 Clemens Fuest

A boat is moored at Rum Point on Grand Cayman Island.

Shady Deals

Tax havens are commonly perceived as islands located somewhere under the tropical sun, where businessmen, lawyers and bankers engage in dubious affairs, escaping taxation and regulation in their home countries.

WHILE THERE CERTAINLY ARE TAX havens that correspond to this cliché, the real world of tax havens is more diverse, with various types of locations being used for different purposes.

The first of is a group of very small countries, frequently places like the Cayman Islands, Bermuda or Mauritius. Typically, these tax havens focus on the provision of legal and financial services, rather than the creation of large industrial production plants. The second type includes larger nations like Switzerland, Ireland, Panama or Hong Kong. These countries offer low taxes and a well-developed financial services industry, but are also locations for significant industrial production. Then there is a third and less well-known type of tax havens: areas of low taxation within countries that may otherwise have high taxes. This includes special enterprise zones and free trade zones, but also legal arrangements limited to certain types of firms. Some countries offer attractive tax arrangements to foreign investors which are not available for domestic firms.

What is it that makes countries become tax havens? Size is one factor. Small countries benefit more than large countries from offering low taxes because the business they can attract from other countries is large, relative to domestic activities. But

being small is not enough. Political stability, a reliable legal system and good governance in general are of key importance. Countries with poor governance will never attract much foreign capital, even if they offer low taxes.

In recent years, tax havens have come under increasing critique. They are widely seen as helping firms and wealthy individuals from other countries to avoid and evade the taxes and regulations of their home countries. For instance, multinational companies may set up subsidiaries in tax havens, endow them with capital and lend money to their subsidiaries in more highly taxed countries. The interest paid would reduce taxable profits in high tax countries and generate profits in tax havens. This erodes tax revenue in the higher tax countries and intensifies tax competition by forcing other countries to reduce their taxes.

Another issue is that banking secrecy laws and a lack of cooperation between tax authorities allow residents of high tax countries to evade domestic taxation. The simplest way of doing so is to hold financial assets in an offshore bank account and avoid reporting the investment income to the tax authorities in the residence country. This is sometimes achieved using sophisticated instruments like foundations, trusts and offshore companies. Suspicion regarding tax havens has been fuelled by spectacular cases of tax evasion like that of the former CEO of the German company Deutsche Telekom, who was detected hiding millions of euros in a bank account in Liechtenstein.

While most observers see the role of tax havens as almost exclusively negative, economic research has led to a controversial debate about the possibility of a positive role of tax havens. One argument claims that tax competition is beneficial in general, because countries tend to levy excessive taxes. From this perspective, everything that reduces the ability of countries to levy taxes seems beneficial. This view raises controversial issues about the legitimacy of tax policy decisions in general. It seems to be most relevant in cases where governments are non-democratic or dysfunctional, a point to which we will return.

Some economists also argue that, paradoxically, tax havens may even be beneficial for the rest of the world if tax competition as such is harmful. Firstly, they challenge the view that tax havens erode the tax revenues of other countries and point to the fact that the share of corporate tax in overall tax revenue has increased in most countries during the last decades, despite declining tax rates. This might suggest that high tax countries are successful in protecting their tax bases. However, others object that growing corporate tax revenues just reflect rising corporate profits, and that tax revenue would be even higher in the absence of tax havens. Secondly, there is evidence that economic growth in high tax countries located close to tax havens is higher than in other countries. One explanation could be that tax havens allow firms to invest in nearby countries with higher taxes precisely because the tax havens allow firms to get around these high taxes. Of course, the causality may also go the other way. Countries located close to areas of dynamic growth may find it attractive to become tax havens. Also, one wonders why high tax countries need foreign tax havens to achieve that; they might as well, and in fact, often do, make direct tax concessions to foreign investors. Thirdly, some economists even argue that tax havens may paradoxically reduce the intensity of tax competition. If tax competition for mobile investment forces countries to reduce general corporate tax rates, they also collect less revenue from purely national and less mobile firms. By letting multinational firms do some tax planning through tax havens, countries may avoid cutting taxes on less mobile firms. This policy strategy is similar to pricing strategies of private firms. They will try to charge high prices to loyal customers and lower prices to other, more price sensitive groups. But again, the question is why high tax countries would need tax havens outside their own borders, rather than creating their own special tax regime for mobile firms.

