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Bank Secrecy, Tax Havens and International Tax Competition

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I. Introduction

There is a growing perception in Washington, DC, that the U.S. corporate tax base may be eroding due to either the bank secrecy of "tax havens" or the so-called tax loopholes that are said to "encourage American businesses to shift jobs overseas."

Indeed, Congress recently held hearings to consider ways to modify bank secrecy rules so that taxpayers won't easily avoid paying tax by sheltering overseas income in low-tax countries. Meanwhile, President Obama's FY 2010 budget submission promises to raise more than $200 billion in new tax revenues from U.S. companies by restricting their ability to defer paying taxes on profits earned abroad and by modifying their ability to allocate various business expenses between U.S. and foreign subsidiaries.[1]

Clearly, the U.S. government should demand that taxpayers follow the law and pay legally owed taxes. But lawmakers need to be careful not to confuse the act of wrongful tax evasion with the effects of global tax competition. U.S.-based firms are already at a competitive tax disadvantage compared to firms based in other major trading nations. Confusing tax evasion with tax competition could lead to policy changes that put the U.S. economy at an even greater competitive disadvantage.

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While some lawmakers, such as Ways and Means Chairman Charles Rangel, have given a nod to the notion of cutting the corporate tax rate, the changes to the international tax rules proposed by the Administration would actually undermine the benefits of lower rates and make U.S. firms and employees less competitive abroad.

OECD countries such as Ireland, Poland, the Slovak Republic, and Switzerland have

[1] The Administration released some details of the proposal through the U.S. Treasury Department on May 4, 2009. http://www.treas.gov/press/releases/tg119.htm. Additional details are expected to be released with the Administration's formal FY 2010 Budget.

enjoyed an influx of foreign capital and investment not because they are "tax havens" but because they have dramatically lower corporate tax rates than the United States, France, Germany, Great Britain and Japan. Until these high-tax countries lower their corporate tax rates, they will continue to lose ground — investment and jobs — to lower-tax competitors.

An increasing amount of economic evidence suggests that dramatically cutting the U.S. corporate tax rate while maintaining the current system of deferral (or, perhaps, moving in the direction of a territorial tax system) would make U.S. firms more competitive abroad while improving the wages and living standards of U.S. workers at home.

Until high-tax countries like the United States, France, Great Britain and Japan lower their corporate tax rates, they will continue to lose ground - investment and jobs - to lower-tax competitors.

This paper explains why the effects of global tax competition should not be confused with "harmful tax practices" or tax evasion, and how far out of step the U.S. corporate tax system — both the rates and international tax structure — has become in comparison to most other developed nations.

II. Tax Evasion and Tax Havens vs. Tax Competition

As often happens in Washington, DC, issues that are unrelated or only slightly related can become rhetorically intertwined in the public's mind simply because they sound similar. Unfortunately, the recent debate over bank secrecy and so-called tax havens has become intertwined with the broader issue of global tax competition and America's standing relative to the tax rates imposed by other developed nations.

Bank secrecy is an area of dispute between two groups of countries: one group that permits its banks to keep depositors' identities secret, and the rest of the world that wants to enforce taxation of the income earned by those accounts. The U.S. is part of the group that is demanding more information about account holders so that it can tax the income of Americans who keep their money overseas. And in fact, while some U.S. individuals with foreign bank accounts dutifully report their foreign income, some take advantage of the host country's bank secrecy laws to hide taxable income. This was the issue in the recent UBS case, which drew considerable scrutiny and public attention.[2] While bank secrecy is fundamentally about individuals who fail to report taxable income, the issue is often raised in discussions of international tax reform although there is only a limited connection.

Bank secrecy is just one of many government policies that may contribute to a nation being labeled a "tax haven." The fundamental issue is whether any nation's policies undermine other countries' tax enforcement. Cooperative agreements among nations, such as the OECD's Harmful Tax Practice initiative launched in 1996, have addressed such concerns by urging more information disclosure to ease tax enforcement.

