INFLUENCE OF TAX HAVENS ON THE FUNCTIONING OF DEVELOPING AND DEVELOPED COUNTRIES

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ABSTRACT

This article discusses the impact of tax havens on developing and developed countries. Economic research in this area has proved that tax havens not only play a key role on the international capital market, but above all are responsible for the internationalisation of economic activity on a global scale. Representatives of theory, practitioners and regulators for decades conducted research related to the assessment of the impact of tax havens on countries with high taxes in terms of the erosion of their base. The obtained results clearly show that these countries face a significant decline in income, however, some researchers (especially Hines) show that there are positive side effects of this process indicating the creation of a new model in the global financial symbiosis.

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INTRODUCTION

The significant increase in legal regulations and taxation in the post-war period in the economies of OECD countries is one of the main factors that led to the development of tax havens over the last decades (Hines, 1994). A huge expansion of global business operations that began in the 1980s had a significant impact on the economies of tax havens. Demand for access to financial services facilitating tax avoidance increased at a galloping pace (Hines, 2005, pp. 65-99).

Tax havens and, in particular, the Offshore Financial Centres, are recognised as entities that played a key role in the development of modern financial markets (Hamp-
Along with the delivery of useful and relatively cheap development strategies for an increasing number of small countries and islands, they have contributed to the growth of global capital, increased the dynamics and volatility of global financial markets, and laid the foundation for the liberalisation of the global economy. The development of offshore companies, in an almost unregulated environment, created a completely new space for financial transactions, which was soon completely dominated by them, and globalisation of economies took on a completely new meaning.

It is not surprising, therefore, that economists and lawyers have focused on research, analyses and solutions undertaken to systematise the types of economic activities naturally attracted and maintained by tax havens. Current research focuses on the impact and size of tax havens’ activities and usually illustrates the division into direct investments in the form of, for example, relocation of service centres (Hines & Rice, 1994) or strictly financial, where there is only cash flow (Rose & Spiegel, 2007).

There are also other additional factors that have played an important role in the development of tax havens. First of all, cross-border expansion of business operations and the development of international trade triggered increased demand for lower-tax reallocation of profits, especially among international companies. Second of all, by reducing loan costs and stimulating investments, tax havens and Offshore Financial Centres partly contributed to the liberalisation of domestic markets and to the increase in the number of participants. OFCs have had a huge impact on international finance, stimulating the deregulation of the global financial market, encouraging the abolition of various restrictions and changing the character of the international tax system. Mobility of capital has made funds flow from countries with high levels of savings to countries with higher interest rates and better investment opportunities. Third of all, progress in transport, in particular in the field of communication and the emergence of the Internet network, made it possible to use tax havens and Offshore Financial Centres basically without the need to visit them.

After collecting data on the real size of activities carried out in tax havens, further research consisted in estimating the impact of tax havens on developed countries. Research conducted in this area estimates the negative impact of tax havens expressed in loss of income by developed countries through various research methods. The obtained results, however, do not lead, at all, to unanimous conclusions regarding the positive or negative impact of tax havens on the economies of other countries. If we consider adverse effects in terms of income loss, based on tax returns for 1996–1998, the U.S. Tax Office found that revenues lost due to non-compliance with transfer pricing rules amounted to $3 billion (U.S. Department of Treasury, 1999). Chairman Levin of the U.S. Senate Subcommittee on Internal Affairs estimated that the size of ‘offshore havens’ increased from $200 billion in 1983 (thirty jurisdictions) to $5 trillion in mid-2001 (sixty jurisdictions), of which $3 trillion are located only on bank accounts (Levin, 2001). United Nations’ estimates indicate about $8 trillion accumulated in ‘offshore companies and bank accounts’ (Mitchell, 2000). According to Oxfam, in 2000, the total sum in ‘offshore centres’ ranged from $6 to $7 trillion, of which $3 to $4 trillion is considered to be private investors’ savings (Oxfam Policy Department, 2000). Another organisation, which is the Tax Justice Network, estimates that the size of funds accumulated in tax havens by
natural persons is about $11.5 trillion. This results in an annual loss of income tax on these assets in the amount of about $250 billion, which is five times greater than the amount required by the World Bank in 2002 to achieve the UN Millennium Development Goal, which was to halve the world poverty by 2015. According to the Tax Justice Network, such a sum of money could also allow a change in the global energy infrastructure, which in turn would prevent further climate change. In 2007, the World Bank confirmed estimates of Global Financial Integrity, claiming that cross-border flows of global profits from criminal activity, corruption and tax evasion are around $1-1.6 trillion annually, half of which comes from developing economies and economies during transformation. In 2009, the updated survey results of Global Financial Integrity estimated that annual cross-border flows from developing countries alone range from about $850 billion to $1.1 trillion a year.

