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34. Global Tax Competition

Congress should:

- end incentives for corporate inversions by lowering the corporate tax rate and shifting to territorial taxation;
- repeal the Foreign Account Tax Compliance Act;
- eliminate subsidies for the Organization for Economic Cooperation and Development;
- reject proposals to force American banks to help enforce foreign tax law; and
- not ratify the Protocol Amending the Convention on Mutual Administrative Assistance in Tax Matters.

Tax competition exists when taxpayers have the ability to reduce their fiscal burdens by moving themselves, their businesses, and/or their money from high-tax jurisdictions to low-tax jurisdictions. When this freedom exists, politicians are much more cautious about raising taxes because of fears that the geese with the golden eggs will fly away. Indeed, the existence of tax competition often leads to lower tax rates. Tax competition can exist inside a nation, with American states and Swiss cantons being notable—and mostly noncontroversial—examples.

Fiscal competition between nations, by contrast, generates considerable controversy. High-tax nations, along with international bureaucracies controlled by those nations (such as the Organization for Economic Cooperation and Development [OECD] and the European Commission), would like to stifle this liberalizing process. So-called "tax havens" are the main target of efforts to replace tax competition with tax harmonization.

The Historical Record

The angst of politicians is understandable. Consider what happened after Ronald Reagan lowered the top federal income tax rate in the United

States from 70 percent to 28 percent, and after Margaret Thatcher lowered the top tax rate in the United Kingdom from 83 percent to 40 percent. Those reforms led to an economic renaissance in the two nations. But those tax cuts also encouraged similar tax-rate reductions all over the world as politicians in other nations felt pressure to improve their tax systems to prevent a big exodus of jobs, investment, and money to the United States and the United Kingdom.

The same thing happened with corporate tax rates, except that Ireland probably deserves most of the credit. Ireland slashed its corporate tax rate from 50 percent to 12.5 percent over about a 15-year period starting in 1987. The "sick man of Europe" became the "Celtic Tiger" because of rapid growth. That was good news in itself, but it also has been good news because pro-growth reforms in Ireland triggered a competitive battle as other nations cut their corporate rates to retain jobs and investment.

Thanks in part to tax competition, there has also been a flat-tax revolution. More than two dozen nations now have single-rate tax systems, mostly triggered by Estonia's reform in the 1990s. The other Baltic nations copied Estonia and now this pro-growth system is very common among the nations that were part of the former Soviet empire.

Last but not least, there have been significant reductions in the double taxation of saving and investment in recent decades. Tax competition among nations has resulted in lower tax rates on interest, dividends, and capital gains, thus ameliorating the common bias in many tax systems against income that is saved and invested. Death taxes and wealth taxes also have been reduced or eliminated as politicians decided it made no sense to drive capital to other nations.

All of these examples of tax competition have been facilitated by globalization. It's now much easier for jobs and investment to cross national borders, so politicians have to be especially sensitive to the impact of potential tax changes. In other words, governments no longer can act like monopolists, assuming that taxpayers have no choice but to submit to punitive tax regimes. And since lower tax rates and reductions in double taxation are key ways of reducing the harmful impact of tax systems, the process of jurisdictional competition has been very beneficial to the global economy.

The (High-Tax) Empire Strikes Back

High-tax nations have launched a counter-offensive against international tax competition. Most notably, they are using the Paris-based Organization

for Economic Cooperation and Development as their vehicle for a campaign that supposedly targets tax havens. These efforts are based on a theory that presumes all tax competition is bad and taxpayers should never be allowed to benefit from better tax laws in other jurisdictions.

That theory, known as "capital export neutrality," promotes tax harmonization such that taxpayers never have an opportunity to make choices that would reduce their fiscal burdens. There are two ways to make this happen, directly and indirectly.

Direct tax harmonization exists when all nations agree to have the same tax rates. The requirement that all European Union (EU) nations have a value-added tax of at least 15 percent would be an example of this approach. And when all nations have the same tax rate for a type of economic activity, taxpayers obviously cannot lower their tax burdens by shifting economic activity to another jurisdiction.

Indirect tax harmonization exists when nations have the ability to impose and enforce "worldwide taxation," which means that their tax authorities can obtain all the information needed to tax their citizens on any cross-border economic activity. And when worldwide taxation is enforceable, taxpayers obviously cannot lower their tax burdens by shifting economic activity to another jurisdiction.

The OECD and high-tax nations have mostly focused on the second form of tax harmonization, which explains the strong push to undermine human-rights laws regarding financial privacy in places such as Switzerland and the Cayman Islands. High-tax governments want the ability to track capital around the world so they can impose additional layers of tax.

There have also been periodic efforts to promote direct tax harmonization, particularly in the European Union where there is considerable cartel-like equalization of excise taxes and (as noted above) value-added taxes. In addition, the EU has tried several times to explicitly harmonize corporate tax rates. Today, the EU is pursuing a "common consolidated corporate tax base" in hopes of undermining tax competition for company investment. The OECD has a similar "base erosion and profit shifting" initiative that also is designed to enable higher tax burdens on companies.

American Hypocrisy on Tax Havens

The policies of the United States are hypocritical on the issue of tax competition. On the one hand, America has a very aggressive worldwide tax system. The internal revenue code imposes worldwide taxation on labor income of Americans, mitigated by a "Section 911" exclusion that

protects those with modest incomes. The internal revenue code also imposes worldwide taxation on corporate income, mitigated by "deferral," a policy that allows companies to postpone the extra layer of tax. And the internal revenue code imposes worldwide taxation on individual capital income (interest, dividends, capital gains, etc.), with no meaningful limits.

