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The misguided war on offshore financial centres

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Contents

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Summary

- Corporate taxes are inefficient, with much greater deadweight costs than most other taxes. The optimal corporate tax rate is zero.

- Bad policies are often good politics. Most voters are easily deluded into thinking that corporate taxes impose no cost on them. Cutting corporate tax and increasing personal taxes is a vote loser.

- Politicians around the world have cut corporate tax rates, not because they have decided to put the welfare of the population ahead of electoral self-interest, but due to tax competition. The electoral cost of the economic effects of increased capital flight would be greater than the electoral gains from holding up corporate tax rates.

- Politicians outside tax havens are reluctant corporate tax-cutters and, thus, reluctant participants in tax competition. Ending such competition would suit them better than winning it. Hence their crackdown on the tax havens that provide the competition.

- Principles that UK and EU politicians would normally claim to support have been abandoned in the war on tax havens, including the sovereignty of third countries in tax policy, the right of law-abiding citizens to keep their financial affairs private and the rule of law.

- The war on tax havens is an inherently dirty business. Most tax havens are stable democracies, with the rule-of-law and tax regimes that are superior to the inefficient systems that have become the norm in Western countries. The UK and EU have no proper justification for interfering in their affairs.

Introduction

Several of the United Kingdom's Overseas Territories, such as the British Virgin Islands, Cayman Islands and Bermuda, have governments that impose no tax on the profits of businesses they incorporate. That is why they are commonly called tax havens. And it partly explains why they have become offshore financial centres (OFCs).

In May 2018, the UK parliament passed a law requiring Overseas Territories to publish the names of the 'beneficial owners' of firms registered in them. The law enjoyed cross-party support and was advertised as an attempt to combat financial crime. But, since these countries had already entered into data sharing agreements with the British authorities, including the police and Her Majesty's Revenue and Customs, this is implausible.

A more likely explanation is that British politicians were trying to discourage British citizens from registering companies in OFCs. Newspapers and campaigning organisations have taken to vilifying companies that reduce their tax bills by incorporating in low tax regimes and, by extension, vilifying the owners who benefit from it. 'They are cheating the rest of us!' This is the idea that has caught on. Someone named on an Overseas Territory's register of beneficial owners will be a *prima facie* 'tax cheat' and face the commercial and social risks attendant on that status. The new law will thereby increase the cost of registering a company in an overseas territory. And what costs more happens less.

It is not only the British government that seeks to discourage the use of tax havens. The European Commission has waged a campaign against them, creating blacklists of 'non-cooperative tax regimes'. Even without the associated legal sanctions, European firms might be expected to avoid the reputational damage that comes from registering companies in blacklisted countries. The OECD has also consistently campaigned against low corporate tax rates since publishing an influential report on the topic in 1998.

No one should be surprised that politicians in non-tax haven countries want to discourage their citizens from registering companies in tax havens. Not only do they fear a loss of tax revenues they would otherwise receive but the competition puts pressure on them to cut their own corporate tax rates. As capital has become more mobile over recent decades, corporate tax rates have fallen all around the Western world. Governments miss out not only on taxing companies registered in tax havens, but they must also tax companies registered domestically at a lower rate.

Though understandable, the war on tax havens is unfortunate. The simple reason is that by pushing corporate tax rates down, tax havens do other countries a service. Corporate tax is an inefficient tax, with much greater deadweight costs than most other taxes. The optimal corporate tax rate is zero.

But this is not the only reason to object to the war on tax havens. More important, perhaps, is the fact that the war is conducted by violating important principles of liberal democracy. It undermines national sovereignty, privacy rights and the rule of law.

Before getting to these matters, however, we must understand tax competition and why tax havens create it only in corporate taxation.

Tax competition and tax havens

Discussions of tax competition usually begin with Tiebout (1959), which introduced the idea within the academic literature. Tiebout argues that the difficulty of arriving at optimal government spending through voting systems is avoided when taxpayers can ‘vote with their feet’.

Imagine that governments spend on only one good – policing, let’s say. Some spend a lot on policing and tax a lot to fund it. Others spend little on policing and hence tax little. Some may spend nothing. If people can move between these fiscal jurisdictions at no cost, they will locate themselves in the one that best fits their preference for tax-funded spending on police. Some will gravitate towards jurisdictions with a lot of police and high taxes, while others will prefer fewer police and lower taxes. Tax jurisdictions will be populated by citizens with a shared fiscal preference.

Adding other kinds of spending does not change the general point. Provided there are enough jurisdictions with enough variation in the combinations of spending, and provided people can move between them at no cost, communities will self-select on the basis of their shared preference for the package where they live.

