to hire scientists than it is for the government to squeeze more money out of businesses.

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When one adds up the effects of the expense allocation rules and other U.S. rules on foreign income, Congress is making it difficult for U.S. companies to compete. The National Foreign Trade Council concluded: "No other country has adopted rules with the broad sweep of subpart F; nor have other countries enacted foreign tax credit regimes as restrictive as the U.S. regime. As a result, the foreign-based multinationals that are now the United States' toughest competitors have consistently enjoyed lighter home-country taxation than U.S.-based companies."[27]

Complexity

A final point of concern about the U.S. corporate tax is its enormous complexity. A study by the World Bank and PricewaterhouseCoopers found that the United States had the fifth-longest tax code among the 20 largest economies.[28] The United States also ranked very poorly (122nd out of 178 countries) for the time required to comply with business taxes.[29] The World Economic Forum found that tax rates and tax regulations are "the most problematic factors for doing business" in the United States.[30]

It is the taxation of foreign income under the worldwide system that is the main cause of complexity for U.S. multinational companies. Consider that Dow Chemical's tax return one year was 7,800 pages in length, and four-fifths of those pages related to the rules on foreign income.[31] Here is a sampling of comments from corporate tax experts that illustrate the frustration with the current system:

- Pam Olson, a former Treasury official: "No other country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity."[32]
- Willard Taylor, one of nation's top tax lawyers: "There's general agreement that the subpart F and foreign tax credit rules that relate to outward investment are stupefying in their complexity and not administrable."[33]
- Kimberly Clausing and Reuven Avi-Yonah in a Brookings Institution study: "The U.S. system is also notoriously complex: observers are nearly unanimous in lamenting the heavy compliance burdens and the impracticality of coherent enforcement."[34]
- Mihir Desai of Harvard University: The tax rules result in "extremely high levels of distortions, very little revenue, and

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as a consequence within the spectrum of the tax code generally, I think it's fair to say the international provisions are among the worst."[35]

- Bob Perlman, a former vice president for taxes for Intel: "The degree to which our tax code intrudes upon business decision-making is unparalleled in the world. . . . Other countries do not have such complex rules."[36]

One root of these problems is that politicians view large corporations as "cash cows" that can absorb tax hikes out of view of the voters. Congress has added a mess of ad hoc provisions over the decades to raise revenue from multinational companies. At the same time, globalization and financial innovation create more complicated tax issues, which in turn provide companies greater scope for tax avoidance. The government has responded with layers of rules and regulations to prevent avoidance, rather than simplifying the system and cutting the tax rate.

Policymakers need to focus on economic efficiency and competitiveness, and not on milking corporations dry. While other countries lead on corporate tax cuts, the United States leads the world on imposing complex tax regulations on corporate foreign income. But the strategy of adding laws and regulations for each new corporate tax problem, without pursuing fundamental reforms, is a dead end for the government, businesses, and the U.S. economy.

Business Responses to Taxes

The complexity of corporate taxation means that international tax competition is a complicated game for businesses. For one thing, different tax rates apply to different types of business decisions. *Marginal effective* tax rates affect incremental decisions, such as how much to expand an existing factory. *Average effective* tax rates affect large and discrete decisions, such as in which country to build a new factory. And *statutory* tax rates affect decisions regarding both investment and tax avoidance, such as shifting profits from high-tax to low-tax countries.

Corporations respond in two basic ways to the international tax climate. They alter their real business activities and they use financial techniques to move reported profits out of high-tax countries. This section describes some of the particular methods that companies use to reduce their global tax burdens. Our goal is to illustrate the

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rising mobility of taxable profits, and highlight the need for a major corporate tax rate cut.

Capital Investment. Businesses have an incentive to invest in places that have low tax rates, as well as favorable depreciation rules for buildings and equipment so that they can quickly deduct the cost of new investment. One study found that the depreciation rules in the United States are slightly more favorable than the average for 19 countries studied.[37] But different types of investment face different tax burdens. For example, U.S. depreciation rules for energy investments, such as oil refineries and electricity generation, are generally less favorable than the rules in other major countries, such as Canada.[38] One effect might be that electricity generation capacity gets added faster in Canada, which allows that country to increase electricity exports to its southern neighbor. In Chapter 10, we discuss the idea of scrapping the depreciation system and adopting simpler and more efficient "expensing," or the immediate deduction of the cost of capital purchases.

Research and Development. R&D is a highly prized activity, and most countries offer a special tax credit to stimulate it, including Britain, Canada, Ireland, Japan, and Spain. The United States has offered an R&D tax credit since 1981, and also allows spending on R&D to be expensed, or deducted immediately. For research-intensive industries, such as computers and pharmaceuticals, it makes sense for companies to locate in places that have a good supply of skilled workers, low tax rates, and favorable tax treatment of R&D.

Dividend Repatriations. U.S. companies often accumulate substantial foreign earnings that they would like to repatriate to the United States. But repatriation can create a large tax hit because foreign earnings are taxed when brought back to the United States. Businesses need to optimally time their repatriations from high- and low-tax subsidiaries to maximize foreign tax credits. Also, businesses need to consider repatriating foreign income in the form of dividends, interest, rent, or royalties, as each may be subject to different tax rules. Another strategy is to avoid repatriating foreign earnings when in a loss position.[39] If firms do repatriate earnings in loss years, they should repatriate them in the form of royalties or interest,

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not dividends.[40] Anyway, one can see how international financial decisions get distorted by complex tax rules.

Debt and Equity. Multinational corporations can change their levels of debt and equity in foreign affiliates to alter their taxable income in different countries. To generate interest deductions, firms generally want to maximize borrowing in places that have high tax rates. "Earnings stripping" refers to the technique of using interest deductions to shift earnings from high-tax countries to low-tax countries. The high U.S. corporate tax rate, for example, is thought to spur foreign companies to shift profits out of their U.S. subsidiaries. Another example of such financial planning would be a Dutch company's financing its subsidiary in high-tax Germany with debt but financing its subsidiary in low-tax Ireland with equity.[41]

Transfer Pricing. Multinational businesses use transfer pricing to shift profits from high-tax to low-tax countries. That involves setting prices on intracompany purchases and sales too high or too low, compared with "arm's-length" or market transactions. For example, if a U.S. company underbills its Irish subsidiary for some materials that it purchased, it has effectively shifted profits out of the United States to low-tax Ireland.

Tax avoidance through transfer pricing is a large and growing phenomenon. Many tax experts view it as the most problematic area in international taxation.[42] But it is not known exactly how large the problem is because it is difficult to determine what the correct price on particular transactions should be. Many transactions are unique and have no market comparison. Also, many intracompany transactions involve intangible assets, which are very difficult to value. Microsoft has apparently used transfer pricing to shift substantial income from its intangible assets to low-tax Ireland.[43]

The United States has imposed very complex rules to thwart transfer-pricing abuses. Corporations face much greater reporting requirements and higher penalties for cheating than in the past. Often, the problem is not clear-cut cheating but the fact that correct transfer prices are simply unknown. For this reason, litigation over transfer pricing is a big industry with billions of dollars at stake in battles between the government and large companies.[44]

As the volume of international transactions grows larger, many tax experts think that transfer pricing is becoming more "economically

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illogical" and "inherently unadministrable."[45] A Brookings Institution study argues that the current transfer-pricing standard is "administratively unworkable in its complexity."[46] We do not know the full solution to these problems, but there is no doubt that a sharp cut to the U.S. corporate tax rate would greatly reduce U.S. transfer-pricing disputes.

Intangible Assets. A rising share of corporate value is in the form of intangible assets or intellectual property, such as patents, trademarks, and copyrights. A recent study found that two-thirds of the value of U.S. manufacturing companies was in the form of intangible assets.[47] These assets are large and very mobile, and thus very important to international tax competition.

U.S. tax rules encourage companies to develop intangible assets in the United States through R&D, and then to earn profits on those assets in foreign countries.[48] Foreign subsidiaries pay a royalty to the U.S. parent for the use of these assets. Most of these royalty payments are effectively free of U.S. taxation.[49] Thus, the current tax system encourages expanded R&D in the United States, which is good. The problem is that firms are encouraged to shift their high-technology production abroad, as we discuss further in Chapter 10.

The high U.S. corporate tax rate gives firms an incentive to pay artificially high royalties from the United States to lower-tax foreign affiliates because that shifts profits abroad. The high U.S. tax rate also encourages companies to move the ownership of intangible assets to lower-tax countries.[50] Ireland and Singapore, for example, are popular locations for U.S. corporations to hold their intangible assets.

It has been widely reported that a Microsoft subsidiary in Ireland licenses the company's software for use in much of the world. That generates deductions for royalty payments in the countries where the software is used and generates income in low-tax Ireland.[51] We see a similar mobility of intangible assets within the United States—businesses often move their intangible assets to Delaware, which does not tax the income from them.

One expert expressed the difficulty of taxing intangible assets in the global economy: "Moving intellectual property between tax jurisdictions is a paper-based enterprise. With the continued surge in intellectual property investment and the integration of foreign and domestic technology markets, there is an increased incentive

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for U.S. companies to locate their assets in tax-advantaged jurisdictions. In spite of the IRS's attempts to stem the flow of intellectual property assets offshore . . . the assets eventually will find their way offshore."[52] The core problem, once again, is that the high federal corporate tax rate provides a strong incentive for the tax base to migrate abroad.

Business Structures. An important part of business tax planning is choosing a tax-efficient legal structure. At the domestic level, there are C corporations, S corporations, limited liability companies, limited liability partnerships, real estate investment trusts, and other business types. For foreign activities, U.S. companies can use branches, subsidiaries, holding companies, partnerships, and joint ventures. Each structure has pros and cons for tax planning. For example, foreign operations can be initially set up as branches so that losses are deductible against U.S. taxes, and then turned into subsidiaries later on when they become profitable. The same foreign activity can be undertaken in different ways with different tax results. Debt can be turned into equity, and vice versa, by the use of different structures.

Enron was infamous for its use of fancy business structures to reduce its tax burden.[53] For example, Enron had trouble deferring U.S. tax on its foreign earnings, so it created a complex structure of about 250 foreign affiliates to accomplish the task.[54] It is common practice for U.S. companies to create a complex array of foreign affiliates to minimize taxes, which is not illegal, just a side effect of the high-rate, worldwide U.S. tax system.

The congressional investigation of Enron's tax activities found that "prudent tax planning typically requires a U.S. based multinational enterprise to use a combination of many different entities in many different jurisdictions, even if the enterprise's tax planning goals are limited to . . . generally unobjectionable ones."[55] The investigation noted that multinational companies often have affiliates in tax havens such as the Cayman Islands, and acknowledged that such tax planning is a legitimate business activity.[56]

An interesting development in tax planning is the growing use of "hybrid" structures spurred by "check-the-box" regulations that became effective in 1997.[57] Hybrids are structures that are considered to be different under U.S. and foreign laws, thus allowing companies

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to arbitrage differences in country tax rules. These rules have facilitated many tax-planning techniques that have allowed U.S. companies to reduce their global tax burdens, thus increasing their ability to compete abroad.

Corporate Headquarters. Tax competition is not just about whether U.S. companies will build factories at home or abroad in places such as China. It is also about whether the factories that are being built in China will be owned by companies headquartered in the United States or in other countries. The location of company headquarters matters for the economy, as we discussed in Chapter 2. For the United States, it is important to provide a hospitable tax climate for corporate headquarters by allowing companies to pursue foreign investments without punitive U.S. tax treatment.

Unfortunately, "from an income tax perspective, the United States has become one of the least attractive industrial countries in which to locate the headquarters of a multinational corporation," noted Glenn Hubbard, the former chairman of the Council of Economic Advisors.[58] Gary Hufbauer and Ariel Assa argue that the current U.S. tax system creates a "hostile climate" for multinational companies, encouraging them to put their headquarters in places such as London or Singapore rather than New York or Los Angeles.[59]

The United States has both a high tax rate and a worldwide tax system, which imposes burdens on foreign business operations. Under current law, one could take a U.S. multinational corporation and move its headquarters to a territorial country, such as the Netherlands, and the company would likely pay less tax.

Many countries offer lower tax rates than the United States, territorial tax systems, and in some cases special tax benefits for headquarters. One expert noted that "headquarters tax havens are proliferating because of tax competition."[60] Belgium, Ireland, the Netherlands, and Switzerland have become popular headquarters locations because of favorable tax rules.[61] U.S. companies Biogen, DuPont, Hewlett-Packard, Philip Morris, Procter and Gamble, and others have set up their European headquarters in Switzerland.[62] Kraft Foods and Yahoo! recently moved their European headquarters from London to Switzerland. EBay has major operations in Dublin and Switzerland.

A Swiss government website boasts that the country "is known worldwide for its attractive corporate tax regime. Tax rates are

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among the most competitive for international onshore locations."[63] The website goes on: "Holding companies . . . are basically exempt from taxation on dividend and capital gains income from their substantial shareholdings. Other income such as interest income and management fees are subject to tax only at the federal level at the effective tax rate of 7.8 percent."[64]

As an aside, headquarters tax havens allow multinational companies to reduce taxes on their high-cost affiliates if they can make deductible payments to the haven headquarters. That may have the effect of reducing the pressure on high-tax countries to lower their rate as long as they permit foreign investors to engage in earnings-stripping activities.

Anyway, many countries want to attract headquarters, and the U.S. tax disadvantage may be leading to a gradual movement of headquarters out of the United States. For example, when U.S. companies are involved in international mergers, it makes tax sense to establish their headquarters abroad. A PricewaterhouseCoopers study found that between 1998 and 2000, U.S. companies were the target (and foreign companies the acquirers) in more than three-quarters of large cross-border mergers and acquisitions.[65] Most notably, the 1998 merger creating Daimler-Chrysler (now split up) established corporate headquarters in Germany, not the United States. However, the mix of U.S. and foreign targets in cross-border mergers has been more even at about 50–50 in recent years.

For U.S. companies with substantial foreign operations, it makes tax sense to restructure as a U.S. subsidiary of a foreign company. Such restructuring can eliminate any U.S. tax on a firm's foreign income, such as under subpart F. It can also allow companies to reduce U.S. taxation on U.S. income through various tax avoidance techniques.

There was a marked increase in the number of U.S. companies using this strategy of reincorporating abroad—called expatriating or inverting—in the 1990s. Between 1996 and 2002, 25 large corporations merged into foreign parent companies.[66] These firms included Cooper Industries, Foster Wheeler, Fruit of the Loom, Global Marine, Ingersoll-Rand, and Tyco. When Stanley Works announced its decision to expatriate, its chairman said that it would cut its effective income tax rate by 7 to 9 percentage points.[67]

Before the inversion trend in the 1990s, it was thought that firms that inverted would suffer share devaluations because of the loss

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in reputational benefits of being a U.S. firm. But the inversions of the 1990s generally led to higher share prices, not lower. That indicated that the global economy has become flatter—shareholders apparently did not care that companies would be headquartered outside of the United States, they just wanted to cut taxes and increase their returns.

Congress passed legislation in 2004 to deny companies any tax benefits from expatriation.[68] Sadly, that was a typical Washington response—politicians putting a Band-Aid on the symptom of a problem, but doing nothing to address the underlying issue of the tax code's uncompetitiveness. Corporate expatriations are a canary in a mineshaft, and Congress decided to kill the canary.

Federal legislation will not stop a gradual migration of U.S. business activities abroad if the U.S. tax system remains so unattractive. American entrepreneurs who are launching businesses and plan to have substantial international sales will incorporate their businesses abroad at the outset. A business that provides services to oil-drilling companies in Texas and the Middle East, for example, would be better off from a tax perspective incorporating in Dubai than in Dallas.

Uncompetitive U.S. tax rules will also dissuade foreign companies from establishing their headquarters here. In 2005, the Chinese computer firm Lenovo purchased IBM's personal computer business, and it initially planned to move corporate headquarters from Beijing to New York.[69] It decided against that, and the company is now incorporated in Hong Kong.

It makes no sense to scare away corporate headquarters and the related jobs, but that message has fallen on deaf ears in Congress. A recent proposal from House Ways and Means Committee Chairman Charles Rangel (D-NY) would have imposed further tax increases on the foreign income of U.S. businesses. One law firm noted on the Rangel bill, "The proposals would increase the marginal U.S. cost to U.S.-based multinationals of expanding and maintaining their foreign activities, which could have the unintended effect of decreasing U.S. jobs that support such foreign activities."[70]

Low Taxes Attract Investment and Profits

Investment and profits have become very responsive to country tax rates through the mechanisms we discussed. This section discusses some of the empirical evidence. First, consider that the top

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locations for U.S. foreign affiliates with regard to reported profits are all moderate- or low-tax places—the Netherlands, Ireland, Bermuda, Britain, and Luxembourg.[71] One study found that countries with tax rates that were 10 percent higher received about 30 percent less direct investment from the United States.[72]

Ireland in particular attracts large amounts of investment and profits because of its low corporate tax rate of 12.5 percent. In 2004, this small nation attracted about 8 percent of all the profits of U.S. foreign affiliates.[73] Economist Martin Sullivan notes that businesses get an initial tax break on their real investment in Ireland, and then they get a second-round break if they shift profits to Ireland through various financial techniques.[74]

Tax scholars generally agree that taxes drive the decisions of multinational corporations.[75] In summarizing the academic studies, the U.S. Treasury found that a "country with an effective tax rate 1 percentage point lower attracts about 3 percent more capital."[76] A review by the Organization for Economic Cooperation and Development concurs with that finding.[77] Here is a brief sampling of the conclusions of some top scholars:

- James Hines finds that "taxation significantly influences the location of foreign direct investment, corporate borrowing, transfer pricing, dividend and royalty payments, and research and development performance."[78]
- Mihir Desai concludes that "multinational firms are extremely aggressive and sensitive in responding to [taxes] on the margins of avoidance, ownership, and investment."[79]
- Jack Mintz notes that "studies show conclusively that business taxes significantly affect investment in a country."[80] He finds that "high effective tax rates on capital result in less foreign direct investment and therefore less economic growth."[81]

To appreciate the effects of taxation, we can look at the actions and statements of particular companies. For example, SanDisk, a U.S. maker of music players, reported $106 million in profit in Ireland in 2005, even though the company had only eight employees there.[82] The company is apparently using financial techniques to move its global profits to Ireland. Some people might criticize SanDisk for avoiding taxes, but we think that the United States should emulate

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Ireland's success and cut tax rates to induce corporate profits to move here.

Intel Corporation calculates that it costs $1 billion more to build and operate a semiconductor plant in the United States than abroad. About 70 percent of the higher U.S. costs are tax costs. Intel's chairman, Craig Barrett, has testified that these tax cost differences are a key driver of the firm's investment decisions.[83] He has also noted that labor cost differences across countries are a much less important factor because "advanced chip factories are highly automated and the employees are well-trained and well-paid in all locations."[84]

For other companies, taxes play a somewhat different role. Dow Chemical and General Electric have both testified that taxes do not necessarily determine where they will invest, but instead determine whether foreign companies can outcompete them in global markets.[85] For example, a German multinational company may have an advantage in foreign markets compared with Dow or GE because German corporate taxes are less burdensome in many ways than U.S. corporate taxes. The effect will be that U.S. firms lose global market share, which reduces their ability to hire workers and invest in the United States.

Lower Corporate Taxes Create Higher Wages

Governments can respond to the increasing mobility of corporations in either of two ways. They can try to fence in the existing corporate tax base with layers of new rules and regulations, which is the approach taken in recent years by the United States. Alternatively, governments can embrace globalization by cutting the corporate tax rate and simplifying the tax system. As we discuss here, the effect of the latter is to boost economic growth and increase wages, while losing governments little if any revenue.

Corporate tax policy is ultimately about investment, wages, and living standards. The effects of corporate taxation on investment have been heavily studied and the results are clear. In a 2008 study, World Bank and Harvard University researchers noted that research generally "finds large adverse effects of corporate taxation on investment."[86] In their analysis, the researchers looked at the relationships between taxes and economic variables across 85 countries:

> In a cross-section of countries, our estimates of the effective corporate tax rate have a large adverse impact on aggregate

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> investment, foreign direct investment, and entrepreneurial activity. For example, a 10 percent increase in the effective corporate tax rate reduces the aggregate investment to GDP ratio by 2 percentage points. Corporate tax rates are also negatively correlated with growth, and positively correlated with the size of the informal economy.[87]

In the global economy, if a country increases its corporate tax rate, it raises the pretax rate of return that investment projects need to proceed because after-tax returns tend to be equalized across countries. Put another way, if a government increases the tax "wedge" between pre- and posttax returns, the pretax return must be even higher to justify a new investment.

