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Tax Havens

by

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ABSTRACT

Tax havens are low-tax jurisdictions that offer businesses and individuals opportunities for tax avoidance. The 45 major tax haven countries in the world today are small, affluent, and generally well governed. They attract disproportionate shares of world foreign direct investment, and, largely as a consequence, their economies have grown much more rapidly than the world as a whole over the past 25 years. The effect of tax havens on economic welfare in high tax countries is unclear, though the availability of tax havens appears to stimulate economic activity in nearby high-tax countries.

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1. *Introduction*

Tax havens are low-tax jurisdictions that offer businesses and individuals opportunities for tax avoidance.

There are roughly 45 major tax havens in the world today. Examples include Andorra, Ireland, Luxembourg and Monaco in Europe, Hong Kong and Singapore in Asia, and the Cayman Islands, the Netherlands Antilles, and Panama in the Americas. These tax havens are generally small and affluent, in total comprising just 0.8 percent of world population, though accounting for 2.3 percent of world income (Hines, 2005). Low-tax jurisdictions are also common within countries, at various times taking the form of special economic zones in China, offshore possessions and local enterprise zones in the United States, and tax-favored regions including eastern Germany, southern Italy, eastern Canada, and others. Tax havens are widely used by international investors; in 1999, 59 percent of U.S. multinational firms with significant foreign operations had affiliates in one or more tax havens (Desai, Foley and Hines, 2006b).

2. *Tax haven experiences*

Countries offer low tax rates in the belief that, by doing so, they attract greater investment and economic activity than would otherwise have been forthcoming. Countries with low tax rates permit investors to retain most of their locally-earned pretax income; other considerations equal, therefore, countries with lower tax rates should be expected to offer a broader range of attractive opportunities, and therefore draw larger volumes of foreign investment, than countries with higher tax rates.

Adding to the attractiveness of tax haven investments is the possibility of using tax havens to facilitate avoidance of taxes that would otherwise be owed to governments of other countries. For individuals, who are taxed by their home governments on income earned in tax havens, tax avoidance typically entails willful income misreporting. For businesses, tax avoidance can be accomplished by the use of financial arrangements, such as intrafirm lending, that locate taxable income in low-tax jurisdictions and tax deductions in high-tax jurisdictions. In addition, firms are often able to adjust the prices at which affiliates located in different countries sell goods and services to each other. Most governments require that firms use arm's length prices, those that would be used by unrelated parties transacting at arm's length, for transactions between related parties, in principle thereby limiting the scope of tax-motivated transfer price adjustments. In practice, however, the indeterminacy of appropriate arm's length prices for many goods and services, particularly those that are intangible, or for which comparable unrelated transactions are difficult to find, leaves room for considerable discretion. As a result, transactions with tax haven affiliates can be used to reallocate income from high-tax locations to the tax haven affiliates themselves or else to other low-tax foreign locations. This, in turn, increases the appeal of locating investment in foreign tax havens.

As a result of these incentives, American firms exhibit unusual activity levels and income production in foreign tax havens (Hines, 2005). Of the property, plant and equipment held abroad by American firms in 1999, 8.4 percent was located in tax havens, considerably more than would be predicted strictly on the basis of the sizes of their economies. Employment abroad by American firms was likewise unusually concentrated in foreign tax havens, with 6.1 of total foreign employee compensation, and 5.7 percent of total foreign employment, located in tax haven affiliates. American firms located 15.7 percent of their gross foreign assets in the major tax havens in 1999; the major foreign tax havens accounted for 13.4 percent of their total foreign sales, and a staggering 30 percent of total foreign income in 1999. Much of reported tax haven income consists of financial flows from other foreign affiliates that parent companies owned indirectly through their tax haven affiliates.

Tax haven countries have enjoyed very rapid economic growth rates that coincide with dramatic inflows of foreign investment. Tax havens averaged 3.3 percent annual per capita real GDP growth from 1982-1999, whereas the world averaged just 1.4 percent annual real per capita GDP growth over the same period. Controlling for country size, initial wealth, and other observable variables, does not change the conclusion that the period of globalization has been favorable for the economies of countries with very low tax rates (Hines, 2005).