That’s a simplification. Being able to move at no cost is not the only condition for perfect Tieboutian fiscal community formation. Another is an absence of ‘leakage’. If I can get the benefit of government spending in another fiscal area without contributing to it, I won’t move to the higher tax area, even when its trade-off between tax and government services suits me better than the one I am taxed in. I will free-ride on those taxed in the leaky fiscal area. Another condition for perfect tax competition is perfect knowledge of the available options.

These conditions are met imperfectly at best. Moving is expensive; the benefits of government spending often leak across tax borders (for example, Belgium arguably benefits from French tax-funded spending on nuclear weapons); and people don't know exactly what options are available and what the effects of moving would be.

According to Nick Shaxson, author of the (2011) *Treasure Islands: Tax Havens and the Men Who Stole the World*, the fact that the conditions for the formation of fiscal communities are not met '… basically kills Tiebout's model stone dead'.[1]

Mr Shaxson is confused. Tiebout's theory says that *if* certain conditions hold, then fiscal communities will form. You cannot refute this theory by showing that these conditions do not hold. Newton's laws of motion describe what happens in a vacuum. We do not live in a vacuum. That does not refute Newton's laws. Add in friction, and we get what Newton's laws tell us to expect (at least, for super-atomic objects travelling at nowhere near the speed of light). More generally, the claim that *if p then q* is not refuted by *not-p*. If John were a dog, he would have four legs. This is not refuted by the fact that John is not a dog.

Combine Tiebout's theory with facts about the presence of its conditions for fiscal community formation, and the theory does alright. For example, in the US, people often move into districts with high local taxes and high spending on schools when they have children and then move out when their children leave school (see Fischel 2006).

Tiebout's theory faces other objections regarding the incentives of fiscal rule-makers, but these need not detain us.[2] The question here is not whether Tiebout's theory of fiscal community formation is true but whether tax havens create tax competition and whether it is something to be welcomed or regretted and, potentially, stopped.

Anti-tax competition campaigners, such as the Tax Justice Network, mean to show that tax competition is harmful. Because Tiebout's theory suggests it is beneficial, allowing people to live under their preferred trade-off between taxation and the provision of tax-funded goods, they are hostile to Tiebout's theory. But my argument does not depend on it. I need only

1 http://foolsgold.international/competitiveness-was-charles-tiebout-joking/
2 See, for example, Bryan Caplan's critique at: https://www.econlib.org/archives/2012/12/where_tiebout_g.html

the reality of international competition in corporation tax rates and the net harm caused by corporation tax. Tieboutian fiscal communities are surplus to my requirements.

Nevertheless, Tiebout makes an important contribution to understanding international corporate tax competition: namely, the significance of jurisdictional switching costs. Migrating is expensive. The migrant must find new housing, a new job, and a new school for his children. He must learn the customs of his new country. And he leaves his friends and family behind. Few will be willing to bear these costs for the sake of reducing the rate of personal income tax they pay. The lack of international income tax competition is therefore no surprise. The fact that every country in the world imposes severe restrictions on immigration makes it even less surprising.

The same goes for consumption taxes, land taxes, sin taxes and poll taxes.

But not corporate taxes. Since the 1970s, the legal restrictions on the registration of companies and on moving capital across national borders have been markedly reduced. And the cost of registering a company in a low-tax jurisdiction is extremely low. Indeed, when the cost is spread across many thousands of shareholders, it is close to zero for each of them. So, we see what we might expect to see: namely, company registrations flowing from high corporate tax jurisdictions to low or no tax jurisdictions, and vast quantities of capital flowing through them, from investors to the ultimate destination of their investment (see Zuluaga 2018).

Of course, low corporate tax rates are not the only consideration. The owners of companies also seek legal certainty and the efficient administration of their company's legal affairs. Again, we see what we should expect. Offshore financial centres (OFCs) typically display a strong commitment to the rule of law. And they host networks of professional services firms – lawyers, trustee companies and funds administrators – that supply high quality administrative services.

OFCs that impose no tax on company profits are not, of course, competing for the tax revenues of the companies they attract. Rather, they benefit from the economic activity attendant on the registration of so many companies and trusts in them. A large portion of their small populations earn a living from work that comes directly or indirectly from the provision of financial services.

This explains why tax havens are small countries. In a large country, only a tiny percentage of the population could earn a living from the services supplied in OFCs. A politician offering to distribute 25 per cent of all company profits to the population will win more votes than one offering to preserve jobs in the (relatively small) trustee and funds administration sectors (see below).

