Renewed assault on tax competition looms large for offshore community

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The global economy has benefited tremendously from tax competition. Thanks to the pressure created by capital mobility, numerous governments have been compelled into lowering both personal and business income tax rates. They have done so only reluctantly, however, and politicians from high-tax nations would like to undermine this liberalising process. They are working through international organisations to chip away slowly at the foundations of tax competition. This is bad for the global economy and could have very serious consequences for the offshore community.

Why tax competition matters

The key to a growing economy is no secret. It requires competent provision of legal protections and property rights, financed by low marginal tax rates that avoid punishing productive behaviour such as working, saving and investing. The more complicated task is convincing self-interested politicians – whose primary goal is the accumulation of power – to refrain from raising taxes and otherwise undermining the productive sector of the economy.

Tax competition solves this problem at least in part by aligning the interests of politicians with the economy. In order to maintain a strong tax base and a thriving economy from which to derive their power, politicians must avoid overreaching with excessive taxes and overly burdensome regulations. This equation only works if there are available alternatives. In other words, tax competition is only feasible if there are nations savvy enough to adopt policies that attract the capital chased away elsewhere by political greed. Typically, those alternatives are found in the offshore community.

Role of the offshore community

Many attack low-tax jurisdictions as serving primarily to protect "tax cheats" and deprive foreign governments of their rightful tax dollars. Unless one thinks that the state has a 100% claim on all output, this is a silly assertion. In reality, the offshore community is of tremendous benefit to the major powers and the economy as a whole. It exists not to foster tax evasion but to enhance the efficient formation and distribution of capital. Rather than unregulated as critics claim, it is governed more effectively. Like any other industry, specialisation in financial services allows for a better product at a lower price, and the existence of skilled investors in the offshore community who allocate resources where they are most profitable has created millions of jobs and made the world more prosperous.

Ideological critics like Nicholas Shaxon nevertheless characterise the offshore community as a place for the lawless and of ill repute. He calls them "treasure islands," as if an offshore financial centre is a place for pirate thieves to hide their stolen booty. But the facts paint a different picture.

It takes more than just low tax rates to attract foreign investment. Research shows that better-governed countries are more likely to succeed in attracting capital, whereas even low taxes do little to bring investment into the poorly administered nations, which is why the list of so-called tax havens is largely devoid of such regimes. This is important to understand when considering other common criticisms lobbed at low-tax jurisdictions, such as claims that they facilitate money laundering for criminals and terrorists. The charge makes little sense once the diligence with which the rules are enforced is considered.

Take the claim that so-called tax havens allow terrorists to launder money and fund their attacks. Why, if this were the case, did the terrorists involved in the 9/11 attack on New York primarily bank within the United States and Western Europe, using money from the Middle East? The answer is that they understood what many politicians do not – that a bloated bureaucracy with convoluted rules is far less likely to spot illicit activity than a nation with streamlined and efficient financial monitoring. Moreover, small nations with economies that rely heavily on attracting foreign capital have the strongest incentives to avoid suspect activities, as even a single slip up – such as hosting the accounts of the aforementioned 9/11 attackers – would have brought the full might and fury of high-tax nations to bear, no doubt to the economic ruin of the offshore jurisdiction in question.

Sadly, not everyone appreciates tax competition or the low-tax jurisdictions which foster it. Some politicians simply resent outside constraints on their ability to pursue desired policies, or oppose competition for ideological reasons. They want freely to tax more, spend more and regulate more. And if that means a weaker economy then so be it, so long as everyone is stuck in the same boat.

Tax competition and financial privacy under fire

Since the 1990s the chosen vehicle of attack on tax competition has primarily been the Organisation for Economic Co-operation and Development (OECD). Its campaign began in earnest with a 1998 report entitled "Harmful Tax Competition: An Emerging Global Issue." The report groused that tax competition "may hamper the application of progressive tax rates and the achievement of

redistributive goals," which is another way of saying that politicians were being unjustly prevented from sufficiently ruining their own economies.

The 1998 report's brazen assault on tax competition went relatively unnoticed, but was followed in 2000 by an overreaching series of recommendations that called on OECD member nations, not only to eliminate many of their own policies that attract foreign capital, but also to pressurise non-member states to do the same. This assault led to the formation of the Centre for Freedom and Prosperity, which spearheaded the backlash against the OECD and ultimately stopped the effort, though that didn't mark the end of the anti-tax competition campaign. Rather, their energy was redirected into the formation of the Global Forum on Transparency and Exchange of Information for Tax Purposes, which set aside the call for raising rates to harmonise taxes in favour of the more subtle, indirect-harmonisation approach of sharing individual taxpayer information between nations.

