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The Tempting of Switzerland:

Financial Confidentiality and Capital Formation

Switzerland is faced with a choice between the tradition of bank secrecy and cooperation with EU tax authorities' demands for transparency. Today I will explore the implications of this choice for capital markets. There is a strong link between financial privacy and capital formation in Switzerland and the world economy as a whole.

The title of my talk is "The Tempting of Switzerland." In your mind's eye, picture Switzerland as a lovely Alpine maiden. Now, envision Chancellor Gordon Brown or another EU member representative of your choice. He urges Switzerland to unlace her stays, so that he may take a peek at the distribution of her assets. He promises that he will only look; he only seeks a little transparency, a little information. What will happen if she agrees?

My concern is that the maiden, like so many maidens before her, will soon be a maiden no longer. I propose a thought experiment; what would the likely outcome be if Switzerland agrees to demands for transparency? What demands would follow? What would the long-term impact be for capital markets? I conclude that bank secrecy laws are an essential component of Switzerland's role in capital formation, as with any financial center. Erosion of banking secrecy to satisfy tax authorities will not simply redistribute wealth to different geographic areas; it will result in the formation of less total wealth.

The Nature of Temptation.

In my example of the maiden above, there are dual temptations. One is that offered by the gentleman. The other is that offered by the maiden herself, by her assets, as it were. Switzerland stands in the same relation to other EU countries such as France and Germany.

I will begin my thought experiment by looking at Switzerland from the perspective of one of her more ardent pursuers, that is, France. France has made a political commitment to extensive government spending. Particularly in the area of social security, its liabilities exceed income. Not surprisingly, France has high taxes, with a tax burden of about 45.5 percent of GDP (including a top personal income tax rate of 54 percent and a value-added tax of about 19 percent).[1] Like

[1]Veronique de Rugy, "European Union Tax Cartel is Bad for U.S. Economy," *Cato Institute Daily*, January 10, 2002, *available at* http://www.cato.org/cgi-bin/scripts/printech.cgi/dailys/01-10-02.html.

other high-tax countries such as Sweden and Germany, France faces a significant problem of tax evasion—according to the International Monetary Fund, about 17 percent of GDP.[2] And capital tends to flow out of such situations. Frances's General Directorate of Taxation estimates that in 2000 the loss of earnings to capital flight was 40 billion. In 2001 85.8 billion dollars in capital left Europe.[3]

Switzerland, a near neighbor and a low-tax nation, has an entirely different balance of accounts. Four European countries with low taxes—Ireland, the Netherlands, Luxembourg, and Switzerland, account for 9 percent of European GDP, but attracted 38 percent of foreign direct investment from the United States between 1996 and 2000.[4] From the perspective of the French, German, and Swedish governments, Switzerland's assets are an extreme temptation. And so, they ask for transparency, and tempt Switzerland in turn. OECD economists have stated they do not require total abandonment of bank secrecy, only the release of information to tax authorities. Indeed, some OECD reports insist that they are not against tax competition, and admit it is beneficial; they target only "harmful" tax competition.[5]

In the face of these arguments, Switzerland and other financial centers—including the United States—might be tempted to believe that they can give up some bank secrecy and remain thriving financial centers. After all, the OECD is not asking for total abandonment of confidentiality. And there are non-tax reasons that investors value discrete bankers. They may wish to conceal their assets from rival entrepreneurs, from greedy family members or criminals. In many South American countries, one must be concerned with extortionists or kidnappers. One might choose to invest in Switzerland, or Luxemborg, or Antigua—to take advantage of those countries' highly educated populations with substantial expertise in financial matters. Switzerland may perhaps please the EU nations and give up some bank secrecy without abandoning its vital role in capital formation.

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[2]Veronique de Rugy, "The Laetitia Casta Model (for Tax Revolts)," reprinted from *The Wall Street Journal Europe*, October 22, 2002, *available at* http://www.cato.org/cgi-bin/scripts/printtech.cgi/research/articles/derugy-011112a.html; *see also* Veronique de Rugy, "The Power of Taxpayers' Exit," *printed in Tax Competition: An Opportunity for Iceland* 50 (edited by Hannes H. Gissurarson and Tryggi Thor Herbertsson, Rekjavik 2001: The University of Iceland Press) (evasion is 27 percent in Italy; 25 percent in Denmark; 17 percent in Germany; 20 percent in Sweden; on 13 percent in Ireland).