Although OFCs are not competing for corporate tax revenues, their success in competing for company registration threatens the corporate tax revenues of non-OFCs. To discourage companies from shifting offshore, they reduce their own corporate tax rates. Not to zero, of course – which would defeat the purpose – but to a level at which (they figure) the tax revenue lost from the lower rate is more than offset by the revenue gained from companies and their profits being retained or gained domestically.[3]

Thus, corporate tax rates have fallen all around the world since the 1970s, when the international movement of capital started to become easier. For example, between 1979 and 2018, the UK corporate tax rate has fallen from 52 per cent to 19 per cent. Over the same period, the rate has fallen from 50 per cent to 33 per cent in France; from 40 per cent to 21 per cent in the US; and from 46 per cent to 26 per cent in Australia.[4]

3 For a more sophisticated analysis of the corporate tax rates favoured by competing governments, see Plumper et al. (2009).

4 These are 'statutory rates', not effective rates, either average or marginal. Effective rates are usually lower than statutory rates because the way profit is measured for tax purposes allows some profit to be exempted from taxation. But this observation, though important in many contexts, is irrelevant here. Over the past 30 years, effective corporate tax rates have fallen along with statutory rates.

Tax competition is good because corporate tax is bad

Many lament the reduction in corporate tax rates caused by tax competition. For example, according to Oxfam (2016: 1):

> Collecting tax is one of the key means by which governments are able to address poverty and inequality. But big business is dodging tax on an industrial scale, depriving governments across the globe of the money they need to address poverty and invest in healthcare, education and jobs. This report exposes the world's worst corporate tax havens – extreme examples of a destructive race to the bottom on corporate tax which has seen governments across the globe slash corporate tax bills in an attempt to attract business. It calls on governments to work together to put a stop to this before it is too late.

Oxfam's position is misguided because, for reasons I will explain in this section, taxes on capital income, including corporate tax, are more economically destructive than other taxes. If you care about the welfare of the poor, you should be opposed to corporation tax.

Even without understanding public finance theory (the branch of economics that studies the welfare effects of taxation), the simple facts of history might have given Oxfam pause before publishing this report. The 40-year period prior to 2016, during which tax competition increased and corporate tax rates fell, also saw the most rapid reduction in poverty in history. In 1980, 40 per cent of the world's population lived on less than $2 a day (in today's money); by 2016, only 10 per cent did. If tax competition impedes poverty reduction, this is a surprising turn of events.[5]

The Organisation for Economic Cooperation and Development (OECD) also laments tax competition. In its 1998 *Harmful Tax Competition: An Emerging Global Issue* – an early shot in the war on tax havens – it calls for governments to cooperate to harmonise corporate tax rates. The report argues that tax competition is harmful because it will shift the tax burden from corporate tax to other forms of taxation.

This is precisely my argument in favour of corporate tax rate competition. Shifting the tax burden to other taxes is welcome because corporate tax is less efficient than alternative taxes. Oddly, when lamenting this shift of the tax burden, the OECD does not discuss the comparative efficiency of corporate and other kinds of tax. Their lamentation of corporate tax competition, and their call for it to be stopped by cartel action between tax collectors, is thus unjustified (at least, by the OECD). And not only unjustified but wrong, as the rest of this section aims to show.

All taxes distort behaviour. That is, they make people behave in ways they wouldn't if not for the tax. This means that taxes are generally inefficient; they lead to outcomes with less utility than the outcomes that would have occurred without the tax (except for Pigouvian taxes – see below).[6] But some taxes are more inefficient than others.

Consider a poll or head tax: that is, a fixed charge levied on each individual residing in the tax jurisdiction. This would affect behaviour very little because it cannot be avoided except by emigrating or committing suicide, which few taxpayers will consider worth the saving it entails. Since changing my behaviour won't reduce my tax liability, the tax does not change my behaviour (beyond the changes consequent on being poorer by the amount of the poll tax – the 'income effect'). So the money it raises for the government comes at (almost) no cost beyond the administrative cost of collecting it. If the government declared that the tax had only been a joke,

5 Offshore financial centres are important conduits for the flow of capital from advanced economies into developing economies (see Zuluaga 2018). The absence of corporate tax is part of the reason. Equally important is the legal certainty offered by OFCs, especially by comparison to the developing economies that are the ultimate destination of investment. This explains why development agencies direct their funds through OFCs (see Carter 2017).