Regarding academic studies (Avi-Yonah, 2000), it was estimated that the loss of tax revenues resulting directly from the deferment of income tax on all subsidiaries of U.S. companies was $2.2 billion in 1997, while in 2004 this amount increased to $3.4 billion. The author also quoted Dooley (Avi-Yonah, 2000) estimating the outflow of portfolio capital from the USA, motivated by tax reasons for the amount of $250 billion in 1980-1982. Schneider and Enste (Schneider & Enste, 2000) found a significant 'black economy' in OECD countries in the early 1990s with an unweighted average for all members at 11.3%-15.4%. Altshuler and Grubert (Altshuler & Grubert, 2008) estimated a loss of about $11 billion in 2002, $13 billion in 2004 and $26 billion in 2007. Sullivan (Sullivan, 2004) calculated that, on the basis of differences in income before tax, the loss in 2004 was between $10 mln and $20 mln, and assessed the estimated increase in loss of income resulting from shifting profits in 1999-2004 for as much as $17 billion.

Christian and Schultz (Christian & Schultz, 2005), using data from tax returns on asset return, estimated a capital transfer of $87 billion in 2001, which at a 35% tax rate would result in a revenue loss of about $30 billion. Pak and Zdanowicz (Pak & Zdanowicz, 2002) examined import and export prices and estimated that the loss of income caused by incorrect prices reached about $73 billion in 2001. Clausing (Clausing, 2009), using methods of regression analysis on data from all over the country, examined the reported profits as a derivative of tax rates and concluded that assuming a 35% rate of tax imposed on revenues brought out of the USA, the sums amount to about $180 billion.

According to some authors (Kurdle & Eden, 2003), the difficulty in accessing general data on the negative impact of tax havens on other countries may be attributed mainly to the fact that the estimates include unlawful activities that are not reported anywhere. The vast majority of existing empirical studies assesses the overall value of tax evasion and is not able to correctly identify this part of tax evasion that results from investments entering tax havens.

Another direction of research has shown that investments attracted by tax havens can have a positive side effect in neighbouring countries. In particular, Hines (Hines, 2005) examined the possible retreat of economic activity from countries with higher taxes as a result of the erosion of the tax base attributed to tax havens. Concerns in this respect are usually higher in relation to nearby tax havens, absorbing the tax base, which should otherwise constitute a source of state revenues. Despite this thesis, Hines’ research suggests completely different conclusions than those generally accepted. For-
eign activities of tax havens and neighbouring investments in countries with higher taxes seem to complement each other: an increase in the likelihood of establishing a branch in a tax haven by 1% is associated with a 2-3% increase in the probability of increasing investment and sales in neighbouring countries with higher taxes. Such an observation indicates that the close presence of a tax haven is rather stimulating than it causes a decline in economic activity within a region or federation. According to Hines, the activity of tax havens can stimulate activity in neighbouring countries by facilitating the reduction of tax rates or by reducing the costs of goods and services that make up production or sales in high tax countries.

