Transparency versus Privacy: Reflections on OECD Concepts of Harmful Tax Competition

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The formal models for a small open economy forecast that the optimal tax rate on capital income is simply zero.

Taxation of Capital Income vs. Labour Income: An Overview, Gordon, 2000

Background: The OECD Attack on Tax Haven Financial Privacy

High-taxing European Treasuries face grave problems as they try to finance redistributive welfare states in societies with low birth rates and declining labour tax bases in an age of globalising investment. Their problem is not much different to the problem faced by the Roman Emperors[2] (though Constantine humanely disclaimed the previous use of the scourge and the rack and contented himself with incarceration of insolvent taxpayers). In those days wealth was buried as gold in the grounds of the villa; in our day it may be buried in overseas parent or subsidiary companies. The reality remains that capital and business income can be made less visible to the tax collector than landed property. The solution of the late Roman Empire was to visit corporal punishment on the taxpayer. The solution now being urged by the OECD in Paris is that small or developing countries with offshore financial centres be pressed into service as subsidiary tax enforcers to boost OECD coffers. The OECD approach is multifarious, involving the criminalisation of tax avoidance and the elimination of various forms of tax competition from these centres in all geographically mobile service industries, including not

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2 'The secret wealth of commerce, and the precarious profits of art or labour, are susceptible only of a discretionary valuation, which is seldom disadvantageous to the interest of the treasury; and, as the person of the trader supplies the want of a visible and permanent security, the payment of the imposition, which, in the case of a land-tax, may be obtained by the seizure of property, can rarely be extorted by any other means than those of corporal punishments.' Edward Gibbon (1776–1781), *The Decline and Fall of the Roman Empire*, Vol. II, Chapter xvii, p. 211. Bury ed., 1909.

only financial, but also distribution services, shipping, service industries and company headquartering. The OECD Initiative is already drafting similar action on competition in e-commerce, with manufacturing industry having been flagged up for future action in the 1998 OECD report.[3]

What could be more reasonable? That, in the interests of comity between nations and the protection of their mutual sovereignty, nations should help each other catch 'tax cheats' by insisting on transparent legal structures and exchange of tax information on request or even spontaneously? Is this not a self-evident case of collective interest in effective law enforcement? And if nations are successful in increasing revenue by deterring or catching tax cheats, won't they be able to lower tax rates, improve economic efficiency, expand output and deliver rising living standards? So stated, the current OECD campaign to eliminate tax havens seems to make both legal and economic sense. But, as with many apparently self-evident truths propounded in the popular press, such propositions may not withstand closer examination.

Indeed, there is a remarkable parallel between the OECD campaign to end tax haven privacy and the US law enforcement agencies' push for the Clipper Chip. The Clipper Chip was put forward in 1993 as the answer to the public and commercial demand for privacy through computer file and e-mail encryption while allowing governments to eavesdrop for law enforcement purposes.

In the case of the Clipper Chip

- ✍The initiative was urged strongly at the bureaucratic level;
- ✍The initiative was adopted at the highest governmental level;
- ✍Public reaction domestically was initially not unfavourable;
- ✍Overseas commercial interests and governments became sceptical;
- ✍Later domestic public reaction to loss of privacy and commercial secrecy became unfavourable.

In the case of the Clipper Chip, US public opinion, from computer nerds

3 Indeed, the OECD seems to be intent on eliminating what they regard as 'harmful' fiscal competition in vast swathes of key global industries. However, on closer inspection, their efforts seem to be focused on industries in which OECD countries are more competitive. Hence the rather telling omission of agriculture, which has 'harmful' fiscal competition amounting to US$360 billion provided by OECD countries to their farmers at the expense of farmers in many poor developing countries as well as countries such as Australia and New Zealand. The agricultural sector is never mentioned in all the OECD exhortations for other countries to eliminate harmful fiscal practices.

to powerful corporations, became so violently hostile that the best laid plans of powerful security and law enforcement agencies were swept away by a public deeply suspicious of letting governments have the keys to their private information.[4]

It remains to be seen whether there will be a similar hostile public reaction against the OECD proposal to eliminate financial privacy in tax havens and whether this OECD initiative will go the way of the proposed OECD Multilateral Agreement on Investment (MAI). But surprises do happen and public opinion often overthrows propositions which seem eminently sensible to the particular agency interests of bureaucrats. Sometimes bureaucratic initiatives can even be dangerous for their instigators, as well as for the Ministers they advise.[5]

Intra-OECD Tensions between Capital-Importing and Capital-Exporting Countries

Just as the data security debate highlighted differences between American and European interests, there are latent differences of interest between capital-exporting and capital-importing OECD nations. Capital-importing OECD countries, such as Australia and the USA which rely on capital inflow to run large structural current account deficits, must come to question support for OECD 'pseudo-residence' tax norms which create disincentives to global capital mobility. In particular, Australia can hardly afford to deter foreign investment, while new US Internal Revenue reporting regulations are likely to affect US capital markets adversely. As 'source-of-income' countries, their national interests do not lie in helping 'residence of recipient' countries negate their attractiveness as investment destinations. This latent clash of interests within the OECD has not yet to surface fully.