The OECD Harmful Tax Practice initiative criticizes four aspects of countries' tax systems:

- the use of preferential tax regimes that include a zero rate or very low tax rates

[2] For example, this was the focus of the recent hearing on "Banking Secrecy Practices and Wealthy American Taxpayers," before the House Ways and Means Subcommittee on Select Revenue Measures, March 31, 2009.

- a lack of transparency
- the absence of information exchange with other countries (of particular import to the bank secrecy issue), and
- "ring-fencing," i.e., giving tax benefits to foreign investors that are denied to domestic residents.[3]

Of the 47 regimes initially identified as problematic, most have subsequently been changed to satisfy the OECD. Of the 33 non-OECD countries and jurisdictions cited as providing inadequate information, only five remained on the list after 2004.[4]

Enacting a low tax rate to compete for investment is a legitimate way to expand a nation's tax base and increase the living standards of all residents. Ireland, Switzerland, Poland and Slovakia might, to varying degrees, have low tax rates, but they are regarded as having "normal" or "conventional" tax systems in most other respects.

As the OECD criteria indicate, a low tax rate is but one element of the tax haven definition. By no means is enactment of a low tax rate in itself a harmful tax practice. It is the low tax rate in combination with the other criteria – the lack of transparency, the lack of information exchange, and the presence of special tax regimes – that defines a tax haven.

Indeed, enacting a low tax rate to compete for investment is a legitimate way to expand a nation's tax base and increase the living standards of all residents. Ireland, Switzerland, Poland and Slovakia might, to varying degrees, have low tax rates, but they are regarded as having "normal" or "conventional" tax systems in most other respects.

III. Tax Rate Competition Abroad

Tax rate competition abroad has dramatically changed the landscape of international taxation over the past two decades. Despite rapid reductions in corporate tax rates abroad and

Table 1

Statutory Corporate Tax Rates for OECD Countries, 2008 (Combined Central and Subnational)

OECD Country	Statutory Corporate Tax Rate
Australia	30.00
Austria	25.00
Belgium	33.99
Canada	33.50
Czech republic	21.00
Denmark	25.00
Finland	26.00
France	34.43
Germany	30.18
Greece	25.00
Hungary	20.00
Iceland	15.00
Ireland	12.50
Italy	27.50
Japan	39.54
Korea	27.50
Luxembourg	30.38
Mexico	28.00
Netherlands	25.50
New Zealand	30.00
Norway	28.00
Poland	19.00
Portugal	26.50
Slovak Republic	19.00
Spain	30.00
Sweden	28.00
Switzerland	21.27
Turkey	20.00
United Kingdom	28.00
United States	39.25
G-7 Weighted Average (Excluding U.S.)	33.84
OECD Weighted Average (Excluding U.S.)	31.31

Source: Organisation for Economic Co-operation and Development (www.oecd.org).

[3] Jeffrey Owens, "OECD's Work in Counteracting the Use of Tax Havens to Evade Taxes," OECD, Centre for Tax Policy and Administration, December 11, 2006, p 3.

[4] These tax havens include: Andorra, Liberia, Liechtenstein, the Marshall Islands and Monaco. OECD (2004) and Dhammika Dharmapala and James R. Hines, "Which Countries Become Tax Havens?" NBER, Working Paper No. 12802, December 2006, p.7.

other changes to international tax systems, the U.S. corporate tax has remained largely unchanged during this period. The last major change to the U.S. corporate income tax was the reduction in the top federal statutory corporate tax rate from 46 percent to 34 percent under the Tax Reform Act of 1986.[5] In contrast, since the early 1980s, the average corporate tax rate for OECD nations has fallen by 38 percent (weighted), and the rate for the larger G-7 nations has fallen by 37 percent (weighted).[6]

By no means is enactment of a low tax rate in itself a harmful tax practice.

