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A journey from a corruption port to a tax haven

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ABSTRACT

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We sketch a model according to which tax havens attract corporate income generated in corrupted countries. We consider the choice of optimal bribes by corrupt officials and the share of the proceeds of corruption that will be concealed in tax havens. Our framework provides novel welfare implications of tax havens. First, tax havens' services have a positive effect on welfare through encouraging investment by firms fearing expropriation and bribes in corrupt countries. Second, by supporting corruption and the concealment of officials' bribes, tax havens discourage the provision of public goods and hence have also a negative effect on welfare. The net welfare effect depends on the specified preferences and parameters. One source of this ambiguity is that the presence of multinational firms in corrupted countries is positively associated with demanding tax havens' operations. Using firm-level data, we provide new empirical results supporting this hypothesis. *Journal of Comparative Economics* **42** (3) (2014) 739–754. Goethe University Frankfurt, Faculty of Economics and Business Administration, Grueneburgplatz 1, 60323 Frankfurt am Main, Germany.

1. Introduction

Tax havens have recently been heavily debated in the policy arena for several reasons, ranging from fragile fiscal positions of many economies to recent revolutions against many corrupt autocratic officials who stored their assets in havens. Academically, the role of tax havens in the world economy is largely viewed within the framework of international tax competition. Most studies assume that the real operation of the firm takes place in a high-tax country, possibly one with an advanced economy. The function of the affiliate in the tax haven is to receive (a portion of) the corporate income, which is thus shifted away from the domestic high-tax country for purposes of tax avoidance.[1]

In this study, we focus on other roles of tax havens in the world economy. First, we examine theoretically the connection between the operations of firms in corrupt countries (possibly with low- and middle-income economies) and firms' demand for tax havens' services.[2] Second, we model the corrupt authority's problem of choosing the optimal bribe rate. Third, we provide new insights into welfare consequences of eliminating tax havens. Fourth, we empirically analyse the link between operating in corrupt countries and the presence of multinational firms in tax havens, using German firm-level data.

Firms operating in highly corrupt countries face special circumstances. First, firms bribe officials to maintain their investment activities. Second, bribes do not insulate firms from risks. In the absence of a credible rule of law, contracts are not enforceable. Firms fear expropriation, blackmailing, or a sudden eruption of instability in the corrupt host economy. Hence,

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[1] Dharmapala (2008) provides a survey.

[2] The negative relationship between corruption and GDP per capita is documented in Svensson (2005), along with other variables related to corruption. Bardhan (1997) surveys the literature on corruption and development. See Financial Action Task Force (2011) for recent examples.

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even if the corporate income tax rate in a corrupt country is relatively low, multinational affiliates have a strong incentive to conceal and shift (a portion of) their income. The question is then: Where to? The origin country is not the most preferred option available for the multinational firm, especially if the parent firm is located in a high-tax country. Alternatively, multinational affiliates can transfer the income generated in highly corrupt countries to tax havens.[3]

Public debates and media reports often assert that not only firms but also corrupt officials, at various levels, use tax havens for hiding income. Reported figures are rather high (e.g., Los Angeles Times, 2011). Our theoretical sketch explicitly considers the transfer of proceeds of corruption to offshore tax havens, and allows the probability of revolt against the corrupt authority (eruption of instability) to be a function of the provided amount of public goods. A higher bribe rate increases the extracted rent by officials, but at the same time it reduces the bribe base, since firms' demand for tax havens' services increases with higher bribes.

The main novelty of our study is to analyse the welfare effects of eliminating tax havens' concealment services on a corrupt country. The results can be summarised as follows:

- Firms' investment in the corrupt country decreases under standard assumptions on the interest elasticity of capital demand and on the cost of shifting income from the corrupt country to the tax haven. Accordingly, private consumption by the citizens of the corrupt country decreases. Thus, the effect on welfare through firms' investment is negative.
- In a world without tax havens, it is more difficult for corrupt officials to conceal bribes. As a result, the provision of public goods unambiguously increases in order to lower the probability of revolt and losing office. Hence, eliminating tax havens has a positive effect on welfare by precluding their support for corruption.

The overall welfare effect depends on the functional forms and parameters of the model. These new welfare results for a corrupt country complement those in Slemrod and Wilson (2009), who consider only a non-corrupt country. In our framework, as in theirs, tax havens constitute a drain on revenues of the non-corrupt country. In our setting, the welfare effect of eliminating tax havens' operations on the non-corrupt country is positive provided that factor prices are constant.

Other, related studies point out that tax havens have positive effects on welfare. These are summarised in three effects: (1) Tax havens support an equilibrium where all non-havens set the same (high) tax rate and hence raise revenues (Johannesen, 2010a), (2) borrowing from tax havens increases the efficiency of the firm and its investment at home (Hong and Smart, 2010), and (3) tax havens with advanced banking sectors (offshore financial centres) improve competition in the banking sectors in neighbouring countries, generating positive welfare effects (Rose and Spiegel, 2007). However, these studies consider the issue from the standpoint of sufficiently advanced economies, whereas our model stresses the importance of viewing the welfare effects of tax havens from a global perspective by incorporating features of less advanced economies. The notion that tax havens are linked to corruption and development has been a concern in many discussions. The Norwegian Ministry of Foreign Affairs published in 2009 a report focusing on tax havens and development (Norwegian Ministry of Foreign Affairs, 2009). In a chapter of this report, Torvik (2009) emphasises the effects of tax havens on resource-rich countries and gives examples of dictators who shift money from dubious sources to tax havens. Related studies are by Schjelderup (2011), who argues that tax havens reduce the costs of entering illegal businesses, and Slemrod (2008), who underlines the status of tax havens as a means of commercialisation of state sovereignty.[4]

Empirically, welfare and detailed information on tax evasion and corruption-related matters are unobservable. However, one essential source of bribes is foreign investment. To check the empirical relevance of our model, we test the hypothesis stemmed from our model positing that the presence of multinational firms in corrupt countries is positively associated with a high probability of demanding tax havens' operations. Based on conditional fixed-effects logistic regressions and after controlling for firm size and unobserved heterogeneity at the parent firm level, we find empirical support for this hypothesis. This new result contributes to the existing empirical literature that links firms' demand for tax havens' affiliates to the tax regime of the home country or the size of the firm (e.g., Desai et al., 2006; Gumpert et al., 2011). Also, our result is related to studies supporting the notion that bribes constitute high costs for firms. For example, Fisman and Svensson (2007) find that high bribe rates negatively affect the growth of firms in Uganda.

We proceed as follows. Section 2 presents the benchmark model and the resulting equilibrium equations determining the share of firms that use tax havens and the optimal bribe rate. In Section 3, we provide a welfare analysis of shutting down tax havens. Section 4 generalises the benchmark setup by allowing the probability of revolt against the corrupt government to be endogenous. Section 5 provides empirical results using the German MiDi firm-level data. Section 6 concludes.

2. Benchmark model

2.1. The setup

We build on the model of Slemrod and Wilson (2009), and extend their setup by including a corrupt country, denoted by c, in addition to the non-corrupt country, denoted by n, and the tax haven. Each of the non-haven countries has a population

[3] Firms in the corrupt country can be broadly interpreted to include not only foreign affiliates but also domestic firms.

[4] The increasing academic interest in the tax havens' businesses is reflected in a number of recent contributions focusing on other, related aspects. Examples are Becker and Fuest (2010), Johannesen (2010b), and Maffini (2009). Hebous (2011) provides a recent survey.