The result will be that fewer investment projects will be undertaken, and capital will flow out of the country. With a smaller capital stock, labor productivity will fall, which puts downward pressure on wages. With fewer machines to work with, workers' labor is worth less and businesses will cut pay. For the economy, a smaller capital stock and lower wages translate into a lower standard of living. Thus, in a globalized economy, much of the corporate tax burden falls on workers, not on the owners of capital.

High taxes on capital, including corporate income taxes, make little sense in the modern economy. Economists Martin Feldstein, James Hines, and Glenn Hubbard note:

> Many economists argue that it is inefficient to use corporate income taxes to raise revenue in open economies. If capital is internationally mobile, the burden of corporate taxes falls largely on other immobile factors (such as labor), and the tax system would be more efficient if these other factors were instead taxed directly.[88]

In other words, if the government wants to raise taxes by $100, it would be better to collect the money directly from a tax on wages rather than a tax on corporate profits. The burden of the latter will end up on workers anyway, but there will be a lot more economic damage done. Interestingly, this idea was discussed two centuries ago by Scottish economist Adam Smith. Smith described how heavy taxes on mobile "stock" or capital caused a loss to workers:

> Land is a subject which cannot be removed, whereas stock easily may. The proprietor of land is necessarily a citizen of

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> the particular country in which his estate lies. 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, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labor. 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. Not only the profits of stock, but the rent of land and the wages of labor, would necessarily be more or less diminished by its removal.[89]

Politicians and pundits claiming to represent America's workers often denounce any proposed corporate tax cut. In reality, workers, investors, and corporations all have the same interest in corporate tax cuts. Harvard University's Greg Mankiw describes a simple model where a democracy contains two groups: workers and capital owners.[90] Since workers outnumber capital owners, they can vote to set any tax rates they want. But in a world of mobile capital, workers voting in their own interest would impose a zero tax on capital because that would result in a larger capital stock in the long run and higher wages.

Numerous empirical studies have looked at these relationships. William Randolph of the Congressional Budget Office found that about 70 percent of the corporate tax burden falls on workers and about 30 percent lands on the owners of capital.[91] These particular shares depend on various factors, such as how mobile capital is assumed to be.

A 2007 study by Oxford University economists looked at the burden of corporate taxes using data on 23,000 companies in 10 countries.[92] They found that in the long run, every $1 increase in corporate taxes results in a drop in wages of more than $1, perhaps as much as $1.70.

A 2006 study by economists Kevin Hassett and Aparna Mathur looked at the relationship between corporate taxes and manufacturing wages across 72 countries.[93] They found that a 1 percent increase in the corporate tax rate would reduce wages by 0.8 percent.

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In another recent study using data covering 30 countries, Rachel Felix of the University of Michigan found that a 10 percentage point reduction in the corporate tax rate would increase average wages by 7 percent in the long run.[94] Thus, cutting the federal corporate tax rate from 35 percent to 25 percent would result in U.S. wages rising 7 percent. Given that U.S. wages totaled $6 trillion in 2006, a tax cut of that size would increase wages by more than $400 billion annually—a dollar value many times the size of the government's likely revenue loss.[95]

Finally, we have recent evidence from Canada about the positive effects of corporate tax rate cuts. Between 2001 and 2004, Canada cut its federal corporate rate from 28 percent to 21 percent. A detailed government analysis in 2007 found that business investment "was strongly and positively influenced" by the rate cuts.[96] The analysis concludes, "Business tax reductions therefore contribute to improved living standards of Canadians."[97]

Corporate Tax Laffer Curve

Given the large potential benefits of a corporate tax rate cut, it is a mystery why Congress has not enacted one. One sticking point seems to be that policymakers are concerned about the effects of tax cuts on the federal budget deficit. Of course, when Congress is considering spending increases, it seems little concerned about the deficit. But let us put that point aside and just focus on the effects of tax cuts on federal revenues.

Recent experiences abroad suggest that governments lose little if any revenue when high corporate tax rates are cut. Corporate tax cuts create strong dynamic responses that can offset reductions in revenues. The size of tax bases are inversely related to tax rates—when rates are cut, tax bases expand as economic activity increases and tax avoidance is reduced. As we have discussed, corporate tax bases are particularly responsive to tax rates.

One piece of evidence for this is that there is little relationship between corporate tax rates and corporate tax revenues across countries.[98] For example, the U.S. statutory and effective corporate tax rates are among the highest in the world, but U.S. corporate tax revenues as a share of gross domestic product are below average.[99]

It is also instructive to look at changes in tax rates and revenues over time. For a group of 19 advanced economies with data back

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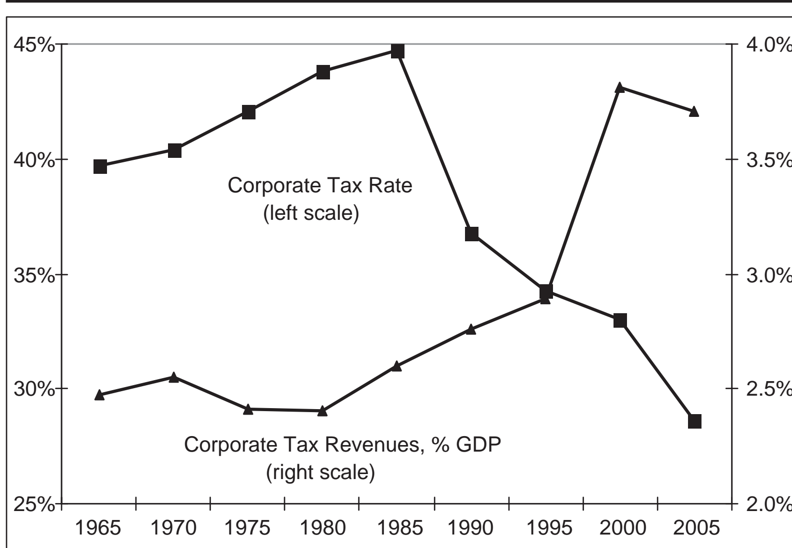
Figure 6.1
CORPORATE TAX RATES FALL AND REVENUES RISE, AVERAGE OF 19 INDUSTRIAL COUNTRIES



SOURCE: Authors' calculations based on data for 19 OECD countries. Federal corporate rates only.

to the 1960s, we calculated the average corporate tax rate and average corporate tax revenues as a share of GDP.[100] Figure 6.1 shows that the average tax rate was 40 percent or more before the mid-1980s. Then tax rates began to plunge, with the average rate falling from 45 percent in 1985 to 29 percent by 2005. But corporate tax revenues did not decline. In fact, tax revenues soared from 2.6 percent to 3.7 percent of GDP during this period.[101] That is a 42 percent increase of corporate revenues relative to the size of the economy, which is an impressive expansion.

Why have corporate tax revenues risen so dramatically? One reason is that many countries broadened their corporate tax bases, often by reducing depreciation deductions. However, it appears that most base broadening occurred in the late 1980s, with fewer efforts in that regard in the past 15 years or so. Indeed, the average value of depreciation deductions across major countries has been more or less unchanged since the mid-1990s.[102] Effective tax rates, which

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include features of the tax base, have fallen with statutory rates in recent years.[103]

Instead, the main factor causing the surge in corporate tax revenues appears to be taxpayer responses to reduced tax rates. Lower rates generate more real investment and higher incomes over time. Harvard's Greg Mankiw and Matthew Weinzierl examined the revenue effects of cuts to taxes on capital in a 2004 study.[104] They found that tax cuts would generate higher investment and growth that would offset half the government's revenue loss in the long term. German economists Mathias Trabandt and Harald Uhlig found similar results in a 2006 study.[105] Suppose a simple calculation predicted that a corporate tax cut would deprive the government of $100 billion over time. These studies suggest that due to real-world dynamic effects, the government would actually forgo only about $50 billion.

In addition to real investment effects, tax rate cuts prompt an array of tax avoidance responses. As tax rates change, corporations have myriad ways to shift profits internationally, as we discussed. Corporate tax cuts also induce changes in domestic avoidance activities. For example, as corporate tax rates fall, economic activity shifts from noncorporate to corporate businesses. One study found that 0.2 percent of the increase in the tax-to-GDP ratio since the early 1990s in Europe was attributable to this shift.[106] In the United States, there has been a big shift in activity to business structures not subject to the high-rate corporate tax.[107]

We have focused on legal tax avoidance; but if the United States cut its corporate tax rate, illegal tax evasion would also be reduced. We don't know how large this effect would be, but we do know that tackling evasion has been a key factor in prompting other countries to cut their rates recently, including Egypt, Germany, and Russia.

Considering the whole range of responses to taxes, cutting the U.S. corporate rate would likely induce a large expansion of the corporate tax base. Both U.S. and foreign firms would invest more in the United States, and they would have less incentive to shift reported profits out of the United States.

The Laffer curve illustrates the idea that above a certain tax rate, cuts to the rate cause the tax base to expand sufficiently for revenues to increase. Economists Alex Brill and Kevin Hassett looked at Laffer curve relationships in the OECD countries. They found that increases

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to corporate tax rates above about 26 percent tended to reduce government revenues.[108] At 40 percent, the U.S. federal plus average state rate is 14 percentage points above that rate, and thus probably far into the revenue-losing Laffer zone. Economist Jack Mintz has found similar Laffer curve results for the corporate income tax.[109] Other research has found that the U.S. corporate capital gains tax rate is also well into the revenue-losing zone of the Laffer curve.[110]

In sum, a modest federal corporate tax rate cut to about 25 percent would probably result in no revenue losses to the government in the long term. However, the goal of tax policy is not to fatten the government with added revenues, but to maximize U.S. economic growth. With that goal in mind, a much larger rate cut is in order. Indeed, many economists agree—at least in theory—that the corporate income tax should be abolished entirely because of the large distortions that it creates. We discuss that option in Chapter 10.

To begin catching up with tax cuts abroad, we propose that policymakers cut the federal corporate tax rate from 35 percent to 15 percent. That would not quite match Ireland's 12.5 percent corporate rate, but it would reduce tax avoidance, spur growth, increase wages, and make America the premier location for international investment.

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7. The Economics of Tax Competition

Governments around the world have pursued many different economic policies. That diversity has created a wide range of economic outcomes—from glittering prosperity in some nations to abject poverty in others. Over time, it has become clearer which sorts of economic policies, including tax policies, should be pursued to improve living standards.[1] However, although a general consensus favors markets, not all governments pursue pro-market policies. Nations are generally free to choose their own economic policies, and some choose to expand their governments whereas others focus on expanding their economies.

Taxpayers have choices as well. If a government's tax policies are oppressive, citizens can revolt, either at the ballot box or by taking to the streets. They can also revolt by avoiding taxes in their working, investment, and migration decisions, which has become much easier in the globalized economy, as this book has explained.

Tax competition is all about choice, and that makes it similar to competition in the marketplace for goods and services. In the marketplace, people compare the costs and benefits of products when deciding what to buy. Consumer choice encourages businesses to produce efficiently and to respond to the real needs of individuals. To an extent, tax competition does the same thing for governments. By limiting the ability of politicians to raise taxes, it encourages them to implement better tax policies and be more frugal with taxpayer money.

The economics literature on tax competition traces its modern lineage to a 1956 study by Charles Tiebout.[2] According to Tiebout, competition between local governments for mobile households enhances society's welfare. Competition encourages governments to tailor spending and taxation to suit local preferences. Individuals will migrate between jurisdictions based on their demand for government services relative to tax levels. Households that want expansive government services can choose to live in jurisdictions with

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higher taxes. Others will choose to live in jurisdictions with lower taxes and more limited services.

Tiebout's theory focused on local governments, but national governments have become more like local governments as a result of globalization. National governments used to have greater monopoly control, imposing tax and spending policies on residents who had few alternatives. Like monopoly businesses, governments tended to provide poor service, had little interest in efficiency, and set "prices" (taxes) too high. Short of revolt, citizens were forced to accept this unhappy state of affairs.

Globalization has started to change the relationship between governments and taxpayers. Workers, investors, and businesses that do not like the fiscal deal they are receiving from their government can pursue better options elsewhere. That has prompted governments to implement tax reforms, as we have discussed. Globalization is a positive force bringing competitive discipline to governments.

However, globalization has numerous critics, both academic and political. The critics do not like free trade, open investment flows, or multinational corporations. And many also want to restrict tax competition. In all these areas, the critics of globalization promote the idea that government control of the international economy creates a better outcome than freedom and choice. With tax policy, some critics claim that Tiebout was wrong, and that tax competition is damaging to the economy and to governments.[3]

In this chapter, we examine the two main economic arguments against tax competition. The first is the notion that tax competition causes inefficiency in the private sector because it drives resources from high-tax to low-tax countries. According to this view, any tax-motivated movement of investment capital or skilled labor between countries is economically harmful.

The second argument is that tax competition causes inefficiency in the public sector. Tax competition is said to cause a "race to the bottom" in tax levels. If tax competition continues, governments will not have enough money to fund essential public services. Not only that, but tax competition will restrict the government's ability to redistribute income, which the critics assume would be a terrible problem.

We discuss why these complaints about tax competition fall short. When you peel back the thin layer of theory cited in opposition to

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tax competition, you find unrealistic assumptions and political biases in favor of bigger government. One underlying premise is the "public interest theory of government," the idea that monopoly governments optimally serve the needs of the people in a selfless fashion. We argue, instead, that policymakers tend to overspend and overtax, and that tax competition creates a much-needed check on government expansion.

Does Tax Competition Harm the Private Sector?

Policymakers in some governments and international organizations are campaigning to curtail "harmful tax competition." Politicians and pundits often use that phrase loosely to mean any type of tax cut that might have international effects. High-tax countries fear that their tax bases are being eroded as capital and labor flee to lower-tax countries. Germany, for example, has been "concerned about the migration of its financial services to London, its holding companies to the Netherlands, its savings to Luxembourg, and its manufacturing to low-tax Ireland."[4]

More sophisticated critics of tax competition have tried to define "harmful tax competition" a little more precisely. The Organization for Economic Cooperation and Development launched a major debate on this issue with a 1998 report, *Harmful Tax Competition: An Emerging Global Issue*.[5] The report was a rallying cry for those who believe that tax competition is damaging the world economy. But from the outset, many tax experts criticized the report for its lack of clarity and its counterproductive goals.[6] Nonetheless, the 1998 report became part of the debate, so it is useful to examine its arguments.

The OECD says that tax competition is harmful because it creates "potential distortions in the patterns of trade and investment that reduce global welfare."[7] It is also harmful when countries are "bidding aggressively" for investment.[8] And the OECD says that tax competition can "unfairly erode the tax bases of other countries and distort the location of capital and services."[9]

The basic idea is that if tax competition causes investment to flow from high-tax to low-tax countries, it is a "distortion" because resources may not end up in the highest-valued uses. Tax systems ought to have no effect on cross-border investment flows, according

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to this line of thinking. While many other government policy differences drive resources over borders, if taxes have that effect, it supposedly creates a major distortion requiring international corrective action. This is the same idea behind the theory of "capital export neutrality" discussed in Chapter 6.

Interestingly, the OECD has generally been a supporter of globalization, and it often has positive things to say about tax cuts and tax competition. In its 1998 report, the OECD concluded favorably that "globalization has also been one of the driving forces behind tax reforms."[10] And a 2001 report by the OECD on harmful tax competition admitted:

> The more open and competitive environment of the last decades has had many positive effects on tax systems, including the reduction of tax rates and broadening of tax bases which have characterized tax reforms over the last 15 years. In part these developments can be seen as a result of competitive forces that have encouraged countries to make their tax systems more attractive to investors.[11]

Alas, the OECD says that it only supports "fair" tax competition, which is a concept as foggy as "fair" international trade.[12] There are two aspects of tax competition in particular that the OECD dislikes: "tax havens" and "harmful preferential tax regimes." Key characteristics of tax havens include low or zero income taxes and privacy laws that limit the sharing of taxpayer information with other countries.[13] Similarly, harmful preferential tax regimes have low or zero taxes, a lack of information sharing, and "ring-fenced" tax provisions. Ring fencing generally means offering low tax rates to foreign investors that are not offered to domestic investors.

The effort to determine which tax systems are "fair" and which are "harmful" is arbitrary, both because tax systems are complex and because the theory behind the effort is flawed. That arbitrariness has allowed the OECD to go after nonmember countries with more zeal than member countries, even though some of the latter are tax havens in certain respects and many offer a variety of preferential tax breaks. We discuss the OECD's battles against tax havens in Chapter 8.

Our concerns are broader than just the OECD initiatives. European policymakers are known to lash out at all manner of "unfair" tax competition. And University of Chicago law professor Julie Roin

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notes that "the ultimate goal of advocates of tax harmonization is more comprehensive" than the OECD's agenda.[14] She notes that "a substantial literature exists extolling the benefits of a global regime under which all countries would be forced to conform their tax bases to a uniform model while maintaining tax rates within a narrow, prespecified range."[15] So there are certainly anti-competition crusaders that have even more comprehensive agendas than does the OECD.

However, the economic "harms" that tax competition is supposed to create are basically the same whether one is considering the OECD's specific agenda or the agendas of those who condemn all tax competition. The fundamental source of harm is supposed to be that capital, labor, and profits flow from high-tax to low-tax countries. So our focus here is to describe why tax-driven investment flows are a good thing, and not damaging to the economy as claimed.

A Zero-Sum Game?

Whenever countries change their tax policies, it can influence the flows of labor, capital, and trade over international borders. Since the economies of the world are interconnected, so are the fiscal policies of countries. That is a fundamental reality of the global economy, but it is these interconnections that create harmful effects, according to the critics of tax competition.

Suppose a country decides to cut its corporate tax rate in an effort to improve business productivity and spur growth. If those reforms have the side effect of attracting additional foreign investment, they result in "eroding" other nations' tax bases. Such erosion is an inefficient "fiscal externality," as some academics call it, or a "spillover effect," as the OECD usually calls it.

Tax competition critics blame spillovers on low-tax nations, but it could be equally said that high-tax nations cause spillovers because they choose to have higher rates. Also note that countries with high tax rates "erode" their own tax bases by causing increased avoidance and evasion by purely domestic techniques.

The words "externality" and "spillover" are usually used in economics to describe situations where market failure has occurred and regulations might be needed. With tax competition, there is no market failure, but these words are used as a pretext to support international schemes to control tax competition. For example, a

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United Nations report called for a new world agency to control fiscal "spillovers."[16]

The idea that fiscal spillovers are damaging rests on a false, zero-sum view—that if some countries prosper, then other countries must lose. But tax competition does not have to be a negative for any country. If some countries install more efficient tax systems, and other countries follow suit, then global investment and growth will increase to the benefit of all nations. Nearly all economists would agree that industrial countries have more efficient tax systems today than in the past because of the tax rate cuts since the 1980s. Note that no international organization or multilateral agreement was required for that policy success—it resulted simply from each country's pursuing its own self-interest in a competitive world.

It is interesting to contrast tax policy with trade policy on this point. A zero-sum worldview is evident in populist criticism of free trade. But nearly all trade experts understand that cuts to trade barriers help the overall world economy expand, creating potential benefits for every country. Indeed, one estimate found that the removal of the world's trade barriers would increase global welfare by $1.9 trillion.[17]

Trade barriers are essentially just taxes on trade. Thus, trade liberalization and tax competition are both focused on cutting taxes. But the politics of trade liberalization and tax competition are surprisingly different. International organizations such as the OECD and the World Trade Organization push hard to reduce trade barriers. But organizations such as the OECD and the United Nations have mainly been critical of tax competition.

If a country decides to reduce its trade barriers to attract more trade, the effort does not get criticized as "harmful" trade competition. No one complains that Hong Kong is a "trade haven" because it has virtually no trade barriers. Yet there are frequent complaints about jurisdictions, including Hong Kong, that are "tax havens."

One reason for this asymmetry is that trade experts generally focus on the benefits of reform to individual consumers. But with tax competition, experts often focus on the supposed losses to governments, not on the benefits to individuals. There is often little recognition that tax cuts on corporations, for example, ultimately benefit individuals, as we discussed in Chapter 6. Both trade liberalization and tax competition reduce the government's control over the

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economy, but some analysts and policymakers find tax competition more troubling.

