# MUSINGS ON THE OECD REPORT ON HARMFUL COMPETITION

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In April 1998, an OECD report was published on the subject of 'harmful fiscal competition'.

The report discusses the concept of Harmful Fiscal Competition, without, however, defining what it mean by the terms "fiscal", "competition" or even "harmful". It used the term 'Tax Haven', which in the author's view is a deliberately pejorative term, without attempting to define what it meant by the phrase. It projected a moral quality to its arguments without demonstrating how such a moral quality arose. Finally, it failed totally to consider the economic impact of differing fiscal systems.

This article is intended to consider some of the issues that the OECD report failed to consider.

We will begin with considering what is meant by taxation. Everybody thinks that they know what Taxation means. Everybody also thinks that they know who God is. But I have never yet come across any generally accepted definition of God, nor have I come across a generally accepted definition of a Tax.

But, if we are to debate the concept of fiscal competition, we at least need to be aware of what we are talking about. In general, for our purposes, taxation is the process whereby economic resources are transferred between the individual members of society and the society as a collective entity. The transfer can be either way. Industrial Grants and Subsidies, Social Security Benefits, and the subsidised losses of State Enterprises are transfers from Society to the Individual, just as the payment of Value Added Tax, Stamp Duties, Road Tolls, Parking Fines and Inheritance Tax are transfers in the opposite direction. All are fiscal events.

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Economists have for years argued on the effects that different types of fiscal policy have on the structure of society. The package of events that makes up a fiscal policy has, of course, profound effects on not only the structure of an economy, but on the society itself. It has been cogently and convincingly argued, for example, that the British Welfare State has effectively created the very conditions that it was intended to abolish. It has created a dependency culture in an under-educated, anti-social and idle underclass. In the same way that giving grain to an area where the crops have failed destroys the local agricultural industry by removing any incentive to plant the next crop, so the Welfare State destroys the incentive to work hard and to take personal responsibility.

There have been many attempts to produce neutral tax systems, such as Professor Nicholas Kaldor's famous 'Expenditure' Tax. All have failed in one way or another. However, each society/jurisdiction has chosen that package of fiscal policy that suits itself and its economic and social imperatives.

Since fiscal policy has such a profound effect on society, the control of fiscal policy has always lain at the heart of politics. One has only to consider Hampden's protest against the Ship Money of Charles I, or the reaction of the Americans at the Boston Tea Party to the duty on Tea imposed by the British Government, or even the reaction of the Scots, in more recent times, to the perceived imposition on them by Mrs Thatcher of the hated Poll Tax.

It was the struggle for the control of taxation that led to the evolution of democracy in European civilisation. 'No taxation without representation' found a ready echo in every country as it struggled toward democracy. Today, it is democracy which gives authority to a Government in imposing taxation. It is the process of democracy that shapes the attitudes to fiscal matters. The British Welfare State did not just happen because Mr Beveridge thought of it. It happened because the British people deliberately voted in a Government in 1945 committed to introducing it. Taxation lies at the heart of any Government. Even in little Governments of little islands, the right to tax is seen as the heart of sovereignty. When any country attempts to impose its idea of fiscal policy on another smaller country, that is, without doubt, striking at the very heart of the validity of the Government of that smaller country.

It is the issue of taxation that has caused so much worry on the rights of the new Scottish Parliament. If the Scottish people decide democratically that they wish to alter their whole tax system, that will raise some very fundamental questions as to the realistic nature of the new Scottish Parliament that will, inevitably, lead either to a basic reshaping of the United Kingdom itself, or to the departure of Scotland from the Union.

These are some of the most fundamentally sensitive political issues in every society on the globe. To whom is my Government responsible? If it is accountable to us, its electorate, then a fiscal policy determined by a foreign institution is unacceptable. If that foreign institution imposes its policy against our democratically expressed will, then it invites resistance and revolution, just as the modern Scots independence movement was effectively launched by Mrs Thatcher's Poll Tax.

Given that we now have some understanding of what taxation is about, what about 'harmful' taxation, and 'fiscal competition'?

