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Which countries become tax havens?☆

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ABSTRACT

This paper analyzes the factors influencing whether countries become tax havens. Roughly 15% of countries are tax havens; as has been widely observed, these countries tend to be small and affluent. This paper documents another robust empirical regularity: better-governed countries are much more likely than others to become tax havens. Controlling for other relevant factors, governance quality has a statistically significant and quantitatively large association with the probability of being a tax haven. For a typical country with a population under one million, the likelihood of a becoming a tax haven rises from 26% to 61% as governance quality improves from the level of Brazil to that of Portugal. Evidence from US firms suggests that low tax rates offer much more powerful inducements to foreign investment in well-governed countries than do low tax rates elsewhere. This may explain why poorly-governed countries do not generally attempt to become tax havens, and suggests that the range of sensible tax policy options is constrained by the quality of governance.

1. Introduction

Countries eager to attract foreign capital face considerable international pressure to minimize their taxation of income earned by foreign investors. Since reducing the taxation of investment income earned by foreigners may entail unappetizing budgetary or political compromises, not all countries seek to attract foreign investment in this way. The "tax havens" are locations with very low tax rates and other tax attributes designed to appeal to foreign investors. Tax haven countries receive extensive foreign investment, and, largely as a result, have enjoyed very rapid economic growth over the past 25 years (Hines, 2005). There are roughly 40 major tax havens in the world today, but the sizable apparent economic returns to becoming a tax haven raise the question of why there are not more.

This paper considers the determinants of who becomes a tax haven and who does not. Some of the characteristics of tax havens are well-documented in the literature: tax havens are small countries, commonly below one million in population, and are generally more affluent than other countries. What has not been previously noted in the literature, but is apparent in the data, is that tax havens score very well on cross-country indices of governance quality that include measures of voice and accountability, political stability, government effectiveness, rule of law, and the control of corruption. Indeed, there are almost no poorly-governed tax havens. In a regression framework that controls for other observable variables including income, population, and geography, the association of good governance with the likelihood of being a tax haven is both statistically significant and quantitatively very large: improving the quality of governance from the level of Brazil to that of Portugal raises the likelihood of a small country being a tax haven from 26% to roughly 61%.

Cross-country evidence of this type can be difficult to interpret, since the data reflect a non-random assignment of local governance quality, which may be correlated with other economic and political conditions that influence whether or not a country becomes a tax haven. The association of governance quality and tax haven status persists in regressions that include additional variables such as measures of economic openness, British legal origins, use of the English language, use of a parliamentary system, communications infrastructure, and natural resource abundance. In addition, measures of past governance quality are associated with being a tax haven in 2004, suggesting that the relevant components of governance institutions are those that are stable over long periods of time.

Why are better-governed countries more likely than others to become tax havens? One possibility is that the returns to becoming a tax haven are greater for well-governed countries: that higher foreign investment flows, and the economic benefits that accompany them, are

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more likely to accompany tax reductions in well-governed countries than they are tax reductions in poorly-governed countries. In this interpretation, poorly-governed countries do not forego potential economic benefits in not becoming tax havens, since few if any of the benefits would flow to them if they did. American evidence is consistent with this explanation, in that tax rate differences among well-governed countries are associated with much larger differences in U.S. investment levels than are tax rate differences among poorly-governed countries.

There is a substantial theoretical literature on the factors that influence the desirability of becoming a tax haven (e.g. Kanbur and Keen, 1993; Hansen and Kessler, 2001; Slemrod and Wilson, 2006). The empirical evidence presented in this paper suggests that tax policy choices are implicitly constrained by the quality of governance. The analysis of investment by American firms in Section 5 suggests that governance quality is an important, and hitherto largely neglected, factor affecting the tax elasticity of foreign investment. Hence tax policies might be added to the list of economic policies likely to be influenced by governance institutions.[2]

Section two of the paper reviews the factors that influence the desirability of becoming a tax haven. Section three describes the data used in the empirical analysis that follows. Section four analyzes the determinants of tax haven status. Section five compares the tax sensitivity of American investment in well-governed and poorly-governed countries. Section six concludes.

2. Tax havens in theory and practice

Tax havens are well positioned to benefit from the considerable international mobility of business investment and the associated tax base.[3] There is ample reason to expect their low tax rates to influence both the investment and the tax avoidance activities of foreign investors, and an extensive literature documents the magnitudes of the effects of low tax rates.[4] The first generation of empirical studies, reviewed in Hines (1997, 1999), reports tax elasticities of investment in the neighborhood of −0.6. What this means is that a ten percent tax reduction (for example, reducing the corporate tax rate from 35% to 31.5%) is typically associated with six percent greater inbound foreign investment. More recent evidence suggests that FDI is even more tax sensitive than this.[5]

Tax havens attract foreign investment not only because income earned locally is taxed at favorable rates, but also because tax haven activities facilitate the avoidance of taxes that might otherwise have to be paid to other countries.[6] Taken together, the evidence implies that countries contemplating adopting very low tax rates can reasonably expect to receive significantly greater foreign investment and tax base as a consequence. Hence the budgetary cost to a country that unilaterally reduces its tax rate need not be very great.