Lower tariffs and quotas on trade result in more global trade, whereas lower taxes on investment result in more global investment. There is no zero sum in either case. Critics assume that the only effect of tax competition is to alter the allocation of investment *across* countries, which we noted in Chapter 6 is the focus of the capital export neutrality (CEN) theory. CEN is concerned with the location of economic activity but ignores the negative effect of high tax rates on productive activities *within* countries.

If tax competition can reduce high marginal tax rates on labor and capital, it can create large gains to a nation's economy. But such advantages are ignored by CEN theory, which assumes that tax rates are predetermined by government planners in a world devoid of competition between governments. Yet in the real world, we have seen that tax competition can help reform inefficient tax policies and increase the overall global supply of savings, investment, and productive labor.

Interestingly, the critics of tax competition and advocates of CEN seem to hold inconsistent views regarding the responsiveness of people and businesses to taxes. They want to eliminate international differences in taxation because they fear that resources are highly responsive to those differences. On the other hand, they pay little heed to the negative effects of high tax rates on the domestic economy, apparently believing that taxpayers are not responsive in their purely domestic decisions.

We think the evidence is clear that taxpayers are very responsive at both the domestic and international levels. However, CEN is a flawed theory and thus is not a useful guide for U.S. tax policy. Instead, the goal that should be focused on is the reduction of domestic tax distortions, and tax competition is a great aid in promoting that goal.

A final note regarding labor flows is needed. It might appear that the tax-induced migration of skilled workers, or brain drain, is indeed a zero-sum global game. But when skilled people move to countries with lower taxes, they will likely increase their work effort and put their brainpower to better use. It is true that brain drain has a substantial effect on poor nations, but even here experts note that emigration has benefits.[18] Emigrants send large financial remittances to their home countries, which is an efficient form of aid.

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Also, emigrants often return home with new skills that they can use to help their countries. Finally, the emigration of skilled workers provides a strong signal to governments that they need to reform their domestic policies.

Diversity vs. Harmonization

For those who view tax competition as a zero-sum game that damages the economy, one policy prescription is to "harmonize" or equalize taxes across countries. The European Union has considered harmonizing member-country taxes since the 1960s. Currently, EU membership requires that countries impose a value-added tax with a rate of at least 15 percent and various excise taxes with certain minimum rates.

Proposals to harmonize corporate taxes have been pushed for decades in Europe, beginning with official reports in 1962 and 1970.[19] In 1975, the European Commission sought to implement a minimum corporate tax rate of 45 percent. In 1992, the Ruding Committee proposed a minimum corporate rate of 30 percent.[20] Luckily, these initiatives failed, and today the average corporate rate in the EU is 24 percent. However, there is currently a major push to harmonize the bases of corporate taxes in Europe.

The European Parliament says that harmonization of business taxes "may be required to prevent distortions of competition, particularly of investment decisions. Where tax systems are non-neutral . . . resources will be misallocated."[21] The parliament notes:

> Tax harmonization is to avoid the negative externalities that can follow an individual tax reform in one country. . . . More specifically, cutting taxes in one country raises the competitiveness and/or attractiveness of this country relative to others. The resulting flows of goods, capital, and also, possibly, high-skilled labor is detrimental to partner countries in terms of economic activity and in terms of tax revenues.[22]

From this perspective, the whole troublesome tax competition problem would be solved if taxes were fixed at the same high rate everywhere—perhaps 60 percent for corporations. That would eliminate all the "negative externalities." However, business investment would, of course, be devastated if tax rates were harmonized at such a high level. No country's tax rate would be "detrimental" to other countries, but all countries would suffer.

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Tax harmonization eliminates any beneficial downward pressure on rates, but it is also at loggerheads with Tiebout's insight that diversity in tax policies can be efficient. Economists generally prefer broad-based tax rate cuts and reduced taxes on savings and investment, but the optimal tax policy for each country likely varies. With diversity, every country can look at the policies adopted abroad, see what works, and adapt the best reform ideas for the home market.

Nations have different cultures and different economies, which suggests that different tax structures may be appropriate. In some countries, citizens want higher taxes to pay for more government services; in other countries, they do not. For example, countries that are surrounded by enemies will need larger military budgets and higher taxes than other countries.

Countries with different industrial structures may favor different tax policies. A country that has a large tourism sector, for example, may want to have low taxes on incomes, but higher taxes on hotel rooms so that foreigners pay some of the costs of government services. Another example of tax diversity was suggested by economists Richard Baldwin and Paul Krugman. They argue that tax harmonization would be inefficient in Europe because "core" and "periphery" countries on the continent should have different tax structures.[23]

The University of Chicago's Julie Roin suggests another situation where tax diversity makes sense.[24] Residents of wealthy cities may not want any new factories because of the resulting pollution, and they will not favor tax cuts to attract investment. However, people who live in cities with high unemployment would be happy to provide tax cuts to lure new investment.

However, it might be that tax competition leads to tax systems that are more similar over time, an evolution that can be called "competitive harmonization." That appears to be what is happening across major industrial countries regarding corporate tax rates. Rates have been cut in recent decades, but they are also in a narrower range than they used to be.[25] Thus, the concerns of harmonization advocates have been partly met, but the harmonization is occurring at a lower rate level than advocates would probably prefer.

Whether independent government actions lead to competitive harmonization or to tax diversity, a more important point is that efforts to impose top-down tax rules through international agreements would be dangerous to taxpayers. Pro-market reforms of all types

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in recent decades have generally not resulted from grand schemes imposed on the world economy. Consider the privatization revolution, which was kicked off by Britain in the 1980s. It swept the world as each country adopted reforms in its own interest.

Similarly, most trade liberalization has not resulted from trade agreements, but from unilateral actions. By one estimate, just 35 percent of tariff reductions in the last two decades have come about from trade agreements, whereas 65 percent have been unilateral actions—countries simply deciding to cut their own tariffs.[26] These reductions were a "race to the bottom" in trade taxes, and supported by nearly all economists.

In sum, most pro-market policy reforms result from countries' acting in their own self-interest after studying experiences abroad. Attempts to place global restrictions on tax systems through international agreements would put a straightjacket on beneficial changes in national fiscal systems. Direct tax harmonization has been talked about mainly in Europe, but Americans need to be wary because the same sorts of proposals for tax harmonization could come through the OECD, UN, or other international bodies.

European political elites have focused on imposing top-down rules on European Union member countries. European policymakers use arguments about "fiscal externalities" and the need for a single market as a pretense to end tax competition. By contrast, the United States has historically favored policy diversity at the level of its 50 states. America has had a single internal market for two centuries, while enjoying vigorous subnational tax competition. Some states have no income taxes, whereas others have no sales taxes. Rates and tax bases vary. On the international stage, the United States should be a defender of tax policy diversity, and of the right of nations to adopt their own fiscal policies.

Government Competition

Let us go back to the idea that tax competition distorts investment flows and creates economic inefficiency. The 1998 OECD report argued that "location decisions should be driven by economic considerations and not primarily by tax factors" to create a "level playing field."[27] The OECD also opined that business investment decisions that are based on tax considerations are not "genuine" economic decisions.[28]

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But taxes are a genuine economic consideration, as are government policies regarding regulation, inflation, immigration, and education. The reality is that many different government policies affect cross-border trade, investment, and labor flows. Different countries have different domestic and foreign policy priorities, and those often affect the international economy. Government policies tilt the "playing field" in many ways.

Countries that have greater political stability and efficient legal systems attract more foreign investment than unstable and corrupt regimes. Countries that have good scientific education attract high-technology companies. Countries that have efficient transportation infrastructure attract manufacturing industries. Such high-quality services may be achieved by spending more money or by adopting reforms such as school choice and privatization.

The point is that many countries are trying to improve their investment climate and competitiveness in many ways, not just by tax rate reductions. Yet the OECD and other groups do not campaign against "externalities" or "spillovers" in areas other than taxation. Consider two countries with identical tax systems. The government in one country spends its budget on transportation infrastructure. The other government spends its budget on welfare programs. The result would be that investment would probably flow from the latter country to the former. The former country could be said to be engaging in "harmful infrastructure competition." Policymakers in the second country might appeal to the OECD or UN to require all countries to increase spending on unproductive welfare programs and less on productive infrastructure to ensure a "level playing field."

Of course, that would be regarded as absurd intervention into national policies, but that is the type of intervention that tax competition critics propose.[29] The *Financial Times* recently profiled how one Swiss canton cut its income tax rate under competitive pressure from other cantons. The *Times* noted that "the European Commission has taken issue with [how] . . . Switzerland's differential cantonal taxes put European Union companies at a disadvantage."[30]

The Swiss have a different view. They see low taxes and competitive local governments as a core asset of their nation, just as France's climate is an asset for French wine production. "For Hans-Rudolf Merz, Switzerland's finance minister, cantonal tax competition lies

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at the very heart of Switzerland's federal system and its unique referendum-based, direct democracy."[31]

Switzerland is a member country of the OECD, but it abstained from the 1998 OECD report on tax competition. The Swiss government pointed out that "financial and investment decisions depend on a multiplicity of economic, political, and social factors," not just taxation.[32] The OECD report did not take those other factors into account, and thus could only "make partial and erroneous evaluations of reality," according to the Swiss.[33]

The OECD has focused most of its efforts against tax haven jurisdictions. But those jurisdictions generally do not alter patterns of real investment. Instead, the purpose of financial centers such as the Cayman Islands is to protect international investment flows from being subject to extra layers of taxation. Such jurisdictions create pools of financial capital that are ultimately used for real investment purposes in many of the same industrial countries that were the original sources of the capital. Tax havens generally do not distort investment; instead, they increase the efficiencies of global capital markets.[34]

As we discussed in Chapter 2, production in advanced countries is becoming more mobile all the time. For most industries, it is mainly government policy differences that determine where new investment will take place. Policymakers in most countries know that, and it has added to their urgency to make improvements in education, infrastructure, regulation, and other policy areas. Tax competition is an important part of this beneficial focus on government reform.

Short of adopting a global government with one-size-fits-all rules for the planet, one cannot have "neutrality" with respect to international investment flows, nor would that be a good idea. The fact that the Swiss have good governance and low taxes is not "neutral," but that only suggests that the policies of other countries need to be improved. In areas such as education, countries aspire to match the "best practices" abroad by improving their own policies. And that is what countries should focus on in tax policy—matching the best practices of countries such as Switzerland, Ireland, and Estonia.

Finally, it is true that not all forms of government competition are beneficial from an economics point of view. When governments compete by handing out spending subsidies to businesses, for example, it is a negative-sum process because it diverts resources to less

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productive uses, and the higher spending creates pressure to raise taxes. One upshot is that a further benefit of tax competition is that it may channel the competitive impulses of governments into positive-sum tax cuts, and away from a damaging competition to increase spending subsidies.

Does Tax Competition Harm the Public Sector?

We examined concerns that tax competition harms the economy, and now we turn to concerns that tax competition harms governments. The most often heard fear about tax competition is that it causes a "race to the bottom" in taxes that will reduce government revenues to excessively low levels. Governments will be starved of funds, and they will have to cut vital public services.

In its 1998 report, the OECD complained that tax competition could result in "re-shaping the desired level and mix of taxes and public spending."[35] The OECD worries that, by attracting investment, low-tax countries will "undermine the ability of governments to finance the legitimate expectations of their citizens for publicly provided goods and services."[36]

Economist Wallace Oates says that the problem with tax competition is that "officials do not take into account the impact their decisions have on the tax bases of other jurisdictions. This typically leads to decisions involving suboptimal tax rates."[37] Similarly, University of Michigan tax law professor Reuven Avi-Yonah argues that because high taxes cause an outflow of capital from some countries, "the result is an undersupply of government services" in those countries.[38]

We think that a reduction in the size of governments would be good news for taxpayers, for personal freedom, and for economic growth. But governments have not yet had to go on a fiscal diet as a result of tax competition. The reduction in tax rates in recent decades has not yet resulted in reductions to tax revenues, although the size of governments as a share of the economy in most countries has leveled off. Looking at the 30 nations of the OECD, the ratio of taxes to gross domestic product edged up from 34 percent in 1990 to 36 percent by 2000, but remained at 36 percent in 2005.[39]

As we noted, income tax rate cuts create strong dynamic responses that mitigate government revenue losses. Falling tax rates spur faster economic growth and reduced tax avoidance, which expands the

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tax base. The result is that tax rate cuts have not caused a "race to the bottom" in tax revenues thus far. However, we are hopeful that as the downward trend in income tax rates continues, tax revenues and government spending will be ultimately restrained as well.

Monopoly Government Is Not Optimal

Let us suppose, optimistically, that tax revenues become increasingly constrained by tax competition. Will competition drive tax revenues down "too low"? Tax competition opponents would say yes because they assume that today's large governments have the optimal size. The European Parliament criticized tax competition because "each country has an incentive to lower corporate taxes below the level that would be consistent with its natural position."[40] What the heck is the "natural" position?

To the European Parliament, it seems that the natural position is the size of government reached as a result of decisions by a political elite without any outside competitive pressures. If tax competition undermines the monopoly position of governments, then tax levels and government size will be suboptimal. The University of Chicago's Julie Roin notes, "Advocates of tax harmonization appear to regard any departure from the level and distribution of the tax burden set in the non-competitive world as unduly low."[41] She calls that error the "privileging of the status quo."[42]

This gets to the core underlying assumption of tax competition critics. Critics assume the "public interest theory of government" in constructing their arguments against tax competition. They assume that governments are benevolent maximizers of citizen welfare. Politicians and bureaucrats like to call themselves "public servants," and many theorists seem to believe it. Under the public interest assumption, tax competition is seen as throwing a wrench into the optimal fiscal balance achieved when governments have monopoly control over capital and labor.

An alternative model of government is the "public choice" view. It regards public officials as engaged in self-interested behavior that may or may not maximize societal welfare. It also regards lobby groups as key drivers of public policy. Public choice explains the actual, and often perverse, results we see in government policies. Rather than legislate for the general public good, politicians and

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bureaucrats often seek to maximize their budgets, exploit the perquisites of office, gain prestige from wielding power, and bask in praise from interest groups for their support of various subsidies.

Scholars of the public choice school argue that "democracy contains an inherent bias toward inefficiently large government."[43] There are plenty of examples. Logrolling between members of Congress results in the passage of expensive provisions that do not have wide public support. Spending bills are packaged as large omnibus measures, which include many items that would not gain support under stand-alone votes. Legislators have a bias toward dishing out government largesse to important constituencies, while hiding the resulting costs from taxpayers in the form of deficits.

Of course, America's Founders were well aware of these sorts of problems. That is why they created a constitutional framework to try to limit federal power. Central to their framework was federalism, which strictly limited federal activities and reserved most power for the states and the people. In the view of the Founders, decentralized power was a crucial protection for individual freedom. Competition between the states has acted as a limit on state government power within the United States, just as international competition does today for the federal government's power.

International tax competition is a powerful force that can help constrain the fiscal irresponsibility of governments. In the United States, the constraint of international tax competition is needed more than ever because constitutional limits on federal spending have largely been discarded and federalism has been mostly abandoned. Governments of most other nations need the discipline of tax competition as well, as they never had the strong formal protections against big government that the United States had.

Until recently, governments had monopolies, and they could try to squeeze as much tax revenue out of residents as possible. Tax competition is starting to restrain the fiscal excesses of governments, just as global competition in markets is limiting the power of formerly monopoly companies around the world.

Opportunities for Reform

Tax competition is a threat to big governments, but it is an ally to enlightened policymakers who are interested in pro-growth reforms. Tax competition puts pressure on governments to make tough

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choices and discard wasteful programs. Nobel Prize–winning economist Gary Becker observed 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."[44]

Nobel Prize winner Milton Friedman similarly opined: "Tax competition is a liberalizing force in the world economy, something that should be celebrated rather than persecuted. It forces governments to be more fiscally responsible lest they drive economic activity to lower-tax environments."[45]

Even numerous OECD studies have recognized the government-limiting benefits of tax competition. An OECD working paper argues: "Decentralization can make governments more accountable, allowing a better matching of resources to preferences. It may also introduce competition across jurisdictions and thus raise public sector efficiency."[46] Another OECD report noted, "In addition to lowering overall tax rates, a competitive environment can promote greater efficiency in government expenditure programs."[47]

The Swiss government argues that tax competition "discourages governments' adopting confiscatory regimes, which hamper entrepreneurial spirit and hurt the economy, and it avoids alignment of tax burdens at the highest level."[48] Essentially, they are arguing that the public interest theory of government is incorrect, and that competition is needed for governments to reach a more optimal size.

A recent report by the Swiss government provided further reasons for its support of tax competition: "Tax competition creates important incentives and promotes innovation in the public sector. Switzerland is less inclined to provide state aid to companies because aid to individual companies or sectors very often distorts competition and is detrimental to efficiency."[49] Thus, tax competition not only encourages public-sector efficiency, it discourages wasteful business subsidies.

We hope that tax competition will do more than just spur cuts to business subsidies. After all, the main items on which governments spend taxpayer funds are redistribution or "entitlement" programs. If tax competition begins to constrain governments, the main benefit would be to force a scaling back in redistribution. In 2007, the U.S. federal government spent $2.55 trillion, aside from interest payments. Roughly, the categories of spending that are, in theory, to

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the general benefit of society are defense, veterans affairs, justice, transportation, environment, general science, international affairs, and administration. Spending on those functions totaled $0.88 trillion, or just one-third of the total.[50] The rest of the budget includes a vast range of redistribution programs, such as health care subsidies and farm subsidies. To the extent that tax competition restrains spending in the long term, these redistribution programs will be trimmed.

Here is an interesting facet of the tax competition debate: The critics often complain that competition will lead to cuts in basic "public services." They want people to believe that unless tax competition is controlled, spending on items such as fire and police will be curtailed. But those basic services are not where the vast bulk of taxpayer money goes in most advanced countries. The bulk of government spending is on redistribution programs.

The opponents of tax competition sometimes admit that it is redistribution that they are really concerned with, not basic public services. The 1998 OECD report on harmful tax competition complained that tax cuts "may hamper the application of progressive tax rates and the achievement of redistributive goals."[51] Tax law professor Reuven Avi-Yonah complains that tax competition limits the "ability to use taxes on capital for redistributive purposes" and results in a system that "is less capable of redistributing resources from the rich to the poor."[52] Avi-Yonah and the OECD are probably correct on those points, but to us that would be a beneficial result.

A final advantage of tax competition is that it encourages governments to discard their most inefficient tax policies. Tax competition promotes flatter or less "progressive" income tax structures. The effect is to reduce the distortions or "deadweight losses" of the tax code, which are directly related to high marginal tax rates. Flatter tax structures with lower rates are more efficient and conducive to growth than multirate or progressive structures.[53]

Tax competition also promotes efficient tax policy by encouraging governments to reduce the taxation of savings and investment. As we discussed, competition creates pressure to reduce taxes on business profits, dividends, interest, capital gains, and wealth. And Chapter 4 explained how the global flat tax revolution is being advanced by the liberalizing process of tax competition.

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In the United States, shifting away from the taxation of savings and investment toward taxing a more efficient base, such as consumption, has gained support among tax experts and the general public alike in recent decades.[54] Fundamental tax reform has been long discussed by federal policymakers, and, if it proceeds, international competition will be a driving force in making it happen.

Conclusion

To wrap up our discussion, let us consider the complete list of "harms" that the OECD identified in its 1998 report on harmful tax competition.[55] Tax havens and harmful tax regimes were said to cause harm by:

i) "distorting financial and, indirectly, real investment flows,"
ii) "re-shaping the desired level and mix of taxes and public spending,"
iii) "undermining the integrity and fairness of tax structures,"
iv) "discouraging compliance by all taxpayers,"
v) "increasing the administrative costs and compliance burdens on tax authorities and taxpayers,"
vi) "causing undesired shifts of part of the tax burden to less mobile tax bases, such as labor, property and consumption."

The first two items are the ones that we have focused on, and the ones that most critics focus on. The first concern is the harm to the private sector. The second concern is the harm to public sector. We found that these concerns are based on the mistaken notion of the public interest theory of government. They also ignore the reality that government policy differences of all types drive flows of capital, labor, and trade in the globalized economy.