[3]*de Rugy*, "The Power of Taxpayer's Exit," at 53.

[4] Martin Sullivan, "Data Show Europe's Tax Havens Soak Up U.S. Capital," *Tax Notes*, February 4, 2002.

[5] *See, e.g.* Paul van den Noord and Christopher Heady, "Surveillance of Tax Policies: A Synthesis of Findings in Economic Surveys," OECD Economics Department Working Papers, No. 303, p. 21 ("tax competition can be beneficial, both by restricting tendencies towards excessive government spending and by providing individuals with a choice between locations according to their desired level of public provision. However, this reasoning does not hold for tax competition that is non-transparent or discriminatory, or where it facilitates illegal tax abuses that enable companies or individuals to reduce their tax liability without actually moving their residence away from a jurisdiction with high public provision. In many cases, tax havens do not attract much real activity; they simply provide a place to shelter the proceeds of real activity that takes place elsewhere.")

A Thought Experiment: Likely Results of "Transparency."

Suppose that Switzerland were to give in and share with French tax authorities the information they require. France will perhaps catch some more tax evaders. But how much more tax revenue would they capture? Assume that a large number of French citizens holding assets in Switzerland are tax evaders—a questionable assumption to begin with. Suppose those assets are assessed for taxation in France. How much capital would remain in France as a result? Not much. There are ways for those reluctant to pay taxes not to pay them other than sending their money abroad.

Most of these are familiar to you all—and to citizens of high-tax countries. Here are some alternate fates for that capital:

- The domestic underground economy, which stands at about one quarter to one third of GDP in Europe's welfare states.

- The pockets of emigrants leaving for other destinations (25,000 people leave France every year for tax reasons; there are 250,000 French now living in London. There could be more).[6]

- Magically disappearing, as if it had never existed at all, because taxation discourages the deployment of human capital (accountants become artists; potential entrepreneurs spend 20 years in graduate school).

- Other forms of tax evasion.

- Legal tax avoidance and structuring.

As long as France, Sweden, Germany, and other EU countries remain high-tax nations, they will fail to accumulate capital. Any concessions Switzerland makes towards transparency will be of little or no use to them. It is not that tax evasion is a good thing. It is not. But some approaches to addressing it transgress on the sovereignty of other nations—for nothing.

Yet a diminution of financial privacy in Switzerland would be of consequence for capital markets. Putting a stop to capital flight might not yield more tax revenues… but it would mean less available capital for the world economy as a whole. Capital flight is a misnomer. A better term is "capital formation." *What goes on in the capital markets of Switzerland, the United States, Luxemborg, Antigua, and so on is not merely the passive reception of capital. It is the creation of capital.* Low-tax environments create the incentives in which wealth is born. And not just crude monetary wealth—it affects the deployment of

[6] *de Rugy*, "The Power of Taxpayers Exit," at 54; Jack Anderson, "A Misery Index," *Forbes*, February 21, 2001.

human capital and knowledge as well. Every time a Swedish doctor stays home to paint his own house rather than hiring a painter to do it, there is a loss of what his human capital could have contributed to the world economy.

A prediction: Suppose Switzerland concedes the information the tax authorities of high-tax EU nations want. Those nations would see no increase in tax revenues as a result. More of their citizens would emigrate and permanently give up their citizenship. Companies would continue to be formed abroad. Evasion would continue to rise as a domestic problem. And the world as a whole would be poorer. Wealth would be destroyed.

At this point high-tax nations would have an option. They might declare themselves satisfied. They might engage in tax reform, addressing domestic deterrents to capital formation and spurs to tax evasion. They might reduce taxes, as tax evasion is lowest in lower tax nations like Switzerland, New Zealand, and the U.K.[7] Or, they might demand more concessions from Switzerland. Which course are they likely to take? I conclude that their likely course will be to demand more and more concessions from Switzerland and other low-tax countries, such as Luxemborg and the United States. Let me lay the ground work for this conclusion.

The Future of Tax Demand.

In 1857 Lord Thomas MacCauley wrote:

A democracy cannot survive as a permanent form of government. It can last only until its citizens discover that they can vote themselves largesse from the public treasury. From that moment on, the majority (who vote) will vote for those candidates promising the greatest benefits from the public purse, with the result that a democracy will always collapse from loose fiscal policies, always followed by a dictatorship.

This is a gloomy outlook. Unfortunately, it is supported by public choice economics. Public choice economics is the study of governmental agencies as economic actors. It suggests that state's appetite for tax dollars will tend to be insatiable.