The policy of offering foreigners very low tax rates is potentially costly to tax haven governments, if doing so reduces tax collections that might otherwise have been used to fund worthwhile government expenditures. It is far from clear, however, that tax haven countries face significant tradeoffs of this nature. Governments have at their disposal many tax instruments, including personal income taxes, property taxes, consumption or sales taxes, excise taxes, and others, that can be used to finance expenditures. Furthermore, even very low rates of direct taxation of business investment may yield significant tax revenues if economic activity expands in response. In fact, the public sectors of tax haven countries are of comparable sizes to those of other countries, though there is evidence that they may be somewhat smaller than would otherwise have been predicted on the basis of their populations and affluence (Hines, 2005).

3. Characteristics of tax havens

Tax havens are small countries, commonly below one million in population, and are generally more affluent than other countries. In addition, tax havens score very well on cross-country measures of governance quality that include measures of voice and accountability, political stability, government effectiveness, rule of law, and control of corruption. Indeed, there are almost no poorly governed tax havens. Poorly governed countries, of which the world has many, almost never become tax havens (Dharmapala and Hines, 2006).

An important reason why better-governed countries are more likely than others to become tax havens is that the potential returns are greater: higher foreign investment flows, and the economic benefits that accompany them, are more likely to accompany tax reductions in well-governed countries than they are tax reductions in poorly-governed countries. Evidence from the behavior of American firms is consistent with this explanation, in that tax rate differences among well-governed countries are associated with much larger effects on U.S. investment levels than are tax rate differences among poorly governed countries (Dharmapala and Hines, 2006).

4. Impact on other countries

Tax havens are viewed with alarm in parts of the high-tax world, where there are concerns that the availability of foreign tax haven locations may divert economic activity from countries with higher tax rates, and erode their tax bases. Alternatively, tax havens could encourage investment in other countries, if the ability to relocate taxable income into tax havens improves the desirability of investing in high-tax locations, or if low tax rates reduce the cost of goods and services that are inputs to production or sales in high-tax countries. In fact, the evidence indicates that foreign tax haven activity appears to stimulate activity in nearby high-tax countries, a one percent greater likelihood of establishing a tax haven affiliate being associated with two thirds of a percent greater investment and sales in nearby non-haven countries (Desai, Foley, and Hines, 2006a).

The empirical regularity that tax havens stimulate economic activity in high-tax countries does not resolve the impact of tax havens on the welfare of high-tax countries. Tax avoidance carries mixed implications for governments of nearby countries, since it may erode tax bases and therefore tax collections, implying that the greater economic activity associated with nearby tax havens might come at a high cost in terms of foregone government revenues. One possibility is that countries would prefer to subject mobile international companies to lower tax rates than they do other firms, but are prevented from doing so by political considerations or the practical difficulty of distinguishing multinational from domestic firms. In such a setting, countries might benefit from permitting multinational firms to obtain tax reductions by using affiliates in tax havens, thereby implicitly subjecting these mobile firms to lower tax burdens than other taxpayers.

In 1998, the Organization for Economic Cooperation and Development (OECD) introduced its Harmful Tax Practices initiative, the purpose of which was to discourage OECD member countries and certain tax havens from pursuing policies that were thought to harm other countries by unfairly eroding tax bases. As part of this initiative, the OECD produced a List of Un-Cooperative Tax Havens, identifying countries that have not committed to sufficient exchange of information with tax authorities in other countries. The concern was that the absence of information exchange might impede the ability of OECD and other countries to tax their resident individuals and corporations on income or assets hidden in foreign tax havens. As a result of the OECD initiative, along with diplomatic and other actions of individual nations, many countries and jurisdictions outside the OECD have committed to improve the transparency of their tax systems and to facilitate information exchange. While there remain a few tax havens that have not made such commitments, the vast majority of the world's tax havens rely on low tax rates and other favorable tax provisions to attract investment, rather than using the prospect of local transactions that will not be reported.

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