The other four concerns can be quickly disposed of. Concerns iii, iv, and v are much more likely to be features of high-tax regimes, not low-tax regimes. High-tax regimes are unfair, they discourage compliance, and they generate higher administrative costs because of the lower compliance. High tax rates create a breeding ground for narrow loopholes in the tax code, which in turn increases compliance burdens. The high-rate U.S. corporate tax has generated a large

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lobbying industry, which we believe would shrink dramatically if the corporate rate were cut to 15 percent.

The sixth supposed harm gets it backward. If tax competition causes a shift in tax collections to labor and consumption tax bases, that would be an efficient shift, not an "undesired" one. The OECD also said that harmful tax competition causes "undesired shifts of part of the tax burden from income to consumption" and "from capital to labor."[56] But that is a political complaint, not an economics complaint. Most economists believe that shifting tax collections from capital to consumption or wages would be beneficial for long-term growth. But such a shift is a key reason why tax experts with liberal political views tend to oppose tax competition. Reuven Avi-Yonah argues:

> From an equity perspective, if capital cannot be effectively taxed, the tax base tends to shift toward labor; and taxes on labor are more regressive than taxes on capital. Thus tax competition impairs the ability of the income tax to redistribute wealth from the rich to the poor. These considerations weigh in favor of limiting tax competition.[57]

A central flaw in Avi-Yonah's analysis, as we discussed in Chapter 6, is that the burden of taxes on capital in the global economy tends to fall on labor in the form of lower wages. So taxes on capital are not necessarily more "regressive" than taxes on labor, and they certainly are more damaging to the economy.

Lastly, note that the supposed harms of tax competition are in conflict. Avi-Yonah argues that tax competition "has negative implications for global efficiency and equity."[58] By "equity" Avi-Yonah is suggesting that he prefers high tax burdens on the rich and increased spending on redistribution. But those policies damage economic performance for many reasons. If "global efficiency" is the goal for policymakers, they should support tax competition because it helps restrain government budgets, reduces marginal tax rates, and shifts tax collections to more efficient tax bases.

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8. The Battle for Freedom and Competition

Tax competition has promoted dramatic changes in tax policy. As we have described, tax rate cuts are spreading across the globe, and flat taxes are being adopted in a growing number of countries. Without tax competition, nations might still be imposing individual income tax rates of 70 percent or more and corporate tax rates as high as 50 percent.

Governments would likely be larger today if tax competition had not challenged their fiscal monopolies. Government budgets expanded rapidly in industrial countries between the 1950s and mid-1980s, but since then overall spending and tax revenues have been roughly held in check as a share of gross domestic product. If tax competition continues apace, it could become a major tool for reducing the size of governments in the 21st century. At the least, it could help prevent governments from growing larger, which is a big threat because populations are getting older and there is pressure to increase spending on entitlement programs.

Supporters of big government know this, and an empire of high-tax nations is striking back against tax competition. Politicians in many countries, driven by the special-interest lobbies that keep them in power, want to turn back the clock. They are taking actions to try to hinder individuals and businesses from gaining greater economic freedom. In particular, they are seeking to either directly or indirectly harmonize taxes across countries, which would cripple tax competition and make it easier to increase the burden of government.

Fortunately, politicians from any one nation cannot curtail global tax competition by themselves. Indeed, attempts by single countries to hinder labor and capital flows with their tax policies usually backfire because those countries become even less attractive to entrepreneurs and investors. If a nation imposes more restrictive tax rules on multinational corporations, for example, fewer corporations will locate there.

Thus, the only feasible way to stifle tax competition is to create an international tax cartel, akin to the infamous oil cartel, the Organization of Petroleum Exporting Countries. Just as OPEC works to keep the price of oil artificially high, politicians work with their colleagues in other nations to keep the price of government—in the form of taxes—high. Efforts are under way through international bureaucracies, including the European Commission, the United Nations, and the Organization for Economic Cooperation and Development, to eliminate downward pressures on tax rates. There are even proposals to create a permanent world tax organization, which would help enforce limits to tax competition.

In this chapter, we discuss the efforts of the international organizations that are attempting to limit competition and harmonize taxes across countries. We also examine the role of the United States. As the 800-pound gorilla of the global economy, and as a traditional defender of free markets, America has a special role to play in the tax competition debate. In recent years, some American leaders have defended competition, but we are concerned that political pressures in coming years may convince officials to go along with the anti-competition agendas of the international organizations.

Direct and Indirect Tax Harmonization

Tax competition exists when people and businesses can benefit from working and investing in other jurisdictions that have better tax policies. In this situation, governments know that they must keep their tax systems competitive or else businesses, jobs, and investment will emigrate. In this way, globalization creates a system of checks and balances that promotes good tax policy. Even the OECD has admitted, “The ability to choose the location of economic activity offsets shortcomings in government budgeting processes, limiting a tendency to spend and tax excessively.”[1]

For policymakers who want to constrain tax competition, there are two ways they can do so. First, they can simply close borders to capital and labor mobility. That was the approach followed before the 1970s, but would be nearly impossible to accomplish in today’s global economy. Second, policymakers can pursue tax harmonization, which seeks to eliminate any advantages for taxpayers who do business outside their own country. It allows politicians to be fiscal monopolists. There are two forms of tax harmonization:

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- *Direct tax harmonization* occurs when nations agree to set minimum tax rates or agree to tax at the same rate. In the European Union, for instance, member nations must impose a value-added tax of at least 15 percent.[2] The EU has also harmonized tax rates for fuel, alcohol, and tobacco, and there have been many proposals to harmonize income taxes. Under direct tax harmonization, taxpayers are unable to benefit from better tax policies abroad because every government imposes the same tax rates. The result is that politicians are insulated from competitive discipline and can set high tax rates.
- *Indirect tax harmonization* can occur when governments assert the right to tax the worldwide income of residents and businesses. In this situation taxpayers are subject to their home-country tax rates, regardless of where they save or invest, and they generally cannot benefit from lower tax rates in other nations. When taxpayers are forced to adhere to their home-country tax laws even when engaged in economic activity abroad, the result, again, is that politicians are insulated from competitive discipline and excessive taxes and spending will likely result.

Much of this chapter focuses on indirect harmonization. The effort to enforce a high-rate worldwide tax system prompts governments to try to gain detailed information about their residents' foreign activities. That often entails efforts by high-tax countries to compel low-tax countries to provide them with personal financial information about their foreign investors. We describe the various initiatives aimed at greater information sharing between countries for the purpose of allowing some governments to enforce their high tax rates.

Indeed, this is mainly one-sided pressure from a few powerful high-tax countries on many smaller, lower-tax countries. High-tax countries are using heavy-handed techniques to try to force governments of low-tax countries to become deputy tax collectors for them. They demand that low-tax jurisdictions collect information on foreign residents and nonresident investors and share that information with the tax authorities of high-tax nations. The low-tax jurisdictions get nothing from such information-sharing schemes.

To understand how harmonization thwarts competition, consider an analogy of retail competition between gas stations. If the owner

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of a high-price gas station could somehow prevent motorists from switching stations, that would be akin to capital controls. It would eliminate competition and allow the station to exploit consumers. Alternatively, the owner could try to harmonize gas prices across stations, sort of like a price-fixing scheme. Using this direct harmonization approach, all gas station owners would form a cartel and agree to set the same high prices.

Alternately, the owners could enforce indirect tax harmonization. In this situation, the high-price stations would insist that lower-price stations report on any purchases made by former patrons of the high-price stations. With that information, high-price station owners would demand that those patrons hand over any savings they enjoyed at the low-price stations. Fortunately, that absurd situation does not exist in the market economy, but it does in the realm of tax competition policy.

The suppression of competition, whether between gas stations or between governments, would be bad news for the economy. The absence of competition would result in resources being used less efficiently. The more stringent the restrictions against taxpayers' shifting resources across national borders, the more likely that politicians are insulated from competition, and the more profligate they are likely to be.

The OECD Launches a War against Tax Havens

Policymakers in high-tax nations have little power to suppress tax competition acting alone. As such, they are often strong supporters of expanding the power of multilateral groups to impose international rules against tax competition. The most prominent such effort is the anti-tax competition campaign of the Organization for Economic Cooperation and Development. The Paris-based OECD is a self-styled "think tank" for the advanced industrialized nations, but as a result of mission creep the OECD is pursuing its own tax agenda these days. The OECD has 30 member countries from Europe, North America, and the Pacific Rim, with the 22 European members forming the biggest bloc.

The OECD has been a proponent of curtailing certain types of tax competition that it deems harmful. Many higher-tax OECD members, such as France and Germany, are large and influential, and they have driven the various efforts to limit tax competition. By

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contrast, those nations inside and outside the OECD that support tax competition are usually smaller and less influential. As such, they often receive the short end of the stick from OECD policies.

In 1996, the G-7 nations requested that the OECD and its Fiscal Affairs Committee launch a "harmful tax competition" initiative. The first product of the initiative was the 1998 publication *Harmful Tax Competition: An Emerging Global Issue*.[3] We discussed the economic errors and inconsistencies in the report in Chapter 7. These inconsistencies were clear to OECD members Luxembourg and Switzerland, and they abstained from signing onto the report.

Luxembourg said that it did not "share the report's implicit belief that bank secrecy is necessarily a source of harmful tax competition."[4] It also argued that international cooperation on exchanges of information about taxpayers ought to be subject to "precise limits" not wide-open transfers of information that would threaten privacy. Switzerland resented the "repressive" approach taken by the report and argued: "It is legitimate and necessary to protect the confidentiality of personal data. In this respect, the report and recommendations are, in certain respects, in conflict with the Swiss legal system."[5]

Initially, the OECD report had little effect on global tax debates. Many observers dismissed the publication as typical statist thinking by European bureaucrats who were upset about the poor performance of their economies. But ignoring the report was a mistake because the Fiscal Affairs Committee of the OECD was quietly preparing an aggressive campaign to attack low-tax jurisdictions.

In 2000, the OECD dropped a bombshell with its new report, *Towards Global Tax Co-Operation: Progress in Identifying and Eliminating Harmful Tax Practices*.[6] The report targeted 41 tax havens, which were supposedly guilty of inappropriate tax, financial, and privacy rules (see Table 8.1). The OECD explicitly threatened these low-tax jurisdictions with discriminatory fees, denial of market access, and other forms of financial protectionism if they did not agree to weaken their attractive tax and privacy laws. High-tax OECD countries wanted these low-tax jurisdictions to weaken their privacy laws so that flight capital could be tracked—and taxed.

After putting the so-called havens on a blacklist, the OECD demanded that the jurisdictions sign "commitment" letters. Drafted by bureaucrats in Paris, these letters obliged signatory jurisdictions to essentially surrender their fiscal sovereignty. They were told that

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Table 8.1
TARGETED BY THE OECD

Andorra	Gibraltar	Netherlands Antilles
Anguilla	Grenada	Niue
Antigua and Barbuda	Guernsey	Panama
Aruba	Isle of Man	Samoa
Bahamas	Jersey	San Marino
Bahrain	Liberia	Seychelles
Barbados	Liechtenstein	St. Kitts and Nevis
Belize	Maldives	St. Lucia
Bermuda	Malta	St. Vincent and Grenadines
British Virgin Islands	Marshall Islands	Tonga
Cayman Islands	Mauritius	Turks and Caicos
Cook Islands	Monaco	U.S. Virgin Islands
Cyprus	Montserrat	Vanuatu
Dominica	Nauru	

they had to promise to emasculate their favorable tax and privacy regimes for the benefit of high-tax OECD nations.

The unfairness of this was combined with hypocrisy. Many member nations of the OECD—including Austria, Belgium, Luxembourg, Switzerland, the United Kingdom, and the United States—would qualify as tax havens based on the OECD's own definition. In some cases, such as Austria, Belgium, Luxembourg, and Switzerland, they have strong financial privacy laws. In other cases, such as the United Kingdom and United States, they do not collect and hand over information about investors from abroad to foreign governments in order to enforce foreign tax laws. But the OECD report did not blacklist these countries; instead, the report just went after less politically powerful nations and jurisdictions.

Many of those jurisdictions are former British colonies and members of the Commonwealth of Nations.[7] At meetings of the commonwealth countries and other international forums, these jurisdictions protested the double standards of the OECD initiative and expressed their resentment at the attempt to infringe on their sovereignty.[8] A 2002 study by the Commonwealth Secretariat in London included scathing criticisms of the OECD, and it defended the progress of formerly poor colonies in growing their economies through favorable rules for the financial services industry.[9] The editor of the study

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asked the OECD nations to "move away from their efforts to establish a cabal or cartel arrangement for global economic decisionmaking."[10]

Unfortunately, some American politicians are emulating the OECD approach and have gone into the blacklisting game. Sen. Byron Dorgan (D-ND) has proposed legislation (S. 396) that would make America's worldwide tax system more onerous, while also penalizing tax havens. His bill creates a blacklist of 40 jurisdictions, and American companies using those places to help them compete in world markets would be forced to act as if income earned in those jurisdictions is U.S.-source income, a change that would dramatically boost their tax burdens. Senator Dorgan's bill does not explain how nations got on his blacklist or how they could get off the list, so the targeted jurisdictions understandably view the exercise with disdain.

Sen. Carl Levin (D-MI) has introduced the Stop Tax Haven Abuse Act, which would change U.S. tax laws to deter Americans from investing in 34 low-tax jurisdictions. Levin claims that places on the list have been described as "secrecy jurisdictions" by the Internal Revenue Service. Levin's bill would penalize taxpayers doing business in targeted jurisdictions.

American taxpayers, both individuals and businesses, would be the real victims of the Dorgan and Levin bills. If these bills are enacted, it will be more difficult for taxpayers to use the efficient tax structures of the targeted jurisdictions. That would help foreign-based companies and investors get a leg up on their American counterparts. Also, like the OECD's initiatives, the Dorgan and Levin proposals would disproportionately target smaller nations, some of them seeking to follow a low-tax policy in hopes of promoting prosperity. Indeed, most of the blacklisted jurisdictions are from the developing world.

Background on Tax Havens

Tax havens play an important role in international tax competition, so we want to step back and provide some background. Dozens of countries and jurisdictions in Europe, Asia, and the Caribbean are called tax havens, but there are no clear criteria for this categorization. Is Luxembourg a tax haven? What about Hong Kong, Ireland, and the United Kingdom? Often the test used for inclusion on a tax haven list is little more rigorous than a reference in a John Grisham novel.

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According to the OECD's 1998 report, a modest tax burden is the "necessary starting point" for identifying jurisdictions as tax havens. The OECD says that the other key factors that can confirm the existence of a tax haven include lack of "exchange of information" with other countries about investors. They also point to a "lack of transparency" and "no substantial activities." But the OECD's definition is so loose that it ultimately just picks and chooses the jurisdictions it wants to punish based on political priorities.

There have been other efforts to define tax havens, or offshore financial centers, as they usually are referred to by experts. A study by the International Monetary Fund says that the key characteristics of OFCs are:[11]

- Orientation of business services toward nonresidents,
- Favorable regulatory regime,
- Low or zero taxation on investment activities, and
- Large size of financial services industry compared with the rest of the economy.

Those are some basic OFC parameters; but to be successful, OFCs need to offer a package of quality services to international businesses and investors, including financial security, privacy, regulatory advantages, technical expertise, and low business costs. The IMF noted that OFCs often provide:

- Asset-holding vehicles to park and isolate high-risk assets,
- Collective investment and derivative trading vehicles to take advantage of tax incentives or undertake risky investments difficult to implement under onshore regulations,
- Asset protection to reduce or eliminate inheritance taxes,
- Asset protection to protect against expropriation,
- Special-purpose vehicles to keep liabilities offshore, and
- Trade vehicles to keep export receipts offshore.

OFCs have boomed in recent years as locations for the establishment of investment hedge funds. Hedge funds in OFCs such as the Cayman Islands provide low-cost and high-return investment opportunities both to non-U.S. investors and to U.S. investors that are tax-exempt. In the latter group are U.S. pension plans, universities, and foundations. These U.S. tax-exempt investors can avoid

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Table 8.2
IMF'S LIST OF OFFSHORE FINANCIAL CENTERS

Hong Kong	Uruguay	Jersey*
Ireland	Barbados*	Malta*
Latvia	Bermuda*	Mauritius*
Luxembourg	Cayman Islands*	Netherlands Antilles*
Singapore	Guernsey*	Panama*
Switzerland	Isle of Man*	Vanuatu*
United Kingdom		

* Jurisdiction also on the OECD's tax haven blacklist.

"unrelated business income tax" on their investments by locating in an OFC.

Another advantage of OFCs is that they are not subject to onerous Securities and Exchange Commission regulations. Further, foreigners who invest in OFC hedge funds, rather than U.S. funds, are not subject to U.S. income or estate taxes. Generally, non-U.S. investors will not invest in hedge funds in the United States because of our onerous tax and regulatory regimes; thus, our economy loses much financial services business to lower-tax financial centers that do not have U.S.-style red tape.

Tax havens also play a key role in the "captive insurance" industry and are widely used by major financial institutions for services such as interbank deposits. The most controversial aspect of OFCs, though, is the private banking business. Much to the dismay of revenue-hungry governments, some private-banking clients use offshore structures to hide their assets and dodge punitive taxes.

Using a statistical analysis, the IMF set out to determine which countries should be classified as OFCs. Its results showed that places such as the Bahamas and the Cayman Islands satisfied the OFC criteria, but so did Ireland and the United Kingdom. Interestingly, only 11 of the 41 jurisdictions blacklisted by the OECD were put on the IMF's list, shown in Table 8.2.

Another IMF study, called the offshore assessment project, created a different list of 46 offshore jurisdictions.[12] And other lists have as many as 70 jurisdictions.[13] The bottom line is that many different jurisdictions, including the United States, offer various advantages and disadvantages to international investors. In each particular area of economic activity, different places around the world can be the

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most tax favored, or the best "havens" for certain types of activities. There are different tax havens for insurance, banking, manufacturing, research and development, corporate headquarters, shipping, and other activities.

One way to think about tax havens is that they have taken a proactive approach to adopting beneficial tax and regulatory laws designed to compete in the global economy. Other nations, such as the United States, have accumulated large tax and regulatory regimes in an ad hoc fashion over time. U.S. policies are haphazard, reflecting the power of special-interest lobbying and class warfare politics. There has been no focused attempt to improve international tax or regulatory competitiveness, as there has been in havens such as the Cayman Islands, Hong Kong, and Ireland.

This raises the general issue of the governance of tax havens. Opponents of tax competition often talk as if tax havens are rogue, almost lawless, regimes, but the evidence suggests the opposite. Economists Dhammika Dharmapala and James Hines used statistical methods to examine the quality of governments in the world's 40 or so tax havens. They concluded that "governance quality has a statistically significant and quantitatively large impact on the probability of being a tax haven."[14]

Indeed, Dharmapala and Hines conclude that "there are almost no poorly governed tax havens," and that poorly governed countries are almost never tax havens.[15] If countries aspire to become tax havens, competitive pressures encourage them to reduce corruption, improve their rule of law, and increase government transparency. Advanced nations should applaud developing nations that are improving their governance structures, rather than persecuting them for their low tax rates and other sound policies.

Other recent research casts doubt on whether tax havens are even "harmful" in the way that the OECD claims they are. As we discussed in Chapter 7, the OECD and other critics argue that low-tax countries unfairly drain investment out of high-tax countries. But recent empirical evidence suggests that tax havens, instead, directly help the economies of high-tax countries. While tax havens attract reported income—or paper profits—from high-tax countries, they seem to stimulate greater real investment activity in nearby high-tax countries. Economist James Hines discusses the economic effect of tax havens:

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> Tax havens are viewed with alarm in parts of the high-tax world. Concern is often expressed about foreign tax haven locations possibly diverting economic activity away from countries with higher tax rates and eroding tax bases that might otherwise be used to raise government revenue. . . . The evidence, however, suggests a different conclusion. Foreign tax haven activity and nearby investment in higher-tax countries appear to be complementary.[16]

Thus, by helping firms reduce their taxes on reported profits in high-tax countries, havens may reduce the sting of investing in high-tax countries.[17] In this way, havens may actually mute international tax competition. That is not a good result from our perspective, but it does suggest that the anti-haven hysteria by some critics is very misplaced, and that the OECD project against tax havens is misguided even on its own terms.

