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## Unintended consequences

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### The less obvious uses of tax havens

FRANCE has always taken pride in its refusal to embrace the harsher aspects of capitalism and globalisation—from its 35-hour work week to laws that make it difficult to sack employees. But in a global economy no one can sit still. In a new year's speech to labour unions and companies in January, Jacques Chirac, France's president, called for cuts in France's corporate-tax rate from 33% to 20%, and as low as 10% for some companies. That is below Ireland's 12.5%, at which the French have often sniped in the past.

Yet it is OFCs that are seen as tax rogues, for two reasons. First, they are seen to be spurring tax competition among countries. True, some onshore economies are doing much the same, but OFCs use taxes to attract mobile financial capital (and profits) without any "real" business underpinning it. Second, OFCs are thought to be aiding tax evasion, the unlawful avoidance of tax. These two issues are often confused.

The risk of tax competition is that it could spiral out of control, starting a "race to the bottom" as real economies cut tax rates on mobile capital and transfer the tax burden to labour and other immobile factors in order to keep up with lower-tax competitors. This prompts other countries to follow suit—and so on and downward. In the bleakest scenarios social-welfare models would crumble because governments would be unable to pay for public services and there could be a backlash.

Poorer countries could also find it harder to compete on taxes, reinforcing the perception that globalisation is unfair. A recent paper by Harry Garretsen and Jolanda Peeters of the Central Bank of the Netherlands analysed annual data for 19 OECD countries from 1981 to 2001 and found that big, rich countries, such as Britain and Germany, were better able to resist tax competition and maintain high corporate tax rates than smaller, poorer ones. It concluded that "if there is a race to the bottom, it

seems that it is more real for some countries than others."

But for now that is still a big "if". A stack of academic studies has documented that foreign investment is sensitive to tax rates, and Mr Garretsen and Ms Peeters found in their study that footlose capital did indeed lead to tax competition. A 1% increase in their measure of capital mobility was associated with a 0.5% drop in effective corporate-tax rates.

But this competition does not seem to have started a downward race. As a proportion of GDP, total tax revenues have increased steadily over the past 30 years even as statutory tax rates have fallen. This is true even in the EU, where drops in statutory tax rates have been particularly dramatic. Effective average corporate-tax rates have also fallen (see chart 4). Yet according to a paper published last June by Gaetan Nicodeme of the Solvay Business School in Brussels and the European Commission, corporate-tax collections in Europe as a proportion of GDP have remained stable over the past decade, at around 3%. He says this may be because lower tax rates have allowed countries to attract a large corporate-tax base.

Even if it does not cause a race to the bottom, tax competition is not necessarily benign, says Michel Aujean of the European Commission. Corporate profits have boomed in recent years and tax collection has followed. More companies are being set up, so there are more to be taxed. And in many countries cuts in statutory tax rates were accompanied by measures that closed loopholes, thus broadening the tax base. All this means that the numbers may not be as reassuring as they seem to be.

Oxfam, a not-for-profit group that works to alleviate poverty, says tax competition is already very real for poor countries. In a report published in 2000 it estimated that developing countries lose at least \$50 billion a year to tax havens, about the same amount as rich countries dole out to poor ones in foreign aid.

John Christensen of the Tax Justice Network takes issue with the term "tax competition". He says that "true competition spurs productivity and efficiency in the market, while tax incentivisation—which is what this is—only increases after-tax profits. The two are not the same." He argues that the tax regimes of OFCs and their onshore copycats distort economic decisions.

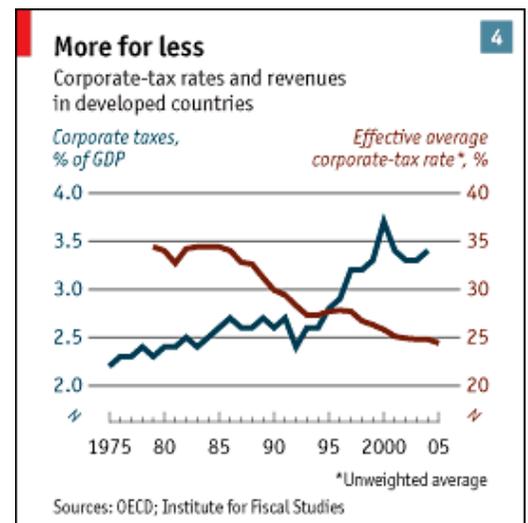
Many economists and businessmen disagree with Mr Christensen, arguing that competition of any kind is a healthy, disciplining force. "Tax competition is the only agent of productivity for governments—it is the only competition they have," says Jacques de Saussure, a partner at Pictet & Cie, a Swiss private bank. But he agrees that it can go too far, because the rich tend to be more mobile than the poor and can hire advisers to minimise their tax bills.

## Complements or substitutes?

Even those in favour of tax competition seem to assume that tax havens take business (and hence taxable profits) away from onshore economies: that the amount of economic activity in the world is fixed and that a dollar booked in Guernsey is a dollar less for France. However, a wealth of academic research has shown that when a company opens a plant abroad, demand in its home country gets a boost too: sales by the parent company grow and jobs and exports at home tend to rise. But does this also hold true if profits are simply shifted to tax havens?