The purpose of this paper is not to predict all the twists and turns or final outcome of the current tax haven financial privacy debate, nor to deny that there are gains to be had from international co-operation against common criminals (indeed, most offshore financial centres already provide full co-operation with OECD countries on criminal matters[6]), but

4 See Levy, 2001, pp. 226–312.

5 Hayek (1960, p. 308) recalls the acid remark of the great French Physiocrat, Turgot, who commented 'One ought to execute the author and not the project', in relation to graduated income taxation.

6 The OECD wants them to go further and, in effect, assist in enforcing expanded OECD concepts of fiscal criminality. Such demands for the extra-territorial enforcement of other countries' expanded concepts of criminal law raise basic issues of the independence and sovereignty of offshore financial centres.

rather to suggest that tax haven financial privacy is not a simple issue of stamping out fraud. Indeed, the OECD initiative raises many questions about optimal tax policies, about the legal ground norms for protection of privacy and property in liberal democratic (as opposed to collectivist or socialist) countries and about extra-territorial enforcement of domestic laws. The purpose of this paper is not to answer definitively such questions nor even to express concluded views: its purpose is to promote a more incisive debate.

A Little History

Interest in tax competition is not new. Adam Smith wrote:

The interest of money seems at first sight a subject equally capable of being taxed directly as the rent of land. Like the rent of land, it is a net produce which remains after completely compensating the whole risk and trouble of employing the stock. As a tax upon the rent of land cannot raise rents; because the net produce which remains after replacing the stock of the farmer, together with his reasonable profit, cannot be greater after the tax than before it, so, for the same reason, a tax upon the interest of money could not raise the rate of interest; the quantity of stock or money in the country, like the quantity of land, being supposed to remain the same after the tax as before it. The ordinary rate of profit … is everywhere regulated by the quantity of stock to be employed in proportion to the quantity of the employment, or of the business which must be done by it. But the quantity of the employment, or of the business to be done by stock, could neither be increased nor diminished by any tax upon the interest of money. If the quantity of the stock to be employed, therefore, was neither increased nor diminished by it, the ordinary rate of profit would necessarily remain the same. But the portion of this profit necessary for compensating the risk and trouble of the employer would likewise remain the same, that risk and trouble being in no respect altered. The residue, therefore, that portion which belongs to the owner of the stock, and which pays the interest of money, would necessarily remain the same too. At first sight, therefore, the interest of money seems to be a subject as fit to be taxed directly as the rent of land.

There are, however, two different circumstances which render the interest of money a much less proper subject of direct taxation than the rent of land.

First, the quantity and value of the land which any man possesses can never be a secret, and can always be ascertained with great exactness. But the whole amount of the capital stock which he possesses is almost always a secret, and can scarce ever be ascertained with tolerable exactness. It is liable, besides, to almost continual variations. A year seldom passes away, frequently not a month, sometimes scarce a single day, in which it does not rise or fall more or

less. An inquisition into every man's private circumstances, and an inquisition which, in order to accommodate the tax to them, watched over all the fluctuations of his fortunes, would be a source of such continual and endless vexation as no people could support.

Secondly, land is a subject which cannot be removed; whereas stock easily may. The proprietor of land is necessarily a citizen of the particular country in which his estate lies. The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour would necessarily be more or less diminished by its removal.
An Inquiry into the Nature and Causes of the Wealth of Nations, Book V, ii, f, pp. 847–849, 1776

It is some 225 years since publication of the *Wealth of Nations* and the American Revolution. The American Revolution had its genesis in the refusal of American colonists to aid the King's excise officers in clamping down on some 'harmful tax practices' – such as smuggling. Adam Smith's observations show why, after two centuries, he commands perennial respect from economists as the master of his subject, for he anticipated both the economic and legal issues raised by the OECD campaign to eliminate harmful tax practices through cartel-like co-operation.

Economic Arguments

Adam Smith correctly observes that a tax-induced emigration of capital (a mobile factor of production) will lower the returns to labour (much less mobile) and land (totally immobile). He therefore prefers taxation of the immobile factor, land. In pointing out that a country can protect itself from tax competition by taxing immobile factors, Adam Smith anticipates, by over 200 years, Gordon's conclusion (Gordon, 2000, p. 26) that 'The formal models for a small open economy forecast that the optimal tax rate on capital income is simply zero'.