Because of these policies, the United States has been very aggressive in bullying other jurisdictions into enforcing bad American tax law. Jurisdictions considered to be tax havens have been coerced into signing "tax information exchange agreements" with the United States. Of course, these pacts don't actually involve any "exchange" since these jurisdictions generally don't try to tax outside their borders. The Foreign Account Tax Compliance Act, adopted back in 2010, uses the threat of a protectionist 30 percent tax on financial flows to force all nations (even places like France, which has very high tax burdens) into acting as deputy tax collectors for the Internal Revenue Service (IRS).

On the other hand, the United States is a tax haven for foreigners. People from other nations (technically, "nonresident aliens") generally can invest in stocks and bonds and not be taxed on any interest or capital gains. And since that money isn't taxed, there's no requirement to provide any data to the IRS. That means there's no information to share with foreign governments. The United States may not have strong human rights laws that explicitly protect the privacy of foreign investors, but the combination of nontaxation and nonreporting makes America an attractive de facto tax haven.

But that's only part of the story. Many American states have incorporation laws that are extremely attractive to foreigners who want confidential structures for conducting business and managing investments. Indeed, some American states don't even bother collecting information on ownership, so there's no information to share with foreign governments.

This combination of federal tax law and state incorporation laws makes the United States a very attractive place for foreigners seeking to escape excessive tax burdens. And it also happens to be a boon for the American economy. According to the Commerce Department, foreigners have more than $13 trillion in indirect investments in the United States.

Issues for Congress

Here are some tax competition-related issues that are receiving congressional attention.

Corporate Inversions

America's very high corporate tax rate, combined with a very harsh worldwide tax system, makes the United States arguably the worst place in the world to base a multinational company. But if firms can "redomicile" (i.e., move their charters from states like Delaware to jurisdictions such as Ireland, Switzerland, Cayman Islands, or Bermuda), they can protect themselves from the competitive disadvantage of being taxed a second time on their foreign-source income. This process is called an inversion, and it can cause people to engage in victim blaming, accusing the companies of somehow being unpatriotic (even though the companies generally keep their headquarters in the United States). There are two key points to understand about inversions. First, the fault is with the tax code. Second, the companies that redomicile still pay tax to the IRS on their U.S.-source income.

Deferral

As noted above, American companies have some ability to delay the extra layer of tax that the U.S. worldwide tax system imposes on foreign-source income. To postpone the tax, companies must keep the money overseas, which presumably is not good for the U.S. economy. There are three competing solutions for this problem. First, a stop-gap measure would give companies a "repatriation holiday," meaning a temporarily lower tax rate on foreign-source income returned to America. Second, Congress could eliminate deferral and impose unlimited and immediate worldwide taxation. That solution would further undermine American companies competing against foreign firms for overseas market share, but it is true that U.S. companies would no longer have an incentive to keep any remaining profits overseas (though they would have a much bigger incentive to redomicile elsewhere). The third option is to join almost every nation and simply institute a territorial tax system. In that case, American companies would pay whatever taxes are due to foreign governments in the nations where they earn income, but there would be no second layer of tax on that income owed to the IRS. In a territorial tax system, there would be no artificial barrier to returning income to the United States.

Foreign Account Tax Compliance Act

The Foreign Account Tax Compliance Act is a sledgehammer in search of a fly. It has disrupted global commerce, yet it isn't even projected to

collect $1 billion annually. (To the degree that Americans were protecting money overseas, that option became very difficult with the imposition of numerous tax information exchange agreements in the past decade.) But the act does have real effects. It greatly disadvantages overseas Americans, who have a hard time finding banking services: foreign financial institutions fear a 30 percent withholding tax and exclusion from U.S. markets if U.S. clients get into any sort of dispute with the IRS. A sensible approach would be to repeal the entire law since it violates the sovereignty of other nations. An incremental approach would be to waive the law for nations that have tax information exchange agreements with the United States.

U.S. Funding for the Organization for Economic Cooperation and Development

The Paris-based OECD began as an innocuous international bureaucracy that compiled statistics and offered noncontroversial ideas to expand economic growth. In recent decades, however, the organization has embraced a statist agenda to promote larger government, including an anti-tax competition project designed to prop up uncompetitive welfare states. Even when it didn't interfere with policy, subsidies for the OECD were of questionable value. Now that the bureaucracy is a vehicle to promote statism, sending American tax collars to finance this organization is both wasteful and harmful.

Proposal to Make American Banks Help Enforce Foreign Tax Law

The Obama administration has asked Congress to modify tax laws to require U.S.-based financial institutions to collect and share information on foreigners who make indirect investments (purchasing stocks and bonds, for instance) in the American economy. Hopefully the Trump Administration will drop this proposal. Regardless, Congress should preserve existing law.

OECD Multilateral Convention

The Obama administration has signed a Protocol Amending the Convention on Mutual Administrative Assistance in Tax Matters. That may sound innocuous, but it actually represents a radical departure from existing law. It would give the White House authority to engage in promiscuous collection and sharing of sensitive financial information with dozens of nations—including many countries that have questionable records regard-

ing data integrity, human rights abuses, industrial espionage, and hostility to American interests. The Senate Foreign Relations Committee has approved the pact; but, fortunately, the agreement is subject to a "hold" by a couple of senators. Thus, it is very unlikely the agreement will go before the full Senate for ratification anytime soon. The protocol represents bad tax policy and should not be approved.

Conclusion

Our political system encourages elected officials to overpromise, overtax, and overspend. Fortunately, tax competition is an external constraint that discourages destructive tax policies. But if high-tax nations and international bureaucracies succeed in their campaign against low-tax jurisdictions, it's quite likely that nations will go back to the confiscatory tax rates that did so much damage to global growth in the 1970s.

Suggested Readings

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