A fascinating study published in 2006 by Mr Hines of the University of Michigan and Mr Desai and Fritz Foley of Harvard Business School provides evidence that it does. Looking at data on American multinational companies from 1982 to 1999, the economists found that tax havens boosted economic activity in nearby non-havens rather than diverting it.

They offer two possible explanations for this surprising result. The first is that a company's subsidiaries



in tax havens may add value by providing important intermediate inputs used by its operations elsewhere. The second, more interesting one is that in helping multinational companies lower their effective tax rates—even if this is done simply by profit-shifting—OFCs could make high-tax countries more attractive to foreign investors. So a relatively high-tax country such as France might see a drop in foreign investment if nearby tax havens went out of business, because foreign companies would no longer be able to use them to minimise French tax bills.

If true, this opens up the possibility that tax havens complement onshore jurisdictions rather than substituting for them, and that the interaction between the two increases total economic activity in the world. If the pie gets bigger, then both tax haven and onshore jurisdiction will benefit. An interesting side-effect may be that onshore economies are able to maintain higher general levels of income tax because mobile capital, which is sensitive to tax rates, will help itself to a lower effective tax rate by using OFCs. "Tax havens are like pressure valves," says Mr Hines. "The companies that might otherwise leave a high-tax country for a lower-tax home stay put because they can use tax havens to lighten their tax load."

This could be the reason why governments in onshore jurisdictions the world over do little to stop the use of tax havens, even though they constantly complain about them. British politicians, for instance, sometimes talk about scrapping their country's rule on resident non-domiciles because it allows wealthy people domiciled abroad, often in tax havens, to live in Britain tax-free. That would simultaneously increase Britain's tax take and seriously dent the offshore business of nearby tax havens. Yet nothing is ever done, perhaps because doing away with the rule would cause an exodus of wealthy and often brainy residents that would hurt the economy more than the tax forgone. Similarly, America and others could quite easily curb the use of tax havens by tightening those parts of the tax code that already penalise the use of OFCs, but they choose not to do so.

In a paper published last spring, Andrew Rose of the Haas School of Business at the University of California at Berkeley and Mark Spiegel of the Federal Reserve Bank of San Francisco argue that OFCs may offer other benefits too. They studied the banking sectors of 221 countries and territories and found that the nearer a country was to a tax haven, the more competitive and efficient its banking system appeared to be. "Offshore competitors can keep onshore banking sectors on their toes," explains Mr Spiegel. "They probably facilitate sleaze but can still have unintended positive effects."

## Laundry list

The sleaze factor is conspicuously absent from all these studies, which concentrate on the OFCs' role as low-tax jurisdictions. But what if a low-tax OFC is shoddily regulated or its rules are opaque?

By definition there are no reliable figures on money-laundering worldwide, because its perpetrators try to make the proceeds of financial crime indistinguishable from legitimate money. Michel Camdessus, a former managing director of the IMF, once estimated the amount of money laundered globally at 2-5% of world GDP. Based on world output in 2005, that would put the current figure at about \$2.1 trillion. This is a problem not just for tax havens but also for some onshore financial centres. Augusto Pinochet, the Chilean dictator, hid millions of dollars with the help of Riggs Bank, based in Washington, DC.

The proportion of illicit funds that is detected is minuscule, and would be even tinier without co-operation across borders. This is where criticism of OFCs is justified. Some of them have rules that make it very difficult to exchange information with foreign enforcement authorities. Others do not register the companies that set up on their shores, so could not provide such information even if they wanted to. Cayman does register its offshore companies, of which it has over 70,000, and willingly assists foreign law-enforcement agencies, but it does not require companies to disclose their beneficial owners, so the information is not all that helpful.

Other financial centres that co-operate on money-laundering and other criminal investigations balk at sharing information on tax matters. This includes not just OFCs but onshore jurisdictions with strict banking-privacy rules.

Jurisdictions that cling to secrecy rules are "selling a shield against the laws of foreign governments",

says Mr Merrill. "Enforcement is almost impossible when faced with this shield." Indeed, although tax revenues have been on the upswing, the OECD's Mr Owens insists that tax evasion is a real problem, and a growing one: Ireland, which some consider to be a tax haven in its own right, last year recovered almost €1 billion in unreported tax revenues from banks in the Channel Islands. South Africa reckons it is losing 64 billion rand (\$ 8.8 billion) a year to tax havens. Crackdowns on tax cheating in America, Britain, Canada and Australia have netted billions of dollars. Most of the cheats are individuals who cannot argue that global competition is driving them to it.

Mr Desai of Harvard is studying the effect of OFCs on the corporate governance of companies that use them. He reckons that they may facilitate corporate misdeeds, even unwittingly, because unscrupulous managers can use the often complex and opaque structures companies set up in tax havens for all sorts of dodgy doings. Mr Desai points out that Tyco and Parmalat both had thousands of subsidiaries offshore which its managers used not only to reduce their tax bills but also to loot the company. Enron's 700 companies in Cayman allowed its corrupt bosses to minimise taxes but also manufacture earnings. "This is the underappreciated real cost of OFCs, rather than lost tax revenues," says Mr Desai.

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