It is a salient weakness of the OECD arguments on 'harmful' or 'unfair' tax competition that it is implicitly taken for granted that a graduated individual residence (or pseudo-residence) income taxation system is

optimal (and that public spending must be taken as given). Yet these assumptions are not correct. For example, OECD countries have often created a 'win-win' situation for themselves by privatising to some extent future public pension payouts through domestic tax havens (such as tax-deductible and tax-exempt pension fund arrangements).

If it be argued that the problem pointed out by Adam Smith of capital emigration can be avoided by governments organizing a global tax cartel to enforce each others' revenue laws, we are back in the familiar closed economy arguments on whether capital income should be taxed. The short answer is that it is not optimal to tax capital income even in a closed economy as savings and investment are adversely affected, feeding into a lower productivity of land and labour and a lower wage tax base.[7]

The 'Broad Base Low Rate' Anti-Avoidance Thesis

A popular academic argument for action to stop offshore tax avoidance or evasion is that by broadening the tax base, it becomes possible for governments to lower overall tax rates and reduce tax distortions.

For example, Brooks and Head (1997, p. 55) argue that 'following the well known work of Henry Simon, it has been generally accepted among economists that income taxation should be based on the most comprehensive feasible economic income concept. On this view, as far as possible all the different types and sources of income should be taxed uniformly and consistently'. The received dogma is that 'a broad tax base with a low rate is more efficient' and therefore all forms of tax avoidance (whether through changed behaviour or legal form) or evasion are distorting. Even where there is no immediate excess burden because avoidance is legally easy, a common view is that tax revenue losses must 'be made up by rate increases on a narrower base, thus increasing welfare cost, or public expenditure benefits must be reduced'.[8] However, this is really an economic heresy.

Like all dogmas, the 'broad base with low rate is more efficient' dogma is only true on certain assumptions. It is only true if the tax base you are talking about is all of the same kind.

The key question is whether all forms of income should be taxed equally. The answer depends on how responsive different parts of the tax base are. Income is not a homogeneous tax base. It is not sensible to tax all forms of income at the same rate if the factors of production generating the

7 These arguments are set out in more detail in Dwyer, 2000.

8 Brooks and Head, 1997, p. 71.

income are not all equally mobile. In particular, it does not make sense to tax mobile capital, especially capital supplied by foreigners, at the same tax rate as income arising from land or immobile labour tied to the jurisdiction.[9]

In reality, there is no such thing as an income tax. As Adam Smith recognised, a tax on income is three taxes – a tax on the wages of labour, a tax on the rent of land and a tax on the profits of capital.

The OECD (1998, p. 14, para. 23) argues that tax competition 'may alter the structure of taxation (by shifting part of the tax burden from mobile to relatively immobile factors and from income to consumption) and may hamper the application of progressive tax rates and the achievement of redistributive goals'.

But is the OECD correct to see tax competition as a problem to be solved by enforcing residence (or pseudo-residence[10]) taxation of mobile capital income?

If tax competition shifts the tax burden from mobile to relatively immobile factors, it is doing the world a service. Economic theory has always held that, from an efficiency point of view, taxes should be laid on things which are inelastic in supply (of which the prime example is land rents). As for progressive marginal income tax rates and income redistribution, there are many economists who would argue that both are economically inefficient. It is also odd that a report which complains (1998, p. 15, para. 25) that tax havens are 'free riders' accepts as given the 'free riding'

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9 Brooks and Head (1997, p. 60) try to deny this, baldly asserting that the 'information necessary for the design of such a system [of differentiated taxes] is not available, and the administrative requirements and political acceptability features must anyway render such an approach totally impractical'. They appear to be unaware of the fact that land in Australia has been valued and taxed for over a century. Scott's (1969) and (1986) figures computed within the Research Department of the Reserve Bank of Australia demonstrate land values rising since World War II as a potential tax base in line with personal income or corporate taxes, with most of the value being concentrated in the large cities. As for political acceptability, that is not the function of economic advice. But if European countries choose not to tax their potential and territorially immobile land value tax bases in cities such as London, Paris or Berlin, they can hardly cry foul against small island offshore financial centres willing to offer low taxes on mobile capital.

10 In fact the operation of controlled foreign company or trust income attribution rules often means that OECD countries are asserting the right to tax foreign income of a foreign company or foreign trust (even several times removed), even if their residents have no legal or equitable right to that income. The residence 'principle' is really becoming in reality a mercantilist export tax on capital in the form of perpetual taxation by the country of residence of the original source of the mobile capital.

implicit in redistributive taxation (1998, p. 14, para. 23). Some 'free riders' are more equal than others, it seems.[11]

Territorial Revenues from Land Rents

A fundamental defect of the harmful tax competition thesis is that it ignores territorially fixed and stable sources of revenue such as land rents. There are three economic factors of production, not just two: land, as well as labour and capital, is a factor of production. Economic theory since the Physiocrats and Adam Smith has always said it is better to tax what is inelastic in supply (for example land) in preference to what is mobile (for example capital). Modern optimal tax theory is just another rediscovery of that principle.