Let us first consider the word 'competition'. It is axiomatic that perfect competition in a market place will always tend to drive down prices of the commodities/services in that market to the lowest possible level consistent with maintaining the required level of supply. There is always also a constant pressure in the market place for costs to be cut, and for the evolution of products to meet the evolving requirements of consumers. Perfect competition does, however, require a multiplicity of suppliers, a multiplicity of consumers and a standard product.

It is when competition ceases to be perfect that problems start to emerge. This arises because the number of suppliers falls to a point where price and supply can be manipulated to that level which produces the greatest profits. This situation can be very unstable, especially if new sources of supply can be discovered, or if the cost encourages a search for alternative products. It may also produce complacency amongst the monopolistic suppliers, so that insufficient investment and innovation takes place, leading to technological development bypassing the product in question.

Competition also breaks down when the number of consumers falls to a level where they can dictate terms to the producers. It can occur where the product ceases to be homogenous, and acquires different varieties.

The pursuit of profit always tends to lead to pressure in a perfect market place. Whether it is suppliers trying to protect themselves, consumers trying to dictate to the suppliers, or the attempt to create strong brand images in order to create controllable markets.

All these pressures exist between countries as well as between businesses. The European Union itself is derived from a desire to create a more perfect market for goods and services, by breaking down local monopolies, encouraging Europe wide competition, and by encouraging the standardisation of products. Countries compete with each other. Just as businesses want to increase their profits, so there is a natural and right political pressure on Governments, both local and central, to manage their economies to provide economic growth, better services and jobs for the electorate.

This, however, is the point where political ideology comes in. Put simply, there is one school of thought that would have the Government encouraging economic growth in the private sector, thereby increasing Government revenue without increasing taxation. This school recognises that there is a relationship between effort and reward, and that if taxation goes over certain levels, there is a very distinct disincentive to economic growth. 'Why work, when the Government takes all the fruits of one's labour'? The Thatcherite school of economics believes in a low tax regime, with Government revenue needs being met by maintaining a reasonable but steady proportion of an increasing National Income. In this school, Government is seen not as a direct supplier of services, but as an enabler.

This is, of course, wholly at variance with the Socialist/Welfare school of thought, which gives Government a far bigger part to play in the provision of services. In this school, it is Government itself that must provide services. Competition between Governments is about the amount of services that can be provided and the amount of money spent thereon. It presupposes that the electorate want more and more services for less and less effort. It can produce a dependency culture, and also, as has been seen recently in Scottish local government, corruption. It is a philosophy that was taken to its ultimate absurdity in the Soviet Union.

How then can any competition be harmful? Competition can certainly be harmful where it is imperfect, and where one of the parties is able to manipulate the market place for the maximisation of profit, irrespective of the welfare of the community concerned. 'Dumping' is the classic example of harmful competition. 'Loss leading' is another. Policies on 'Predatory Pricing' are seen as being harmful, on the grounds that profits from one business are being used to cover losses in another, and grossly distorting the market place. When the loss leader has destroyed the competitors, it will then be a monopoly in imperfect competition, with the survivor having the ability to manipulate the market.

But what about fiscal competition? Taxes are costs (or income) to businesses. There is nothing moral about fiscal events or taxes. They are thoroughly amoral. Just as rent and car parking charges are costs, so are property taxes, rates, subsidies or government grants. Any cost or income opportunity, no matter how incurred or arising, is a matter for any business to address. If labour costs are lower, for whatever reason, in country A than country B, business will tend to gravitate to country A. If transport costs are higher for manufacturers in country A than country B, the business will tend to gravitate to country B. If the package of taxes on a business are higher in country B than country A, the business will tend to gravitate to country A. If country A has a more attractive package of tax holidays and financial inducements than country B, the business will tend to gravitate to country A. Eventually, all these attractions and counter-attractions will cancel themselves out, so that each business is in the location that suits it best, given the financial and fiscal environment.

In the context of an economy, however, there are also certain centralising forces that must be recognised. The cost of access to the consumer is much less in a densely populated conurbation than in a sparsely populated area. It is true that the advent of electronic communications has diminished this factor, but if it were not so, business would simply not pay the extra costs of being located in large cities.