Tax minimisation measures involve various implications for the authorities of neighbouring countries, because they can lead to erosion of the tax base and the resulting reduced tax collection – assuming that the increased economic activity associated with neighbouring tax havens involves a greater cost manifested in lost tax revenues of the state. The assessment of this impact depends, however, on the careful consideration of the type of measures leading to tax evasion, to which branches in tax havens are established. In particular, it is possible that the use of international companies in tax havens allows governments of countries with high taxes to improve their tax systems by imposing on foreign companies other taxes than those applicable to domestic companies. In addition to side effects in neighbouring countries, Desai and Foley (Desai & Foley, 2006) have also noticed an important fact that the reduced costs of using tax havens (i.e. lower tax rates on foreign investments) do not seem to push businesses out of developed countries and that reliable calculations estimating such pushing away do not exist (Biswas, 2002). The companies are partially responding to reduced start-up costs in the tax haven by increasing their foreign investments in neighbouring countries with high taxes. Careful use of branches in tax havens, according to the authors, allows foreign investors to avoid some tax burdens and to maintain foreign investments at a higher level than in the case of operating costs in tax havens at a higher level.

Rose and Spiegel (Rose & Spiegel, 2007), analysing the Offshore Financial Centres, used the gravitational trade model to explain the activities between the two countries as a positive function of the economic masses of these countries and the negative function of the distance between them. In practice, the population and real GDP per capita are used as a substitute for economic mass, and the great circle and several other measures as a substitute for economic distance. After determining these influences, the authors checked whether international indicators can still fulfil an additional role. Rose and Spiegel observed both the determinants of the Offshore Financial Centres and the consequences flowing from the Offshore Financial Centres for neighbouring countries. They empirically proved that they encourage inappropriate behaviour in the source countries, as they facilitate tax evasion and money laundering. At first glance, therefore, the term ‘parasite’ most accurately characterises them, as they are designed to carry out activities detrimental to the state of the economy of the native countries of their clients. Nonetheless, tax havens can generate positive effects, such as increasing the competitiveness of the local banking sector. With the help of the national banking monopoly model faced by external competition from the tax haven, Rose and Spiegel have shown that the closeness of the latter increases the competitive behaviour of the banking monopoly and can increase the level of general prosperity. Due to the fact that the proximity of a given country to the tax haven is connected with a more competitive national
banking system and a greater level of financial intermediation, the term that better reflects the character of tax havens is the ‘symbiont’.

In the light of the above, without denying the loss of the tax base to countries with high taxes in connection with transactions carried out in tax havens, everything seems to indicate that the overall net impact of offshore investments on rich countries should not be described as negative. There is a risk that the measures taken against tax havens in response to the above-mentioned erosion of the tax base will be disproportionate to the overall net benefits resulting from investments in tax havens.

Current economic literature focuses on the impact of tax havens on developed countries, but hardly deals with their impact on developing countries. According to the latest research, tax evasion strategies using tax havens affect the indicators of developing countries, which therefore suffer from adverse impact on their development programmes (Sharman, 2010). As in the case of industrialised countries, the decline in tax revenues and the decline in international trade resulting from the activities of tax havens are clearly the greatest concern of developing countries.

According to the information posted on 13 March 2009 on the Oxfam website, developing countries lose about $124 billion annually due to offshore assets placed in tax havens. The analysis conducted for Oxfam by James Henry, former chief economist at McKinsey&Co, showed that natural persons in developing countries are holding at least $6.2 trillion in tax havens, depriving their countries of tax revenue between $64-124 billion annually. If we also include funds transferred to tax havens by private companies, the amount would be much higher. The size of the above losses could easily exceed the amount of $103 billion that developing countries receive annually as part of foreign assistance. This problem is still growing, as about $200-300 billion are shifted to offshore companies each year. According to Oxfam, a wider reform of the financial system would reduce unpredictability, increase accountability and give developing countries a greater share in managing the global economy.

