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An Empirical Review of Tax Havens

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Abstract:
Generally, tax havens are jurisdictions with low effective tax rates that offer business entities and individuals opportunities to avoid tax in other jurisdictions through restrictive exchange of information with other countries. There fifty-nine main tax haven jurisdictions globally today. These tax havens are generally small, prosperous countries with stable government administration. The said countries by undue reasons and techniques attract high levels of global Foreign Direct Investment (FDI) leading to a more vibrant economic performance in comparison to average global economic growth. It is however not very possible to with certainty determine the impact created to the general wellbeing of the economic status emanating from these tax havens. Albeit there is a significant economic inspiration to the neighboring economies that charge high levels of that spar growth as a result of these tax havens existence.

Keywords: *Tax Havens, OECD, offshore financial centres, GDP, foreign direct investment*

1. Introduction

Tax havens are generally jurisdictions with low effective tax rate that offer individuals and corporate entities opportunities to avoid paying taxes due to other countries. There are roughly fifty-nine main tax havens globally today. The countries in question include: Luxembourg, Ireland, Andorra and Monaco within Europe, Singapore and Hong Kong within Asia, and the Cayman Islands, the Netherlands Antilles, and Panama in the Americas. The herein above-mentioned jurisdictions according to Hines, (2010) are in many occasions small but quite well performing with very effective governments. Generally, such countries account only for a meager 0.9% of the global population. Within various countries, the tax havens become a common phenomenon citable at various periods more. These can be seen in countries like China at their special economic zone. It is also citable in the USA under the local enterprise zones plus the off-shore assets areas. The other regions preferred as tax havens Eastern Germany, Eastern Canada, Southern Italy plus the special economic zones in Kenya. It is however good to mention that such activities are not limited to the above-mentioned areas since it cuts across many others. The use of Tax havens is enormous by various global investors to maximize their wealth as well as to avoid paying of hefty taxes in areas considered as charging high tax levels. According to Desai, Foley and Hines (2006), in 1999, fifty nine percent of United States of America multinational companies with substantial foreign business operations had associates in one or several tax havens.

2. Tax Haven Practices

Basically, countries charge low tax rates on incomes with the anticipation of attracting relatively higher foreign direct investment and economic growth than would else have been the case under normal or high tax rates like any other country. Most jurisdictions with low tax regimes give room to the various investors to ensure that their locally earned income is retained and they may go a step further allow income earned from outside their jurisdiction to be not taxable locally. A good example is a case where Apple Inc. an American multinational technology company which has a subsidiary in Ireland could pay extremely low effective income tax in Ireland for all the incomes from sales within European Union. Due to this low tax rates the company was ordered by the European commission to pay fourteen billion U.S. dollars in back duty to Ireland a case Ireland denies in the year 2016. Coupled limited or restrictive exchange of information withother tax jurisdictions, countries with low tax rates attract more foreign direct investment than jurisdictions having higher effective tax rates.

It is a significant task that these tax havens also aide in tax evasion by allowing the participants in such activities to willfully reduce on their tax capacities that would have otherwise been payable to the rightful jurisdictions. This is as much as the tax havens by themselves look very attractive. In case of persons who are liable to tax in their home countries on income generated in tax havens, tax avoidance normally involves willful under-reporting of income and exaggeration of expenses to post lower taxable income or losses. Tax avoidance can also be achieved through use of financial engagements, like inter-firm lending between or among firms that are inter- related such as holding company lending funds to its subsidiary situated within high-tax jurisdictions. This is in turn leads to large part of the revenues so generated by the subsidiary being funneled back to the holding company in the low-tax jurisdiction. Through this arrangement, taxable income will considerably be shifted to the low-tax jurisdictions. In addition to that, multinational firms often use transfer pricing as a technique to shift profits from high tax countries or other the non-tax havens to the low tax havens. The prime motive being the payment of low or no tax or no tax at all. Most countries require that firms transact using market prices for business transactions when selling products between associated parties, this will limit the scope of tax-encouraged transfer pricing adjustments. However, in practice, ascertaining appropriate arm's length/market prices for number firm products, especially intangible products, or for which similar unrelated transactions are hard to find, leaves a window manipulation with tax avoidance in mind. Due to this, business transactions with associates or subsidiaries situated in tax haven can be a way of transferring income from jurisdictions that have high tax rates to the tax havens with the motive of avoiding taxes in non-tax haven jurisdictions. This practice in turn, intensifies the attractiveness of locating investments to overseas tax havens.

