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Fighting multiple tax havens

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ABSTRACT

This paper develops a competition theory framework that evaluates an important aspect of the OECD's Harmful Tax Practices Initiative against tax havens. We show that the sequential nature of the process is harmful and more costly than a "big bang" multilateral agreement. The sequentiality may even prevent the process from being completed successfully. Closing down a subset of tax havens reduces competition among the havens that remain active. This makes their "tax haven business" more profitable and shifts a larger share of rents to these remaining tax havens, making them more reluctant to give up their "tax haven business". Moreover, the outcome of this process, reducing the number of tax havens, but not eliminating them altogether, may reduce welfare in the OECD.

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1. Introduction

The OECD report on Harmful Tax Competition (1998, p. 23) worked out a number of factors that may be used for identifying tax havens. One of these factors is existing national bank secrecy rules, which have been utilized to support tax haven activities. Such rules protect investors "against scrutiny by tax authorities, thereby preventing the effective exchange of information on taxpayers benefiting from the low tax jurisdiction" and effectively enable investors to avoid paying the respective capital income taxes in their country of residence. Since the 1990s several initiatives have been launched against tax havens by the OECD, the G8, the United Nations Office for Drug Control and Crime Prevention and the European Union, in response.

Most prominent is the 1998 OECD initiative subsequently known as the Harmful Tax Practices Initiative, which was intended to discourage the use of preferential tax regimes for foreign investors and to encourage effective information exchange among the tax authorities of different countries. As part of the initiative, the OECD produced a list of countries and territories that it deemed to be tax havens. Over the years OECD attitudes with regard to tax havens shifted from confrontational to cooperative. OECD and non-OECD countries have worked together to develop mutual standards of transparency and exchange of information, which have come to serve as a model for a vast majority of the 3600 bilateral tax conventions entered into by the OECD and non-OECD countries and may now be considered as the international norm for tax cooperation (see, e.g., Kudrle, 2008). If this information exchange is sufficiently effective, this would close down the respective country's activities as a tax haven. The dynamic process of implementation of these agreements, however, stretches over many years. Between 2000 and the London Summit Declaration in 2009, only 100 Tax Information Exchange Agreements (TIEAs) had been signed between OECD countries and the financial centers; furthermore, these signings for the most part have been limited to a small number of countries. Despite the surge in TIEA signings which has taken place in the months after the London Summit, it is evident that not all agreements were made simultaneously, and the process is far from being complete. The fight against tax havens has been characterized by a sequential pattern, and agreements have not been conditioned on each other.

We compare the sequential approach taken with a simultaneous coordinated approach of effectively closing down tax haven activity (i.e., by enforcing appropriate information exchange institutions that remove the implementation process). 'Exit' by some tax havens (in the sense of complying with OECD information exchange rules) has implications for other tax havens' business opportunities. Tax havens compete with each other for customers and their capital. If the

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vast majority of competitors exits the tax haven business, the equilibrium payoffs of the tax havens that remain active increase, making it more attractive for them to continue their business. We show that this market concentration effect makes the process of closing down the tax haven business of one tax haven country after the other particularly costly, compared to a simultaneous and coordinated, all-in-one approach.

The OECD and other supranational entities engaged in the fight against tax havens may not have the option of an all-in-one approach. But for this case our analysis reveals a hidden cost of the sequential process that is not obvious from the outset.[1] Taking estimates of possible parameter values, we show that a sequential approach can be 1.5 times more costly than a simultaneous conditional approach. Furthermore, we show that given a sequential implementation pattern, from the perspective of the overall cost, it is less costly to approach larger havens first. A finding which does not correspond to the pattern of recent TIEA signings.

The public finance literature on tax havens has so far concentrated on the welfare implications of corporate tax planning and avoidance. The standard view underlying the OECD initiative is that tax havens may strengthen tax competition and erode the tax revenues of non-tax-haven countries.[2] Some of the literature also reveals possible countervailing effects suggesting that tax havens may actually provide benefits as well.[3] A diversity of views exists that is surveyed by Dharmapala (2008). However, this literature basically takes tax havens (typically one) as a given.[4] Slemrod and Wilson (2009) take a negative view on tax havens and account for the existence of multiple tax havens and tax haven fighting expenditures. To our knowledge this literature disregards the role of competition and market concentration between tax havens and the change in competition that emerges from the OECD policy that tries to change the set of tax havens. However, it is exactly this effect which needs to be taken into consideration in the process of closing down tax haven operations.[5]

For a description of competition between tax havens we adopt the formal structure of Bertrand markets with subsets of price sensitive and loyal or partially uninformed consumers, building on the fundamental insights of Varian (1980). More specifically, we rely on the competition model by Narasimhan (1988).[6] Tax competition is typically described as a variant of competition in tax rates (i.e., in “prices”). The Varian/Narasimhan framework is a natural generalization of such Bertrand competition, with the standard Bertrand type of competition as a special case. This more general structure is sufficient to map a continuum of competition regimes, ranging from local monopolies to standard Bertrand price competition (which is closest to the standard approach in the tax competition literature), and it is suitable to consider the competition and market concentration effects stemming from policies that deactivate tax-haven activities for a subset of tax havens.