Today, the U.S.'s combined federal-state statutory corporate tax rate is 39.25 percent, well above the weighted average of 31.31 percent for member nations of the OECD[7] and the weighted average of 33.84 percent for the larger G-7 countries (see Table 1).[8]

The U.S. now has the second highest statutory corporate tax rate among the 30-member OECD, exceeded only by Japan. If the U.S. had reduced its corporate tax rate at the same rate as other developed nations during this period, its combined federal-state rate would be only 25 percent today.

The gap between the U.S. and other countries continues to widen. Between 2007 and 2008, 23 countries lowered their corporate tax rates including Canada, China, Columbia, the Czech Republic, Denmark, Germany, Hong Kong, Israel, Italy, Malaysia, New Zealand, Singapore, South Africa, Spain, Switzerland and the United Kingdom.[9]

Some have criticized the focus on the statutory corporate tax rate in making international comparisons on the grounds that the nations that have lowered their statutory corporate tax rates have also broadened their tax bases to pay for the lower rates.[10] The trends described above, however, are not limited to the statutory corporate tax rate. Indeed, these trends are emblematic of more fundamental changes in corporate tax systems among developed nations.

A recent analysis of effective marginal tax rates, which accounts for the major features of each country's business tax system — the corporate tax rate, the depreciation system, investor-level taxes, and other considerations — reached similar conclusions.[11] The U.S. rate was 23.6 percent in 2005, but for the G-7 countries (excluding the U.S.), it was 19.5 percent. The trend in the U.S. for two decades has been no change in the effective marginal tax rate; meanwhile abroad, effective marginal tax rates have fallen by 30 percent since the mid-1980s.

At first glance, the U.S. compares more favorably when using another common measure, the average tax rate (corporate tax revenue as a fraction of corporate profits or

[5] The Tax Reform Act of 1986 also repealed the investment tax credit. In 1993, the top statutory federal corporate tax rate was increased from 34 percent to 35 percent.

[6] Weighting the statutory corporate tax rate by gross fixed capital formation accounts for differences in the size of the respective nations' economies. Such weighting is customary when making such comparisons. For example, see U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, December 20, 2007, Chart 1.1 (p.11).

[7] The calculations are for the 22 OECD nations for which data are consistently available for the full 1982 through 2008 period. Gross fixed capital formation is used to compute average weighted tax rates. The weights for 2007 and 2008 were based on 2006 figures.

[8] The weighted averages for OECD nations and G-7 nations exclude the United States.

[9] *KPMG's Corporate and Indirect Tax Rate Survey 2008*. http://www.kpmg.lu/download/surveys/2008/corporateandindirecttaxratesurvey2008.pdf.

[10] For example, see the August 19, 2008, blog posting by Paul Krugman: http://krugman.blogs.nytimes.com/2008/08/19/the-greek-menace/.

[11] For example, a recent analysis of effective marginal tax rates, which captures the major features of a country's business tax system, shows that they have fallen by roughly 30 percent since the 1980s. See Robert Carroll, "Comparing International Corporate Tax Rates: U.S. Corporate Tax Rate Increasingly Out of Line by Various Measures," *Tax Foundation Fiscal Fact* No. 143, August 28, 2008. http://www.taxfoundation.org/files/ff143.pdf.

output). However, this measure fails to take into account the large non-corporate sector in the U.S.[12]

IV. How International Tax Structures Affect Competitiveness

The high U.S. tax rate is inextricably linked to how the U.S. taxes the foreign source income of U.S. multinational corporations. Importantly, while most developed countries impose no tax on the foreign source income of their multinational firms, the U.S. does tax the foreign source income of U.S.-based firms. The tax is not due until the income is repatriated to the U.S. or paid as a dividend to a U.S. parent.[13] That is, the high U.S. corporate tax rate is only relevant when income earned by a foreign subsidiary of a U.S.-based firm "comes back" to the United States. The delay in collection of the tax is called deferral.

Two conceptual approaches for taxing foreign source income are the territorial and the worldwide systems. Under the territorial system used by most major trading nations, tax is due only on income earned at home. Under the worldwide system, all income is subject to tax in the country where the firm is headquartered, regardless of where the income is earned. ... The U.S. uses a hybrid of these two systems.