According to Hines (2010), American firms reveal uncommon business activity intensities and income generation in overseas tax havens due to tax incentives offered by low tax jurisdictions. He further goes ahead to argue that, of the value of assets in terms of plant, property and equipment (PPE) held overseas by American business corporations in the year 1999, eight percent was based in tax havens, significantly higher than would be expected strictly in relation to their sizes geographically and economically. Employment overseas according to Hines (2010), more so by American firms has also just focused in the foreign low tax jurisdictions. This can be cited in areas where only six percent of the total foreign remuneration of employees, and around five percent of the total employment abroad are majorly based within the tax havens. Multinationals in America in the year 1999 based their gross foreign assets at 16% of key tax havens. These key foreign tax havens are supposed to have contributed around thirteen percent of their gross sales, and a more surprisingly, approximately 30% of all the incomes from overseas. A bigger income proportion reported from the tax haven is largely financial inflows from other overseas associates that holding firms owned indirectly via their tax haven associates or subsidiaries.

Low tax jurisdictions have experienced very fast growth in their economies that match with intense inflows of foreign direct investment. Tax havens as per Hines (2010), did average to 3% of the annual per capita in terms of the real (GDP) growth from the years 1982 to1999. This is in comparison to the global growth which averaged 1.4% p.a on the real per capita growth in the GDP during the same period. Hines, (2010) also reiterates that other factors held constant and more so the size of the country, the country's initial resources, plus the other visible economic variables, the globalization era is deemed to have remained of great benefit to the economies of countries with low tax rates but a high level of disadvantage to the high-tax countries

3. Features of Tax Havens Jurisdictions

Generally, tax havens are tiny tax jurisdictions, synonymous with populations of less than two million people, and are in most cases prosperous than other nations of the same size. Tax havens as established by Dharmapala and Hines, (2006) soundly compares on governance quality across the countries which include such measures as stability of political environment, accountability, effectiveness of the government, and also the rule of law. Undeniably, there are no poorly governed tax havens since poorly governed countries rarely become havens to tax. This is due to the fact most rational investors who are keen to maximize their wealth will not risk investing in countries that are poorly governed. Poorly governed countries are perceived to be risky, hence being considered not conducive destinations for foreign direct investments (FDI).

A key reason for the countries well-governed compared to the countries poorly governed in becoming tax havens is that there are higher potential benefits like higher foreign direct investment (FDI) and other economic benefits that trails along which are more likely to compensate for the tax rates that are reviewed downwards such well managed jurisdictions. This is to say that, in well-governed jurisdictions, the opportunity cost of tax reduction is compensated by benefits foreign investments and the corresponding economic prosperity that such investments bring along; and poorly governed countries even if they try to emulate well governed countries by lowering their tax rates, they will not attract similar level foreign direct investments largely due to poor governance.

According to Dharmapala and Hines, (2006), the evidence from the conduct of US multinational firms is in line with the assertion that the rate of tax rate variations among well-governed states relate to greater effects USA levels of investment than are the differences of tax rate amongst such countries governed poorly. The two researchers are trying to put across the fact that governance and government effectiveness plays a fundamental role in the determination of foreign investments in low tax rates areas.