Economic theory declares that the most desirable tax base is a tax on unimproved land and resource values because it cannot be shifted and has no distorting effects on investment in physical capital or labour supply. As Kopits (1992, p. 5) notes, a country can use its resource rents to respond successfully to tax competition for mobile capital. Professor Martin Feldstein, former Chairman of the US Council of Economic Advisers, acknowledges a tax on unimproved land values 'involves no distortion' and is clearly efficient.[12] A beauty of such territorial-based taxation is that it also solves the tax treaty issue – international double taxation becomes a non-issue and the OECD tax treaty network becomes unnecessary.

There is no reason why reduced taxes on mobile capital could not be financed by increased land taxes within the OECD countries. If they

11 The OECD report (1998, p. 15, para. 25) argues: 'governments and residents of tax havens can be 'free riders' of general public goods created by the non-haven country'. The report does not specify what these public goods are. One might observe that, typically, public goods or income redistribution benefits are only available to residents of a country. If a country such as the UK chooses to allow residents of its offshore islands free migration access to the UK or access to social security or public health care or chooses to defend dependent territories then one must presume such a decision is taken in the interests of the UK as much as any dependent territory. As for domestic free riders, it is nonsense to argue that domestic tax avoiders or evaders are 'free riders' without looking at the 'free rider' beneficiaries of tax-financed redistribution. Who is the free rider – the man who wants to keep his hard-earned money from the tax collector or the welfare recipient waiting for the cheque from the government treasury? The answer often seems to depend on political or ideological proclivity. Taxpayers often argue that they do not mind financing genuine common public needs but they do resent paying for welfare state beneficiaries who have contributed little or nothing themselves. This is not the place to settle such arguments but it is foolish to ignore their existence if one is trying to understand tax avoidance or evasion as social phenomena.

12 Feldstein, 1976, p. 96. See also Musgrave, 1959, p. 158.

choose to tax their workers more, rather than land, that is their domestic political decision, just as it was a domestic political decision for many OECD countries, notably in Europe, to embark on high welfare spending programmes which necessitated high taxes on labour and made them internationally uncompetitive. Having made those decisions, they should not blame the rest of the world for the logical economic consequences.

The implicit assumption of the OECD model is quite wrong. The world supply of capital is not fixed and depends on the net rate of return. If all governments successfully co-operated to increase the tax burden on capital income, world capital accumulation would slow down and world living standards would stagnate. Once this fundamental error of the harmful tax competition model is grasped, the concept collapses – it is really a new mercantilist error of the kind excoriated by Adam Smith – and damaging to OECD countries themselves as well as to offshore financial centres. Indeed it is perplexing that the OECD paper has no theoretical discussion at all on why tax competition is harmful in a *worldwide* sense as opposed to the narrow interests of OECD national tax collecting agencies. Nor does the OECD acknowledge that OECD citizens may have different interests to those of OECD tax bureaucrats.

The Zero Optimal Tax Rate on Capital even in a Closed Economy

The fundamental Ramsey principle of taxation is that taxes should be levied on those activities which are least responsive. One would not tax a factor of production which was in perfectly elastic supply. This has profound implications for internationally mobile capital. Theoretical models of optimal taxation in an open economy produce two broadbrush results (Frenkel and Razin, 1996, Chapter 14).

1. The optimal principle of international taxation is the residence principle, that is non-residents should not be taxed on their capital income by the source country.
2. The optimal tax rule for a country that cannot enforce taxes on foreign source capital income is to abstain entirely from taxation of domestic source capital income as well.

Even in a closed economy, it may be efficient to exempt capital income from tax in the long run (Chamley, 1986; Correia, 1996). The optimal tax rate on capital income from all sources is thus zero. The intuition behind these conclusions is not that difficult to understand, even though the policy implications are dramatic. One would not tax non-residents on

their capital income because that drives up the cost of capital to the local economy – non-residents can take their mobile capital and invest it elsewhere. By driving away mobile capital, the tax becomes an inefficient tax on immobile factors of production, such as immobile labour or land (Kopits, 1992, pp. 5, 15; Head, 1997, p. 86). One should not tax the capital income of non-residents just as one does not outlaw foreign investment. One wants foreign capital to increase the productivity and wages of the local population.