Two key elements of these tax arrangements are important to the competitiveness of U.S. multinational corporations:

- the interplay between the U.S. corporate tax rate and the rules that govern the taxation of foreign source income in the U.S., and
- how U.S. multinational corporations' foreign competitors are taxed abroad.

Together, these elements determine whether the changes being contemplated by the Obama Administration will help or hinder the competitiveness of U.S. firms.

Deferral helps place the foreign business operations of U.S. multinational corporations on a more equal footing with foreign businesses operating in the same country.

Two conceptual approaches for taxing foreign source income are the territorial and the worldwide systems. Under the territorial system, tax is paid on income only where it is earned, regardless of where a taxpayer may reside.[14] Under the worldwide system, all income is subject to tax in the country of residence, regardless of where the income is earned. Income earned abroad may also be subject to tax by the country where it is earned. On the principle that the same income should not be taxed by more than one country, foreign taxes paid are generally creditable against domestic tax on foreign income up to the domestic tax rate.

[12] Over the period of 2000 through 2005, corporate revenues as a percentage of GDP averaged 3.5 percent for the OECD, but were only 2.2 percent for the United States. When income received and taxes paid by the non-corporate sector are also included, this ratio rises to 3.3 percent. See U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century,* December 20, 2007, p. 13, and Carroll, Op. Cit., p.4.

[13] The U.S. tax system distinguishes between active income (e.g., from sales) and passive income (e.g., rents, royalties, interest). Passive income is generally subject to tax when earned, while active income is eligible for deferral.

[14] Certain passive or financial income from abroad, such as royalties, also is subject to tax in the country of residence.

The United States uses a hybrid of these two systems. U.S. multinational corporations are subject to tax based on their worldwide income. For foreign subsidiaries of U.S. multinational corporations, tax is usually paid only when income is repatriated back to the U.S. parent as a dividend. That is, U.S. tax is deferred until repatriated, at which time a credit can be claimed for foreign taxes paid.

The Importance of Deferral to the Competitiveness of U.S. Companies

Deferral has the effect of relieving a substantial portion of the U.S. tax, in present value terms, on the income of foreign subsidiaries of U.S. companies. Because U.S. tax is only paid when foreign profits are repatriated, the U.S. corporate tax rate is only relevant when U.S. multinational corporations choose to bring foreign earnings back to the United States. This structure also means that there is a tax disincentive for firms to repatriate foreign income.[15] This is the source of the Obama Administration's concern that the U.S. tax system encourages U.S. firms to ship jobs overseas.

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Importantly, deferral helps place the foreign business operations of U.S. multinational corporations on a more equal footing with foreign businesses operating in the same country. How does this work in practice? Consider a U.S. corporation operating in a country with a territorial system. The income of the U.S. subsidiary will be subject to the foreign country's corporate income tax. A foreign corporation operating in that same country will also be taxed on its foreign income earned in that country. If the U.S. multinational corporation were taxed each year on its worldwide income — i.e., no deferral — the U.S. company would find itself at a disadvantage relative to its competitors because of the high U.S. corporate tax rate. Tax deferral, in effect, helps place U.S. companies on a more equal footing by lowering the U.S. tax on income earned abroad.

The shift towards lower corporate tax rates abroad means that the United States can expect to see reduced inflows of foreign capital and investment because the United States will be a less attractive place to invest, innovate and grow.

The Changing Place of the Unites States in the World Economy

The U.S. system of taxing international income dates to the 1960s when the United States dominated the world economy. The U.S. was the source of half of all multinational investment worldwide, produced 40 percent of the world's output, and was the world's largest capital exporter. From this vantage point, a tax system that was viewed as neutral with respect to the location of foreign investment by taxing all income and taxing it all at the same rate has some appeal. This system, however, is based on the notion that investment abroad is a substitute for domestic investment. It also assumes that world markets are perfectly competitive, with no brand-name loyalty, economies of scale, or other sources of extraordinary profits.