An empirical survey of trends in taxation confirms that taxes will be reduced only when forced down by extraneous forces, and only with great difficulty. Since 1965, taxes have soared upward, though there are signs the upward trend is slowing. Reagan's and Thatcher's tax cuts in the 1980's forced taxes in some other nations down (the top average personal income tax rate in major industrial OECD countries has fallen 20 percent since 1980, and average

[7] *den Noord & Heady*, at 38, 47 (noting that tax compliance is high in Switzerland despite bank secrecy).

top corporate rates are down about 6 percent).[8] But where corporate taxes, income taxes or capital gains taxes are reduced, other taxes may well rise; total tax burdens are still rising.[9] Social security taxes are expected to ramp up in the future. And there have been few if any cuts in government spending. France, Germany, and Sweden made only tiny reductions in their tax burden and remained high-tax nations overall. Even in Switzerland, where federalism disciplines tax rates, there has been some deficit spending[10] and this is expected to increase due to increasing health care liabilities. In the United States, the most recent tax cuts have been miniscule, and there have been no spending cuts.

Public choice describes the phenomena of rent-seeking, the relentless pursuit of government largesse by small groups at the expense of taxpayers as a whole. These small groups are sometimes called "special interests," but there is really little special about them. Almost everybody falls into one group or another at some time in their life. To paraphrase American commentator Jonathan Rausch, "we have seen the face of special interests, and it is us." To put the economic problem another way, the existence of a pool of tax monies creates a tragedy of the commons—a pool of resources that is wasted, never conserved, because those who take from it do not pay the full cost of their use of the resource. This is what Nobel Prize-winning economist James Buchanan was getting at when he once replied scornfully to the assertion that government existed to solve "public goods" problems, "Government *is* a public goods problem."

In other words, one powerful real-world tendency is for taxes and spending to rise; everyone under the sun wants their particular problem to be declared a "public goods" problem so that someone else will pay for it. The theory that harmful tax competition will produce a race to the bottom with public goods insufficiently funded is unlikely. There is no sign of this empirically. Tax competition may tend to pressure taxes downward, but not quite enough to counteract the relentless dissipation of democracy in most countries. Only countries that have little choice but to reduce taxes to improve their desperately poor economic standing —such as Ireland or New Zealand, and most recently Iceland—manage to do so (and these are tiny countries where rent-seeking is easier to detect and harder to get away with). In the U.K., long a low-tax country, taxes are rising as well.

And there is no evidence that low taxes mean insufficient public goods. Switzerland is an excellent case study. Switzerland has bank secrecy, and low taxes as a result of competition between her cantons. Is Switzerland lacking in public goods? Hardly. For example, she spends 1.5 percent of GDP on defense,

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[8] Chris Edwards and Veronique de Rugy, "International Tax Competition: A 21st Century Restraint on Government," *Cato Institute Policy Analysis* No. 431, April 21, 2002; OECD, "Tax Rates Are Falling," *OECD in Washington*, March-April 2001.

[9] *See generally, Edwards and de Rugy; den Noord and Heady.*

[10] Victoria Curzon-Price, "How to Become a Rich Country: Lesson From Switzerland*," printed in Tax Competition*, at 11.

more than the 1.4 percent spent in Germany.[11] And higher taxes do not mean more revenues to spend; in 1997, Switzerland raised the same amount of tax money per capita as Sweden, even though the Swedish tax rate, at 61.5 percent, is double that of Switzerland.[12] And reducing tax rates in Ireland changed the government's deficit, at 15 percent of GDP in 1980, to a surplus by 1998.[13]

The larger point is, however, that relentless, powerful institutional forces tend to drive government to spend and tax more and more. In recent years, even the disciplined Swiss government has ventured into deficit spending.[14] Spending has started to creep up in Ireland as well. This means that any concessions that Switzerland makes towards ending bank secrecy to benefit tax authorities will not be nearly enough to satisfy the hungry high-tax states in the end. What would happen?

High tax nations within the EU are likely to move towards extraterritorial taxation and demand increasing tax harmonization. A look at currect OECD member nation's positions on tax matters strongly supports this.

- One OECD paper on tax devotes page after page to discussions of tax reform—but there is scarcely any mention of tax reductions.[15]

- Legislation has been proposed in the United States to treat *legal* structuring of a corporate transaction to reduce its tax consequences like tax evasion—tax avoidance is equated with tax evasion.

