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Tax competition with parasitic tax havens

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A R T I C L E   I N F O

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A B S T R A C T

We develop a tax competition framework in which some jurisdictions, called tax havens, are parasitic on the revenues of other countries, and these countries use resources in an attempt to limit the transfer of tax revenue from capital taxation to the havens. We demonstrate that the full or partial elimination of tax havens would improve welfare in non-haven countries. We also demonstrate that the smaller countries choose to become tax havens, and we show that the abolition of a sufficiently small number of the relatively large havens leaves all countries better off, including the remaining havens. We argue that these results extend to the case where there are also taxes on wage income that involve administrative and compliance costs.

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1. Introduction

According to the .OECD (1998)., a tax haven is a jurisdiction that imposes no or only nominal taxes and offers itself as a place to be used by non-residents to escape Elitzur tax in their country of residence. Part of its attractiveness is that it enacts laws or administrative practices that prevent the effective exchange of information on taxpayers benefiting from the low-tax jurisdiction.[1] Although a previous literature has modeled tax havens as a benign phenomenon that helps high-tax countries reduce the negative impact of their own suboptimal domestic tax policies, there is considerable concern that the havens are "parasitic" on the tax revenues of the non-haven countries, inducing them to expend real resources in defending their revenue base and in the process reducing the welfare of their residents. This paper develops an equilibrium model of tax havens and tax competition that provides a rigorous framework within which to address why countries are, and should be, concerned about the detrimental effects of havens on their citizens' welfare.

Policy actions by OECD countries certainly reflect this concern. Before an OECD report issued in 1998, action against tax havens was predominantly unilateral, as exemplified by the introduction in 1962 of the U.S. Subpart F provisions that addressed so-called passive income earned in tax haven countries and not distributed to the United States.[2] Subsequently many other OECD countries enacted domestic tax rules designed to lessen the attractiveness of tax reductions achieved through the use of tax havens.

The 1998 OECD report concluded that "governments cannot stand back while their tax bases are eroded through the actions of countries which offer taxpayers ways to exploit tax havens [and preferential regimes] to reduce the tax that would otherwise be payable to them" (p. 37). It lists several recommendations concerning domestic legislation, tax treaties, and international cooperation. In the last category is a recommendation to produce a list of tax haven countries that would enable non-haven countries to coordinate their responses to the problems created by the havens and to "encourage these jurisdictions to reexamine their policies" (p. 57). In 2000, the OECD followed up by publishing the names of 35 countries called "non-cooperating tax havens," which were given one year to enact fundamental reform of their tax systems and broaden the exchange of information with tax authorities or face economic sanctions. By 2005, almost all of the blacklisted tax havens had signed the OECD's Memorandum of Understanding agreeing to transparency and exchange of information.[3]

Notably, the 35 designated tax havens are invariably small. Their average population is 284,000, and is 116,000 if one excludes the only two designated countries (Liberia and Panama) whose population exceeds one million. Although the 35 tax havens represent over 15% of the world's countries, their total population comprises just 0.150% of

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[1] The OECD report distinguished tax havens from cases of countries that raise significant revenues from the income tax but have preferential tax regimes for certain kinds of income, generally restricted to non-residents; see footnote 4. This paper is about the kind of tax haven covered by the OECD's definition.

[2] This history is recounted in Eden and Kudrle (2005).

[3] Public U.S. support for the OECD initiative flagged after 2000, as exemplified by statements by the Secretary of the Treasury suggesting that the U.S. government was no longer committed to fighting the tax havens. The financial crisis of 2008 prompted renewed interest in tax havens, as part of multilateral efforts to strengthen the financial system. The proclamation of the G20 summit issued on April 2, 2009 called for "action against non-cooperative jurisdictions, including tax havens," and continued that the G20 countries "stand ready to deploy sanctions to protect our public finances and financial systems."

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the world's population (0.058% excluding Liberia and Panama). Of the 35 designated tax havens, 27 are island nations.[4]

In sharp contrast to the longstanding concern among policy makers about the deleterious effects of havens, some recent literature has focused on a potentially beneficial role for tax havens.[5] The starting point is the well-known result that, under certain conditions, a small, open economy should levy no distorting tax on mobile factors such as capital.[6] Countries do, however, levy distorting taxes on mobile capital, and much of the recent theoretical literature conceives of tax havens as a device to save these countries from themselves, by providing them with a way to move toward the non-distorting tax regime they should, but for some reason cannot, explicitly enact.[7] For example, in Hong and Smart (2005), citizens of high-tax countries can benefit from haven-related tax planning because it allows them to tax domestic entrepreneurs (in a lump-sum way) without driving away mobile multinational capital. The presence of the haven reduces the (distorting) effective marginal tax rate for any given statutory tax rate.

Some empirical support for the "tax havens are good" argument is offered by Desai et al. (2006a), who argue that the scale of U.S. multinational corporations in foreign non-haven countries drives the establishment of affiliates in haven countries.[8] Desai et al. (2006b) explain these findings with a model in which there are complementarities between investment in havens and investment in neighboring non-haven countries, so that the presence of a tax haven enables tax planning that lowers the cost of investing, and thus stimulates investment, in these countries.

The idea that countries should welcome tax havens as a way to overcome their inability to explicitly differentiate the effective tax rate on mobile and immobile capital must be reconciled with the fact that governments of non-haven countries often expend considerable resources to limit the effect of haven transactions on their own tax revenue.[9] It suggests that these countries do not view havens as a way to overcome exogenous, perhaps politically motivated, constraints on their tax policy.