The implications of these changes in market concentration for a simultaneous or sequential deactivation of tax havens are the main drivers of our results. Changes in market concentration play a major role in many other areas of international economics. Merger or exit by some competitors in a given market generates externalities to other competitors and also influences others' merger or exit decisions. These effects have been explored along a large variety of dimensions. Examples in contexts such as strategic trade policy, outsourcing, and other policy areas are Dixit (1984), Horn and Levinsohn (2001), Lommerud et al. (2006) and Norbäck et al. (2009). In our framework the change in market concentration is caused by one player who is not a tax haven itself, but governs the possible exit or deactivation of some of the tax havens that compete among themselves, rather than by a merger. This difference is discussed in more detail in Section 6.

Our paper is structured as follows: Section 2 develops the model framework. In Sections 3 and 4 we solve for the equilibria of the multi-stage game. Section 5 discusses and compares the different deactivation regimes, their results and implications. Section 6 discusses the robustness of the results, in particular with respect to more than two tax havens and provides a numerical example. Section 7 concludes.

2. The structure of the problem

We consider a multi-stage game with three players: One player is the government in the country or group of countries that engage in fighting tax havens (or, for that purpose, the OECD).[7] We call this player S. Residents in S are the sole owners of financial capital. The other two players are tax havens, denoted H_1 and H_2, which seek to attract mobile capital by offering concealment services. Depending on the tax rate on capital income in S, whether the tax havens are active, and the terms which the tax havens offer for their services, financial capital can allocate between S, H_1 and H_2. Our analysis generalizes for more than two tax havens, as is shown in Section 6.

In Phase 1 – the haven deactivation phase – actions by S, H_1 and H_2 determine whether no, one or two tax havens will be available for investors. Country S may offer to compensate the tax haven in exchange for its promise to enter into full information exchange and effectively discontinue its tax haven business. The assumption by which S compensates the tax havens to terminate their operation rather than threatening them with retaliatory actions that are costly for the country that carries them out is mainly for analytical simplicity and clarity.[8] We distinguish between two different types of offers made. One of these types is seen as a possible option that is currently not pursued. The other type maps more closely the current OECD initiative.

2.1. Simultaneous joint offer

Country S offers payments $b_1 \geq 0$ and $b_2 \geq 0$ to the two tax havens H_1 and H_2, respectively. S is able to commit to either pay both amounts or none, and to make this payment dependent on whether both havens agree. Tax havens then simultaneously and independently declare whether they would be willing to accept this offer. Each tax haven commits to close down in exchange for receiving the payment, but continues to operate if no payment is received. Accordingly, if both agree, then S makes both payments. If payments are made, both tax havens go out of business. If only one tax haven declares agreement or if none of the tax havens declares agreement, then no money is paid out and both tax havens remain active, and we move to Phase 2 of the game with two active tax havens.

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[1] The problem entered into the policy discussion only very recently. An example is Rosenzweig (2011, p. 21) who acknowledges: “It only takes one tax haven in the world to undermine a cooperative dynamic among other countries in the world.”

[2] A formal analysis along these lines is provided by Slemrod and Wilson (2009). For an analysis focusing on the harmful effects for developing countries see Torvik (2009).

[3] See, e.g., Hong and Smart (2010), Desai et al. (2006) and Johannesen (2010).

[4] Slemrod (2008) provides an empirical analysis of the possible factors (including income, literacy, development aid, size or whether a country is an island) that make it more or less likely that a country engages in activities as a tax haven (following the OECD classification).

[5] Considerable research has taken place to understand the economics of bilateral versus multilateral trade negotiations and agreements, see for example Bagwell and Staiger (2010). Research involving bilateral tax treaties has mainly focused on their investment effects between high-tax countries, see Chisik and Davies (2004).

[6] This competition model became a workhorse model in Industrial Organization. In the tax competition literature, this framework has been used by Wang (2004), Andersson and Konrad (2001), Konrad and Kovenock (2009) and Marceau et al. (2010).

[7] There is a free-riding problem among the OECD countries. We disregard this problem in order to concentrate on the market effect. In some sense and particularly with regard to the fight against tax havens, the OECD is the institution that coordinates its members on a common anti-tax-haven policy.

[8] An approach not using a “carrot” but a “stick” would yield results with a similar flavor. A punishment threat to a haven is costly for S as well, and causes a differential in payoff for the tax haven between compliance and non-compliance plus punishment. Unlike for the simple compensation that we consider, however, the cost and this differential need not be of equal size.

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