The debate about these arguments and the interpretation of the available evidence is not finished. But one should note that it mainly addresses the issue of tax planning by multinational firms. While this planning may or may not be detrimental, it does happen more or less openly. Tax authorities of high tax countries are usually quite well informed about the foreign activities of their multinational firms.

This is an important difference to the second area of concern: tax evasion by wealthy private individuals. In these cases, taxation cannot be enforced because private investors hold assets in foreign bank accounts precisely since this allows them to evade domestic taxation. Bank secrecy and the absence of cooperation between tax havens and tax authorities of other countries make tax havens an interesting location for this type of investor. It is much more difficult to find merit in this role of tax havens, and few economists would be willing to defend it.

For a long time, high tax countries did not seem to be too worried about tax havens and offshore financial centres. For instance, Britain could have forced its crown dependencies and overseas territories like the British Virgin Islands or the Cayman Islands to change their tax practices but did not do so. To some extent, tax haven activities are also favoured by loopholes in the tax systems of high tax countries. For instance, one way of preventing profit shifting to tax havens is to limit the deductibility of interest payments of royalties to these countries. Of course, this requires high tax countries to cooperate closely because if one high tax country fails to follow this rule payments can be channelled through that country into the tax haven. For a long time, almost no such cooperation has taken place.

However, more recently concerns about the impact of tax havens have led to various political initiatives directed against tax havens. Some of these initiatives are unilateral. For instance, the United States government has put considerable pressure on Switzerland and the UBS, one of the country's leading banks, to

AP PHOTO/CAYMAN ISLANDS DEPT. OF TOURISM

The Swiss Bank UBS on Zurich's Bahnhofstrasse, Switzerland.

AP PHOTO/KEYSTONE, WALTER BIERI, FILE

cooperate with American tax authorities in enforcing taxation. But the most important initiative was started by the Organisation for Economic Cooperation and Development (OECD) in 1998. This began with a rather broad approach, questioning the role of tax havens in various areas including the taxation of both multinational corporations and private individuals. After some debate the initiative set aside the taxation of multinational firms and focused on the issue of tax evasion by individuals. It became a key objective of the initiative to make sure that tax haven countries were willing to provide information to foreign tax authorities in cases where the latter were to investigate cases of tax fraud or evasion. For this purpose the OECD developed a set of rules specifying conditions under which information would have to be provided. In 2000, the OECD published a 'black list' of 38 tax haven countries which were classified as uncooperative because they failed to comply with the OECD rules for exchange of tax information. In the following years, most of these countries changed their practices and adopted the standards for information exchange required by the OECD. Increasing pressures related to the financial crisis have accelerated this process. In May 2009, the OECD reported that its list of uncooperative tax havens was empty.

However, this does not mean that tax evasion by wealthy individuals is a thing of the past. There are many loopholes in the arrangements. For instance, if financial assets are held through offshore firms, rather than personally, information exchange may fail to identify tax evaders. Moreover, complying with OECD rules currently requires tax havens to sign information exchange agreements with just twelve countries, not all countries.

This raises the question of whether the OECD should try to extend information exchange and pursue global tax transparency as a long term objective. Here two obstacles arise. The first is a practical one. Providing information to foreign tax authorities is costly. As long as this exchange is symmetric, that may be acceptable. But in offshore financial centres information flows will be asymmetric, so that the distribution of additional administration costs is also asymmetric. In principle, this could be addressed by introducing a fee payable by the country requesting the information.

Another, more fundamental issue is that, in certain cases, hiding investment in offshore financial centres may be driven by legitimate objectives. For instance, for residents of countries with dictatorial or dysfunctional governments, investing in tax havens and hiding their accounts may be the only way of protecting themselves against expropriation or extortion. Therefore information should only be provided to governments of democratic states with a reliable legal framework, where taxpayer information is protected effectively. This suggests that the way towards more tax transparency requires efforts not just from tax havens but from all countries. Minimum standards of good governance should not just apply to countries providing information but also to those requesting it.

What is the future role of tax havens and offshore financial centres? In order to survive they will have to demonstrate that their business model is something other than providing opportunities for tax evasion. Given the increasing role of international financial flows and global business, and given the experience and expertise of financial institutions located in these countries, that should be possible.

CLEMENS FUEST is Professor of Business Taxation and Research Director of the Oxford University Centre for Business Taxation. He is a research fellow of CESifo and IZA.