The place of the U.S. in the world economy, however, has shifted. The United States is now the world's largest importer of

[15] This disincentive could be eliminated by moving the U.S. tax system in either direction – towards a territorial system or a worldwide system.

capital and no longer dominates foreign markets. Moreover, it is now recognized that most multinational corporations produce differentiated products and compete in industries characterized by economies of scale, thereby undermining the idea of perfect competition in world markets. Companies can choose where to locate, and, under the worldwide system, unless the domestic tax rate is the same in all countries in which a company operates, the decision to locate the company's headquarters in one country or another will be affected by the countries' tax systems.

Although the worldwide approach was once dominant, roughly two-thirds of OECD nations now use a predominantly territorial system.[16] Japan recently switched from a worldwide to a territorial system and the United Kingdom is poised to make a similar change.[17] This means that the United States remains the only large economy with both a worldwide system and a corporate tax rate exceeding 30 percent.

V. Role of Tax Competition

Tax competition has undoubtedly played an important role in the changing landscape of corporate tax systems abroad — both the downward trend in corporate tax rates and the trend toward territorial tax systems. As capital has become more mobile, differences in corporate tax systems have become more important for attracting investment. Some countries have positioned themselves to take advantage of the increasing international mobility of capital.

A recent study finds that from 1982 to 1999 countries with low tax rates grew 2.5 times faster — 3.3 percent annually compared to 1.4 percent for the world economy.[18]

Features of a country's tax system can also affect a country's tax base, and the benefit of shifting income from high-tax to low-tax countries rises with the difference in tax rates.[19] Investments in high-tax countries, for example, might be debt financed with the funds coming from low-tax countries. In this case, interest payments reduce the taxable income in the high-tax country while producing taxable income in the low-tax rate countries. Multinational corporations can also structure a variety of transactions, such as royalties and dividend repatriations, to increase their tax efficiency.

The shift towards lower corporate tax rates abroad means that the United States can expect to see reduced inflows of foreign capital and investment because the United States will be a less attractive place to invest, innovate and grow. U.S. firms will face a higher cost of capital than foreign firms, making it more difficult to compete in foreign markets.

A recent study by Brill and Hassett (2007) considers the relationship between countries' corporate tax rates and their tax bases—that is, the effect of relocating firms and the shifting of investment, income and deductions, across international boundaries

[16] President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System*, Washington, DC: U.S. Government Printing Office, November 2005.

[17] Ernst & Young LLP.

[18] James R. Hines, "Do Tax Havens Flourish?" Tax Policy and the Economy, Vol. 19 (Cambridge, MA: MIT Press, 2005), p. 66.

[19] This discussion draws from Dhammika and Hines, Op. Cit., pp. 3-4.

[20] Alex Brill and Kevin Hassett, "Revenue Maximizing Corporate Income Taxes: The Laffer Curve in OECD Countries," American Enterprise Institute, Working Paper #137, July 31, 2007.

on countries' tax bases.[20] Estimating the relationship between corporate tax rates and corporate tax receipts over the past several decades, this study finds that the revenue-maximizing tax rate among OECD nations is about 26 percent, falling from 34 percent in the mid-1980s. Based on these results, a reduction in the average OECD rate to 26 percent should be expected to increase the size of countries' tax bases to such an extent that revenues would increase.

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There is also increasing evidence that corporate tax systems affect workers' real wages and the living standards of countries. The intuition behind this finding is that taxes tend to be borne by the least mobile factor of production (e.g., labor or capital). In the global economy, capital is highly mobile while labor is not. High corporate tax rates reduce capital accumulation, which lowers labor productivity and, ultimately, real wages and living standards.

According to a study by the Congressional Budget Office, in an open economy framework as much as 70 percent of the corporate tax may be borne by labor.[21] Another empirical study suggests that between 45 percent and 75 percent of the corporate tax is likely borne by labor.[22] Other studies show that those countries that have reduced corporate tax rates the most have tended to have the largest gains in real wages.[23] Thus, a substantial share of business taxes tends to be reflected in real wages rather than in the return to capital.

