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Tax Havens, Tax Competition and Economic Performance

Low-tax jurisdictions play a valuable role in the global economy. Economic research indicates that so-called tax havens provide a tax-efficient platform for cross-border investments, help boost saving and investment, and thus increase global economic growth. Tax havens also encourage good policy in non-haven countries. In part because of jurisdictional competition, maximum tax rates on personal income have fallen by about 23 percentage points since 1980 and top tax rates on corporate income have fallen by almost 20 percentage points. These policies have boosted growth and job creation.

The United States is the world's largest beneficiary of tax havens and tax competition, both because the U.S. is a tax haven for foreigners and because tax havens facilitate the flow of capital to the American economy. Foreigners have more than \$11 trillion invested in the U.S. economy, including more than \$7 trillion invested in America's financial markets. Nearly \$1.3 trillion is placed in the U.S. financial system by Caribbean institutions. This money helps finance America's economic growth.

By Yesim Yilmaz

What are tax havens?

Tax havens are countries with very low tax rates set—sometimes as a matter of long-standing policy and sometimes as a recent and deliberate strategy to draw out-of-jurisdiction investment. This definition is imprecise, but for a good reason:¹ many additional characteristics including the nature of corporate registrations, requirements on beneficial ownership information, rules governing trusts, and the financial privacy companies and individuals enjoy could qualify a jurisdiction as a tax haven. In British Virgin Islands, Delaware, and Panama, one can incorporate a company within a few hours with little information about ownership and nature of work. Switzerland, Singapore and Cayman Islands are among countries that generally do not disclose information on personal financial transactions.²

¹ Any country or region could potentially qualify as a tax haven; therefore, the lists of tax havens vary greatly from one publication to the next. The IMF [IMF, 2000] for example, has a list of sixty-four offshore financial centers, including the United States; Diamond and Diamond [2002] discuss seventy-one havens in detail, and mention 20 or so more.

² Hines [2004] identifies seven large countries (Hong Kong, Ireland, Lebanon, Liberia, Panama, Singapore and Switzerland) and approximately twenty-six very small ones as tax havens important for US business purposes. These countries are in direct competition with the United States—both for investment from third parties and for investment from the United States. In 1999, these countries accounted for four-fifths of a percent of the world population, and slightly more than two percent of the world's production. During the

Interestingly, the United States qualifies as a tax haven for both the federal rules that govern foreigners' income, and the state rules on corporate taxation, registration and privacy. Compared to U.S. taxpayers, non-resident aliens pay low or no taxes on investment income—an important characteristic of tax havens according to the Organization for Economic Cooperation and Development, an obdurate opponent of tax competition. The federal government generally does not tax the investment income of a foreign corporation if the earnings are unconnected with a U.S. trade or business, and foreigners are not required to pay taxes on their investment income from U.S. businesses unless they reside within the United States [Mitchell, 2001].

Furthermore, states offer many additional tax benefits designed to attract out-of-state investments, and the federal government generally does not have the authority to override these decisions. Nevada, Texas, Wyoming, and Washington do not tax corporate income; Alaska, Delaware and Nevada do not collect beneficiary information on registered companies; in Wyoming, corporations can take advantage of nominee bank accounts that protect ownership identity; and trusts in Delaware do not have public filings or recordings, and do not generally require accounting [ITIO and STEP, 2002]. Additionally, tax rules are “negotiable” in many states, and many large out-of-state investors are able to get concessions in return for investing within the state.³