6 Of course, the government spending funded by the tax may have an upside that more than compensates for this inefficiency. But that does not mean that the tax is efficient.

and gave all the money back to the people it was taken from, no one would be any worse off than if the tax had never been levied. In other words, the tax is a simple transfer from the population to the government with (almost) no 'deadweight cost', no reduction in the welfare of the population.

Contrast this with a £100 tax on apples. This would push the price of apples up to roughly £100.50. At that price, only the wealthiest apple lovers would buy them. Consumption of apples would collapse and consumption of their near substitutes, such as pears, would explode. A £100 tax on apples is thus highly inefficient. If the government declared that it had only been joking, and gave the tiny amount of money raised back to the few from whom it was taken, many people would still be worse off – all those thousands of people who would have preferred an apple but, because of the tax, ate a pear instead. This loss to would-be apple eaters is the 'deadweight cost' of the apple tax (along with the losses to apple growers).

Suppose that, without the tax, the average apple consumer would get 5p more 'consumer surplus' from eating an apple than a pear. That is, the average difference between what these consumers are willing to pay and what they do pay is 5p greater when eating an apple than a pear. And suppose the tax causes a shift from apples to pears of 100 million units over the course of a year. Then the tax costs these consumers £5 million altogether. That is the lost consumer surplus. Assume an equal loss of 'supplier surplus' for apple producers. The total deadweight cost is then £10 million. Now suppose that 1,000 apples were consumed despite costing £100.50. The government would raise £100,000. Expressed as a percentage of the amount raised by the government, the deadweight cost of the tax would be 10,000 per cent. Every pound transferred to the government would cost the population £100. That's inefficient.

Of course, poll taxes and apple taxes are vanishingly unusual. I discuss them only for expository purposes. The taxes we are familiar with lie between these extremes. Nevertheless, some are more efficient than others. For example, Pigouvian taxes on activities with external costs (such as pollution) eliminate the effective subsidy that comes from the absence of an internal cost for the socially costly outcome. They distort behaviour but in a way that improves efficiency. (Without the tax, too much of the polluting activity was going on.)

By contrast, consumption taxes, such as value added tax (VAT) and goods and services tax (GST), are both distortionary and inefficient. They reduce aggregate consumption below the level people would otherwise prefer. And, because price elasticities vary across goods and consumers, they distort the pattern of consumption: that is, the mix of goods consumed.[7] Income taxes are also inefficient, shifting people away from their preferred trade-off between work and leisure. Some work more than they would without the tax so that they can earn the net income they want (the income effect), while others work less because, with the tax, they now value marginal leisure higher than the marginal net income from working.[8] Even if the aggregate hours worked were unchanged because these effects perfectly offset each other, the tax would still be inefficient because the pattern of work is inefficient – everyone is doing more or less work than they would without the tax.

So much for the general inefficiency of taxation. What makes corporate tax especially bad? Why would we be better off if corporate profits were not taxed and the lost revenue were made up by increasing, for example, consumption tax?

The answer is that corporate tax is a tax on capital income – that is, a tax on the income derived by investing capital. And, as Chamley (1986) showed, the optimal rate of tax on capital income is zero.[9] The same revenue can be raised by alternative taxes, such as taxes on consumption or labour income, at a lower deadweight cost.

The deadweight cost of capital taxes is often taken to be the reduction in saving and investment that they cause. They do indeed have this effect. But it is a secondary consideration. As Feldstein (2006: 15-16) puts it:

> The right way to think about saving is that it is the amount that we ‘spend’ today to buy future consumption. When we think about a tax on apples, we measure the deadweight loss by looking at the

7 See Ramsey (1927). Some have suggested avoiding this inefficiency by making consumption tax rates inversely proportionate to price elasticity. The UK government takes the opposite approach when it exempts supermarket food from VAT while applying it in full to restaurant food.

8 See Feldstein (2006) for a thorough account of the deadweight costs of income tax. They go well beyond those mentioned here. Note also that consumption taxes can have the ‘income effect’, since they reduce what can be consumed with any given level of income.

9 Chamley (1986) shows that the optimal rate of capital taxation is zero under some narrow assumptions, for example, that consumers have identical preferences and live forever. However, subsequent research has shown that his conclusion survives the relaxation of these artificial assumptions (see Atkeson et al. 1999)

> impact of the tax on the number of apples that are consumed, not on how much individuals spend on buying apples. If a tax that raises the price of apples by 10 percent causes a 10 percent reduction in the number of apples consumed, there will be no change in what the individual spends on buying apples. The same old level of spending simply buys 10 percent fewer apples. We recognize that that causes a deadweight loss even though there is no change in the amount spent.
>
> Similarly, if a tax on capital income reduces the future consumption that a dollar's worth of saving can buy, we should focus on how much that future consumption is reduced and not on what happens to the amount of saving that is used to buy that future consumption.
>
> This shift of focus from the impact of the tax on the volume of saving to the impact of the tax on future consumption has a very profound effect. Even if the tax does not change saving at all, it has a very large effect on future consumption and therefore can create a large deadweight loss.