The crucial principle of open economy tax policy is that one should always tax an immobile factor in preference to a mobile factor. The reason for this is that, if taxed, the mobile factor will in the long run start to exit and shift the burden back to the immobile factor *but with a greater economic loss* than if the tax had been placed on the immobile factor in the first place.

Just as capital can flow across borders, so capital can evaporate over time. Hence, in the long run, the optimal tax rule is not to tax capital income at all. Taxing the return on capital lowers the capital intensity of the economy and reduces the productivity and wages of labour. This is one of the major arguments for shifting from an income to a consumption tax base (although that can be done just as – or more – easily by exempting capital income from tax).

The second principle states that if capital income is to be taxed without distorting the allocation of investment then, other things being equal, it is desirable to tax income from domestic and foreign investments equally. But if one cannot tax foreign income equally – and even with the most sophisticated legislation that is likely – then one should cut the rate of tax on domestic capital income.

So, economic freedom and international tax competition are *world* welfare enhancing. Far from hurting the OECD, it is nudging OECD countries towards optimal tax policies which are in the best interests of their citizens.

If the optimal tax rate on capital income is zero, and capital is mobile in any case, the attempt of OECD officials to promote worldwide enforcement of 'residence' capital taxes is as pointless and futile as Xerxes flogging the waters of the Hellespont or Canute commanding the tide to retire.

Legal Arguments

Leaving aside the economic arguments, it is noteworthy that Adam Smith bases his first objection on the intolerable vexation an inquisition

into every man's affairs would involve. This objection comes naturally to English-speaking peoples. Since before Magna Carta of 1215 through the Bill of Rights of 1688 to the present day, the sentiment of common law jurisprudence has always been that the subject is free and that the common law exists to protect his property and his privacy. The common law is not the code of a sovereign such as Justinian but the protecting law of the people.

Among the common law rights of the people which have been protected over the centuries are:

✍The right to trial by jury;

✍The presumption of innocence;

✍The right not to be forced to incriminate oneself;

✍The right not to be arrested or invaded in one's privacy other than by judicially-supervised warrants based on cause;

✍The right not to be deprived of life, liberty or property other than in accordance with due process of law;

✍The right to ensure confidential communications with spouses or lawyers are not used as evidence against oneself.

Thus it is hardly surprising that Article IV of the Bill of Rights to the United States Constitution entrenches the common law. 'The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.' Article V goes on to protect the right not to be forced to incriminate oneself and to protect life, liberty and property against unlawful deprivation.

Economists and business people usually take the legal foundations of a free society and a free market economy for granted. But the declaration of the rights of individuals evolved as concrete responses to abuse of state power. An example of their value is seen in one of the earliest US Fourth Amendment cases. Decided in 1886, *Boyd v. United States* involved a federal customs statute that required businessmen (involved in importing goods) to choose between producing invoices and record books during a government inspection or having the imported goods confiscated by custom officials. Justice Joseph P. Bradley, delivering the opinion of the Court, struck down the customs statute. He declared, 'It is not the breaking of a man's doors and the rummaging of his drawers that constitutes the

essence of the offense; but it is the invasion of his indefeasible right of personal security, personal liberty and private property, where that right has never been forfeited by his conviction of some public offense'.

English-speaking peoples have tended to be wary of the dangers of majoritarian collectivistism crushing individual rights. As Hayek (1960, p. 195) observed:

The decisive factor which made the efforts of the [French] Revolution toward the enhancement of individual liberty so abortive was that it created the belief that, since at last all power had been placed in the hands of the people, all safeguards against the abuse of this power had become unnecessary. It was thought that the arrival of democracy would automatically prevent the arbitrary use of power. The elected representatives of the people, however, soon proved much more anxious that the executive organs should fully serve their aims than that the individual should be protected against the power of the executive. Though in many respects the French Revolution was inspired by the American, it never achieved what had been the chief result of the other – a constitution which puts limits to the powers of legislation.[13]

For many years, taxation in common law countries was essentially a civil matter. With none of the serious consequences of criminal penalties to consider, legislatures felt few reservations when granting privileged litigant status on the officers of the Revenue. For example, the taxpayer was required to furnish the information necessary to expose himself to a tax liability and the Revenue was allowed free and full access to private papers by way of audit and might be able to make an arbitrary assessment and the onus would then lie on the taxpayer to disprove it. However, in recent years, there has been a tendency to treat tax defaults as a criminal matter, without removing the privileged position of the Revenue as a civil litigant. The inevitable result is that many of the common law rights enunciated above are becoming non-existent or tenuous in not only civil but criminal tax matters: there is no bar to using information acquired for civil disputes in criminal prosecutions. In particular, while common law countries have never formally subscribed to the legal self-contradiction known as 'abuse of law' in fiscal matters, the advancing tide of obscure and subjective anti-avoidance legislation, aided by occasional judicial *realpolitik*, has created a situation where unsuccessful tax planning or tax avoidance may be re-characterized as attempted criminal tax evasion.[14]

13 Rights in European Constitutions or the European Declaration on Human Rights have tended to be hypothetical when it comes to taxpayer rights, see Cooper (1997).