- There is strong support within the EU for tax harmonization, beginning with the harmonization of the VAT.

- The United States already taxes U.S. citizens living abroad on income earned abroad. With extra-territorial taxation, the end of bank secrecy becomes the functional equivalent of tax harmonization.

Tax avoidance almost certainly plays a much greater role in capital flight than tax evasion. High-tax nations have every incentive to blur the distinction between the two. Should Switzerland end its tradition of bank secrecy with respect to tax authorities, there would no longer be any practical obstacle to wider adoption of extraterritorial taxation. That means that a loss of financial privacy weakens the forces of tax competition between nations. A loss of financial

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[11] Ibid at 16.
[12] Ibid at 11.
[13] Turlough O'Sullivan, "Partnership for Prosperity: Lesson from Ireland," *printed in Tax Competition*, p. 21.
[14] Curzon-Price, at 169.
[15] See den Noord and Heady.

privacy plus extraterritorial taxation becomes the functional equivalent of tax harmonization.

Capital Markets In a Transparent, Harmonization World.

This would undoubtably mean a diminution of Switzerland's role as a financial center. But perhaps this would be a better outlook for capital markets as a whole. After all, the OECD has said harmonized taxes would be more neutral.[16] Surely from an economic perspective we would like investment decisions to be made on the basis of comparative advantage—the distribution of resources, not artificial tax incentives. Perhaps Switzerland would come out better off. Capital markets the world over would be less distorted;[17] Swiss entrepreneurs would benefit along with everyone else. This is a tempting argument.

However, the argument is wrong. The view that harmonized taxes are more neutral relies on wholly unrealistic assumptions about taxation. In reality, no tax is neutral—it moves wealth out of the efficient private sector and into the public sector. In the public sector, no new wealth is created, it can only be redistributed through rent-seeking. And much can be destroyed. In the United States, economist Bill Niskanen estimates that for every dollar of government spending, $2.43 must be collected in taxes. Another reality is this: As German economist Roland Vaubel has said, "for Europe, harmonized taxes are higher taxes."[18] Tax harmonization creates a cartel that reduces or eliminates tax competition.

There is some content to the neutrality argument. Sectoral taxes, complicated taxes, and tax arbitrate do cause distortions. Flatter, broader taxes are better, yes. But this is nothing compared to the level of distortion that is produced by taxes that are just plain too high. Yes, investment decisions between nations should be driven by comparative advantage. But the institutions of a country are a part of the reality there. Tax policies are a feature of the world and should compete just as different deposits of resources do—particularly because there is barely any force other than competition constraining them. Bank secrecy is a part of Switzerland's comparative advantage. Long may it remain so.

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[16] See, e.g. Pelgrin, Schick and Serres, p. 25 ("the failures of some countries to exchange information with the companies' country of residence can help to conceal outright tax evasion. Second, the enterprises can obtain the advantages of tax deferral by keeping their profits in a zero or low-tax regine rather than bringing it to the standard regime of their country of residence…. In addition to causing revenue losses, these practices distort investment choices between countries, notably countries that may be considered as "close substitutes" from the point of view of multinational companies.")

[17] See Pelgrin, Schick and Serres, p. 21-25 (discussing how mobility of tax bases internationally causes misallocations of capital), p. 25.

[18] Roger Bate, Iceland.

Conclusion

Tax evasion is not a good thing. But there are economically sound ways to address the problem of tax evasion. For one nation to foist the costs and moral consequences of its high tax regime onto another is not one of them. Concessions on bank secrecy will not end the problem of evasion, but will cost Switzerland a measure of investor's trust. And there is more to come. For high-tax EU nations, there is little difference between the impact of tax evasion and legal tax avoidance—in the long run, their polices regarding those are unlikely to differ. They will come after any and all capital that they perceive to be flowing to Switzerland, the United States, Ireland, and other low-tax nations.

Switzerland has stood firm before in the face of tremendous pressure. Bank secrecy has made individuals rich, but it need not be defended on egoistic grounds. It has made Switzerland rich, but it need not be defended on nationalist grounds. It has made the world richer by fostering the formation of capital that has lead to more jobs, more inventions, more tools for humanity to raise standards of living around the world.

> Transparency in banking is likely to lead to dissipation of wealth, just as transparency in a maiden's garments is likely to lead to a dissipation of morals. It is not wise in either case to underestimate the force of the appetites involved.