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Honor among tax havens☆

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ABSTRACT

A simple, partial equilibrium model of the supply of offshore tax havens is analyzed, when multinationals are capable of sheltering some of their worldwide income. This model provides a few contrasting predictions to those in “Tax Competition with Parasitic Tax Havens” by Slemrod and Wilson. Slemrod and Wilson model tax sheltering as a production process which uses up scarce resources in the tax haven providing it. Here, multinational firms can transfer some of their income costlessly to an offshore tax haven, which charges a fee for this privilege. (So there are no real resource costs to tax sheltering activity in this model.) But the tax havens must commit credibly to honor their implicit promise to keep tax rates low. The cost of sheltering income, the number of tax havens, and the extent to which multinational firms shelter income there are all determined by this credibility requirement. Although the tax rates in the rest of the world (the larger countries which are not tax havens) will affect the number of tax havens, they will have little or no effect on the amount of income which multinationals choose to shelter.

1. Introduction

While the vast popular literature may exaggerate the allure of tropical offshore tax havens (or the perfidy of multinational firms which choose to incorporate subsidiaries there), there is no doubt that many multinational corporations use tax havens to reduce their tax payments. When the parent company is located in a country (such as Canada or Germany) which allows income of foreign subsidiaries to escape nearly all corporate taxation in the parent company's home jurisdiction, the advantages of transferring income to a tax haven are obvious. But even if the parent company's home jurisdiction uses the credit method, there are substantial advantages to transferring income to subsidiaries in low-tax jurisdictions.[1] Transferring income to subsidiaries in tax havens may have some (negative) real consequences on a firm's overall before-tax income, but transfer pricing, intra-company borrowing, and reallocation of ownership of patents and other sources of intangible income do seem widely used.

While the scholarly literature is growing on the nature and consequences of multinationals' use of tax havens, the literature on the decisions of countries to become tax havens is a much smaller one. Slemrod and Wilson's (2009) paper is perhaps the first that analyzes formally the decisions of countries' governments whether or not to become tax havens.[2] Here, a different technology is assumed for the services of tax havens. Although the intellectual debt that this paper owes to theirs is obvious, the modeling variation presented here may provide some testable distinctions. In particular, Slemrod and Wilson show how the supply curve of tax havens should slope up. This paper provides an explanation of why that supply curve might instead be (almost) horizontal.

Slemrod and Wilson describe the tax havens they analyze as “parasitic” because they “sell protection from national taxation”. In other words, the tax havens they describe do not levy lower taxes on capital in order to attract production. Firms, in their model, produce output (using capital and labor as inputs) in countries which are not tax havens. They purchase “‘services’ that facilitate the concealment of taxable income” from tax havens. These tax havens are the sort identified in the 2000 OECD report, very small countries in which a negligible proportion of the world's output and employment is located.

I follow this interpretation of tax havens, that tax sheltering does not involve any movement of a firm's actual production. Use of tax havens of this sort involves purely notional transactions, in which ownership of a patent is transferred among subsidiaries, or in which a firm in a

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1 See Desai et al. (2003), for example.

2 Pieretti et al. (2011) analyze a slightly different choice, whether to attract portfolio investment through low tax rates or through provision of good corporate governance.

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high-tax country issues debt which is held by an affiliate in a tax haven. For my purposes, what is important is that assets can be moved quickly by a parent among its subsidiaries. The hostage problem a company faces with a host country government is less severe than would arise if the company built a factory.

Now the data presented by Hines (2005) show that the previous paragraphs may exaggerate the ephemeral nature of activities in tax havens. He expands somewhat the OECD's list of tax havens. In his sample, although tax havens account for less than 1% of the world's population, 5.7% of the foreign employment of subsidiaries of American-based multinationals is located there, and over 8% of the plant and equipment. However, more than 3/4 of this employment, and more than 2/3 of the investment, are concentrated in Hong Kong, Ireland, Switzerland and Singapore, which are entities that the OECD report did not consider to be tax havens. Many of the (fiercely competitive) favors granted by these 4 governments seem to be inducements for multinationals to relocate production facilities, a different sort of activity than that considered by Slemrod and Wilson.[3]

There are a few features of tax havens, and of the companies which use them, which I wish to emphasize:

- Tax havens peddle avoidance, not evasion. Of course, one hardly expects any government to announce overtly that it is offering illegal services for sale. But even if multinationals may not be eager to trumpet to the world the details of their tax minimization strategies, their diffidence is motivated by public relations considerations, not fear of prosecution. While the OECD report emphasized secrecy as a "harmful" practice of tax havens, tax havens still seem to be thriving in a less secretive environment. Dharmapala and Hines (2009) note that "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 that local transactions will not be reported".