If tax competition could not be taken head on by raising rates, then pushing for something equally onerous was the next best thing. Who, after all, can be against such feel good concepts as sharing or transparency? But where most suppose that government should be transparent to its citizens, the anti-tax competition crusaders call instead for citizens to be transparent to government. They want, in other words, an end to financial privacy. Given the massive power asymmetry between individuals and the state, the removal of privacy protections would have a significant impact on the overall preservation of human rights.

Since the OECD changed tactics, its work has been marked by consistent goalpost moving and underhanded maneuvers. Its list of supposed transgressions committed by non-member states, for instance, ignored that many member nations pursued the same policies. Low-tax jurisdictions were thus hypocritically thrown onto a "blacklist" of so-called tax havens and threatened with sanctions should they resist calls to "reform" their laws by adopting bad tax and regulatory policies. In order to demonstrate "co-operation" with the dictates of high-tax nations, targeted jurisdictions were called upon to sign a certain number of Tax Information Exchange Agreements (TIEAs) with other nations. The TIEAs established a process by which information would be shared upon request – in other words, only when a nation had a reason to suspect a particular individual of wrong doing.

When the OECD and its proponents realised the TIEAs were not sufficiently disrupting tax competition, they upped the ante. The previous goal was now considered a "starting point" and new requirements conjured, with the leaders of Britain and France in a 2009 joint declaration demanding sanctions and "international counter-measures" for non-compliance. Thus was born the "peer review" process which has plagued offshore nations in recent years, where the large welfare states sit in judgement over their competitors. And with low-tax jurisdictions already under siege on multiple fronts, the United States upped the ante again with passage in 2010 of the Foreign Account Tax Compliance Act (FATCA), a sweeping new tax law that threatens to bring the international financial sector and the global economy to its knees.

Full automatic information exchange in sight

Through FATCA, the United States is asserting its universal right by might to enforce domestic tax laws on the entire world. FATCA's requirements – that every financial institution in the world serve as deputy tax collectors to the US Internal Revenue Service (IRS) – are appalling thuggish and laughably unworkable. Thanks to the sloppy manner in which it was passed – without a single hearing or debate – the law has proven to be so poorly written that it could never be enforced.

But US tax collectors, proving every bit as imaginative as their counterparts at the OECD, devised a solution – without proper legal authority, but fully aware that no one in the US had immediate authority to do anything about it. Rather than enforce the law directly on institutions, they would pressurise foreign governments into doing it for them. These "intergovernmental agreements" are being dangled today in front of nations with the promise of full reciprocity from the United States, a promise that IRS officials know full well they do not have the legal authority to make, and which elected officials in the US would never support. It's as empty as the OECD's repeated assurances that low-tax jurisdictions need merely jump through one more set of hoops.

FATCA is proving to be a logistical nightmare for both the US and the international financial community, which all told could face compliance costs into the tens of billions of dollars. The US stands to gain almost nothing in return – a measly estimated USD800 million per year in additional tax revenues according to Congressional accountants – but that was never the point. The law's false justification of exposing tax cheats is exposed by the fact that the US already possessed the highest tax compliance rate in the industrialised world. FATCA was instead dreamed up by the ideological opponents of tax competition, with its real purpose to bring wayward jurisdictions to heel at the altar of big government.

Recognising the opportunity presented by FATCA, the OECD has taken the ball and run with it. As the fight over FATCA drags on – the law's enforcement date now having been delayed for a third time as the IRS struggles with implementation – global tax collectors are taking steps to ensure that even if FATCA is defeated they can still win the war against tax competition. FATCA clones are already spawning as European welfare states salivate at the thought of worldwide tax collection.

For its part, the G20 and the OECD have shed the pretense of modesty, abandoned on-demand information sharing, and put automatic exchange of information firmly on the table as the next global mandate. The July 2013 Communiqué at the conclusion of the Meeting of Finance Ministers and Central Bank Governors in Moscow declared the body is "committed to automatic exchange of information as the new, global standard," and tasked the ever eager Global Forum with "establishing a mechanism to monitor and review the implementation of the global standard on automatic exchange of information." That surely means blacklists and sanctions for holdouts of the new global regime.

The end game

It's hard to imagine what might have happened if the offshore community had stood strong in the face of early OECD demands, tame as they were by current standards, or if anyone had stood up in the face of US fiscal imperialism. But opposition was meek. Lawmakers from low-tax jurisdictions appeased OECD nations in hopes they would go away. But you don't turn an alligator into a vegetarian by feeding him your arm, so it's hardly a surprise that high-tax nations have instead pursued their targets with renewed vigor, threatening to eat them out of house and home.

Whichever potential new global regime becomes the standard – FATCA, the OECD Global Forum, or God forbid some nightmarish merging of the two – there will be no place in it for tax competition or low-tax jurisdictions. Automatic exchange of information begets global tax collection as surely as the sun rises tomorrow. With it comes the clearest dichotomy imaginable for the offshore community: will it finally fight for the right to exist and come together as a community to resist the OECD as happened in the early 2000s, or lay down to die with another appeasement?

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