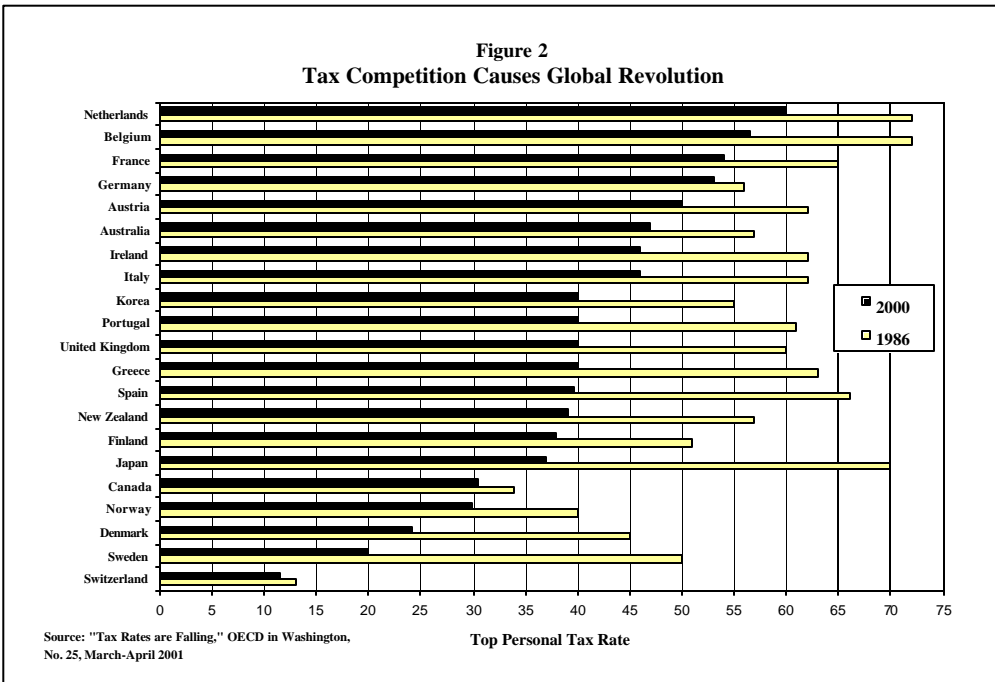
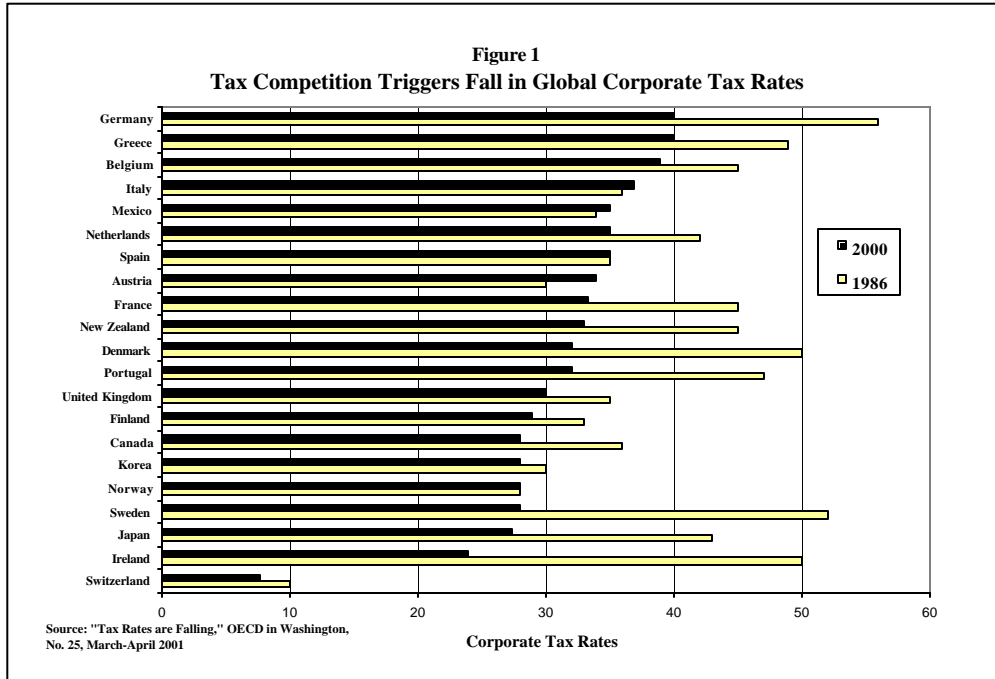
The presence of tax havens has two important implications for the world economy: First, tax havens reduce the effective marginal tax rate on capital and, as a result, create more incentives to save and invest. Because the cost of doing business in (or through) tax havens is lower, businesses operating in or through these countries can undertake investments with lower expected returns or higher risks than those in high-tax jurisdictions. With these new investment opportunities, individuals will most likely consume less (or keep a smaller share of their wealth in non-income generating assets such as homes, artwork, or commodities), and save and invest more. It is important to note that some portion of increased savings and investment represent funds that would have been paid as taxes in a high-tax jurisdiction, some of the funds are capital people reallocate from other sources in their portfolio to take advantage of investment opportunities that were not previously available, and some of the funds represent a shift from consumption and into new capital.