The OECD's Double Standards

The OECD's anti-tax competition project is designed to help high-tax nations enforce their tax systems by forcing low-tax jurisdictions to act as deputy tax collectors. Proponents of bigger government tend to be in favor of the OECD's campaign, whereas advocates of smaller government are opposed. But thoughtful people on both sides of the debate agree that the OECD efforts contain huge double standards. Writing in *Tax Notes International*, Marshall Langer, a leading offshore expert, noted:

> It does not surprise anyone when I tell them that the most important tax haven in the world is an island. They are surprised, however, when I tell them that the name of the island is *Manhattan*. Moreover, the second most important tax haven in the world is located on an island. It is a city called *London* in the United Kingdom.[18]

Langer cited policies in Britain and the United States that made them attractive to nonresident investors, and thus tax havens. We noted that the IMF also classified Britain as an offshore center. Further, the Government Accountability Office issued a report on state-level tax policies in the United States and found certain states to be havens of various sorts. For example, Delaware companies are famous around the world because of their tax and privacy advantages for non-U.S. citizens.[19]

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Even the OECD essentially admitted that Britain and the United States are tax havens. In a 2006 report, it noted that both countries allow bearer shares and bearer debt instruments, which facilitate tax competition because these securities provide financial privacy to investors.[20] Moreover, the OECD admitted that neither nation collects the company ownership information needed to help enforce foreign tax laws.

Another policy not mentioned by the OECD is the U.S. practice of not collecting information about certain types of interest and capital gains paid to nonresident aliens. These policies are important because the OECD's definition of a tax haven focuses on the collection and sharing of information about the activities of foreign nationals. The United States and the United Kingdom clearly qualify as tax havens, though neither nation was added to the OECD's blacklist.

Britain and the United States are not the only "onshore" tax havens. Luxembourg and Switzerland are among the world's premier financial centers for nonresidents. Yet because they are OECD members, they also dodged the blacklist. Austria, Belgium, and the Netherlands are also tax havens in certain ways, but their OECD membership resulted in a free pass as well.[21] With so many tax havens in its membership, it perhaps should not be surprising that the onshore community of OECD nations has captured, according to some measures, 80 percent of the world's offshore market.[22]

Why is the OECD cracking down on certain small-country tax havens, but not tax havens within its own membership? Policymakers in blacklisted jurisdictions suspect that the effort is designed to squash competition in the financial services sector from smaller and less powerful nations. They argue that they should not be bullied into changing their laws unless OECD nations agree to the same rules.

This "level-playing-field" argument leveled by blacklisted countries against the OECD has proved to be politically powerful. Why should small countries shoot themselves in the foot by eliminating their pro-growth policies, if large OECD member countries continue to offer their own favorable tax rules? If OECD mandates are such a good idea, why doesn't the Paris-based bureaucracy ask member nations to adopt them first? The obvious hypocrisy of the OECD's position is one of the main reasons its campaign against tax competition has been stymied thus far.

Critics of tax competition, including some politicians from high-tax nations and various leftist organizations, want to curtail all tax

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haven policies, but they know that a wholesale assault against big countries as well as small would have been politically futile. The OECD's blacklist was just a means of going after the easiest targets first. This is the likely reason why the OECD did not include Hong Kong and Singapore on its blacklist. Those jurisdictions have very strong economies, and the bureaucrats probably figured they could attack them only after getting smaller and less powerful economies to surrender.

A fundamental issue underlying tax competition is fiscal sovereignty, or a nation's right to implement tax policies that it believes will maximize growth and living standards. The OECD's disregard for fiscal sovereignty is clear in its original tax competition report. It claimed that "countries should remain free to design their own tax systems as long as they abide by internationally accepted standards in doing so."[23] That is quite a claim! Who gave unelected OECD officials the power to impose international tax standards? Unfortunately, the mindset that top-down global tax rules must be imposed to control competition is a continuing and widespread threat.

The Battle for the Bush Administration

The United States is the largest member of the OECD and its biggest donor, contributing one-quarter of its budget. As such, the United States has the power to play a key role in the OECD's tax competition agenda. During the 1990s, when the anti-tax competition project began, the Clinton administration was very supportive. President Clinton's treasury secretary, Lawrence Summers, complained about tax competition as the "dark side to international capital mobility."[24] Support from the Treasury made a big difference since a global tax cartel could not work without the United States, just as OPEC could not succeed without Saudi Arabia. The jurisdictions on the OECD's blacklist could safely thumb their noses at nations such as France and Germany, but resisting pressure from the American government is much more difficult.

Low-tax jurisdictions were fortunate, therefore, that the Clinton administration was in its waning months when the blacklist was produced. They dodged another bullet when Al Gore did not win the election in 2000 since the White House would have almost certainly remained supportive of the OECD's anti-tax competition campaign.

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It was not clear at the time whether the Bush administration would reverse the Clinton policy. As it turned out, the Bush administration never fully rejected OECD efforts to curtail tax competition, but it has generally been on the side of tax competition and supportive of low-tax jurisdictions.[25]

A key development in the battle was the creation of the Center for Freedom and Prosperity in Washington to defend tax competition.[26] The CF&P launched an aggressive campaign to counter the one-sided activism of the OECD. In 2001, the Bush administration was inundated with letters critical of the OECD's efforts from members of Congress and various public policy organizations. The then House majority leader Dick Armey (R-TX) was instrumental in the effort to curtail U.S. involvement with the OECD initiative. Armey argued that the United States should not support "a global network of tax police," and that it was unfair for large wealthy countries to bully smaller nations to change their successful economic policies.[27]

These arguments and political pressure eventually led Treasury Secretary Paul O'Neill to express his reservations about the OECD project in congressional testimony: "I felt that it was not in the interest of the United States to stifle tax competition that forces governments—like businesses—to create efficiencies."[28]

But O'Neill's weighing in against the OECD's initiative was not a clear-cut victory for tax competition. Treasury officials are supposed to enforce America's onerous worldwide tax regime, and that has led some of them to argue in favor of the OECD initiative as a way of digging for more information about the foreign investments of Americans. Indeed, Secretary O'Neill bullied several low-tax jurisdictions into entering taxpayer information-exchange agreements, although he did recognize that information sharing should be limited to specific investigations and not general "fishing expeditions."[29]

The U.S. Treasury Department has been somewhat hypocritical in its positions. With regard to the OECD initiative, Secretary O'Neill testified to Congress that the United States should "not interfere in the internal tax policy decisions of other countries."[30] Yet at the same time, department officials were indeed pushing other countries into helping enforce American tax laws by changing their own policies toward taxpayer information and financial privacy.

U.S. policymakers need to be very careful about pushing other countries into information-exchange deals because the United States

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is itself a large tax haven. As we discussed, foreigners can invest money in the United States and receive tax-free interest and capital gains. And since the U.S. government does not require financial institutions to report these payments, there is no information to share with foreign governments. If the Treasury Department pressures other nations into giving information to the Internal Revenue Service, foreign governments will likely pressure the United States and U.S. financial institutions to act as deputy tax collectors for them.

This is not an idle concern. At the request of other countries, the Clinton administration proposed a regulation that would have required U.S. banks to report interest earned by foreigners to the IRS so that it could be shared with other countries.[31] That led to an immediate outcry from the financial services industry because there are more than $2.6 trillion in foreign deposits in U.S. banks today.[32] As one U.S. banking organization noted, if the regulation had been finalized and the IRS breached the financial privacy of these deposits, it could have triggered "massive withdrawals of foreign deposits from U.S. banks."[33] The money would flee to more attractive investment climates with stronger privacy protections.

The Bush administration ultimately decided not to finalize the "interest-reporting" regulation. It responded to the concerns of business groups and to the advocacy of organizations such as the CFP. It was also likely concerned that the regulation would face legal challenges since regulations are supposed to promulgate existing laws, not overturn them.

Level Playing Field

Let us return to the OECD's anti-tax competition campaign. The OECD put together its blacklist of low-tax jurisdictions and threatened them with financial protectionism if they did not sign "commitment" letters signaling the surrender of their fiscal sovereignty and pledging to help other nations enforce their tax laws.

At first, it appeared that the OECD would win the battle. Six tax havens preemptively surrendered and signed the letters even before the blacklist was published.[34] But the opposition in the United States, led by the CF&P, stalled further OECD successes. When the Bush administration took office and indicated less enthusiasm for the OECD's initiative, low-tax jurisdictions were in a stronger position. They pointed out the unfairness of the whole process, including the

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fact that many OECD countries also have supposedly harmful tax rules that have not been altered.[35]

The blacklisted jurisdictions developed a clever strategy to fight the OECD. They would agree to sign the commitment letters, but would also insert clauses stating that they would abide by the rules only if every OECD nation agreed to do likewise.[36] But since some OECD nations are among the world's biggest tax havens, this "level-playing-field" clause is a powerful blocking mechanism.

For several years, the OECD has been unable to bully low-tax jurisdictions into helping it form a global tax cartel. Groups such as the CF&P have educated members of Congress about the issue and many members instinctively have sided with the smaller countries being pressed by the unelected OECD. In addition, the nations and territories on the blacklist have been effective in presenting their case. Their insistence on a level playing field has exposed the OECD's hypocrisy and created a stalemate.

It is possible, of course, that OECD countries, such as Luxembourg, Switzerland, the United States, and the United Kingdom, could end their own tax haven policies. That would make other low-tax jurisdictions more vulnerable to being strong-armed by the OECD. In Britain, Prime Minister Gordon Brown, who was previously the finance minister, has a long track record of undermining the interests of UK territories that are on the OECD blacklist. In the United States, the Democrats may win the White House in 2008, and that party's current leaders are generally hostile to globalization and tax competition.

Still, OECD nations such as Luxembourg and Switzerland will likely continue defending their low-tax policies. And there are other tax haven jurisdictions, such as Hong Kong and Singapore, that are unlikely to compromise their success as highly competitive low-tax economies. It is true, however, that the OECD has the luxury of a large staff and a huge budget of more than $400 million annually. The bureaucracy can wage a relentless campaign to steadily erode tax competition.

This is why the level-playing-field argument is a necessary, but probably not sufficient, tactic to win the tax competition fight. Advocates of tax competition need to continue educating policymakers and the public about how low-tax nations and tax havens are good for the global system. Whether they are onshore or offshore, these

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jurisdictions expand global commerce, boost economic performance, and protect human rights.

Moreover, the OECD's entire role in this issue needs to be critically examined. It is one thing for an unelected governmental organization to publish statistics and describe policies in member nations. But the OECD crosses the line when it starts aggressively lobbying for particular policies to be passed by countries, pressuring member and nonmember countries to conform with its edicts, and trying to act like a global policing and standards-making body for tax policy.

With its campaign, the OECD is essentially seeking to impose self-serving international standards that lock in high-rate income taxes while precluding low-rate consumption-based tax reforms. The OECD's campaign also needs to be reviewed with respect to sovereignty issues. Targeted nations have argued that OECD pressure and threatened sanctions are breaches of international law and violations of their independence.[37]

The OECD has been involved in other dubious policy campaigns. For a while, the OECD had a campaign to cripple competition from "open-registry" shipping fleets. A large share of the world's trade is done on ships of open-registry countries, such as Panama. Such nations will register ships owned in other nations, providing various tax and regulatory advantages. Unlike monopolistic "national" registries, open registries compete to attract ships and tend to have market-oriented policies. The campaign against open registries was organized by the OECD's maritime committee. Like the drive against tax competition, this campaign involved nations with uncompetitive policies using the OECD as a vehicle to squash competition from lower-cost countries.

Fortunately, the Bush administration ultimately withdrew support from the OECD's open-registry campaign, probably in part because a large share of America's trade is carried on open-registry ships, and efforts to change the system would have led to higher prices for traded goods. The OECD's maritime committee ultimately disbanded its effort. Now we need to get the OECD to shelve its similarly damaging campaign against tax competition.

European Union

The governing bodies of the European Union—the European Commission and the European Parliament—are strong advocates

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of tax harmonization and opponents of tax competition. EU policy initiatives are important for non-EU countries to monitor because the thinking behind those initiatives often influences the policies of the OECD, UN, and other international bodies. Also, tax competition within Europe has been crucial in sustaining the downward pressure on tax rates around the world in recent decades. If tax competition within the EU were to end, it would be a severe blow.

Here is a typical official viewpoint from a European Parliament fact sheet: "The objective of more recent moves towards a general taxation policy [across countries] has been to prevent the harmful effects of tax competition, notably the migration of national tax bases as firms move between member states in search of the most favorable tax regime."[38] Another parliament fact sheet calls for harmonization of business taxation "to prevent the undermining of revenues through tax competition."[39]

Although EU studies admit that tax competition has some good aspects, the primary policy thrust is to squelch it.[40] For example, the EU has pushed low-tax European countries to put withholding taxes on capital income paid to nonresidents to prevent citizens' benefiting from lower taxes on their savings in those countries. A current EU campaign calls for harmonizing corporate tax bases across Europe.

European leaders routinely float proposals to stifle tax competition. The former German chancellor called for fully integrated European taxation.[41] The head of the European Central Bank said that the euro should lead to greater harmonization of all taxes in Europe.[42] France's former prime minister condemned tax competition as "fiscal dumping," and said that "the corporate tax system as a whole will have to be harmonized."[43]

The EU has had some modest success in curtailing European tax competition. Value-added taxes, energy taxes, and excise taxes have all been subject to some degree of tax rate harmonization, as we noted. But other harmonization schemes have failed. The EU has tried on a number of occasions to harmonize corporate income tax rates across countries. The 1992 Ruding Commission proposed creating a minimum corporate tax rate of 30 percent.[44] Going back further, a 1975 European Commission draft directive called for harmonizing corporate rates at between 45 and 55 percent.[45]

These plans were not enacted largely because every EU member must agree in order to harmonize individual and corporate income

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taxes, which are "direct" taxes. That unanimity requirement is very important. Without it, past efforts to harmonize the corporate tax rate would have succeeded, thus preventing the dramatic cuts to corporate rates that have occurred in recent years. The average EU corporate tax rate fell from 38 percent in 1996 to just 24 percent in 2007.[46] The drop in rates has greatly improved the efficiency of European taxation, a benefit that would not have occurred if harmonization had put a straightjacket on reform.

Having failed to harmonize the corporate tax rate, the European Commission is currently working toward creating a "common consolidated corporation tax base," which would mandate a one-size-fits-all definition of business taxable income. Supporters of this initiative argue that a common corporate tax base would make cross-border investments and tax administration easier.

However, such a tax base mandate would reduce competition and take a big leap toward eliminating member-country tax sovereignty. It is likely that a harmonized corporate tax base would become a vehicle for backdoor increases in company tax burdens. Unlike consumption-based taxes, the corporate income tax has an unwieldy and complex definition.[47] That allows politicians to impose large tax increases in ways hidden from the general public's view, such as by reducing depreciation deductions in an arbitrary way.

Another initiative has been the European Commission's "savings tax directive." It requires member nations either to impose a withholding tax on interest paid to nonresidents or to collect information about the interest earnings of nonresidents and forward it to their respective governments, which would then tax the income. The directive has been expanded to include five non-EU countries. Fortunately, the directive is not nearly as extensive as originally proposed, and it is widely seen as being ineffective.

The bad news is that the EC continues to try to expand the scope and reach of the savings tax directive. High-tax European nations are not satisfied with the current system for two reasons. First, there are many loopholes that allow taxpayers to avoid either the withholding tax or the information-exchange regime. One easy option is to set up a company and then have the company be the owner of a bank account because the current system applies only to natural persons and not business entities. Loopholes like this are so prevalent that the savings tax directive is known as "the dummy

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tax" in the German press because any intelligent person can figure out how to avoid it. Politicians from high-tax nations, not surprisingly, are distressed that they have not received the projected windfall of additional tax revenue from the directive.

The second cause of dissatisfaction with the savings tax directive is the ability of taxpayers to move their money to nations that are not subject to the directive. The current directive applies only to EU member nations and their overseas territories, as well as Andorra, Liechtenstein, Monaco, San Marino, and Switzerland. This list includes some of the world's major financial centers, such as Britain, the Cayman Islands, and Switzerland. But it does not include the Bahamas, Hong Kong, Panama, Singapore, the United States, and other significant offshore locations. The EC asked America to participate, but the Bush administration rejected that request. Hong Kong and Singapore have particularly gained as some European havens have become more vulnerable to encroachment by high-tax countries.

The EC has responded to these two weaknesses in the savings tax directive by proposing a much more punitive system. The EC wants the directive to apply to a broader range of assets, including those held by business entities. Equally important, the EC wants new jurisdictions to join the cartel, including Hong Kong and Singapore. The good news is that the effort to expand the savings tax directive appears doomed to failure. Hong Kong and Singapore have essentially said that they have no interest in undermining their competitive positions to prop up Europe's welfare states. The EC's efforts to bring additional nations into the cartel seem unlikely to succeed. Moreover, it is highly unlikely that Switzerland will acquiesce to a savings tax directive that would apply to more financial instruments.

Speaking of Switzerland, the EC has a specific campaign against Switzerland's pro-competition company tax laws. The EC claims that the canton-based tax system in Switzerland allows subnational governments to create preferential tax systems that violate Swiss-EU trade agreements. Switzerland has responded by explaining that the trade agreements do not apply to taxes. The Swiss also note that there is nothing impermissible about cantonal tax systems, even if trade treaties were expanded to cover tax matters. In any event, Switzerland's combination of decentralization and direct democracy makes it unlikely that the EC will succeed.

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A final point of optimism is that the various political organs of the European Union may be less of a threat to tax competition over time because EU expansion has resulted in membership for a number of nations that are more sympathetic to free markets and competition. This is slowly but surely changing the political culture in Brussels. More importantly, the EU's unanimity requirement for tax policies means that pro-tax harmonization forces need to get all 27 nations to agree to cartel policies. This was difficult when there were 15 members, but now that pro-market nations such as Estonia and Slovakia are members, it may be impossible.

If Europe's high-tax nations have had a hard time enforcing a tax cartel in Europe, it is unlikely that the EU can impose one on the rest of the world. This is especially important because of the link between the savings tax directive and the OECD's anti-tax competition campaign. The OECD is unable to make progress until and unless all of its member nations agree to the bad policies that the Paris-based bureaucracy wants to impose on blacklisted jurisdictions. This level-playing-field condition might be satisfied, however, if the EU is successful in expanding the scope and reach of the savings tax directive. Fortunately, that is rather improbable. But this does not mean there is no threat. As stated above, international bureaucracies with large budgets can slowly erode tax competition, especially if there is no pro-competition leadership to respond.

United Nations

The United Nations has the potential to become a huge threat to tax competition because of its global standing and left-of-center politics. In recent years, a number of initiatives to impose global taxes and to stifle tax competition have been proposed by top UN officials and promoted by various UN divisions.

One initiative came from the UN's Financing for Development project in 2001. It called for the creation of an international tax organization (ITO). Such a new bureaucracy would be responsible for convincing countries to "desist from harmful tax competition" and could have the power to override the tax policies of sovereign nations.[48] No doubt, any new tax bureaucracy at the UN, such as an ITO, would have a large bias toward tax increases. The UN suggested that a new ITO "could take a lead role in restraining tax competition designed to attract multinationals."[49]

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The UN has repeatedly pushed for the imposition of a global tax. In 1996, the former UN secretary-general Boutros Boutros-Ghali called for a new global tax imposed on airline tickets and currency transactions. In 1999, the UN human development report called for the creation of a global tax on the Internet. In 2001, the Financing for Development project called for the creation of new "global source of funds" from a "high yielding tax source."[50] The report suggested study of a "Tobin tax" on foreign exchange transactions to finance "global public goods." More recently, the issue of UN-imposed taxation has been raised under the pending Law of the Sea Treaty.

Another dangerous UN proposal is the idea for an ITO to tax the income of emigrants from countries around the world.[51] A UN report said that an emigrant tax is needed because emigration "exposes source countries to the risk of economic loss when many of their most able citizens emigrate."[52] Economically, the scheme would hurt countries such as the United States that have large numbers of immigrants. But the idea is also very disturbing from a civil liberties perspective. It presumes that people are the property of governments, or at least that governments have a perpetual right to people's income. Although the UN proposal provides no details, the idea apparently is that an ITO would assess a tax on, say, U.S. citizens of Chinese origin and send the money back to the government of China.