This inevitably means that there are differences between economic regions, reflecting these factors. Indeed, the centralising force is such that it will continue until the costs of being 'at the centre' outweigh the advantages. We can see this at work in that large Banks move their administration departments out of the City of London into the country. Costs are lower. The disadvantage of being some distance from Head Office is low.

Taxation, therefore, is simply one cost. Competition leads business to that point where economic disadvantages (including costs) are in balance with economic advantages.

Governments can, therefore, influence the market place by influencing costs. That is palpably obvious. One only has to listen to British manufacturers complaining about the current Exchange Rates to realise that Government policy has increased their costs and reduced their income.

If Government can vary tax incidence, it can, therefore, change the pressures in the market place. It can divert business from one location to another. Indeed, this too is a well recognised fact. Government Subsidies are simply negative taxes. Special financial incentives offered by, for example, the Irish Development Agency, to locate in Ireland; the special tax rates available in Shannon, or Dublin IFSC are all incentives. So are the UK rules on international Holding Companies, and on the taxation of non-domiciled individuals (which, it can be forcefully argued, are an attack on the tax base of the Channel Islands and of the Isle of Man!). So are the Netherlands participation privilege rules , the Belgian Head Quarter Company rules, the German incentives for business in the old East Germany, etc, etc.

It is argued that such fiscal competition creates distortion of the market place, that business does not go where it is most efficient economically. The argument is that taxation should be entirely neutral in its impact, and therefore cease to be a competitive cost. But this is unbelievably simplistic. We have already noted that competition is only truly 'fair' in a perfect market, but that such perfect markets scarcely exist. Taxation is only one cost of many.

For some businesses a low tax rate in one location is offset by the hideous transport costs of operating there. It is notable that heavy engineering businesses in high tax countries like Germany or France do not relocate to remote tropical islands with zero taxes. The only businesses than relocate there are those for whom the cost of taxes outweighs other considerations. The market is, in fact, working, by causing businesses that can comparatively best be run from the margins of an economic area to gravitate to such margins, leaving resources in the centre available for those business that must be there.

Fiscal competition is therefore like any other form of competition. In a perfect market, it enhances the efficiency with which an economy functions. It is only harmful when the competition ceases to be perfect, and is open to manipulation, which appears to be precisely what the OECD report is proposing.

What then is harmful fiscal competition? To my country, it is anything that encourages the movement of economic activity from my country to another. To one Government, it may be anything which reduces its ability to tax its citizens and spend their money. To the economist, it is anything which interferes with the mobility of resources in response to the free market pressures towards economic efficiency.

In any economic area, no matter how large or small, there is a need for mechanisms to lubricate between areas of different economic performance. There have always been two ways in which this can happen. The most ancient of these is by currency exchange rates. Where one area prospers, and another is poor, the exchange rate between the two currencies will move to the point where there is an equal flow of resources in both directions. Goods manufactured in the poor area will be cheap when exported to the rich area. The rich area will concentrate on producing goods and services using resources simply not available to the poor area (such as education and technical skills).

Of course, this creates different pressures. The constant draw of the rich area for the brightest and best of the young people of the poor area creates a brain drain which locks the poor area into its poverty. At the same time, however, the cheapness of the poor area is a major attraction for businesses wishing seeking to reduce costs. As the poor region gathers economic strength, the exchange rates will reflect this, maintaining equilibrium between the two regions.

It is, of course, a slow process. Introducing fiscal variation can speed the process up (I include subsidies and grants as negative taxes). The danger here, however, is that the fiscal incentives do not necessarily work in the same direction as the natural market forces. The 'Command Economy' concept may actually work against natural market forces, thereby actually enhancing poverty rather then diminishing it. There are many examples of this in the world.

One thing is certain, however. If a common currency is imposed, Exchange Rate variations cannot play any part in this process of lubrication. The whole of the burden must then fall on deliberate fiscal variation, which, we have noted, may not necessarily work in the same direction as market forces. The most powerful argument against currency harmonisation in the EU is not a political one, but an economic one. It should be added, however, that there are equally powerful arguments for currency harmonisation.