Second, tax havens curb the size of the public sector, and force governments to cut taxes and improve efficiency in public service delivery. By providing a “low-tax” alternative for mobile taxable resources, tax havens make it difficult for politicians of the world to divert funds from the private sector to the public sector. In fact, since the 1980s, effective corporate income tax rates across the industrialized world have fallen by nearly fifteen percentage points, and statutory tax rates have dropped by almost 20 percentage

same year, U.S. multinational companies held sixteen percent of their total assets and realized thirty percent of their net income in tax havens.

³ The Supreme Court has shied away from hindering the right of states to offer tax incentives for out-of-state corporations.

points [Hines, 2005]. During the same period, tax haven activities as a share of world economic output have increased eight-fold. Without tax competition from tax havens, the sweeping reduction in corporate tax rates would not have been possible (see Figure 1). Personal income tax rates also have fallen dramatically, with top rates in industrialized nations dropping by more than twenty percentage points since 1980 (see Figure 2).



To keep their tax bases intact in the presence of competition from low-tax jurisdictions, politicians must reduce public spending, cut taxes on mobile taxable resources, or shift a relatively larger portion of their tax revenues to less destructive forms of taxation imposed on labor and consumption. Needless to say, shifting taxes to immobile bases is a daunting endeavor with high political costs. Taxing immobile sources would make the tax system more “efficient” (and evasion more difficult), but from the politician’s perspective, tax hikes on bread, milk, and payrolls are extremely unpalatable. Not surprisingly, faced with jurisdictional tax competition from tax havens, governments have invariably chosen to reduce tax rates on corporate and personal incomes. For example, the reductions in the effective tax rates since 1980s are almost entirely due to tax rate reductions by governments (and a small percent is due to capital moving out).

Do international tax rules matter?

Studies that look at the relation between foreign direct investment and after-tax rates of returns on investment consistently find a strong, positive correlation. Among other things, this relation reflects the extent to which investors respond to tax incentives [Hines, 1999]. U.S. multinational firms invest fewer dollars in countries with high tax rates, whether direct taxes on corporate income, or indirect taxes levied on things other than the corporate income—for example payroll taxes, license fees, etc. [Desai, et al., 2006]. The use of indirect taxes expanded considerably recently, and businesses have become very sensitive to indirect tax rates in making their investment decisions. One study finds that U.S.-owned affiliates of multinational companies tend to reduce their asset holdings by 7.1 percent in countries with 10-percent higher indirect tax rates (measured across countries). A 10-percent increase in corporate taxes, on the other hand, results in a 6.6 percent decline in the total assets held [Desai, et al., 2004].⁴

Other evidence on the relation between international tax rules and business investment decisions includes the financing and structuring of companies, particularly since equity and debt are treated equally in low-tax countries⁵ [Desai, et al., 2004], low overall tax liabilities [Harris, et al., 1991] and low tax/sales ratios observed for multinationals with tax haven presence [Desai, et al., 2003].⁶

Because international tax rules matter for business investment decisions, governments cannot ignore the impact of lower taxes in other jurisdictions. Low tax rates elsewhere attract investors and reduce the tax base in the home country, and significant evidence supports the view that countries react to losing “market share” in foreign direct investment by reducing their effective tax rates. For example, the average effective tax

⁴ Desai et al. [2004] also show that on the output side, higher indirect taxes have a larger impact on output, compared to higher corporate taxes: a 10 percent hike in indirect tax rates reduce output by 2.9 percent, while a similar change in direct taxes is associated by 1.9 percent less output.

⁵ This is because companies are more likely to use debt for financing in high tax jurisdictions, which typically allow a tax deduction for the interest on debt.

⁶ Another indirect evidence of businesses’ sensitivity to international taxes is the reported increases in U.S. multinationals’ domestic returns relative to their foreign returns to equity following the 1986 tax cuts [Klassen, et al., 1993] Hines [2004] presents a detailed discussion of this evidence.

rate in manufacturing (measured across 58 countries with significant U.S. multinational presence) has gone down from 33 percent in 1980 to 21 percent in 2000 (Table 1).

Tax cuts instituted in response to tax competition appear to be the biggest factor behind the reductions between 1992 and 1998 [Altshuler and Grubert, 2004]. The evidence shows that countries suffering the greatest loss of capital were most likely to reduce tax rates. Additionally, those nations with high initial average effective tax rates cut tax rates more than the average country.