Yet another UN initiative is the so-called Committee of Experts on International Cooperation in Tax Matters.[53] This group meets annually and often produces reports supportive of indirect tax harmonization. The group used to be known as the Ad Hoc Committee of Experts on International Tax Matters, but its title was officially upgraded by the UN. Indeed, in 2003, the then secretary-general Kofi Annan suggested that the group be turned into a permanent commission, similar to the United Nations Children's Fund.

Like the project of the Financing for Development group, the Committee of Experts has no official power, but it is part of a multipronged effort by international bureaucracies to restrict tax competition and criticize low-tax jurisdictions. This committee also has influence on the UN's model tax convention, which like similar models of the OECD and EU efforts, is predicated on particular views about worldwide taxation and income tax systems that are biased against savings and investment.

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The United Nations does not pose a major threat to tax competition in the short term, and the creation of an international tax organization does not seem likely anytime soon. The right to tax—and the right to control the taxation of economic activity inside national borders—is the very essence of national sovereignty, and most national governments will only surrender that right grudgingly.

However, the UN is a big long-term threat. It purports to represent citizens of the world, and despite its many huge failures of recent years, it still generates a halo of goodwill among many government officials. One could see the large and high-tax countries getting together under the auspices of the UN and, while protecting their own sovereign rights, conspiring to undermine smaller, low-tax jurisdictions.

Conclusions

Thus far, opponents of tax competition have not been very successful at creating a cartel to restrict tax cuts around the world. But the tone and content of OECD, EU, and UN reports, and comments by various political leaders, are ominous. Many officials want to create global tax rules, a permanent global tax organization, and possibly globally imposed taxation.

The last thing that citizens in most countries need is a global tax superstructure on top of all the taxation that they currently deal with. If we do manage to ward off the creation of a global tax cartel, it will be taxpayers in the highest-tax countries that will be the biggest beneficiaries. Taxpayers in France, Sweden, and other such places should be the biggest supporters of tax competition, and the biggest opponents of creating an OPEC for politicians.

The United States should fight tax cartel proposals, and it should also defend tax haven jurisdictions. Tax havens are well governed, they help promote good fiscal policy, and they help protect human rights. The United States should not participate in international efforts to bully havens into weakening their economies.[54] As Dick Armey noted, applying such pressure could make those countries less willing to aid us in the more important mission of stemming the financing of terrorism and other criminal activities.[55]

If high-tax nations want to reduce tax avoidance and evasion, they should fix their own tax systems by cutting high tax rates and pursuing fundamental tax reforms. Indeed, an OECD staff report

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noted: "Legal tax avoidance can be reduced by closing loopholes and illegal tax evasion can be contained by better enforcement of tax codes. But the root of the problem appears in many cases to be high tax rates."[56]

In the next chapter, we look at the civil liberties aspects of tax competition. A key goal of tax competition opponents is to create large-scale information exchanges between governments, which would be a potentially huge blow to personal financial privacy. Tax competition is not just an economics issue, it should also be considered from a privacy and human rights perspective.

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9. The Moral Case for Tax Competition

Tax competition is usually discussed as an economics issue, and this book is focused on topics such as falling tax rates and tax reform. But the debate over tax competition also has a moral component. Tax competition is greatly beneficial in the battle for human rights and personal freedom. Low-tax jurisdictions, or tax havens, are a safe refuge for oppressed people seeking to protect their assets. The critics of tax competition want to shut down tax havens, and we explained in the prior chapter why that would be bad economic policy. In this chapter, we explore the high costs of that agenda to freedom and individual rights.

Privacy laws in tax haven countries shelter the assets of people needing protection against government persecution based on ethnic, religious, political, and other grounds. Jurisdictions with strong financial privacy protections are also safe refuges for the savings of people living in nations plagued by crime, corruption, and mismanagement. Moreover, in the digital age, when governments collect and share vast amounts of personal information about their citizens, financial privacy protections are a unique and important asset to preserve and protect.

There is also an "economic morality" component to the tax competition debate. Tax competition spurs economic growth, which creates improved living conditions and more opportunities. Researchers have found that economic growth helps support democracy, better governance, and more tolerant and happy societies. Thus, we describe the importance of nations being able to retain their fiscal sovereignty and to seek prosperity through competitive tax policies as they choose.

Human Rights and Individual Security

Taxpayers in the advanced economies often complain about excessive tax rates and profligate governments, but at least they live in societies where the rule of law provides some protections for

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individual rights. In much of the world, that is not the case. Many nations fail to provide the basic protections of civilized society. Corruption is rampant, expropriation is common, crime is endemic, and there is widespread persecution of religious, political, ethnic, or sexual minorities in many countries.

In such environments, people with money are frequent targets of oppression. Financial institutions in these nations are often compelled to provide information to governments, so they are unable to protect the privacy of customers. Tax returns are a ready source of information for governments seeking targets for plunder. Likewise, people who live in nations plagued by political instability, crime, or economic mismanagement are at great risk of losing their savings, thus putting their families in peril.

If people have the ability to use tax havens, they can protect themselves, at least partially, from government-inflicted or government-caused financial calamity. The following examples are hypothetical, but they are based on real-world risks. In each case, the ability to place assets in a secure tax haven can play a vital role in helping people avoid persecution or financial ruin.

- *A Venezuelan entrepreneur.* Corruption in Venezuela's tax office creates the possibility that an entrepreneur's financial profile will be sold to thugs, who will kidnap his daughter and cut off her ears or fingers unless the businessman pays a ransom. A report from the United Nations noted: "People with substantial private wealth are targets for criminals of all kinds. In some parts of the world kidnapping has become an industry."[1] A Venezuelan entrepreneur could reduce the threat to his family by putting his money in a Miami bank, secure in the knowledge that his government will not have access to information about the account.
- *A merchant in the Democratic Republic of Congo.* According to Freedom House, Congo is "unfree."[2] The World Bank says that Congo has inadequate rule of law.[3] And Transparency International gives Congo a poor grade on corruption.[4] In this wretched environment, a merchant becomes the target of a government that routinely seizes private wealth if she manages to accumulate any assets. And since the corruption likely infiltrates the judiciary, there is no rule of law to protect her. If the merchant

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is to make any progress on building savings and growing her business, she will need a safe haven abroad, such as a Swiss bank account.

- *A religious minority in unfree countries.* Jews in the Middle East, Christians in some parts of Asia, and other religious minorities are often vulnerable to unfair treatment. Open Doors International, for example, lists 24 nations where Christians are subject to "severe persecution," "severe limitations," or "oppression."[5] Persecution is sometimes linked with envy over the financial success that minorities sometimes enjoy. Historically, tax havens have provided a refuge for religious minorities. Most famously, the Swiss laws regarding banking secrecy were significantly strengthened in 1934 after Adolf Hitler took control in Germany and tried to prevent Jews from protecting their assets.[6]
- *Any industrious person in Haiti.* According to the World Bank, Haiti has one of the world's least effective governments.[7] Any person who works hard to get ahead and starts building savings is subject to private or public expropriation with little means of redress. Rather than be sucked dry by a kleptocratic Haitian government, a taxpayer could rationally decide to put his savings in the tax haven of say, Anguilla, shielded from the thieves in his own government. One expert noted: "There are situations in some developing countries where law-breaking helps one to survive. If people want to open a business, to acquire land or build homes they are confronted with high transaction costs. . . . Tax evasion can be seen as an 'exit' option, a signal through which taxpayers can express their disagreement."[8]
- *A family in Zimbabwe*. According to the World Bank, Zimbabwe is among the world's most politically unstable regimes.[9] Expropriation is a common threat for those who are viewed as enemies by the nation's dictator. In 2008, hyperinflation destroyed the value of any savings denominated in Zimbabwe currency. The threat of high inflation and currency devaluation has always been a prime reason for people in unstable countries to put their savings in safer investment locations abroad. Unfortunately, there are 93 other "unstable" nations in the world, in addition to Zimbabwe.[10]
- *An Argentine businessman*. Owning offshore accounts enables people to protect themselves from financial instability and

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expropriation. In Argentina, the government's gross incompetence in the past has subjected citizens to massive currency devaluations and financial instability. This is an oft-repeating pattern. In 2008, Argentinean inflation is running at 20 percent, and yet another economically illiterate government is at the helm. Because this situation is not unusual around the world, one expert testified to Congress that tax haven "clients were motivated to establish their banking relationships for a variety of reasons . . . [including] . . . avoidance of foreign exchange controls, fear of currency devaluation, fear of confiscation resulting from political upheaval."[11] For the hypothetical Argentine businessman, a bank account in the Bahamas is an excellent way of protecting his finances from an incompetent government.

- *A human rights activist in Turkmenistan.* Political minorities are persecuted and nongovernmental organizations are harassed in Turkmenistan. In immature democracies and countries controlled by dictators, opposition party leaders and political dissidents are often targeted for persecution. If ruling elites in such countries can threaten the personal finances of their opponents, democracy is likely to wither. However, if political minorities and civil-society organizations can park their assets in, say, Luxembourg, a nation with strong secrecy laws, they have a greater ability to fight for liberty. According to Freedom House, 121 nations, including Turkmenistan, do not enjoy a free press.[12]
- *A Chinese entrepreneur in Indonesia.* Tax havens are especially important for ethnic minorities. The Chinese are often maltreated in places such as Indonesia, Malaysia, and the Philippines, and Indians are maltreated in East Africa. Much of this discrimination is driven by envy of financial success, so it is particularly important for minorities to have ways of maintaining their savings hidden from the public eye. A bank account in secure Singapore helps protect against ethnic attacks.
- *A homosexual in Saudi Arabia.* Sexual minorities are persecuted in many nations. Depending on the country, gays and lesbians face challenges ranging from ostracism to criminal prosecution. Indeed, there were 84 nations with laws targeting homosexuals.[13] Needless to say, the ability to conduct financial operations in a place like Liechtenstein—which would refuse to cooperate with a government seeking to target sexual minorities—may

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be the only way for homosexuals to guard their assets against an oppressive government.

The key link in all these examples is that persecuted people gain protection by being able to move their savings to jurisdictions with strong financial privacy laws. These people are often not motivated by a desire to escape excessive taxation, but they benefit from tax havens since financial privacy protections are a core element of tax haven jurisdictions. Financial institutions in tax havens are generally not obliged to help enforce foreign laws, particularly when foreign governments are investigating activities that are not illegal in the low-tax jurisdiction. This "dual criminality" principle is a valuable protection for civil liberties around the world.

However, as we discussed in the last chapter, international organizations such as the Organization for Economic Cooperation and Development have their sights set on destroying financial privacy in low-tax jurisdictions. That is a very troubling path to travel in a world full of predatory governments and countries plagued by criminal gangs. The consequences could be deadly if people lose the means to protect themselves from extortion and other crimes. This is not an isolated problem. The World Bank gives 114 nations negative grades on upholding the rule of law and 121 countries negative grades on corruption.[14]

Unchecked government power in many countries means that people are highly vulnerable to attacks by a predatory political elite. There are 45 "not free" countries according to Freedom House.[15] And there are 130 nations that score below 5 on Transparency International's 1–10 corruption scale.[16] *Foreign Policy*, meanwhile, lists 60 nations on its Failed-States Index.[17] By contrast, as we noted in the last chapter, almost all tax havens have good governance, which is far too rare a quality among the world's nations.

Financial Privacy

Concerns about financial privacy have exploded in the digital age as companies and governments have been far too sloppy in handling personal information. We are all vulnerable to identity theft and other crimes when data networks are breached and computer disks are stolen. That is why tax haven countries and their financial institutions offer a unique role as experts on financial privacy. These jurisdictions defend a basic right to privacy, which is a valuable role since

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far too many governments leave their citizens' personal information vulnerable.

Governments increasingly collect and share personal information of all kinds. In the tax world, there are growing pressures for expanded information sharing between governments. But a world in which financial privacy is lost and governments are sending great amounts of personal information back and forth on computer disks and through the Internet is a very disturbing prospect.

A United Nations report made a key point in this regard: "Global sharing of information means that criminal access can occur at the weakest point of entry, multiplying the risks associated with unauthorized disclosure."[18] As information sharing expands, the risk that personal tax and financial information will find its way to corrupt governments or criminal gangs increases. But governments in advanced nations such as Britain and United States have also allowed disgraceful breaches of the public trust when vast personal data in computer files have been stolen, leaked, or lost.

A recent British scandal drove home the sloppiness of government handling of taxpayers' personal information. A low-level tax official lost two computer disks containing the detailed tax, financial, and banking records of 25 million Britons.[19] The disk was sent by courier and then disappeared, and has not been found.

In the United States, there have been many large data breaches by the federal government. In 2006, the electronic records for every U.S. veteran discharged since 1975 were stolen from the home of a Department of Veterans Affairs employee. The data for 26 million veterans, included names, Social Security numbers, and other personal information might have found their way into criminal hands.[20] This department has an appalling record on sensitive data going back years.

In 2006, the Department of Transportation lost a laptop containing 133,000 records of personal information on Florida residents. In 2007, the Transportation Security Administration lost a computer hard drive containing personal information on 100,000 of its employees, including Social Security numbers and bank deposit data.[21] TSA is a division of the federal "Homeland Security" Department, but by maintaining vast and vulnerable databases on individuals, our federal government is making Americans less secure.

The Internal Revenue Service has a history rife with poor management, corruption, and data leaks. A 2007 report by the agency's

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inspector general found that between 2003 and 2006, 490 IRS laptops, often containing unencrypted personal taxpayer information, were stolen from the agency.[22] The U.S. government is a complete sieve when it comes to the personal information of citizens. But we suspect that the U.S. government has no worse a record on privacy than the governments of other advanced nations, let alone the many corrupt and nondemocratic governments in the world.

The role of tax havens in an age of government incompetence and malfeasance is as a last refuge of financial privacy and protection. Switzerland is one haven that has both low taxes and famously strong financial privacy. The *New York Times* quoted a lawyer from Baker and McKenzie in Geneva assessing the country's policies: "Aside from tax advantages . . . wealthy foreigners are attracted because the nation is considered safe, a particularly appealing factor for Latin Americans yearning to escape kidnapping threats in their own countries."[23] Indeed, even "affluent taxpayers in at least one major OECD member country also fear that tax data is routinely sold to criminal gangs seeking targets for kidnapping," according to the International Trade and Investment Organization.[24]

A recent high-profile case illustrating the importance of tax havens to financial privacy is the Russian Yukos affair.[25] In a move that many saw as politically motivated, Russia charged the former head of the energy company Yukos, Mikhail Khodorkovsky, with fraud and tax evasion and sentenced him to prison in Siberia. The Russian government has been trying to get access to Khodorkovsky's bank account information from Switzerland. But the Swiss supreme court rebuked the Kremlin, refused to hand over the requested bank documents, and charged that continuing investigation of the company is simply a power play by the Russian government. The Swiss government decided that the rule of law is more important than playing politics and handing over private banking information just because a foreign government requested it. Countries that believe in the rule of law, such as the United States, should support Switzerland and other nations that have strong financial privacy laws.

It is ironic that the importance of personal privacy has been recognized by some of the same international organizations that are trying to destroy the privacy laws of the world's tax havens. The United Nations bureaucracy generally opposes tax competition and seeks to end financial privacy, yet the UN Declaration of Human Rights

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recognizes and protects privacy as a basic human right.[26] One UN report found that "serious issues arise when governments engage in human rights violations. For much of the 20th 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."[27]

The United Nations is not the only organization talking out of both sides of its mouth. Even the leader of the OECD's anti-tax competition campaign, Jeffrey Owens, recognized the role of tax havens in the protection of human rights. As reported by the London *Observer*, "Owens . . . stressed that tax havens are essential for individuals who live in unstable regimes."[28] And a former Clinton Treasury official who was closely involved with the OECD's anti-tax competition campaign later admitted: "How far do we want to go with this information exchange, and the secrecy issues, the privacy issues, and so forth, which relates to the problems of corrupt governments, of danger to your children and to individuals. That subject should be discussed."[29]

The OECD has acknowledged that bank secrecy "has deep historical and cultural roots in some countries" and "is also a fundamental requirement of any sound banking system."[30] Yet the OECD—like the United Nations—is apparently willing to suspend important human rights safeguards for unsound tax policy reasons. These bureaucracies are putting the interests of high-tax governments before the safety and liberty of the world's citizens.

The Money Laundering Red Herring

Some tax competition critics are frustrated that direct attacks against tax havens have not succeeded thus far. They have not convinced enough people that low taxes are a bad thing, so they are also trying to shut down havens by asserting that they are disproportionately vulnerable to money laundering. That is a serious accusation, but the evidence indicates that dirty money is much more likely to be found in "onshore" banks in major countries, not in offshore banks.

There are no longer any "noncooperative" jurisdictions, including any tax havens, on the blacklist of the Financial Action Task Force, an international agency that monitors the fight against dirty money.[31] Moreover, every major tax haven is a member of the Egmont Group,

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which is the international coordinating body for the financial intelligence units of member nations. Membership in the Egmont Group is not open for regimes with lax attitudes to money laundering, further illustrating why low taxes and financial privacy are not associated with dirty money. Additionally, all the major tax havens have received "QI" status from the IRS, indicating high-quality anti–money laundering laws.

None of this should be surprising since an overwhelming share of the world's dirty money is obtained from the drug trade in nations such as America. The State Department reports that "onshore" nations are more likely than tax havens to be "major money laundering countries."[32] The notion that drug dealers and other criminals rely on offshore banks makes no sense because they can only wire money offshore if they first deposit it onshore. Yet if they get the money in an onshore bank, the laundering has already been successful. It does not make sense for criminals to call attention to themselves by then trying to send the funds offshore. Thus, a large share of criminal money is laundered in wealthy industrial nations, not tax havens. It is estimated that about half all laundered money goes through U.S. financial institutions.[33] Smart criminals avoid tax havens because of the obvious red flag it provides to authorities.

The Phony Terrorism Issue

Since September 11, 2001, there has been some concern about whether terrorists could exploit the privacy laws in low-tax jurisdictions to hide their pernicious activities. Anti–tax haven activists seized on these fears to bring pressure against tax havens. However, there is no evidence that terrorists have used offshore financial centers. The September 11 terrorists, for instance, relied on banking systems in the United States, Europe, and the Middle East, including the informal *hawala* system.[34]

The low-tax and financial privacy rules of offshore centers need not conflict with important criminal investigations. Many banking centers such as the Cayman Islands and Switzerland have mutual legal assistance agreements with the United States to exchange information on nontax matters.[35] Others have clearly stated that they will gladly cooperate with U.S. law enforcement in the battle against terrorist financing. Jurisdictions that resist cooperating on these matters should certainly be pressured to do so by the United States.

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Tax havens have a huge incentive to keep terrorists and other bad actors out of their financial systems. Consider what happened with the September 11 terrorists. Investigators discovered that they primarily stashed their funds in the Florida branch of an American bank. Nobody jumped to the conclusion that this was an indictment of America's banking laws or that this bank somehow was complicit with terrorism. But imagine what would have happened if the terrorists had set up an account in the Bahamas. Critics would have instantly assumed that the root problem was the "bank secrecy" laws in the Bahamas, and actions would have been taken against the Bahamian financial services industry. Low-tax jurisdictions know that they have to meet a higher standard than onshore banks, and so they have an incentive to be much more aggressive in weeding out and refusing to deal with sketchy clients.

Finally, it is high taxes in some cases that aid terrorist activities, not low-tax jurisdictions. In particular, exorbitant taxes on cigarettes in many countries have created a huge black market worldwide that is dominated by criminal gangs. Cigarette smuggling is a known source of profits for terrorists.[36] For example, U.S. cigarette smuggling has been a source of funding for the Middle East terrorist group Hezbollah.[37]

Fiscal Sovereignty

The campaign against low-tax countries and tax havens interferes with the right of jurisdictions to pursue their own fiscal policies, in particular pro-growth tax policies. Although having "no or low" income taxes is a key criterion for being listed as a tax haven by the OECD, most economists think that low income tax rates represent sound growth-oriented policy.[38]

Many tax havens are rich, particularly the ones that are OECD members, such as Luxembourg and Switzerland. So are some jurisdictions on the OECD tax haven blacklist, such as Bermuda, the Cayman Islands, and Liechtenstein. It seems rather odd for any international organization to criticize countries for the very policies that helped make their citizens wealthy and prosperous.