After reviewing the current economic literature on the impact of tax havens on developed and developing countries, it is worth focusing on the impact of tax havens on the economy of their own. The benefits achieved by tax havens due to attracting foreign investors by means of advantageous tax systems are obvious. The tax haven authorities receive additional income, even at low tax rates, which otherwise they would not get. They also collect a tax on the salaries of employed staff, income of suppliers of goods and services, as well as VAT and sales tax, if any exist. However, the level of real economic development stimulated by foreign investors in tax havens is a completely separate issue. According to Irish (Hines, 2005), for example, the extreme volatility of operations in tax havens does not allow for continued stable economic growth that benefits the majority of the local tax haven population. Economic development in fact requires a proper base, such as strong links between economic sectors. Most tax havens are small islands whose economies are very vulnerable. They are usually based on agriculture and are exposed to natural disasters. This means that tax havens depend heavily on foreign aid and it is very difficult to compete in the production sector, mainly due to the small size. Their biggest economic failures are usually limited comparable benefits, lack of economies of scale, dysfunctional market structures, high transport costs, high level of openness to foreign trade, tendencies to adopt fixed prices, not their setting, limited
natural resources, small labour market and shortages of professional, institutional knowledge and experience (Armstrong & Read, 1998).

However, it should be noted that in tax havens with a recognised position, there is usually an immediate positive impact of foreign investment on the economy, as there are close ties between the offshore economy and other industries such as tourism construction, administrative and technical staff training, and development of the local financial and professional counselling market (Hampton & Christensen, 2002). In addition, improving training and employment programmes in the tax haven sector can stimulate domestic labour and allow local people to later orient them to employment in other sectors of the economy.

There are also infrastructural benefits: the presence of a large number of branches of international companies in industry will develop the sector of services they need, as a result, facilitating both local and foreign companies to locate in the main industry. In general, international companies attracted to the jurisdiction of tax havens bring benefits to local employees because they offer training, good salaries and better working conditions compared to local standards, the ability to travel and a sense of community achieved in a large company. On the other hand, employment is more uncertain than in small, locally focused companies, skills acquired may not be useful in other workplaces, and there is also growing subordination.

It should also be emphasised that according to recent findings (Hines, 2005) tax havens attract more foreign investments than countries with similar size and income levels, and partly this results in a faster rate of development of tax havens compared to countries with high taxes. Hines proved that since the public sectors of tax havens are not noticeably smaller than the public sectors of other countries, the more preferential tax systems offered to foreign investors do not negatively affect state finances, because the economic success of tax havens manifests itself in the sustainability of their policies. It seems that they stimulate greater investment activity and allow the authorities to tax more mobile foreign capital to a degree smaller than the local capital. Solid results of their economies suggest that tax havens will continue the policy of offering preferential tax rates to foreign investors, despite negative reactions from countries with high taxes fearing the tax base erosion.

However, as emphasised by Irish (Irish, 1982), the level of benefits derived from the status of a tax haven and the probability that such status will be a catalyst for economic development decreases with each subsequent country entering this business zone. As a consequence, as competition between tax havens increases, it is likely that tax havens with an established position will find it increasingly difficult to maintain the level of benefits and links achieved through this status. Perhaps it will be even harder to new tax havens to achieve a high level of benefits and connections with investors, which may not be worth the price of getting a haven status.

SUMMARY

In the light of the above considerations, one should consider the view that the development of the global economy, its progressive globalisation and, above all, the dynamics of information exchange will lead to the creation of new solutions on the financial mar-
kets. These solutions will be a natural response to rigid legal regulations, which after initial enthusiasm from investors and reluctance of regulators will take on a new, more liberal legal framework, ultimately leading to closer cooperation between financial markets. However, the open question remains about the position of developing countries in this system, because ultimately they suffer the most on the flow of capital, as long as it exists only between developed countries and tax havens. Therefore, the view of Hines seems to be correct, indicating the intensification of investments by enterprises from developed countries, neighbouring economies provided a close catalyst location and a ‘symbiont’, which is a tax haven.

REFERENCES