Effective tax rates in manufacturing exhibited another big dip between 1998 and 2000 and empirical studies suggest that company behavior (and not country behavior) helps explain the decline. In other words, companies took advantage of tax differentials by shifting economic activity among jurisdictions in ways that lowered their overall tax burdens. For this brief period, variables such as initial tax rates, share of foreign direct investment, and country size lose their explanatory power. The prevailing statutory tax rate, however, exhibits strong positive correlation with the declines in the effective tax rates. High statutory tax rates cause changes in company behavior because of incentives to reorganize in ways that reduce effective tax rates.

Table 1
Average Effective Tax Rates in
Manufacturing for 58 Countries

Year	Average Effective Tax Rate	Standard Deviation
1980	0.33	0.85
1982	0.34	0.98
1984	0.34	1.03
1986	0.32	1.05
1988	0.31	1.09
1990	0.26	0.89
1992	0.25	0.86
1994	0.22	0.72
1996	0.23	0.79
1998	0.24	0.77
2000	0.21	0.67

Note: The averages are weighted by the number of foreign-controlled subsidiaries in each country.

Source: Altshuler and Grubert [2004]

To take advantage of low effective tax rates elsewhere, companies more frequently organize as hybrid firms (treated as branches from the U.S. point of view but incorporated as entities in the hosting tax haven country), or create ownership chains (which involve foreign affiliates owning other foreign affiliates in tax haven countries). While hybrids shelter payments of interest and royalties to a tax haven company from U.S. taxation [Altshuler and Grubert, 2004], ownership chains reduce tax obligations by indefinitely deferring the repatriation of retained earnings [Desai, et al., 2006]. Both strategies have become more prominent recently. Setting up of hybrids has been greatly simplified since 1997, and between 1982 and 1998, share of indirectly owned affiliates

through ownership chains increased from slightly under twenty percent to almost forty percent of all affiliates [Desai, et al., 2003].

How do tax havens perform?

Between 1980 and 2000, foreign direct investment increased from one-half of one percent of world production to four percent of world production. This increase in foreign direct investment has disproportionately benefited tax haven countries and helped lower-tax jurisdictions grow much faster than the rest of the world. The per capita real gross domestic product (GDP) in seventeen tax haven countries (places where U.S. multinationals frequently do business) grew by 3.3 percent between 1982 and 1999, while the average growth rate of per capita real GDP elsewhere was 1.4 percent [Hines, 2004].⁷

This calculation could overestimate the growth in tax havens because by definition, GDP is output produced within the borders of a country; in tax havens, this figure possibly includes some reported income (for tax-avoidance purposes) associated with output produced elsewhere. As an alternative, Hines [2004] reports the annual growth in per-capita gross national product (GNP), which measures the value of goods and services produced by a county's nationals. Measured this way, tax-haven growth is still significantly higher than world averages: Per capita GNP in the world grew by 1.4 percent while in tax-haven countries it grew by an average of 3 percent every year between 1982 and 1999.

Despite their low tax rates (or perhaps because of them), tax-haven governments are not relying on low levels of tax revenue compared to the rest of the world (see table 2). Governments in tax-haven countries consume a quarter of the total GDP—less than the

	(I) Government Product/GDP, 1999 (Penn World Tables)	(II) Government Spending/GDP, 1995 (IMF)	(III) Tax Revenues/GDP, 1995 (IMF)
Tax Havens	25.35	30.34	22.39
World Total	19.74	30.94	22.28

Notes: The values are in percentages. Tax haven averages are calculated over 22 such countries for column I, and for 13 countries for columns II and III.

Source: Hines [2004], Table 5.

burden of government in Europe and the United States, but higher than the global average. Empirical analysis of government size and other country variables (such as population, per-capita income) shows that while smaller countries have bigger

⁷ The tax haven countries include Hong Kong, Ireland, Panama, Singapore, Switzerland, Antigua and Barbuda, Barbados, Belize, Cyprus, Dominica, Grenada, Jordan, Luxembourg, St. Kitts and Nevis, St. Lucia, and St. Vincent. The data is from the Penn World Tables. The highest-growth-rate countries among the bigger tax-haven countries were Singapore and Ireland (at slightly above 5 percent per year).

governments, tax-haven countries have smaller governments controlled for their size and affluence levels. That is, governments of tax havens collect and spend fewer dollars compared to the higher-tax countries of similar size and income level.⁸

Are tax havens harmful?