14 Once tax matters are characterised as criminal, not only taxpayers but also professional advisers, banks and financial institutions are exposed to penalties. Brandon (2000, p. 43)

In these circumstances, not only taxpayers but their lawyers and accountants may be prosecuted and incarcerated as criminals for the offence of unsuccessfully trying to protect taxpayer's money from the possible ambit claims of the Revenue. Such prosecutions are immensely aided by information obtained without any of the normal protections for the accused in a criminal trial.

Anti-Avoidance Legislation and Corruption of the Rule of Law in OECD Countries

These considerations partly explain why the OECD's arguments for exchange of information from offshore financial centres are arousing strong passions from lawyers and their international business and personal clients. They argue that 'tax evasion' is not a simple concept, that to characterise failed tax planning as fraudulent tax evasion is to criminalise the natural human instinct to hold on to what one has worked for and that 'tax evasion' in modern revenue legislation becomes an exceedingly subjective concept as most anti-avoidance legislation is predicated on deemed mental states.

Indeed, many lawyers would argue that modern OECD income tax systems in their anti-avoidance legislation often tax, not on the basis of facts, but on the basis of hypotheses as to what the taxpayer thought or intended – a modern form of Orwellian 'thought crime'.[15] They would argue that the enormous fiscal discretions invariably given to tax officials

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notes 'If the professional adviser suspects that his client is engaged in tax evasion, *whether in his own jurisdiction or outside it*, he should consider disclosing his suspicion ... he is at risk of prosecution if he does not disclose.' (Emphasis added.) What is going to be the long-run economic cost to international financial markets of trying to turn every officer of every financial institution worldwide into some sort of global tax policeman? Do ordinary police officers face the risk of prosecution for failing to arrest where they 'should' have suspected criminal activity? Why should higher burdens be placed on persons or institutions conducting commercial dealings?

15 The situation has not improved since Tipke (1984) outlined some basic rules for tax justice such as objective rules and ethics in the tax laws and government themselves. On the question of being punished for presumed 'thought crimes', it is a crime under UK money laundering legislation, not to report a suspicion (as opposed to knowledge) relating to financial dealings with criminal proceeds. Leaving aside the philosophical question of whether it is wise for a legal system to inculcate distrust between subjects in their commercial dealings rather then the reverse, how does a legal system look into a man's head? The tactic used has been to reverse the onus of proof, so that an accused banker, for example, must prove h not suspect. This, in turn, conflicts with the presumption of innocence and in *McIntosh v Her Majesty's Advocate*, the Scottish Appeals Court has struck down such a reversal of the onus of proof as being in conflict with the now-binding European Convention on Human Rights.

under anti-abuse or anti-avoidance legislation are a corruption of the rule of law, under which every taxpayer should be entitled to hold on to and dispose of property without being taxed on other than objective and verifiable criteria. More ominously, they would argue that wide discretions in the hands of tax collectors are an invitation to corruption and abuse, just as the wide discretions given to officials in the Soviet era led to entrenched corruption in the post-Soviet pseudo-market economies.[16]

Given this background, many lawyers would argue that it is hardly surprising that taxpayers want financial privacy offshore to avoid exposure to harassment by vindictive or ideological revenue officials. They would have us remember Adam Smith's words

The tax which each individual is bound to pay ought to be certain, and not arbitrary. … Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt.
An Inquiry into the Nature and Causes of the Wealth of Nations, Book V, ii, b, pp. 825–26, 1776

On the other side, the OECD view is that, unless Revenue authorities have free and full access to information, there is an incentive to cheat; effective enforcement of modern 'residence-based' income tax legislation requires access to information in foreign countries. Offshore financial centres which guarantee privacy are seen as virtually inciting domestic taxpayers to evasion.

Transparency versus Privacy

It is not surprising that 'transparency' has become almost a mantra for the OECD in pressing the case against 'unfair tax practices'. The word sounds a positive good – and it is, when one is speaking of the accountability of taxpayer-funded bureaucracies, domestic or international, to those who pay for them. For example, when billions of dollars of funds provided to Russia go missing, a little transparency and accountability to taxpayers is a good thing.