To understand this deadweight cost, consider John, who begins saving for retirement when he is 30-years old. If the real rate of return is 6 per cent per annum, then £1 saved by John today will provide £10.30 of consumption when he retires at the age of 70 (£10.30 = £1 x 1.06^{40}). Now suppose the government taxes this capital income at a rate of 50 per cent, reducing the annual return to 3 per cent. Then £1 saved today will provide John with only £3.25 in retirement. With the tax, John would need to save £3.15 today to deliver £10.30 of consumption in 40 years' time. The tax has more than tripled the current cost of consumption 40 years hence.

The deadweight cost of taxing capital income is so high because it compounds along with capital income itself. As Atkeson et al. (1999: 3) put it, '… a constant tax rate on capital income is equivalent to an ever-increasing tax rate on consumption'. But only for the saver. The government would do just as well from a constant rate of tax on consumption or labour income, which would cost the taxed population less.[10] When the cost compounds but the benefit doesn't, you have a recipe for inefficiency. That is the basic argument against corporate tax and other capital taxes.

10 This is a well-established result in the economic literature. The appendix of Feldstein (2006) provides a mathematical explanation.

The same amount of revenue could be raised at less cost to the population by shifting to other taxes.

It would suffice on its own. But matters are even worse for corporate tax. Deadweight costs, though the greatest, are not the only costs of taxation. The government must spend money on collecting taxes, and those who are taxed must spend money on paying or avoiding their taxes. The greater these costs in relation to the tax raised, the less efficient the tax.

Again, corporate tax is unusually inefficient. Measuring a company's profit is a complex business. And achieving the lowest measure of it can reduce a company's tax bill by many millions of pounds. It is worth putting effort into the job. An enormous industry, aimed at nothing but reducing tax liabilities, has been spawned by corporate tax. Tens of thousands of intelligent, highly educated people devote themselves to nothing more than avoiding tax. Insofar as they are good at their jobs, they reduce the efficiency of corporate tax. They push up the cost of avoiding the tax while reducing the tax collected towards zero. If not for corporate tax, they might do something productive.

Finally, 'rent seeking' costs must be factored in. Start not with corporate tax but consumption tax. Some countries, such as New Zealand, apply the tax at a constant rate on all products. Others, such as the UK, differentiate between products. This encourages producers to lobby the government for a dispensation, claiming their product to be a human right or in some other way socially valuable. The efforts put into this lobbying are unproductive. The rigid, no exceptions approach to consumption tax is, in part, an attempt to avoid this rent seeking cost.

The same cost arises with corporate taxes. Because the tax treatment of companies affects the allocation of capital, politicians are tempted to use it as a tool for fine-tuning society. Realising this, companies queue up to make the case for why they should receive some special dispensation. A green energy company will seek special treatment on the ground that it is saving the planet. A film company might seek special treatment on the ground that it promotes cultural development, and so on. All the effort that goes into this lobbying is unproductive. And, insofar as it is effective, it exacerbates the deadweight costs of corporation tax by misdirecting the allocation of capital.

That's the nice version of the corruption. Sometimes the favour will be sought not by appealing to the moral sensibilities of the politicians but by more straightforward bribery, campaign donations being a particular favourite. Because large corporations collect together vast resources, they can gain far more from lobbying for tax advantages than the lobbying costs them. Corporate tax is thus an invitation for the corruption of politicians.[11] It is worse, in this respect, than taxes on interest earnings, land value, and most other things.

In short, corporate tax is not only worse than most alternative taxes because it is a capital tax and therefore entails disproportionate deadweight costs. It is an especially bad capital tax, giving rise to high administration and rent-seeking costs. By reducing corporate tax rates, tax competition and the OFCs that create it benefit society.

11 As is the practice of subsidising companies with tax revenues – or 'industrial policy', as the current UK government prefers to call it. When the EU prohibition on state aid to companies is removed by Brexit, rent seeking is likely to increase.

Why politicians like corporate tax

A man might go to the gym and lift weights not because he enjoys it but because other men go to the gym. If he didn't also go, he would be unable to successfully compete for lovers. He would be happier if these other men stopped attending the gym so that he could stop too.