Recent increases in international investment activity and the concomitant shifting of economic activity to tax havens (and other low-tax jurisdictions) have motivated a number of high-tax countries to undertake actions designed to hinder the flow of jobs and capital to jurisdictions with better tax law. For example, the OECD launched a “harmful tax competition” initiative in the 1990s, a scheme designed to penalize so-called tax havens. The OECD justifies its actions by arguing that extensive tax competition “undermines fair competition and public confidence in the tax system” [OECD, 2004].

In this context, the relevant question is not whether “tax havens reduce confidence in the tax system” but whether the economic success of tax havens comes at the expense of growth elsewhere—presumably in higher-tax countries. There is no doubt that the threat of tax competition compels higher-tax nations to reduce tax rates. However, this does not mean that tax competition is a zero sum game as the OECD appears to argue, or that the gains in the private sector are offset by the losses in the public sector. If tax havens help channel funds towards activities that are more productive than the ways in which governments use funds, then the net gain to the world economy will be positive.⁹ In other words, the presence of tax havens could be complementary to economic gains in neighboring high-tax jurisdictions if tax havens force high-tax jurisdictions to organize more efficiently – or, even more importantly, to lower tax rates.

In a recent empirical study, using firm-level data from U.S. multinational firms, Desai et al. discredit the claim that the existence and use of regional tax havens reduces economic activity in high tax locations [Desai, et al., 2006a]. On the contrary, the authors find evidence that tax havens have positive spillover effects for nearby high-tax jurisdictions by providing a tax-efficient platform for investment. More specifically, they find that a one percent greater likelihood of establishing a tax-haven affiliate is associated with a 0.3 percent greater investment and sales in nearby non-haven countries. Desai et al. point out that:

“From the standpoint of host country governments, the ability of foreign investors to use tax havens in the same region has the beneficial effect of stimulating investment, even as it may erode tax revenue collection from any additional investment. For governments that, on efficiency grounds or other grounds, would prefer to reduce tax rates on inbound foreign investment but are constrained from

⁸ See Hines [2004] for details. This does not mean that tax havens provide fewer services.

⁹ This should not be interpreted as “tax havens allow funds to relocate in countries that are more productive.” It is quite possible that the pre-tax return to investments in many tax havens is lower than the returns in high-tax jurisdictions. But high taxes make it impossible for companies to take advantage of business opportunities in high-tax environments.

doing so by political or other considerations, encouraging the widespread use of regional tax havens offers a convenient alternative. The fear that the existence and use of regional tax havens might encourage firms to substitute economic activity away from nearby high tax locations receives no empirical support in the behavior of American multinational firms.”

The finding that tax havens benefit neighboring jurisdictions is a special case of a more general rule: fewer restrictions on capital, through low taxation or removal of other rules, will make existing capital more efficient and facilitate a larger capital stock. The consequent gains in growth and prosperity will benefit everybody. (It is, however, harder to empirically demonstrate the extent of the gains to the rest of the world, especially the indirect gains.) Tax havens constitute an important source of such gains in efficiency because they are the only alternatives to the current “highly imperfect international system for the prevention of double taxation.” [Teather, 2005, p. 31] Teather notes that tax havens provide an environment where companies can freely pool international capital, without having to worry about multiple tax rules, and onerous investment regulations. Thus, tax havens increase the efficiency of global capital markets, and the gains in growth benefit not only the tax havens themselves and their neighbors, but also everyone else who eventually receives the fruits of growth through better products, more jobs, or cheaper prices.

In response to the question, “What should a tax system look like?” tax havens would be a good starting point for investigation. A recent paper by Mitchell [2006] makes the moral case for tax havens, highlighting the relation between oppressive governments and oppressive tax systems. Mitchell notes that tax havens establish environments that are respectful of individual human rights, and offer politically stable environments with strong rule of law, and little corruption. In these ways, tax havens create higher standards of governance to which other countries must eventually adhere to in order to keep their tax bases. This picture is in stark contrast to the frequent description of tax havens as thug-filled countries primarily in the business of money laundering.¹⁰

What do tax havens mean for Americans?

Because the U.S. imposes taxes on foreign-earned income of U.S. based corporations, using tax havens for tax avoidance is relatively costly for American multinationals. Other incentives built into the U.S. tax system discourage tax haven presence for U.S. multinationals: for example, in calculating their U.S. tax obligations, American multinational companies can deduct foreign taxes from their U.S. obligations and can claim credit, over an extended period, for any tax payments they have made in excess of U.S. obligations. Thus, American firms might be reluctant to take advantage of tax havens especially if the consequence is increased U.S. tax liabilities [Hines, 2004; Hines, 1999].