But it is an inversion of the roles of master and servant to suggest that the private affairs of the subject should be transparent to an all-powerful

16 The IMF has pointed to the dangers of discretionary, non-transparent tax laws in fostering corruption (see Wolf and Gurgen, 2000, p. 6).

state. Privacy is a basic human right and civilized society – as well as commerce – would be rendered impossible without it. The word 'privacy', like 'property', connotes what is peculiarly one's own. The common law utterly rejects the idea that the citizen belongs to the state. No clearer expression of that rejection was ever seen than when Britain and the Commonwealth stood alone against what Winston Churchill described as a 'monstrous tyranny' founded upon the opposite principle. The German National Socialist dictatorship completely subordinated the individual and the private to the demands of the state and its state police had neither restraint from warrants nor any respect for business, bankers', lawyers' or family confidences.

Seen from this legal and historical perspective, demands that foreign governments should be able to invade the privacy of the subject in Commonwealth countries become troublesome indeed. It is a serious concern that basic legal protections and rights have been already eroded by tax collection imperatives in OECD countries. It is a troubling notion to both offshore financial centres and their investors that foreign government officials should be able to extract information concerning the private financial affairs of families or companies without a local warrant showing good cause and without notice to persons affected.

A Convergence of Legal and Economic Arguments for Privacy?

There are many reasons for these concerns. Why *should* offshore financial centres degrade the protections of their own legal systems or the rights of their own citizens by co-operating with OECD demands? OECD countries do not, for example, enforce against any resident Afghan citizens the laws made by the Taliban government of Afghanistan prohibiting women from certain occupations: the law they apply to the actions of resident Afghans is their own law. When the Taliban government issued a new law in 2001 that its minority Hindu citizens were required to wear a yellow badge stating that they were Hindus, the US Congress did not decide to go along with it and enforce this law against Afghan Hindus in the US, but rather voted 420–0 to strongly condemn the Taliban law and helped the momentum of international outrage that forced the Taliban government to withdraw this decree. Summing up the outrage of the US Congress, Representative Tom Lantos, California Democrat and Holocaust survivor, and the ranking minority member of the US House International Relations Committee, said: '*We cannot allow the Taliban to systematically repress its Hindus in such an eerily similar manner* [to the Holocaust]'.

Nor, for example, did Australia assist Serbia to call up Serbian-Australian dual nationals for military service. Why, then, should offshore financial centres be expected to assist in applying the tax laws of OECD countries against their own citizens or companies or against income arising or received within their borders? Are they not entitled to say that they, too, are sovereign and *their* tax laws apply to acts done in *their* territory?

This is particularly important when it comes to invading personal privacy, commercial confidentiality or attorney-client privilege. Respect for privacy is not merely an old-fashioned nineteenth-century virtue demonstrating good breeding – it is vital for modern commerce. The US Government sought long and hard to prevent the spread of computer encryption technology on national security grounds. Yet it had to abandon that fight, not simply because of the resistance of outraged libertarians, jurists, academics and computer enthusiasts, but because America's largest corporations demanded and needed bullet-proof encryption technology to carry on their worldwide businesses. Indeed, the subject of commercial privacy has become a controversial issue in the EU with allegations that European companies have lost contracts due to lack of data security against American competitors.

It is therefore hardly surprising that, for reasons not necessarily connected with taxation, individual and corporate clients of offshore financial centres may view OECD demands for transparency and exchange of information with alarm. Where, for example, are the safeguards to prevent a foreign tax official passing on the data provided to a rival in a tender bid for a defence technology contract, especially if the rival bidder is from that official's country? (For a recent example of this type of concern, see 'Euro Police HQ Raided in Fraud Inquiry', *Daily Telegraph*, 2 June 2001: 'Three years ago, it was discovered that an official in the EU's Schengen Information System, a separate body, was selling computer data to organised crime groups'.)

What the critics of the OECD are urging is that access to information about the subject is a form of political power and that, in Lord Acton's (and Pitt's) dictum, power is apt to corrupt the minds of those who possess it. Once tax bureaucrats have privileged access to information about the direct or indirect affairs of billionaires and famous persons, there is an incentive to bribe and corrupt them; those interested may include rival corporations, jilted lovers, political opponents, extortionists or foreign power seeking influence via blackmail.[17] Far from improving *government*

17 Even in a relatively non-corrupt country such as Australia, there have been disturbing cases of abuse of information by persons in the employ of government authorities.

transparency, unchecked official access to *private* information[18] is seen by critics as likely to create a new privileged class of bureaucrats with every opportunity and incentive for corruption or other abuses of power.