A classic example of the dangers is seen in the relationship between the Republic of Ireland and the UK for most of this century. A common currency until the 1970s and a similar high tax policy produced economic disaster, with mass emigration in Ireland. Currency variation since then, with a different tax policy (remember that EU grants are negative taxation), has produced the reverse.

If, then, it is desired to have a common currency, and there seems little doubt that this is going to happen, the importance of fiscal variation becomes overwhelming. In the USA, with its single currency, there are, I believe, over 16,000 different fiscal authorities. Non-Americans often forget that the Federal Tax system is only the tip of the iceberg. If you are Californian living in Los Angeles, you are acutely aware of that! One of the reasons why Arizona is growing so fast is because of the tax refugees from California who are moving there. California continues to be the richest state of the USA. It sees no difficulty in Arizona enjoying some prosperity by fiscal competition. On the contrary, most Californians are happy that the competition prevents the Republic of California from taxing them even more heavily.

If there were a common currency in Europe, and complete fiscal harmonisation, there would be no economic assistance for regions which are less well favoured. Everything would gravitate to the centre, as happened in France in the eighteenth century. That would produce gross inequity, gross social injustice. That is the fast track to Revolution.

The OECD report projects an aura of moral indignation. But is this indignation valid?

It is often expressed by bureaucrats that the payment of taxation is a moral duty on the citizen. This, it would appear, is argued as being more than simply the duty of the citizen to obey the law. It is, of course, hardly surprising that the bureaucrat should take such a view. After all, money is the source of the bureaucrat's power, and anything that might threaten its flow is seen as an attack on the system, and thus an attack on his own personal job security.

I would argue, however, that tax is outside the scope of morality. The taxes imposed on the citizen by Government are no more 'moral' than are traffic regulations. It is necessary for the order of society and for the welfare of the individual that certain rules are observed, and it is that which distinguishes anarchy from order. But to suggest that there is some moral imperative is absurd. If, for example, it were immoral to avoid Inheritance Tax, that would imply that Inheritance Tax has some inherent moral quality about it. That would mean that it would be equally immoral to repeal the tax.

We have to conclude, therefore, that taxation is entirely amoral, and that while a type of tax may be perceived to be immoral, because of the way it works (e.g. Poll Tax), the tax system as a whole is amoral.

There is a need for Government to raise funds to meet its policy objectives. The way that that is done can vary enormously. The way that it is done is chosen by a Government which has obtained, in western democracies, a democratic mandate for its policies. A Government without any such mandate has a difficult task in asserting its moral authority, unless it can pin its authority to some theocratic claim. Assuming, however, that we are dealing with a democratically elected Government, the moral authority for its taxation policy lies with its electoral mandate.

Given that the programme of Government is defined by its democratically approved manifesto, it will require sufficient revenue to meet those manifesto commitments. What then if it should raise *more* in taxation than it needs, as a deliberate decision. In local authority, in my experience, there is a requirement to budget ahead and to balance the books. Budgeting for a deliberate surplus over and above that required for unforeseen contingencies is actually illegal.

In the legal definition of theft, it is stated that theft is an act calculated to deprive unlawfully a person permanently of what is lawfully his. I suggest that there *is* a moral quality to the crime of theft. Just as it can be asserted that fraud on the Revenue (tax evasion) is immoral, so it can be asserted that to tax unnecessarily is also immoral. To tax where it is not required, and where there is no democratic mandate, must be theft.

What then is the position if the Government applies a taxation policy for which it has no mandate? Is that moral? What is the position of a powerful Government that threatens a weaker Government unless it adopts a taxation policy for which it has neither electoral mandate nor even revenue or social need? I suggest that this is blackmail, and if the weaker Government gives way, thereby committing theft, conspiracy to defraud.

Finally, the OECD report makes much play of the "evils" of tax havens,[2] without ever satisfactorily defining what the phrase means. The only attempt to define it was a circular one, i.e. a tax haven is a jurisdiction which behaves like a tax haven.