Politicians are in the same position when it comes to cutting corporate tax rates. They do it reluctantly because of the competition they face, not enthusiastically because they have come to understand the terrible deadweight and other costs of the tax. Some may understand them but, even if they do, they will still find corporate tax attractive because the median voter does not understand these costs. Nor does the median voter have any natural hostility to corporate tax. On the contrary, he is likely to favour it, for the simple reason that it seems to be a tax levied on someone else – or, better, it seems to be a tax levied on some*thing* else. It is paid not by people but by companies.

Of course, companies are legal fictions which cannot bear costs or enjoy benefits. Though a tax bill may be paid from funds drawn out of a company account, the cost is borne by real people who would have been better off if the tax had not been paid.[12] Only sentient beings can suffer costs. Whatever is taxed – be it land, incomes, consumption or profits – the cost is always borne by people. And, as noted, when it comes to corporate tax, the cost to people is unusually high.

12 Precisely who bears the cost of corporate tax is a difficult question. Shareholders, employees and consumers are the candidates. Which groups bear how much of the cost depends on variables such as the mobility of labour and how much competition the company faces from (foreign) firms not subject to the tax.

But the illusion of an impersonal bearer of the cost is too convenient for politicians, and they speak in ways that encourage it. During the 2008 presidential election campaign, for example, Barack Obama complained about John McCain's policy to give tax breaks to 'some of the richest companies in America'. A company can no more be rich than it can be tired or elated. The owners or employees of a company may be rich, but not the company itself. And, when you tax a company, the cost may be borne by people who are not at all rich.

Distinguishing between the legal incidence of tax (the name on the cheque) and the economic incidence of a tax (the people who bear the cost) might serve the interests of a vote seeking politician if the median voter were a student of economics. Given the actual economic ignorance of voters, however, talking about what society is owed by rich companies is a better strategy.[13]

For the same reason, the deadweight cost of taxation is a concept never to be heard in political debate, even when, as from 2010 to 2016, the Prime Minister has a 1st Class Honours degree in Philosophy, Politics and Economics from Oxford University. The concept is too difficult to be a vote winner.

Indeed, the Tax Justice Network goes beyond merely ignoring the deadweight costs of taxation and explicitly denies they even exist. In a publication on the topic of tax competition, it asserts that 'tax is not a cost to an economy, but a transfer within it'.[14] When even people who devote themselves to studying the economic effects of taxation can be so deluded, it is no wonder that politicians are reluctant to shift the tax burden from corporate tax to alternative taxes.

If our imaginary reluctant gym-goer could find some way of stopping other men from going to the gym, and it cost him less than going to the gym costs him (in fees, time and discomfort), he would do it. The same goes for politicians who are reluctant to cut corporate tax rates. They would rather stop the competition than cut corporate tax rates, provided they can do so at a lower cost than the cost of tolerating the competition – this cost being measured in votes, which is what ultimately determines the success of politicians. Hence the political war on tax havens. Waging a

13 For a survey of voter ignorance, see Caplan (2008).
14 'Tax "competition" and tax wars', Tax Justice Network, https://www.taxjustice.net/faq/tax-competition/

war on tax havens costs few votes, if any. Eliminating corporate tax and increasing VAT, personal income tax or almost any other tax would be a vote loser.

It is a doubly sad democratic dynamic. For, just as corporate tax harms society, so do the tactics by which politicians seek to defend it. As I will explain in the next section, these tactics undermine the rule of law, the foundation of peaceful and progressive societies.

Tax competition and liberal principles

The tactics now used to prevent tax competition undermine the rule of law in at least two ways. The first is to give discretionary power to tax collectors. The UK's general anti-avoidance rule (GAAR), introduced in 2011, allows Her Majesty's Revenue and Customs (HMRC) to collect not the amount of tax you owe according to the letter of the law but according to the spirit of the law. Your tax arrangements, including those using OFCs, may be entirely within the law. But that is no defence. If HMRC deems your tax arrangements to be tax avoidance, then it can collect the amount of tax you would owe if you hadn't made them.

If the difference between legitimate tax planning and tax avoidance were clear, this might not undermine the (degree of) legal certainty that is required for the rule of law. Alas, the distinction is not at all clear. As Littlewood (2010: 265) puts it:

> Many legal concepts are, of course, difficult to define. But the idea of tax avoidance is especially, perhaps uniquely, difficult. Most legal concepts have a more or less solid core and are disputed only at the margins – as with, for example, the distinction between income and capital gains. But the idea of tax avoidance has no core – the uncertainty goes right through, for there is no such thing as a non-contestable case of tax avoidance. Consequently, not only does the concept remain undefined, but there is no agreed set of guidelines as to how it might be recognised.