This paper develops a model of tax competition in the presence of parasitic tax havens that explains and justifies existing initiatives to limit haven activities. In the model, tax havens lead to a wasteful expenditure of resources, both by firms in their participation in havens and by governments in their attempts to enforce their tax codes. In addition, tax havens worsen tax competition problems by causing countries to reduce their tax rates further below levels that are efficient from the viewpoint of all countries combined. Either full or partial elimination of havens is found to be welfare-improving. Indeed, initiatives to limit some, but not all, havens can be designed to raise welfare both in the non-haven countries and in the remaining havens. To demonstrate this last possibility, we model the decision to become a haven and, in so doing, demonstrate that small countries have a greater incentive to become havens.

Our model is designed to capture the role in the world economy of the small, mostly island economies that act as tax havens. For this reason we do not develop a model of symmetric, identical countries, but rather a model in which some countries act as havens and other countries do not—the former are parasitic on the revenues of the latter, in a way we make explicit. Second, we model the real resources that are used up as companies shift taxable income to tax havens and home country governments attempt to limit this shifting. To address this issue, we model tax havens as juridical entrepreneurs that sell protection from national taxation, resulting in what Palan (2002) calls the "commercialization of state sovereignty."[10] The equilibrium price for this service depends on the demand for such protection, which in turn depends on the tax system, including the resources devoted to tax enforcement by the non-haven countries, and on the technology available to the parasitic havens. Our analysis allows this "price" to take the form of cash or various "in-kind benefits" provided to the tax haven. The activities undertaken by havens facilitate what may be viewed as forms of legal tax avoidance or illegal tax evasion. We do not prejudge their legality and recognize that the dividing line between legal and illegal activities is often blurry. For brevity, however, the term "avoidance" is sometimes used in this paper to cover both types of haven activities.

In addition to examining restrictions on the number of havens, we explicitly model the decentralized use of enforcement activities. The notion that tax enforcement policy is a separate instrument of tax policy that can play a role in tax competition has been recognized in the work of Cremer and Gahvari (1997, 2000). An important insight from this work is that each country has an incentive to enforce its tax base suboptimally, because the resulting reduction in the effective tax rate causes more of the mobile tax base to locate within its borders. Whereas this result may also hold in the current model, we explicitly examine the mix of statutory rates and enforcement levels used to finance a given public good level. Our conclusion is that countries would be better off if they agreed to increase their tax rates and lower enforcement. Doing so would raise the demand for the services provided by tax havens, which would raise the effective price of these services and thereby discourage their use. Countries fail to take into account this "cost externality" when choosing how vigorously to enforce their tax codes.

[4] Some countries that levy low corporate tax rates do so in part to attract real investment, knowing that once multinational companies have made such an investment, it is in their interest to use transfer pricing and other strategies to shift taxable income into the low-tax host country and away from other high-tax jurisdictions in which they operate. For example, the analysis of havens in Hines (2005) covers a different set of countries than the OECD list, including some countries, most notably Ireland and Switzerland, that have the kind of dual motivation discussed in this footnote.

[5] Dharmapala (2008) critically surveys what he calls the "positive" and "negative" views of tax havens.

[6] The intuition behind this result is straightforward. All taxes levied in this economy will ultimately be borne by the immobile factors. Given that, it is better to levy taxes directly on the immobile factors; attempting to tax the mobile factors will not change the incidence but will, unlike taxes levied directly on the immobile factors, drive away the mobile capital, thus reducing the productivity and therefore the pre-tax return to the immobile factors. See Gordon (1986) and Bucovetsky and Wilson (1991) for demonstrations that small open economies should not levy distorting source-based taxes.

[7] A separate literature examines the issue of whether countries would benefit from international agreements that potentially lessen tax competition by restricting the degree to which countries can provide preferential tax treatment to relatively mobile factors. The results are mixed. See Janeba and Peters (1999), Keen (2001), Janeba and Smart (2003), Wilson (2005), and Bucovetsky and Haufler (2008). Marceau et al. (forthcoming) demonstrate that rules against preferential treatment enable small countries to compete away mobile capital from larger countries, but that non-preferential regimes are still preferable. Yet another literature models information sharing between governments as a strategic variable in tax competition; see, for example, Bacchetta and Espinosa (1995). Peralta et al. (2006) assume that countries cannot directly discriminate in the rates of profit taxation of mobile and immobile firms, but a government may optimally decide not to enforce the arm's length principle of transfer pricing in order to host a multinational firm while setting high profit taxes on domestic firms. Similarly, Becker and Fuest (2005) demonstrate that if immobile and mobile firms must be taxed at the same rate, then the government may wish to alter other aspects of the tax code to reduce the effective taxation of the mobile firms, including the use of a pure profits tax and the degree to which capital costs are tax deductible.

[8] To establish causality, they use foreign countries' economic growth rates as instruments for the scale of a multinational corporation's operations in foreign non-haven countries.

[9] One path of reconciliation might be that a country would want to spend resources to limit which companies can take advantage of tax havens (to, presumably, the more mobile ones).

[10] We do not consider other outlets for such commercialization, although Slemrod (2008) analyzes country decisions to engage in three such outlets: tax havens, issuing "pandering" postage stamps, and money laundering. The data analysis provides support for the idea that commercialization of state sovereignty is more likely in countries where it is more difficult to raise revenue in alternative ways. Examples of commercialization that are more likely to directly raise revenue (stamp pandering and tax havens) are more attractive to poorer countries.

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