What does the word Offshore mean? What is a 'Tax Haven'? Words can mean different things to different people. The concept of the tax haven is an old and very outdated concept. Its usage betrays a fundamental failure to understand the 'offshore' world.

'Offshore' is a word with subjective meanings. To an oilman, it means sitting on a rig in the middle of the North Sea, or in the Gulf of Mexico. But to somebody in the financial world, it means simply a different jurisdiction which will permit somebody from outside that jurisdiction to obtain some special financial benefit. For me, the

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2 In the Author's view.

USA itself is offshore, because I can use the USA to obtain some very special tax advantages. In other words, everywhere is 'offshore' of the jurisdiction in which I am situated.

But yet we talk easily of an 'Offshore Jurisdiction' ('a Tax Haven' to the OECD authors), and we seem to know what we are talking about - or do we?

I believe that there is a fundamental confusion between 'Offshore Business', and the location where it is done. I do not think that there are any offshore jurisdictions as such. There are only jurisdictions doing, to a greater or lesser degree, 'offshore business'.

If a US Limited Liability Company ("LLC") is set up in Delaware and structured so that it has two non-resident aliens as members, and all its income is foreign source income not connected to a US trade or business, the US LLC qualifies as a US entity for a good number of the US double tax treaties, while remaining entirely tax free in the US itself. This is offshore business being conducted in the USA. Does that make the USA a Tax Haven or an Offshore Jurisdiction?

Or what about the United Kingdom with its special deals for non-domiciled resident aliens, and for International Holding Company operations? It is possible for non-domiciled residents to live in the UK entirely tax free, a privilege not available in many so-called ' Man provides no tax breaks for 'non-domiciled' persons. It is possible for a Tax Havens'. It is not possible for a UK person to live in the Isle of Man tax free: the Isle of Manx person to live in the UK tax free as a non-domiciled person. Who is doing the damage to the Isle of Man's tax base?

There is hardly a country in the European Union which escapes the charge that they are doing 'offshore business'. We all know about the Netherlands participation privilege, the Belgian headquarters company. In this context, of course, Government handouts are merely negative taxes.

The truth is that everywhere in the world seeks a competitive advantage for business. Taxation is a cost. An international business can achieve a competitive advantage by reducing costs. Since every country wants to do more business, and increase prosperity, they must compete fiscally.

The reality therefore is that there are no "Offshore Jurisdictions". An attack on the offshore business done in, say Jersey, must also be an attack on the offshore business done in Frankfurt, London or New York.

Given that, however, when we talk of an 'offshore jurisdiction' we usually mean those forty or so small jurisdictions around the world, many of them islands, which have deliberately set themselves up to a greater or lesser degree to attract international offshore financial business by providing special tax breaks. Unfortunately, our 'shorthand' misleads journalists and, it would appear, Euro-bureaucrats and Euro-politicians. When we describe somewhere as an 'offshore jurisdiction', we really mean a jurisdiction in which there is a preponderance or concentration of 'offshore financial business'.

So we need to take great care with our use of words. We should really stop taking about 'Offshore Jurisdictions'. We should talk about 'Offshore Business' which can be done in all jurisdictions.

The other aspect of these so-called 'offshore' jurisdictions is that they differ from each other enormously, with different laws, languages, cultures and fiscal arrangements. Some, like Barbados, are very proper and conservative. Some, like the British Virgin Islands, are very entrepreneurial. Some, like Hong Kong, are large and powerful, Others are minute, such as Nevis or Niue! However, today, with the drive against money laundering and the drugs trade, there are effectively no jurisdictions which are entirely unregulated and, in most of them, the regulatory regime is far more oppressive that in the so-called 'onshore' jurisdictions.

Some jurisdictions have deliberately set out to be specialists at certain things. For example, the Netherlands and Cyprus are top of the Double-Tax Treaty league, whereas the United Kingdom, the Republic of Ireland, and Monaco are at the top of the tax free residence field.

There is, therefore,[3] no such thing as a "Tax Haven" or an "Offshore Jurisdiction" as such. It is not possible to isolate any jurisdiction, or to lump a group together. To attempt to do so is wholly unproductive and futile.

3 In the author's view.