The issue of the legitimacy or otherwise of personal and commercial privacy brings us to another interesting issue – the role of the market in eliciting information. As Friedrich von Hayek and his fellow Austrian economists were fond of pointing out, a free market economy is an information processing mechanism. Private information is only made available to the market by a system of rewards, a reality recognised by the World Trade Organization and Trade Related Aspects of Intellectual Property (TRIPs) agreements expanding intellectual property protection for patents (whether appropriately or not is beyond the scope of this paper). Thus some countries, while enforcing fiduciary and contractual duties of employees, directors and contractors do not outlaw 'insider' trading *per se*. They, like many economists, take the view that, provided there is no breach of duty or contract, the prospect of profits from acting on inside knowledge serve the useful purpose of embedding that information as rapidly as possible in the share price. To put it another way, transparency is a surrender of privacy and the price of that surrender is a profit to he who provides the information. What corporation does not keep as closely guarded a secret as it can, its plans for merger or takeover with another company or for launch of a new business?

Once one begins to think about the positive role of privacy in inducing quiet labour and planning towards socially useful economic activity, demands for abolition of offshore financial privacy are no longer seen as an unambiguously 'good thing'. The world is more subtle than that and the efficient operation of financial markets is seen to demand respect for financial and business privacy, just as much as the proper accountability of public moneys is seen to demand transparency.

Conclusion

There seems reason to question the OECD assumption that transparency and exchange of information to foreign tax officials should be accepted as self-evident truths in the quest for a better world economic order. This is

18 In John Locke's and American classical political philosophy, governments are created to protect life and property, not to take them. There is no inconsistency, on this view of the world, between accepting, on the one hand, warrants for officials to gain information about suspected terrorists or drug traffickers while rejecting, on the other hand, any invasion of privacy by tax collectors.

not to say that it is desirable that malefactors hide their misdeeds, but rather to urge re-consideration of OECD arguments against the centuries-old wisdom – in both legal and economic terms – of fundamental principles of the common law protecting privacy. Almost all offshore centres do co-operate against common criminality, but it is quite another matter to expect them to damage both their own citizens' rights and their own economic prospects by attacking the legitimate privacy of their financial sectors at the behest of foreign tax collectors. Privacy of private sector information has social and economic benefits, just as transparency of public affairs has benefits.

But, at the end of the day, perhaps the tax haven debate will be resolved not by OECD governments or their bureaucrats, or by academic debate, but by the answer businesses and citizens of both OECD and offshore financial centres give to the privacy question which decided the outcome of the American cryptography debate – 'Do you trust your own or foreign government officials with free, unmonitored and unchallengeable access to your private information or private information about you?' We suspect the answer may be be a very loud 'No'.

Postscript

This article was originally written prior to the terrorist attacks of 11 September 2001 against the USA. Like millions of others around the world, we watched with horrified disbelief when television made us unwilling witnesses to the deaths of thousands of human beings as the second World Trade tower was hit and both towers later collapsed. Given the shock, psychic depression and insecurity which now afflicts so many people, it is perhaps inevitable that governments will seek extraordinary powers to prevent and punish such evil acts.

Yet we still think the distinction needs to be made – and that it is vital that it is made – between acts which are, or ought to be, criminal in anyone's language or culture and the routine administrative fiscal matters that the OECD is trying to address, including through measures which many regard as anti-competitive. Nor does every command of an earthly sovereign or majority stand as one of the ten commandments – *vox populi* is not *vox Dei*. Moral distinctions lie at the heart of the rule of international law requiring common criminality as a precondition for legal assistance.

It is right and proper for countries to seek and expect international co-operation to suppress inherently immoral things such as terrorism, piracy, and murder which are universally condemned. In these matters, as Edmund

Burke put it on 28 May 1794: ‘There is but one law for all, namely, that law which governs all law, the law of our Creator, the law of humanity, justice, equity – the law of nature, and of nations’.

It is quite another matter for any country to expect others to enforce its merely regulatory or positive laws, be they taxation, traffic, religious or liquor laws. From the times when England gave protection to the Jews and Huguenots to the Canadian supply of liquor to the USA in the 1920s, governments have often wisely chosen not to enforce their neighbours’ more repressive laws.

Equally, however, governments have often been willing to co-operate against internationally condemned acts of criminality, such as piracy or the slave trade. On current limited public information, it appears that most offshore financial centres are rightly extending the fullest co-operation and assistance to the US authorities, and that most of the terrorist networks used onshore banking systems in Europe, the USA and the Middle East extensively. From the little that has been publicly reported, it seems money may have been raised from ostensibly legitimate sources within the USA, UK, Europe and the Middle East for terrorist ends. Any attempt to use terrorism as an international G8/OECD bureaucratic springboard to fiscal or financial protectionism against offshore financial centres which respect normal client financial privacy would therefore appear to be both unjustified and unwise. It would be unjustified because these small countries are co-operating with anti-terrorist measures and unwise because coercion on unrelated, merely regulatory, matters may prejudice otherwise willing future co-operation towards the global common good in preventing and punishing truly awful criminal acts. This appears to be the view of the US Administration which recognises that international co-operation through consensus and coalition is essential to eliminating terrorism.

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