4. Effects of Tax Havens on other Tax Jurisdictions

Governments in the high-tax countries view tax havens with unease, this is due to the possibility of overseas low tax jurisdictions (tax Havens) attracting economic activities from nations with high- tax rates, and eat away their tax bases leading to loss of tax revenue and investments within their jurisdictions. This is a process optimized through the shifting of

profits and base erosion (BEPS). Under this process tax bases through a well schemed plan are moved from high tax countries to tax havens with the objective of tax avoidance. The same applies to profit shifting where profits are located in tax havens. Alternatively, Dharmapala (2008), argue that, tax havens could spur positively in investment in other tax jurisdictions. This however could only be if there is an ability to shift the taxable revenue into tax havens was to improve the investing appeal and the modes of business operations in the high-tax jurisdictions. The other option would be if the low tax rates were to help reduce the cost of the products used as inputs for merchandise within the high-tax jurisdictions. Desai, Foley and Hines (2006), say that tax havens in the economic activities overseas appear to be promoting other economic activities in the neighboring high-tax jurisdictions.

Low tax jurisdictions empirically show with consistency an encouraged economic activity in high-tax jurisdiction which however does not resolve the negative effect of tax havens on thewell-being of the economy of high-tax jurisdictions. A number of studies show that tax avoidance carries effects which are mixed for the surrounding governments. This is because it has high chances of eroding the bases of tax to favour tax haven. Basically, tax avoidance has both direct and negative impact on the collection of tax. This can be solved by countries subjecting their multinational mobile corporations to rates of taxes lower than those they charge to other body corporates. However, the implementation of such option will be practically or impossible because of various political considerations above all the patriotic duty of the government to its citizens which are not to levy higher taxes to its residents while favoring non- residents.

5. Categorization of Low Tax Jurisdiction (Tax Havens)

Despite tax havens being diverse and varied, studies on taxation researchers have classified tax havens into three major categories as follows

5.1. European Related Tax Havens

Zyrich-Zug-Litchenstein Triangle was the first known tax haven which was formed in the mid- 1920s. Next was Luxembourg in 1929 that was established that to aide in financial secrecy and privacy plus limited information exchange with other tax jurisdiction. Lately, modern tax havens of Europe include various corporate-focused areas maintaining high transparency as envisaged by OECD. Ireland and Netherlands are the examples of such modern tax havens.

The European tax havens have lately acted as global main part of tax havens flows elsewhere. They form the five global conduits referred to as the Offshore Financial Centres (OFCs). When lately talking of the tax haven list, four European related havens of tax prominently feature in the list of top ten. These are the Netherlands, Ireland, Switzerland and also Luxembourg.

5.2. British Related Tax Havens

Included in the British Overseas Territories are the top customary and corporate tax havens like the UK. Many of these tax havens are either former or current dependencies of the United Kingdom. They as a matter of fact still apply in their legal systems the very core structure as of the UK. In this British Empire, six tax related havens do appear in the list of the first ten havensgenerallyknownastheCaribbeantaxhavens.TheyaretheCaymanIslands,the Bermuda, the British Virgin Islands and the Channel Islands for e.g. Jersey. The tax havens of Asia include mainly Singapore and Hong Kong which according to Hong and Smart (2010) are two of the five key global conduits offshore financial centres.

5.3. Emerging Market Related Low Tax Jurisdictions (Tax Havens)

It is good to note that a good number of these tax havens go back late 1960s and emulate the general structures of tax havens found in the older groups mentioned above. However, most of them are not enumerated as members of (OECD). Some of these havens though have suffered setbacks during initiatives by the OECD to curb tax havens. The most prominent examples being Samoa and Vanuatu. To the contrary however, other tax havens like Taiwan and Mauritius have materially grown in the past decades. This makes them being ranked in top ten global havens. Because of that, some authors describe Taiwan as the *Switzerland of Asia. This is as a result of how* it focuses on financial secrecy.

6. Incentives for Countries to become Tax Havens

These are numerous as hereunder enlisted.