¹⁰ Tax havens, incidentally, usually are among the world’s most cooperative nations in the global fight against terrorism and money laundering. The only notable feature of tax havens is that they correctly do not recognize any right for high-tax nations to tax income earned in low-tax jurisdictions.

Traditionally, U.S. direct investments abroad have been structured to take advantage of intangible assets like patents and trademarks (or to defer repatriation of income). In recent years, however, U.S. manufacturing companies appear to have become more sensitive to differences in taxes across countries [Altshuler and Grubert, 2004]. The location of real manufacturing capital held by U.S. parents appear to correlate more strongly with the local tax rates (of the host country), and the transactions between the U.S. parents and their manufacturing subsidiaries in low-tax jurisdictions have been increasing. Given globalization in trade, and increased competition from low-cost producers, moving capital (and even production) to low-tax countries might eventually become an unavoidable survival strategy for American companies.

What would the relocation of productive activity and capital to tax havens mean for Americans? On the negative side – assuming politicians do not control government outlays, the U.S. government will borrow more to cover short and medium term costs, putting additional financial constraints on current and future generations. Competition from tax havens could also reduce the amount of foreign direct investment into the U.S. if foreign multinationals choose to invest in tax havens for reasons similar to those that influence the U.S. companies.

While low-tax jurisdictions put competitive pressure on the United States, the process of tax competition unarguably generates more benefits than costs for America. The United

Country	2002	2003	2004	2005	2006 (Q1)
United Kingdom	203,237	345,235	501,721	579,920	647,957
All other Europe	483,421	462,334	611,774	680,573	720,203
Caribbean Banking Ctrs*	837,771	955,536	1,186,221	1,200,803	1,274,049
Japan	176,331	170,315	173,872	159,930	142,941
All other Asia	162,938	214,276	260,142	257,307	239,436
Subtotal	1,863,698	2,147,696	2,733,730	2,878,533	3,024,586
All other countries	202,433	234,774	284,143	280,815	298,927
Grand total	2,066,131	2,382,470	3,017,873	3,159,348	3,323,513

* The Caribbean banking centers comprise Bahamas, Bermuda, British West Indies (Cayman Islands, after 2001), Netherlands Antilles, and Panama.

Source: Treasury International Capital Reporting System

States is the world's largest repository of global capital. The Commerce Department reports that foreigners have invested more than \$11 trillion in America's economy, including more than \$7 trillion of financial investment [Nguyen, 2005]. Tax havens are a

particularly important source of capital for the U.S. economy. The Treasury Department reports that foreigners have more than \$3 trillion of capital in U.S. banks and other financial accounts. As of March 2006, tax havens helped funnel nearly \$1.3 trillion to U.S. financial markets [TIC, 2006]¹¹ (see table 3). Losing some or all of this capital to other tax havens – which would happen if the U.S. ceased its favorable tax treatment of foreign investors – would have significant negative impact on the U.S. growth and employment¹²

On the plus side, firms are likely to pass on savings from low-cost production to consumers. Additionally, as the U.S. government loses some of its tax base, in the long run, it could become smaller and more efficient, and jurisdictional tax competition might force the federal and state governments to reduce corporate tax rates from their current (combined) 39.9 percent—which is the highest rate corporations face among the developed countries [Atkins and Hodge, 2005]. Such reforms would be especially desirable since lower tax rates would eliminate the incentive to shift activity from the U.S. economy.

Conclusion

This risk of economic failure associated with ineffective competition for funds makes tax havens important sources of economic discipline for the U.S. Tax havens will not be a problem for the U.S. economy, as long as U.S. remains a tax haven itself, with productive and stable investment environment. In other words, presence of tax havens contributes to the long term success of the U.S. economy by making it harder for the U.S. to reduce the “quality” of the investment climate both for domestic and foreign investors.

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¹¹ Available at <http://www.treas.gov/tic/exhibitsa-d.pdf>.

¹² Added to this concern is the recent surge of economic nationalism (for example, Congress’s involvement in the foreign ownership of U.S. ports for security reasons), which is expected to discourage the flow of foreign funds to the U.S.

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6) April 2002, Prosperitas Volume II, Issue II, "The Case for International Tax Competition: A Caribbean Perspective," by Carlyle Rogers, Web page link below:

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