Other tax havens are less-developed nations, and they seek to emulate the policies in countries such as Switzerland to become wealthy. For the OECD to crack down on such developing nations that have instituted low-tax policies seems especially onerous and

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unfair. After all, most OECD nations did not have income taxes themselves during the 1800s, which was when they started to climb out of agricultural poverty to middle-class prosperity. America became prosperous in part because it was not plagued by an income tax until 1913. Why is it wrong for developing nations to follow the same low-tax development strategy?

Another aspect of the crackdown on low-tax nations that is both unfair and hypocritical is the disparate treatment of capital and labor. Critics of tax competition, such as the OECD, are upset that capital is flowing to low-tax jurisdictions, many of which are in the developing world. But OECD nations are big beneficiaries of a "brain drain," or skilled-labor outflows, from developing nations.[39]

We think that international flows of both labor and capital are good for the global economy and for personal liberty. But one often hears leaders of OECD countries complain about capital outflows at the same time that they are implementing policies to try to attract inflows of skilled labor. In Chapter 5, we discussed some of the immigration policies and tax breaks in OECD countries that are aimed at attracting skilled workers. We know of no OECD effort to stop the flow of skilled labor into OECD countries, so why should countries that have attracted capital help the OECD stop those flows?

Dealing with Tax Evasion

A common argument against tax havens is that they enable some people from high-tax nations to evade taxes. That is undoubtedly true, but of course there are myriad ways that taxpayers evade taxes without going offshore. The more important concern for policymakers should be the underlying causes of tax evasion. If policymakers in high-tax nations want to reduce tax evasion of all types, they should focus on reducing tax rates, rather than blaming their problems on nations with more efficient tax systems.[40]

No one knows the overall size of U.S. tax evasion, let alone the portion represented by foreign tax havens. Certainly, politicians and tax collection agencies have an incentive to overstate evasion to justify bigger budgets and more staff, and thus some numbers may be inflated. An oft-repeated claim is that tax havens lead to $70 billion of lost federal tax revenue every year. Yet this was not an official estimate; it was concocted by a former staffer to Sen. John

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Kerry (D-MA). The number was discredited when the staffer essentially admitted that it was just his personal guess.[41]

Some estimates falsely assume that all the funds in tax havens are there for tax-evasion purposes. News articles and congressional hearings sometimes feature charts showing the total amount of money deposited in the Cayman Islands, but those numbers tell us little about tax evasion. That is because the bulk of funds in the Caymans are institutional funds, including perfectly legal monies, such as hedge funds and interbank deposits. Moreover, a significant portion of the funds comes from countries other than the United States. Further, since there is a tax information-exchange agreement between the Cayman Islands and the United States, common sense tells us that little of that money is hiding from the IRS.

Academic experts generally conclude that there is substantial tax evasion in the world, but there are dramatic differences between nations. Perhaps most importantly, experts conclude that high tax rates are a main cause of evasion. Friedrich Schneider, a professor of economics at Johannes Kepler University in Austria, is perhaps the world's leading expert on underground economies, and has advised the World Bank and International Monetary Fund. His research finds that "an increased burden of taxation and social security contributions, combined with labor market regulation are the driving forces of the shadow economy."[42]

In his studies, Schneider finds that some jurisdictions, such as Hong Kong, Singapore, Switzerland, and the United States, have very high compliance rates. Indeed, in a study for the IMF, Schneider found that the United States had one of the smallest shadow economies of countries studied.[43] By contrast, higher-tax countries such as France and Germany have significantly larger underground economies. The lesson to be learned is that high taxes and other barriers to legal and productive activities help spur evasion.

One spurious claim by tax competition opponents is that the use of tax havens for evasion by some people results in higher taxes for the rest of us who are law-abiding. Actually, that gets it backward. Governments around the world have been cutting tax rates partly because they want to discourage people from moving their money offshore. In other words, havens are part of the tax competition process helping to put downward pressure on tax rates in high-tax countries, which benefits all of us who comply with national tax laws.

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We discussed how tax levels soared during the 1960s and 1970s, and then started to level out once tax competition began forcing restraint in the 1980s. Although it is impossible to know how much tax burdens would have increased in the absence of tax competition, it is safe to assume that competition—including competition from offshore tax havens—saved taxpayers from higher tax rates. Tax evaders may not be ethical people (at least the ones who live in nations with honest governments and reasonable tax levels), but the risks they take can benefit us all by creating greater fiscal restraint.

The Moral Benefits of Growth

The first responsibility of governments is to protect the safety of citizens from external aggression and domestic crime. The second responsibility is to provide an open environment conducive to economic growth and opportunity. There are numerous items needed to create that environment, including property rights, the rule of law, and a stable currency. Another key condition for prosperity is a tax system that does not unduly discourage productive behavior.

Enacting policies that are supportive of economic growth is not just about economics. There is an ethical obligation of governments not to stand in the way of individuals' moving ahead in society, starting businesses, and "pursuing happiness" as America's founding document declares. Failure to pursue good policies deprives people of opportunity and creates hardship for the most vulnerable members of society.

Benjamin Friedman's recent book, *The Moral Consequences of Economic Growth*, casts growth in moral terms. An economist at Harvard, Friedman is a liberal Democrat, but he recognizes that economic growth has very positive effects.[44] He notes, "Economic growth—meaning a rising standard of living for the clear majority of citizens—more often than not fosters greater opportunity, tolerance of diversity, social mobility, commitment to fairness, and dedication to democracy."[45]

What does this have to do with tax competition? The answer is that competition encourages governments to enact sensible pro-growth policies. As the world's tax systems become less onerous, the overall economic pie of global income rises, which raises the standard of living in every country that moves ahead with reforms. In turn, higher incomes lead to greater happiness, as a growing

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body of empirical research has found.[46] Additions to income in poor countries, in particular, create large improvements in happiness. Adam Smith noted a link between rising incomes and happiness more than 200 years ago:

> It is in the progressive state, while the society is advancing to the further acquisition, rather than when it has acquired its full complement of riches, that the condition of the laboring poor, of the great body of the people, seems to be the happiest and the most comfortable.[47]

Economic growth allows people to buy better food, clothing, and housing. It also allows people to afford better health care, and economies to invest more in life-saving medical research. Wealthier nations are healthier nations.[48] And people in wealthier nations tend to live longer than people in poor nations.

Although government spending has led to some improvements in the quality of life, market competition and private innovation are the main factors that make wealthy nations wealthy. Vito Tanzi, the former top economist at the International Monetary Fund, argues that "all the theoretical reasons advanced by economists to justify the role of the state in the economy, including the need to assist the poor, could be satisfied with a much smaller share of spending of GDP than is now found in most industrial countries."[49] Looking at data for a large sample of countries, he found no advantage in having bigger governments for improving "human development" indicators, such as education achievement, infant mortality, or life expectancy. In other words, bigger governments do not create smarter or healthier populations.

Private-sector economic growth also yields benefits with regard to civil society. Benjamin Friedman wrote, "The value of a rising standard of living lies not just in the concrete improvements it brings to how individuals live, but in how it shapes the social, political and ultimately the moral character of a people."[50] *The Economist* agreed:

> Growing prosperity, history suggests, makes people more tolerant, more willing to settle disputes peacefully, more inclined to favor democracy. Stagnation and economic decline are associated with intolerance, ethnic strife and dictatorship. . . . If people are becoming better off relative to their own past standard of living, they will care less about where they stand in relation to others. If they are not growing

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> better off relative to their own past standard of living, they will care more about their placing in relation to others—and the result is frustration, intolerance and social friction. Growth, in short, has moral as well as material benefits.[51]

Economic growth is even linked to a decrease in armed conflict and the spread of democracy around the world.[52] Gregg Easterbrook argued in the *International Herald Tribune*:

> Probably one reason democracy is taking hold is that living standards are rising, putting men and women in a position to demand liberty. And with democracy spreading and rising wages giving ever more people a stake in the global economic system, it could be expected that war would decline. It has. Even taking Iraq into account, a study by the Center for International Development and Conflict Management, at the University of Maryland, found that the extent and intensity of combat in the world is only about half what it was 15 years ago.[53]

Economic growth is not an elixir. It does not solve all problems, but a more prosperous economy certainly makes many problems easier to address. Tax competition helps promote economic growth by encouraging supply-side tax reforms and limiting the growth in governments.

Conclusion

Tax competition and tax havens should be applauded, not persecuted. These features of the modern world economy encourage governments to implement policies that boost growth and create opportunity. Tax competition plays a key role in encouraging governments to reduce the taxation of savings and investment. Tax reforms can genuinely improve the lives of ordinary people through higher incomes and the related benefits to society that come with growth.

Tax havens also provide a refuge of financial privacy in a world where governments are collecting masses of personal information, and are increasingly sharing it across international borders. Tax havens help protect people from political, ethnic, and religious persecution. They provide a haven for people living in nations dominated by corrupt and incompetent governments. People living comfortable

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lives in industrial democracies often forget that much of the world's population lives in nations that are not free. For these people, tax havens can help them gain a level of safety and financial security that they cannot achieve under their own governments.

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10. Options for U.S. Policy

We have chronicled the tax reforms that have swept the world in recent decades. Initial income tax cuts by Britain and America turned into an avalanche of reforms as tax competition took hold and tax rates fell on every continent. Tax systems in nearly all industrial nations are substantially less damaging today than three decades ago. Lower individual tax rates are more favorable to work and entrepreneurship. Lower corporate tax rates have promoted rising investment and higher wages. Tax rate cuts on dividends, capital gains, wealth, estates, and cross-border investment have encouraged greater savings and higher growth.

Although tax rates have plunged, overall tax revenues have not been cut in most countries. Tax competition has not yet forced governments to go on a fiscal diet and reduce spending. But supporters of limited government can take heart—ratios of tax revenue to gross domestic product are no longer rising rapidly, as they did before the 1980s. Instead, tax ratios have peaked and leveled out in most countries. In some countries, including Estonia, Hungary, Ireland, Latvia, the Netherlands, Poland, and Slovakia, revenues relative to GDP have fallen in recent years.

In coming decades, we hope that tax competition will play a crucial role in restraining governments. The rising costs of entitlement programs in the United States and other countries will generate large pressures to increase taxes. Perhaps governments will act responsibly and start reforming these programs to avert huge tax hikes. But if they do not, vigorous tax competition will provide a defensive backstop. The more tax rates are increased, the more tax bases will shrink, and ultimately governments will be forced to control spending.

Tax competition is a tool to preserve limited government in the 21st century. That is why America needs to be a leader in protecting and enhancing global tax competition. U.S. policymakers should oppose tax harmonization, the creation of world tax authorities,

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widespread information sharing between governments, and other techniques designed to stifle competition.

U.S. policymakers also need to embrace tax reform because American wages and incomes depend on the efficiency of our tax system. Our overall tax burden is less onerous than in many other industrial nations, but our tax system lags behind the "best practices" of other advanced nations in many important ways. Federal tax rates on corporate income, corporate capital gains, dividends, estates, and other items are higher than in most countries. The individual and corporate income tax systems are hugely complex and distortionary. If the government retains this tax code as other countries make further reforms, America will tumble in the rankings of the wealthiest and most competitive nations.

The United States has been on the sidelines of tax reform for two decades as countries such as Estonia, Ireland, and Slovakia have forged a path of remarkable pro-growth changes. This chapter describes how America can get back in the saddle on tax reform. A first step is to cut individual income tax rates to 15 and 25 percent and abolish narrow breaks in the tax code. The corporate tax rate should be cut to 15 percent and territorial taxation adopted. The long-term goal is a low-rate flat tax that encourages investment and growth, while providing equal treatment to all taxpayers.

Oppose Restrictions on Tax Competition

The global tax revolution would not have happened in the heavily regulated world economy of the 1950s. Back then, there were high trade barriers, tight controls on capital movements, restrictions on foreign investments, and little labor mobility. It was the deregulation of labor, capital, and trade in later decades that spurred cuts to the oppressive tax rates of the mid-20th century and unleashed global economic growth.

Few policymakers today want to regulate trade and capital flows as countries did in the 1950s, but dangerous movements are afoot to control and limit tax competition. As we discussed, these efforts are being led by international organizations such as the Organization for Economic Cooperation and Development, the European Commission, and the United Nations.

Policymakers in these bureaucracies and in some governments seem to want to turn back the clock and create an OPEC for taxes

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to insulate governments from competition. That is the bad news. The good news is that the United States is uniquely situated to protect and advance global tax competition. America is still an 800-pound gorilla in the world economy, so trying to restrict tax competition without American support would be like operating OPEC without Saudi Arabia. Thus, U.S. policymakers should:

- Use American influence inside the OECD to kill the anti-tax competition project. The United States is the biggest funder of the OECD, providing nearly one-fourth the organization's budget. That means that the U.S. government has the ability to block further attacks by the organization on lower-tax jurisdictions. One precedent is the U.S. effort that helped to defeat the OECD's anti-competitive campaign against open-registry shipping, which we discussed in Chapter 8.
- Reject European Union invitations to participate in cartel-like tax initiatives, such as the savings tax directive. As we discussed in Chapter 8, the EU wanted America to join the savings tax directive, but the Bush administration rejected the idea. That refusal, along with Swiss resistance, resulted in a weakened directive being implemented in 2005. But the EU does not give up easily, and now it wants to expand the directive's scope and include more nations.
- Block possible United Nations schemes for global taxes, global tax regulations, and a global tax organization. Fortunately, the UN has not made much progress toward those ends, but these ideas are often discussed and may come to fruition unless taxpayers remain vigilant.
- Oppose efforts to change U.S. tax policies in anti-competitive ways. For example, a proposed tax regulation from the Clinton era regarding the reporting of interest earned by nonresidents should be withdrawn.[1] Also, efforts to expand the reach of the U.S. worldwide tax system should be opposed. Finally, the various efforts by U.S. policymakers to blacklist low-tax nations and jurisdictions should be rejected.

One way to help ensure that American policies stay on the side of international tax competition is for us to proceed with domestic tax reforms. With America's current tax system, politicians often fret about companies moving profits to the Cayman Islands and the like,

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and they are susceptible to siding with high-tax countries on tax policy matters. However, if we proceed with major tax reforms and make the United States a magnet for investment and jobs, it will be much easier for policymakers and the public to understand the benefits of open tax competition.

Cut Individual Tax Rates

Why shouldn't the United States have the simplest and most pro-growth tax system in the world? Chapters 2, 3, and 4 described how the global economic climate is changing rapidly, and we hope that U.S. policymakers will awaken from their slumber and respond. Ireland has a rock-bottom corporate tax rate; Estonia has replaced its corporate income tax with a simple withholding tax on dividends; and many countries have capital gains and death tax rates of zero. Meanwhile, 25 jurisdictions have abolished their complex income taxes and replaced them with simple flat taxes.

There is no reason why these reforms could not be implemented in the United States. Indeed, America should be *the* premier flat tax nation because of our free-market heritage and because of our Constitution, which promises limited government. The words on the façade of the Supreme Court, "Equal justice under law," should be the guiding theme in reforming the federal tax code. The current tax code's mess of multiple rates and special breaks is not just bad economic policy, it is an affront to basic justice. America should take steps toward a tax code that treats taxpayers equally and maximizes growth, and that means a low-rate flat tax.

The first step is to deal with the tax cuts enacted in 2001 and 2003 that expire at the end of 2010. About half these tax cuts were supply-side tax cuts and about half were social policy tax cuts.[2] To promote economic growth, the supply-side tax cuts should be made permanent. Those include the cuts to income tax rates, cuts to dividend and capital gains rates, and repeal of the estate tax.

If current tax cuts are allowed to expire, the top federal individual income tax rate will jump to 40 percent. With average state taxes on top, the U.S. rate would be 46 percent, which would exceed the OECD average of 43 percent. Even worse, if the current dividend tax cut is allowed to expire, the United States would easily have the highest dividend tax rate of all industrial countries.

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It makes no economic sense for America to be a high-tax-rate country, yet that is where we are headed without reforms. Capital gains taxation is another area that needs attention. Virtually all major countries offer favorable treatment for gains, and numerous countries have capital gains tax rates of zero. Indeed, because we should not double-tax savings and investment, zero is the proper tax rate and should be the ultimate goal of U.S. reforms.

After dealing with soon-to-expire tax cuts, policymakers should proceed with a major overhaul of the income tax. The current tax code should be scrapped and replaced by a simple two-rate system of 15 and 25 percent.[3] Virtually all deductions and credits should be abolished, with the exception of a large basic exemption and provisions such as 401(k)s and individual retirement accounts, which protect savings from double taxation. Also, individual dividends and capital gains should be taxed at the lower 15 percent rate.

A group of House conservatives, led by Reps. Paul Ryan (R-WI), Jeb Hensarling (R-TX), and John Campbell (R-CA), proposed a similar two-rate tax plan in 2007.[4] The plan included repeal of the alternative minimum tax, and it set the split point between rates of 10 and 25 percent at $50,000 for singles and $100,000 for couples.

With this structure, the two-rate tax plan would have produced a tax cut of about $150 billion in 2007, which is about 6 percent of total federal revenues.[5] That reduction in revenues could be matched by cuts to federal spending.[6]

Combined with our proposed individual tax reforms, the corporate tax rate should be cut to 15 percent. Table 10.1 shows the basic tax rate structure with these reforms. The top rates on wages, dividends, interest, and business profits would be cut substantially. Further, the combined top tax rate on all types of income would be equalized at roughly 25 percent. By roughly equalizing the tax treatment of debt and equity, the plan would end one of the biggest distortions of the current tax code. America would enjoy the most efficient tax code it has had since the late 1920s.[7]

Reductions in marginal tax rates are crucial for tax reform. Cutting marginal rates increases productive activities and reduces unproductive activities, such as tax avoidance and evasion.[8] Dropping the corporate rate to 15 percent would make the United States a magnet for global investment and would likely generate a long-term economic boom.

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Table 10.1
PROPOSED TWO-RATE TAX SYSTEM
TOP FEDERAL INCOME TAX RATES

	Current Law	Proposed System
Corporate income tax rate		
Capital gains	35%	15%
Dividends	35%	15%
Interest	0%	0%
Wages	0%	0%
Individual income tax rate		
Capital gains	15%	15%
Dividends	15%	15%
Interest	35%	25%
Wages	35%	25%
Small business profits	35%	25%
Combined corporate and individual tax rate		
Dividends	45%	28%
Interest	35%	25%
Wages	35%	25%
Small business profits	35%	25%

Cutting the top individual tax rate is also important because half all business income in the United States is earned by businesses that are taxed under the individual tax code.[9] Individual marginal rates have a substantial effect on small business hiring, investment, and growth.[10] For example, a 5 percentage point cut in marginal tax rates has been estimated to cause a 10 percent increase in small business capital expenditures.[11] In 2006, 72 percent of small business income went to taxpayers in the top two tax brackets, and those taxpayers would face lower marginal tax rates under our plan.[12]

Cut the Corporate Tax Rate

The centerpiece of our reform plan is to cut the federal corporate tax rate from 35 percent to 15 percent. That would be a dramatic cut, instantly giving America a far more competitive tax system. Although some policymakers might think that such a cut is too large, a 15 percent rate would still be higher than Ireland's rate. And

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with the addition of state-level taxes, the overall U.S. rate would be about 20 percent, or only slightly lower than the European average of 24 percent.

A 15 percent corporate rate would create neutrality in the tax code. Dividends and capital gains would bear a 15 percent tax at the corporate level and a 15 percent tax at the individual level. The combined burden of 28 percent on dividends would be similar to the top rate on wages and small businesses under our plan of 25 percent.[13] The corporate capital gains tax would also drop to 15 percent under the proposal, which is more in line with the treatment in other major nations.