More than 100 years of case law in New Zealand and Australia, which have the oldest GAARs, has failed to create a legally clear concept of tax avoidance.[15] Since they are both English common law jurisdictions, there is no reason to believe the UK courts will be able to do any better.[16]

The legal uncertainty this creates is not merely an affront to general principles of liberalism; it imposes another deadweight cost on society. By increasing the uncertainty of companies' post-tax returns, it increases the pre-tax returns that investors will demand. In other words, it increases the cost of capital and thereby reduces investment. Marginal investments, whose risk-adjusted return would be sufficient if not for uncertainty created by the GAAR, will not be made (see Zangari 2017).

GAARs are a regrettable element of politicians' attempts to curtail tax avoidance. But they are not especially connected with the war on tax havens. As noted, the GAARs of New Zealand and Australia long pre-date globalisation and the corporate tax competition. But they set the direction of travel. Recent attempts to limit the use of tax havens also violate important principles of liberal societies.

In 2018, the UK government required its 14 overseas territories, including the British Virgin Islands, Bermuda and the Cayman Islands, to publish lists of the beneficial owners of all the companies registered in them (through an amendment to the *Sanctions and Anti-Money Laundering Bill*.) This may exceed the powers of the UK parliament. Some critics have even complained that it amounts to a revival of colonialism. But, let us assume that the UK parliament acted within its powers. It is still a regrettable law.

To see why, we need only consider the justification provided by its main sponsors, the Labour MP Margaret Hodge and the Conservative MP, Andrew Mitchell. According to Ms Hodge:

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15 GAAR provisions began to appear in New Zealand and Australian tax law in the late 19th century.

16 The UK GAAR hinges on the notion of 'abusive' tax avoidance. That, presumably, is why giving up smoking because of the tax on cigarettes is not penalised by the GAAR. Far from being abusive, it is the purpose of the tax. But, then, presumably, travelling to Spain to buy many cartons of (relatively) tax-free cigarettes is an abusive avoidance of the tax. In fact, no one has fallen foul of the GAAR for doing this. But since the purpose of the tax is to make people quit smoking, not to make them buy cigarettes in Spain, it is unclear why not.

> That [landscape of OFCs] allows, whether it's a tax avoider or a tax evader, a kleptocrat, a criminal, gangs involved in organised crime, money launderers, or those wanting to fund terrorism … [The public register] will stop them exploiting our secret regime, hiding their toxic wealth and laundering money into the legitimate system, often for nefarious purposes …Transparency is a very powerful tool. With open registers we will then know who knows what and where, and we will be able to see where the money flows.[17]

Mr Mitchell made a similar argument:

> Once the media and charities spotlight is focused on this nefarious activity, it will be forced into ever-more disreputable havens. But as with the fight to defeat malaria, we will narrow the footprint and more easily eradicate this scourge … Secrecy breeds wrongdoing. Transparency is central to exposing bad behaviour and preventing it.[18]

The police already have access to the information that this new law will make public. If they suspect someone of using OFCs to launder money acquired through criminal activity, they can gather any relevant information about the beneficial owners of companies registered in the Overseas Territories (and Crown Dependencies) within 24 hours.

The crime fighting justification is thus specious. Making the list public does not expose beneficial owners to the rule of law; it exposes them to the rule of the mob. Anyone will be able to trawl through these registers in the hope of finding the name of someone they would like to vilify. It also exposes beneficial owners to crime. Prominent or very wealthy people have an understandable desire to protect themselves from the prospect of kidnapping, stalking and identity theft that is increased by their financial affairs and address being publicised.

The principle stated more or less explicitly by Mr Mitchell is this: if you might be doing something wrong in private, then that privacy should be

17 'Theresa May changes course on tax havens after facing Commons defeat', Sky News, 4 May 2018, https://news.sky.com/story/theresa-may-changes-course-on-tax-havens-after-facing-commons-defeat-11355052

18 'It's time to stop crooks, kleptocrats, dictators and warlords from exploiting our overseas territories', ConservativeHome, 30 April 2018, https://www.conservativehome.com/platform/2018/04/andrew-mitchell-its-time-to-stop-crooks-kleptocrats-dictators-and-warlords-from-exploiting-our-overseas-territories.html

removed. ('Secrecy breeds wrong doing'.) Imagine this principle applied generally. The greatest source of privacy in modern societies is the family home. And this privacy is used for much wrong doing: domestic violence, sexual crimes and drug taking, among much else. The privacy of the home is surely a cover for much more crime than OFCs. Well, then, shouldn't this privacy be ended by compelling everyone to install cameras throughout their homes which stream to the internet for public inspection?