Any reduction in government revenue that accompanies becoming a tax haven can, in principle, be recouped by increasing other taxes, such as personal income taxes or value-added taxes. Indeed, the classic argument of Diamond and Mirrlees (1971) that governments unnecessarily distort production when they tax intermediate production implies (Gordon, 1986) that governments with a sufficient number of available tax instruments can make all domestic residents better off by not taxing internationally mobile capital.[7] The reason is that small open economies are inevitably price-takers in world markets, from which it follows that they are unable to shift any of their tax burdens onto foreign investors. As a result, they have no incentive to tax foreign investors, since doing so simply distorts their economies without extracting resources from foreigners. Since the costs of taxing foreigners are borne by domestic factors in the form of lower wages and land prices, and these costs include deadweight losses due to inefficient taxation, domestic residents would be made better off by removing any taxes on foreign investors and instead directly taxing the returns to local factors of production.

The experience of tax haven economies in the period since 1980 is consistent with the theory predicting significant associated economic benefits. Hines (2005) reports that tax haven economies grew at an average annual real per capita rate of 3.3% between 1982 and 1999, which compares favorably to the 1.4% growth rate of the world as a whole. Furthermore, the public finances of tax havens remain robust despite their low tax rates on foreign investment. Tax haven governments have proven able to tap revenue sources other than business taxes to finance significant levels of government spending, either through the greater economic activity that accompanies becoming a tax haven, or by imposing higher rates of other taxes.

Concern over the possible implications of international tax competition has prompted many governments to consider international cooperative efforts designed to preserve their abilities to tax mobile business income.[8] The most ambitious and effective multilateral tax agreement to date is the Harmful Tax Practices initiative of the Organization for Economic Cooperation and Development (OECD).[9] The purpose of the initiative was to discourage OECD member countries and certain tax havens outside the OECD from pursuing policies that were thought to harm other countries by unfairly eroding tax bases. Many of these policies have been subsequently abolished or changed to remove the features to which the OECD objected. As part of this initiative, the OECD also 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. As a result of the OECD initiative, along with diplomatic and other actions of individual nations, 33 countries and jurisdictions outside the OECD committed to improve the transparency of their tax systems and to facilitate information exchange. As of 2004 there remained only five tax havens not making such commitments.[10]

3. Data

While there are many alternative notions of what constitutes a tax haven, the analysis in this paper uses as its definition the list of 41 countries and territories provided in Appendix 2 of Hines and Rice (1994, p. 178), which reflects the coexistence of a low business tax rate and identification as a tax haven by multiple authoritative sources. All

[2] For instance, Nunn and Trefler (2006) analyze the impact of governance institutions on tariff policy.

[3] Tax havens may serve different purposes for business investors than they do for individual and trust investors. The analysis that follows concerns only the business uses of tax havens, which in any case appear to greatly exceed their use by individual investors — see Dharmapala and Hines (2006) for further discussion.

[4] See Gordon and Hines (2002) and Devereux (2007) for recent surveys. For a fuller discussion of the tax rules facing U.S. multinational firms and the evidence on behavioral responses to international taxation of U.S. multinationals, see Hines (1997, 1999) and Desai et al. (2003).

[5] For example, Altshuler et al. (2001) compare the tax sensitivity of aggregate capital ownership in 58 countries in 1984 to that in 1992, reporting estimated tax elasticities that rise (in absolute value) from −1.5 in 1984 to −2.8 in 1992. Using data drawn from a much larger sample of countries, and covering the years 1982, 1989, 1994 and 1997, Desai et al. (2003) offer evidence of an average −1.5 tax elasticity of asset ownership. Altshuler and Grubert (2004) offer evidence of a −3.5 tax elasticity of investment in a sample of 58 countries in 2000.

[6] Multinational firms can structure a variety of transactions – intrafirm borrowing, royalty payments, dividend repatriations, and intrafirm trade – in a manner that is conducive to tax avoidance. Studies of the responsiveness of firms to taxes on these margins examine reported profitability, tax liabilities, and specific measures of financial and merchandise trade in order to identify the effects of taxes; Hines (1999) and Devereux (2007) survey this evidence.

[7] See Gordon and Hines (2002) for a further elaboration of this argument, and Keen and Wildasin (2004) for an important caveat concerning the abilities of governments to transfer resources among themselves.

[8] It is far from clear, however, that tax havens reduce incentives to conduct business in high-tax countries, and recent evidence (Desai et al., 2006a,b) suggests that the presence of nearby tax havens stimulates activity in high-tax locations.

[9] For further discussion of the OECD initiative, see Hines (2006).

[10] These tax havens are Andorra, Liberia, Liechtenstein, the Marshall Islands, and Monaco (OECD, 2004).