The British have seen a significant number of prominent firms leave the country for more friendly tax environments. Yahoo and Kraft Foods have relocated their European headquarters to Switzerland. Ireland was the destination for prominent UK firms such as Henderson Group Global Investors, Shire Pharmaceuticals, United Business Media, the engineering group Charter, and the office space provider Regus. Lloyd's of London is headed to the Netherlands. ... This migration is more than just changing the postal address of the headquarters; it involves the relocation of employment, investment and income.

The shift towards lower corporate tax rates abroad means that the United States can expect to see reduced inflows of foreign capital and investment because the United States will be a less attractive place to invest, innovate and grow. U.S. firms will face a higher cost of capital than foreign firms, making it more difficult to compete in foreign markets. In a world of greater economic integration and increased trade and capital flows, a firm's decision about where to locate and expand its

[21] William Randolph, "International Burdens of the Corporate Income Tax," Congressional Budget Office Working Paper Series, 2006–09, August 2006.

[22] Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., "Labor and Capital Shares of the Corporate Tax Burden: International Evidence," International Tax Policy Forum, December 2007.

[23] Wiji Arulampalam, Michael P. Devereux, and Giorgia Maffin, "The Incidence of Corporate Income Taxes on Wages," mimeograph, University of Warwick, September 2007; Kevin Hassett and Aparna Mathur, "Taxes and Wages," American Enterprise Institute for Public Policy Research, Working Paper Number 123, June 2006; Alison Felix, "Passing the Burden: Corporate Tax Incidence in Open Economies," Ph.D. dissertation, University of Michigan, 2007, ch. 1.

operations will be increasingly influenced by factors such as a country's corporate tax rate and overall investment climate.

This is important because a smaller capital stock in the U.S. would mean the American workforce has less capital to work with. Rather than integrating the latest technologies into production processes, workers would be more reliant on older technologies. Innovation would be integrated less quickly because of the higher taxes on investment. All of this would translate into a less productive workforce that earns lower real wages and living standards that rise more slowly.

As this linkage between the corporate tax and real wages (and living standards) becomes more widely understood in the United States, it can be expected that support for reducing the corporate tax rate will continue to grow. Another important consideration is whether the United States' other advantages outweigh the damage caused by the tax system. In the past, U.S. levels of education and training provided distinct advantages to the United States. As emerging countries begin to approach U.S. levels of education and training, other imbalances, such as a business tax system that is out of line with other nations, become more important.

VI. Great Britain: A Case Study

As discussed above, differences in tax rates can have a significant effect on the location of income and investment, and by extension, a country's tax base. Consider, for example, the recent experience of Great Britain. Great Britain has made efforts to keep up with other countries, allowing its corporate tax rate to gradually fall from 40 percent in the mid-1980s to 28 percent, where it stands today. In the last decade alone, the rate was lowered three times, from 33 percent to 31 in 1997, then to 30 percent in 1999, and finally to 28 percent in 2007 (which is roughly equal to the weighted average tax rate for EU member nations of 28.8 percent).

Just as the U.K. is adapting to competitive pressures from abroad by reducing its corporate tax rate and making more generous the tax treatment of British foreign subsidiaries' profits, so the U.S. will realize that its multinationals will be better able to compete at home and abroad with similar changes.

Despite these changes, the British have seen a significant number of prominent firms leave the country for more friendly tax environments. In just the past year alone, Yahoo and Kraft Foods have both relocated their European headquarters to Switzerland. Ireland was the destination of choice for prominent UK firms such as Henderson Group Global Investors, Shire Pharmaceuticals and United Business Media, the engineering group Charter, and the office space provider Regus. More recently, Lloyd's of London, the well-known insurer, announced the relocation of its headquarters to the Netherlands[24] while the British publishing firm Informa announced that it will soon move its tax residence to Switzerland.