6.1. Economic Prosperity

The argument of James R. Hines Jr. is that low tax jurisdictions are in many cases small but very well-governed with very effective government administrations. Hines concludes that these countries have the experience of significant prosperity in their economy. Hines and Dharmapala in 2008 opined that about 15% of countries are tax havens. What however puzzled them was why many jurisdictions had not become tax havens from the fact that it could lead them to a great economic prosperity. This would be answered by the following assertions. That the least is governance which countries are struggling to improve and maintain to attract good foreign investors. The next is an option of reducing tax rates compared to the need of collecting enough revenues. Third is the level of pressure from OECD to ensure transparency and also the need for information exchange among the state members.

Currently there are approximately fifty-nine key tax havens globally. Dharmapala and Hines (2006), conclude their research that governance is quite fundamental for smaller countries in that would want to be a tax haven. The scholars view on the financial benefits of being a tax haven put them in sharp conflict with NGOs that think otherwise about the tax justice from such havens. An example is the Tax Justice Network who has since accused such havens being promoters of tax evasion.

6.2. Gross Domestic Product (GDP)-Per-Capita

In most cases, a good number of the Tax havens averagely have high rankings of GDP per capita. This is because of their economic statistics that are eye-catching. Mostly, such statistics are inflated artificially by the Base Erosion Profit Shift (BEPS) flows. Tax havens that are Corporate-focused as the largest facilitators of BEPS flows specifically make up most of the top 10 to 15 GDP-per-capita tables. This though excludes the oil and gascountries.

6.3. Acceptance

Most corporate tax disputes which are very rare according to Zucman, (2014) are mostly between high-tax jurisdictions and not between high and low tax jurisdictions. They found out that current international tax system of the high-tax countries has no incentives that can combat profit shifts to tax havens. Such countries, the study says that mostly focus their efforts of enforcement on profits relocation that are booked in other high-tax countries which leads to stealing revenue from each other. The failure in tax policy thus explains profit shifting persistence to countries with low-tax rates in spite of the involvement of high costs for the high-taxjurisdictions.

7. Benefits of Tax Havens

7.1. Growth Promotion

Tax havens promote economic growth globally as per Hines (2010). His study notes that a big controversy however is the suggestion that solving the various perceived issues in the tax regimes of higher-taxed nations leads to such direct economic growth. The academicians have thus cited evidence to show that in some scenarios the tax havens are purported to enhancing growth in economy in higher-tax countries and thus can support the various hybrid regimes of tax that offer advantages to the higher taxes' levels on the domestic activity. This assertion however does not augur well with those organizations advocating for global taxjustice.

7.2. Research Methodology

The study adopted a review of secondary sources of information which adopts initiatives from journals and white papers from the government and non-governmental organizations within the region.

8. Conclusion

From such findings the paper establishes that because of the high rates of taxation in non-tax havens, the havens equipped with good governance, favorable judicial systems and efficient governments entice investors with low but effective rates of tax and financial secrecy. Tax havens serving as offshore financial centres have been seen to be encouraging bad behavior in countries of their origin because they mostly boost evasion of tax and laundering of money. This is made possible through the erosion of base and shifting profit generally abbreviated as (BEPS); where corporate entities and individuals transfer assets and also profits for jurisdictions considered as high tax to those seen as low tax havens.

As much as these tax havens aid in the facilitation of undesirable economic activities, they also have a number of positive outcomes both to the high tax also the low tax havens. We can tentatively conclude that tax havens of Offshore Financial Centres are largely parasites, undeservingly benefiting from incomes of other countries due to their low tax rates, limited information exchange and financial secrecy. To curb the attraction of tax havens/offshore financial centres to investors, non-tax havens should consider reviewing their taxation rates in order to discourage capital and income flight to these tax havens. High tax countries or non-tax havens should weigh impact of charging high taxes to the general welfare of its citizen in terms of lost tax revenues due to BEPS. Through this analysis the non-tax haven will decide on mechanism to curb the effects of existence of tax havens on their economies, which will include and not limited to reviewing their tax rates downwards which in effect make tax havens less attractive as investment destinations.

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