I hope authoritarianism has not made so much progress that this proposal will still strike readers as reasonable. Liberal societies require privacy. You can give it up voluntarily, as when you reveal your life on Facebook, or you can have it removed against your will when you commit a crime. But the idea that you should lose your privacy because you could use it for wrong doing is wholly inconsistent with the legal principles of the UK and other free societies.

Now consider the EU's blacklist of 'non-cooperative tax jurisdictions'.[19] This violates two generally agreed principles. One is that sovereign governments are free to design their own tax policies. The criteria for blacklisting make it clear that changing other countries' tax policies is the goal. There are three criteria which must be satisfied to avoid blacklisting (European Commission 2017):

- *Transparency:* Countries must comply with international data sharing standards.
- *Fair Tax Competition:* Countries should not violate the EU and OECD principles concerning tax competition. More specifically: 'Those that choose to have no or zero-rate corporate taxation should ensure that this does not encourage artificial offshore structures without real economic activity'.
- *BEPS implementation.* Countries must implement the OECD's Base Erosion and Profit Shifting (BEPS) minimum standards.

Most Overseas Territories and Crown Dependencies pass the transparency and BEPS tests. It is the Fair Tax Competition criterion that is meant to catch them. It does this by specifying that a common feature of incorporation around the world – namely, that it need not be accompanied by 'real

19 Blacklisted countries are subject to sanctions that ban funds from EU development agencies being transferred through them. And companies with activities in blacklisted countries are subject to stricter reporting requirements than companies with no such activities.

economic activity' by the company (or substance, as it is sometime known)[20] – fails the test when combined with a particular tax policy: namely, no or zero-rate corporate tax. Every advanced economy would fail the test if it stopped taxing corporate profits: that is, if it pursued what I have argued to be a wise policy.

The Overseas Territories and Crown Dependencies are not rogue states. They are stable democracies committed to the rule of law. EU politicians have no proper business meddling in their domestic policies. Calling this interference colonialism may be overstating the case. But the interference displays a remarkable contempt for the sovereignty of their governments and a willingness to use force against legitimate and peaceful jurisdictions. The second principle violated is that justice is blind – or, in other words, that the same rules apply to everyone. The European Commission applies the criteria for blacklisting only to 'third countries', exempting EU countries from the same scrutiny and the possibility of being blacklisted. It justifies this by saying that, within the EU, it uses 'different tools' to ensure fair and transparent tax (see European Commission 2017).

Perhaps it does. But that is irrelevant. Let us suppose sanctions are warranted by failing to meet the blacklisting criteria listed above. Why is membership of the EU exculpatory? The European Commission's argument is preposterous. You might as well argue that the criminal law need not apply to members of the aristocracy, because aristocrats have other reasons for behaving well. There is no evading the fact that the EU applies standards to third countries that it does not apply to its own member states.

20 Tests for substance might include having offices and staff in the country of incorporation or, perhaps, engaging in trade within that country. It is currently unclear how burdensome the EU means to make the substance test.

Conclusion

Bad policies are often good politics. Taxing corporate profits is an example. Public finance theory tells us that the optimal rate of corporate tax is zero. But most voters know nothing of public finance theory and are easily deluded into thinking that corporate taxes impose no cost on them. Cutting corporate tax and increasing personal taxes is a vote loser.

Nevertheless, politicians around the world have cut corporate tax rates. It isn’t because they have discovered that the optimal rate of corporate tax is zero and decided to put the welfare of the population ahead of electoral self-interest. It is because of tax competition. The electoral cost of the economic effects of increased capital flight would be greater than the electoral gains from holding up corporate tax rates.

Politicians outside tax havens are reluctant corporate tax-cutters and, thus, reluctant contestants in tax competition. Ending such competition would suit them better than winning it. Hence their war on the tax havens that provide the competition. And hence the abandonment of principles that UK and EU politicians would normally claim to support – the sovereignty of third countries in tax policy, the right of law-abiding citizens to keep their financial affairs private and the rule of law.

The war on tax havens is an inherently dirty business. Most tax havens are stable democracies, with the rule-of-law and tax regimes that are superior to the complex and economically inefficient systems that have become the norm in Western democracies. The UK and EU have no proper justification for interfering in their affairs.

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