The common factor driving these firms to relocate their headquarters is the combination of the relatively high British rate and the way Great Britain taxes profits earned abroad. Similar to the U.S. approach, Great Britain has taxed British multinational corporations on a worldwide basis, although a shift towards territorial taxation was announced

[24] There has also been an exodus of hedge funds from Great Britain to Switzerland to benefit from lower tax rates on fund managers. For example, one hedge fund, Krom River, reportedly is relocating to Switzerland so that fund managers pay tax at 10 percent rather than the 40 percent top rate in Great Britain.

several weeks ago. For Great Britain, it had been the combination of the large differential between their 28 percent corporate tax rate, the low tax rate among some of their competitor nations, and their worldwide system that made it difficult for British firms to compete globally. The exiting firms have tended to have substantial international operations and have indicated that they can better develop and expand international operations from countries with lower tax rates. To be clear, this migration is more than just changing the postal address of the headquarters; it involves the relocation of employment, investment and income.

The global trend towards lower tax rates has created a period of tax competition abroad as countries attempt to improve their economic performance, expand their tax bases, and increase their living standards. Unfortunately, the United States has largely been a bystander and is only recently beginning to face the change in its relative position in the world economy.

Why have some firms relocated to lower-tax countries such as Ireland, the Netherlands and Switzerland? Consider, for example, a foreign subsidiary of a British multinational corporation competing with a German corporation in Poland where the corporate tax rate is 19 percent. The earnings of the British foreign subsidiary are currently subject to the British 28 percent tax rate (less a credit for Polish taxes paid) on all earnings in Poland, while the German subsidiary, which enjoys a German territorial regime, pays only the 19 percent Polish tax rate. It is easy to see why the British firm might be disadvantaged: It faces a tax rate that is potentially 9 percentage points higher than its competitors operating under a territorial regime.

What happens if the British firm relocates to Ireland? Now, the subsidiary of the new Irish multinational corporation pays the same tax rate as the subsidiary of the German multinational: only the Polish corporate tax. The competitive disadvantage is eliminated by the relocation. The same holds true for firms relocating to other lower-tax countries.

Great Britain's latest response has been to reconsider its system of taxing foreign income on a worldwide basis. The recently announced government budget includes a dividend exemption for profits paid back to British multinational corporations from their foreign subsidiaries. Thus, Great Britain appears to be the latest country to move towards territorial taxation of foreign source income.

The British experience may well foreshadow changes in the United States. Just as the U.K. is adapting to competitive pressures from abroad by reducing its corporate tax rate and making more generous the tax treatment of British foreign subsidiaries' profits, so the U.S. will realize that its multinationals will be better able to compete at home and abroad with similar changes.

VII. Conclusion

The recent attention to bank secrecy, tax havens and international tax rules has joined together a set of somewhat unrelated issues and confused the policy debate on international tax reform and how best to make the U.S. more competitive. Bank secrecy is primarily concerned with the information exchange between nations to ensure that offshore income is properly reported to tax authorities. While strict secrecy is one aspect of tax havens, there is a broader set of harmful tax practices that must be present to label a nation as a tax haven.

Similarly, the mere presence of a comparatively low tax rate does not define a nation as a tax haven. The global trend towards lower tax rates has created a period of tax competition abroad as countries attempt to improve their economic performance, expand their tax bases, and increase their living standards. Unfortunately, the United States has largely been a bystander and is only recently beginning to face the change in its relative position in the world economy.

The Obama Administration appears set to advance major changes in international tax policy, but these policies seem misdirected. They are intended to raise substantial revenue from U.S. multinational corporations and address the perception that current rules encourage U.S. multinational corporations to ship jobs overseas. But it might be wise for the Administration to proceed carefully, lest the "law of unintended consequences" apply.

The Obama Administration appears set to advance major changes in international tax policy, but these policies seem misdirected. They are intended to raise substantial revenue from U.S. multinational corporations and address the perception that current rules encourage U.S. multinational corporations to ship jobs overseas. But it might be wise for the Administration to proceed carefully, lest the "law of unintended consequences" apply. Limiting or repealing deferral alone, without dramatic reductions in the corporate tax rate, will likely make U.S. multinational corporations less able to compete on a global basis.

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