Federal policymakers are awakening to the fact that America needs a corporate tax rate cut. Charles Rangel (D-NY), chairman of the House Ways and Means Committee, has proposed reducing the corporate rate from 35 percent to 30.5 percent. Treasury Secretary Henry Paulson has also promoted a corporate rate cut. Unfortunately, both the Congress and the Treasury have adopted a zero-sum mindset that any corporate rate cut has to be combined with proposals to raise taxes, such as by broadening the corporate tax base.[14]

The idea that rate cuts need to be matched with tax increases was the cause of major flaws in the last major federal tax reform. In 1986, Congress cut the corporate tax rate from 46 to 34 percent, but also expanded the base in ways that increased the tax bias against investment, while also jacking up the corporate capital gains tax rate. Effective tax rates on some types of investment actually rose under the 1986 law, which was thought to cause a modest outflow of investment from the United States.[15]

America does not need another mixed-bag reform like the 1986 act. Base broadening in 1986 gave us some of the damaging subpart F rules that we discussed in Chapter 6, and base broadening gave us a corporate alternative minimum tax that makes "corporations perform the expensive and burdensome task of complying with two separate tax systems without raising any significant revenue."[16]

Federal policymakers need to put aside their fixation of trying to wring every possible dime out of corporations. U.S. corporations have been squeezed by complex tax rules probably more than corporations anywhere else on earth. We are not against closing true loopholes in the tax code, but the belief that there exists an array of

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big loopholes that can be closed without doing economic damage is fiction.

However, corporate profits are very mobile, and we described the many ways that companies shift profits from high-tax to low-tax countries. Profit shifting through transfer pricing, for example, is creating large administrative headaches for both governments and businesses. The most effective way to deal with mobile profits is to cut the corporate tax rate. If the rate were cut to 15 percent, corporate profits would flow into America from around the world, and federal coffers would overflow.

In Chapters 3 and 6, we discussed how the federal government is probably losing revenue with its high corporate tax rate. A rate cut would generate dynamic responses that would likely produce higher, not lower, federal tax revenues. We think that a federal rate cut to 25 percent would not lose federal revenues over the long run.

To get the rate down further to 15 percent, narrow breaks that create distortions could be closed, such as the special deduction for manufacturing companies, the exclusion of interest on state and local bonds, and the housing tax credit.[17] But rate reductions could also be financed by cutting business subsidies on the spending side of the federal budget, which cost about $90 billion per year.[18] Further, there are hundreds of billions of dollars of other damaging subsidies in the federal budget that should be terminated.[19]

However, focusing on the level of revenue raised from the corporate tax loses sight of the forest for the trees. A corporate tax-cutting revolution is going on around the world. America needs to follow suit else the economy will suffer serious damage. As global investment rises ever higher, the damage from America's high-rate corporate tax increases.

Martin Sullivan, a corporate tax expert at *Tax Notes*, summarized the argument for dropping the tax rate:

> If ever there was a case that a tax policy could change behavior and those changes in turn would yield revenue offsets, this is it. With corporate tax reform, there would be some increase in overall economic growth (increasing revenue from all sources, not just the corporate income tax). There would be some shifting of real investment into the United States—as plant closings would decline and inbound investment increased. Finally, artificial profit shifting out of the

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> United States would slow down and there would be incentive to begin shifting profits into the United States.[20]

A corporate tax rate cut should not be a partisan issue. As we discussed, a long-term effect of corporate tax cuts is to increase worker productivity and boost wages. Left-of-center governments in countries such as Britain, Canada, and Germany seem to understand this, and they have supported corporate tax rate cuts.

In addition to federal reforms, the U.S. states should cut, or better repeal, their corporate taxes. The average top rate in the 44 states that have corporate income taxes was 7.4 percent in 2007, actually up slightly from 7.0 percent in 1980.[21] State corporate income taxes are perhaps the nation's most inefficient taxes. They raise just 3 percent of state revenues and are hugely complex to administer.[22] It makes no sense to burden American companies with these taxes in today's competitive economy.

Of course, the federal government could repeal its corporate tax as well. The federal corporate income tax has survived for almost a century despite having little support in economic theory. Princeton University's Uwe Reinhart provides a good summary of the problem with the corporate tax:

> Abolishing that tax outright arguably would be the best supply-side economics imaginable. . . . Corporations cannot possibly pay the corporate income tax, because they are not human beings. Instead, that tax always is fully passed to one or all of three groups of human beings: to customers through higher prices, to shareholders through lower returns on capital, or to employees through lower take-home pay. Under fierce global competition, the potential of shifting corporate taxes to customers often is limited. Similarly, in a global capital market, the corporate tax cannot easily be shifted to capital owners who have the option of taking their capital elsewhere. Economists therefore suspect that the bulk of the corporate income tax is shifted back to the least global mobile target, the employees. Liberals, in particular, should therefore favor the abolition of corporate income taxes.[23]

The corporate income tax creates large distortions compared with other taxes. It discourages investment, promotes debt over equity, and wastes the time and energy of business leaders. Unfortunately, there is political resistance to repeal. The reason the corporate tax

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survives "is the popular perception that corporations ought to pay their fair share of tax. While this may be a powerful popular justification in political terms, it is incoherent on economic grounds."[24]

It is true, however, that many tax experts support the corporate tax for administrative reasons. Corporations act as useful withholding agents for capital income that ultimately flows to individuals. Also, corporate tax repeal could result in some foreign governments'—those with worldwide tax systems—gaining tax revenue on U.S.-source profits at the expense of the U.S. government. As a consequence, "one reason most countries tax corporate profits is because most countries tax corporate profits."[25]

Still, these sorts of technical problems could be solved. Estonia has shown, for example, that the corporate tax can be essentially abolished within an income tax system. Estonia taxes corporate earnings only when they are paid out as dividends. We think that corporate tax repeal is a good long-term goal for the United States, but the first step is to get the rate down to 15 percent.

With luck, the corporate tax will succumb to a gradual demise through continued global tax competition. British tax expert Michael Devereux opined, "If I can make a bold prediction, I would say that corporate taxes will eventually just wither—there will be no corporate tax at all, partly because of the process of tax competition between states and partly as companies can organize their affairs effectively to reduce their corporation tax."[26]

Adopt Territorial Taxation for Businesses

A key issue for tax policy in the global economy is how to deal with multinational corporations. In Chapter 6, we discussed the U.S. worldwide tax system, which was designed in the 1960s and is now outdated. The system is complex, it discourages the repatriation of foreign earnings, and it puts U.S. businesses at a disadvantage in foreign markets.

There is growing support for replacing the worldwide tax system with a territorial system, which is the approach taken by two-thirds of major industrial countries, and most other nations as well. That would entail exempting the active business income of foreign affiliates from federal taxation, which is sometimes called "dividend exemption."

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Exempting foreign profits from U.S. taxation is a commonsense approach. After all, foreign-source income is already subject to tax by foreign governments where it is earned. Moreover, foreign affiliates are primarily staffed by foreign workers, and about three-quarters of their financing comes from foreign sources.[27] Foreign affiliates benefit from infrastructure provided by foreign governments, and they generate foreign economic activity, which does not impose costs on U.S. taxpayers. In fact, foreign affiliates benefit the U.S. economy in a variety of ways, as we discussed in Chapter 2.

There are two key advantages to moving to a territorial system. First, it would end the current tax barrier to the repatriation of foreign earnings. Second, it would help make the United States a good home for the headquarters of multinational corporations.

On the first point, note that repatriated foreign earnings are subject to the 35 percent federal corporate tax, which suppresses repatriation.[28] Intel's chairman Craig Barrett explained how this affects his business:

> Once a wafer fabrication facility is located at a foreign site, it is highly likely that earnings in the foreign country will be invested in additional plant expansions overseas, rather than being invested in the U.S. If brought back to the U.S., after the U.S. 35 percent corporate income tax, only 65 cents of each dollar of earnings would be available to be invested here, while in contrast as much as a full dollar (or 87.5 cents in Ireland, for example) would remain for investment in a foreign location after local tax.[29]

Because of the tax barrier to repatriation, there is a huge buildup of earnings held abroad by U.S. corporations. That buildup reached $800 billion before a temporary reform in 2004, which we describe below.[30] These built-up earnings are not being returned and invested in the United States, which likely damages the U.S. economy. Martin Sullivan explains:

> When dividends from foreign subsidiaries are essentially locked out because of the tax waiting for them at the U.S. border, the domestic economy can pay a price. After all, foreign earnings are a potential source of funds for U.S. capital formation. More capital means more productivity, and more productivity means wages can increase without inflation.[31]

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There is broad agreement that moving to a territorial system would solve this problem of profit repatriation. Yale University's Michael Graetz notes, "The crucial advantage of an exemption system is to eliminate the burden on the repatriation of foreign earnings to the United States and remove the barrier to investing here."[32]

The advantages of a territorial system were demonstrated when Congress passed a temporary tax cut on repatriated profits in 2004.[33] For one year, companies were allowed to repatriate their built-up foreign earnings at a lower tax rate, which resulted in a surge of repatriation totaling $300 billion.[34] Most repatriation was in industries that have mobile tax bases, such as pharmaceuticals and high technology. Intel Corporation repatriated $6 billion, which helped it finance construction of a new facility in Arizona.

The second main advantage of a territorial tax system is that it would improve America's attractiveness for corporate headquarters. Currently, a high tax rate and the worldwide tax system make the United States "one of the least attractive industrial countries in which to locate the headquarters of a multinational corporation."[35] A number of years ago, a leader of Intel testified to Congress, "If I had known at Intel's founding what I know today about the international tax rules, I would have advised that the parent company be established outside of the U.S."[36]

If the United States switched to a territorial system, companies could earn profits abroad without a U.S. tax burden placed on top of the foreign taxes paid. That would make it easier for firms to expand their foreign sales, which in turn would tend to expand the size of their U.S. headquarters operations, as we discussed in Chapter 2. Headquarters generate high-skill jobs in management, finance, and research and development (R&D). Tax experts Gary Hufbauer and Ariel Assa argue that headquarters are "incubators of human capital" that "create interesting, high-paying jobs."[37] We noted that 86 percent of R&D performed by U.S. multinationals is done in the United States.[38] Hufbauer and Assa argue that the United States should adopt a territorial system and other reforms to attract headquarters activities.[39]

A territorial system is certainly the way to go, but there are some kinks to be ironed out. In 2005, territorial plans were proposed by the President's Advisory Panel on Federal Tax Reform and by the Joint Committee on Taxation.[40] These plans included some features

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that would not be favorable for U.S. competitiveness. For example, the JCT plan would essentially disallow a deduction for a portion of U.S. R&D, which would create a disincentive for companies to perform research in the United States.[41]

Also, under these two plans, the foreign royalty income of U.S. companies would be more heavily taxed than under current law.[42] Currently, most foreign royalties are not taxed because of the way that the foreign tax credit works.[43] This current structure encourages R&D spending in the United States.

But under the two territorial plans, royalties would be fully taxed, which is a harsher treatment than under current law. That could cause a shift of R&D activities and U.S. intangible assets to lower-tax climates abroad.[44] Because of this problem, numerous large corporations are not in favor of current territorial proposals, which is creating a major sticking point for corporate tax reform.[45]

One solution might be to simply exempt foreign royalty income from U.S. taxation under a territorial system. That would encourage U.S. firms to continue locating R&D in the United States. However, that policy may also encourage knowledge-intensive production to move offshore, strengthening a bias that exists under current rules.[46] Perhaps a compromise would be to treat foreign royalty income as half taxable and half not taxable.[47]

Royalties and intellectual property present complex issues in tax reform, but these issues are tougher to solve because America's corporate tax rate is so high. If policymakers slashed the U.S. corporate tax rate to 15 percent, these issues would disappear into the background. U.S. and foreign corporations would locate their R&D here, their headquarters here, and their production here. There would be little incentive to move activities offshore because the United States would become a low-tax magnet. America should adopt territorial taxation, but that reform should be matched with a large cut to the statutory tax rate.

Enact a Flat Tax

There are two types of flat taxes. There is a pure flat tax of theory proposed by Robert Hall and Alvin Rabushka of the Hoover Institution in the 1980s, and championed by Dick Armey and Steve Forbes in the 1990s.[48] And there are real-world flat taxes enacted in 25 nations and jurisdictions, as we discussed in Chapter 4.

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Although the real-world flat taxes fall short of the simplicity and neutrality of the academic model, there is no doubt that the flat tax nations have moved the ball forward for global tax reform. The world has more than two dozen working models of tax systems that are more efficient than the systems in the United States and most other countries.

However, whether one favors Hall-Rabushka or the models in operation in places such as Estonia and Slovakia, the thrust of the reforms are the same. The goals of tax reform are to install low, flat rates on individuals and businesses, repeal narrow tax breaks, and reduce the tax bias against savings and investment.

Let us look at the Hall-Rabushka plan in more detail.[49] The plan would impose a 19 percent flat tax on individuals above a basic exemption amount.[50] Individuals would not be taxed on interest, dividends, or capital gains because that income would be taxed at the business level. After-tax earnings that are saved would accumulate without additional layers of tax.[51] That would eliminate huge financial-planning headaches caused by the current complex tax rules on savings.

Large and small businesses would file the same tax return and pay 19 percent on a cash-flow measure of profits.[52] The business tax base would equal revenues less deductions for wages and other normal expenses, but businesses would also deduct the full costs of equipment and buildings when purchased.[53] Such "capital expensing" would simplify the tax code and eliminate distortions on investment. Currently, businesses "capitalize" their investments and take depreciation deductions over a period of years.

The flat tax is not just a simpler income tax. It is a consumption-based tax system that removes the income tax system's bias against savings and investment.[54] The economic effects would be similar to abolishing the income tax and replacing it with a national sales tax at 19 percent.

At 19 percent, the Hall-Rabushka plan was designed to raise about the same amount of revenue as the current individual and corporate income taxes. We think a better goal for a flat tax is 15 percent, and our proposed reforms move in that direction. For one thing, a 15 percent rate would reduce the number of taxpayers who might experience a tax increase under tax reform. Also, when the dynamic effects of tax reform are taken into account, the revenue-neutral tax

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rate would be less than 19 percent. Besides, as we noted, there are hundreds of billions of dollars of damaging programs that could be cut from the federal budget to finance tax reform.[55]

How would a flat tax affect U.S. competitiveness in the global economy? First, capital expensing would spur domestic investment and attract foreign businesses to set up production in the United States. Second, the territorial nature of the flat tax would attract corporate headquarters, spur the repatriation of foreign profits, and allow U.S. firms to better compete in foreign markets.

It is true that because the flat tax is territorial, some U.S. firms would have an incentive to shift profits abroad in search of low tax rates. However, the United States itself would have a low tax rate, so many foreign firms would shift investment and profits into the United States. All in all, the United States would become a tax haven under a low-rate flat tax.

Although the Hall-Rabushka flat tax is territorial, it is not "border adjustable," which is a concern of some supporters of tax reform. Border adjustment means imposing taxes on imports, but exempting exports from taxes to make U.S. producers more competitive in world markets. Retail sales taxes and value-added taxes are examples of border-adjustable taxes.

Tax reform leaders favoring border adjustability include Rep. Phil English (R-PA), former Ways and Means Committee chairman Bill Archer, and tax reform experts Ernest Christian and Gary Hufbauer.[56] They believe that border adjustment is needed for U.S. firms to compete on a level playing field in global markets.

However, other experts are skeptical. Economist Alan Viard, for example, argues that border adjustment "cannot yield the permanent competitiveness gain" that supporters claim.[57] Viard and others think that changes in the currency exchange rate would offset any competitiveness advantages created by border adjustment. Nonetheless, market exchange rates reflect numerous factors, and it might take years to reach any new equilibrium after tax reform. Note also that major tax reform would affect other factors that influence trade, such as the level of domestic saving.

We think that the border adjustment issue would also fade into the background if the corporate tax rate were cut to 15 percent. That low rate combined with capital expensing under a flat tax would give the United States a hugely superior tax system. American companies

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would gain a large competitive edge in world markets, which would generate higher productivity and rising wages for American workers.

Grabbing the Tax Reform Baton

The United States should aspire to have the best tax system in the world. U.S. policymakers should grab the tax reform baton from leaders in Estonia and Ireland and run with it. The United States has not pursued major tax reforms in more than two decades, but the need for reforms is more urgent than ever. Tax competition is growing ever more intense in the "flat" global economy.

Enacting the tax reforms we described would be a giant step toward putting America back in first place on economic freedom and prosperity. Cutting tax rates is the key to reform, particularly the rates on the most mobile tax bases, such as corporate profits and individual savings. A low-rate flat tax that eliminates hurdles to savings and investment is the gold standard of reform that policymakers should aim for.

U.S. policymakers also have a crucial role to play in ensuring that tax competition continues to thrive in the global economy. Tax competition is a powerful force for better tax policy, and it will be a crucial defense in coming years against tax increases to fund runaway entitlement spending. The United States should veto all efforts to impose global tax rules, and it should lead the fight for economic freedom, growth, and tax competition.

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Appendix

Table A.1
TOP INDIVIDUAL INCOME TAX RATES IN THE OECD

Country	1980	1985	1990	1995	2000	2005	2007	Change 1980–2007
Australia	62	60	49	47	47	47	45	−17
Austria	62	62	50	50	50	50	50	−12
Belgium	76	76	58	61	60	53	53	−24
Britain	83	60	40	40	40	40	40	−43
Canada	64	57	49	49	48	44	44	−20
Czech Rep.	n/a	n/a	n/a	43	32	32	32	−11
Denmark	66	73	68	64	59	59	59	−7
Finland	68	67	60	57	54	53	52	−16
France	60	65	60	62	61	56	49	−11
Germany	65	65	53	57	56	44	47	−18
Greece	60	63	50	45	43	40	40	−20
Hungary	n/a	n/a	50	44	40	38	36	−14
Iceland	63	56	40	47	45	39	36	−27
Ireland	60	65	58	48	42	42	41	−19
Italy	72	81	66	67	51	44	44	−28
Japan	75	70	65	65	50	50	50	−25
Korea	89	65	64	48	44	39	39	−50
Luxembourg	57	57	56	50	47	39	39	−18
Mexico	55	55	40	35	40	30	28	−27
Netherlands	72	72	60	60	52	52	52	−20
New Zealand	62	66	33	33	39	39	39	−23
Norway	75	64	51	42	48	40	40	−35
Poland	n/a	n/a	n/a	45	40	40	40	−5
Portugal	84	69	40	40	40	40	42	−42
Slovakia	n/a	n/a	n/a	42	42	19	19	−23
Spain	66	66	56	56	48	40	39	−27
Sweden	87	80	65	50	55	56	56	−32
Switzerland	38	40	38	37	36	34	34	−4
Turkey	75	63	50	55	45	40	40	−35
United States	73	55	38	43	43	39	39	−34
Average	68	64	52	49	47	43	42	−26

SOURCE: James Gwartney and Robert Lawson, *Economic Freedom of the World* (Vancouver: Fraser Institute, 2007), as updated to 2007 by the authors. Data include the national and average subnational tax rates.

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Table A.2
TOP CORPORATE INCOME TAX RATES IN THE OECD

Country	1996	1998	2000	2002	2004	2006	2008	Change 1996–2008
Australia	36	36	36	30	30	30	30	−6
Austria	34	34	34	34	34	25	25	−9
Belgium	40	40	40	40	34	34	34	−6
Britain	33	31	30	30	30	30	28	−5
Canada	45	45	45	39	36	36	34	−11
Czech Rep.	39	35	31	31	28	24	21	−18
Denmark	34	34	32	30	30	28	28	−6
Finland	28	28	29	29	29	26	26	−2
France	37	42	37	34	34	33	33	−3
Germany	57	57	52	38	38	38	30	−27
Greece	40	40	40	35	35	29	25	−15
Hungary	33	18	18	18	16	16	16	−17
Iceland	33	30	30	18	18	18	18	−15
Ireland	38	32	24	16	13	13	13	−26
Italy	53	41	41	40	37	37	31	−22
Japan	52	52	42	42	42	41	41	−11
Korea	33	31	31	30	30	28	28	−5
Luxembourg	40	37	38	30	30	30	30	−11
Mexico	34	34	35	35	33	29	28	−6
Netherlands	35	35	35	35	35	30	26	−10
New Zealand	33	33	33	33	33	33	30	−3
Norway	28	28	28	28	28	28	28	0
Poland	40	36	30	28	19	19	19	−21
Portugal	40	37	35	33	28	28	25	−15
Slovakia	n/a	n/a	29	25	19	19	19	−10
Spain	35	35	35	35	35	35	30	−5
Sweden	28	28	28	28	28	28	28	0
Switzerland	29	28	25	25	24	21	21	−7
Turkey	44	44	33	33	33	30	20	−24
United States	40	40	40	40	40	40	40	0
Average	38	36	34	31	30	28	27	−11

SOURCE: KPMG, "Corporate and Indirect Tax Rate Survey," 2007. Updated to 2008 by authors. Data include both national and subnational taxes.

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