Slemrod and Wilson as well consider the activities of multinationals in tax havens as tax avoidance, not tax evasion. But their tax havens provide concealment services. Concealment takes some work, and uses up some resources. In contrast, providing an address for a holding company does not require much skill or effort: the people in the tax havens in my model won't do very much.

- Tax havens often charge a flat fee for their services. Non-resident corporations in Gibraltar, for example, are exempt from all taxes on income not derived from Gibraltar and not remitted to Gibraltar. Such companies must pay a flat annual fee of 230 pounds, in addition to a one-time set-up fee of 0.5% of authorized capital. Non-resident Panamanian corporations also pay no tax on income derived from activities outside of Panama, but pay an annual corporate franchise fee of $250. Annual license fees in the Cayman Islands (a country with no corporate income tax at all) do vary with the corporation's capitalization, but in a stepwise fashion: $500 for a capitalization of $50,000 or less, $700 for a capitalization of $50,000 to $2,000,000, and $1750 for capitalization of $2,000,000 or more. International Business Corporations in Anguilla pay a flat annual license fee of $230, as well as a one-shot flat set-up fee of $750.[4]
- The value of tax havens to a firm seems to vary considerably with the nature of the firm's business. Banks and shipping companies, which have very mobile capital, are often cited in the popular literature as being particularly egregious beneficiaries of offshore preferences. A list of the 25 (of the Fortune 500) American corporations with the most subsidiaries in tax havens[5] includes 7 whose primary business is banking, 4 in the energy sector, 2 insurance firms and 2 engineering firms; there are few "traditional" manufacturing firms. The Cayman Islands[6] hosts headquarters of 75% of the world's hedge funds, and had subsidiaries of 47 of the world's 50 largest banks in 2001.
- Many large multinationals incorporate many subsidiaries in tax havens. Enron, in its (brief) heyday, was perhaps an extreme example, with 882 different subsidiaries incorporated in tax havens. The vast majority of those were incorporated in the same country (the Cayman Islands), but Enron did use many different tax havens.

While the practice of incorporating many subsidiaries in the same tax haven will not be addressed in this paper, the tendency to locate in several different tax havens will play a role. It will be argued below that use of multiple tax havens will help provide insurance against tax-haven-specific risk. Desai et al. (2003) show that use of several different tax havens may be necessary to minimize tax liabilities when the parent company's country uses the credit system. But insurance may be another motivation. Canada uses an exemption system, and each of the 5 major Canadian chartered banks has wholly-owned subsidiaries in 4 or more different tax havens.

- Despite the absence of tangible hostages, tax havens are perceived as somewhat risky. Perhaps the most compelling evidence on the perceived risk of offshore tax havens is provided by Dharmapala and Hines (2009), in which the quality of government has a significant positive impact on the probability of a country becoming a tax haven. Certainly these findings are consistent with the tax havens' own perceptions. Literature selling the services of tax havens (whether produced by government agencies or by private intermediaries) places a heavy emphasis on government stability and commitment.

In the model developed below, two different types of confiscation risk will be identified. One is an exogenous risk of regime shift. This risk is determined by factors out of the control of the current government of the tax haven, which would correspond to the measures used in Dharmapala and Hines. The other is the risk that the current government may choose to confiscate. In the model, firms will locate in a tax haven only if the current government can commit credibly not to confiscate while it is in power. The annual fee charged to shelter income will turn out to provide such a commitment, in the equilibrium considered.

2. The model: timing

The full formal model analyzed here contains many stages. However, the important decisions here are those made by countries which have chosen to be tax havens: what fees to charge, and (subsequently) whether to renege on their promise not to tax subsidiaries of multinational firms.

There are two groups of agents making decisions in the model: countries' governments, and multinational firms.

In each stage, all decisions are made simultaneously and non-cooperatively.

The sequence of decision making within any period proceeds as follows:

1. Countries choose their type. A country can be a "producing country", in which case it will tax the return to investment (with the tax rates chosen subsequently), or it can be a tax haven. No production takes place in tax havens. Tax havens charge a flat incorporation fee (determined subsequently) to subsidiaries of multinational firms. They promise not to levy any further taxes on the reported income of these subsidiaries.
2. Producing countries choose their tax rates.
3. Tax havens choose the annual incorporation fees for tax-exempt subsidiaries of multinational firms.
4. Multinational firms choose a tax avoidance strategy. They can choose to incorporate a single subsidiary in a tax haven, or choose what I will

[3] Of course, these larger "semi havens" do not neglect completely opportunities for paper shifting.
[4] Annual license fees are also charged by jurisdictions which are not tax havens.
[5] Citizenworks (2004).
[6] Institutional Investor (2006), HSBC (2001).