Discussion Paper No. 89

OFFSHORE BET

The benefits of capital mobility

Diego Zuluaga

June 2018

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About the author

Diego Zuluaga is a US-based economist and author. He is a Policy Analyst at the Cato Institute’s Center for Monetary and Financial Alternatives in Washington, DC. His work focuses primarily on financial technology, consumer credit, prudential banking regulation and monetary policy.

Prior to joining Cato, Diego was Head of Financial Services and Tech Policy at the IEA, where he authored papers on a range of economic issues including the taxation of corporate profits, the regulation of online platforms, and the social value of financial services in a modern economy. His work has featured in a range of outlets including the Times, Newsweek and City AM. He appears frequently on broadcast media, including BBC World, Sky News and CNN.

Acknowledgements

The author would like to thank **Florian Sichert** for valuable research assistance.

Executive summary

- Offshore financial centres (OFCs) are alleged to be hotbeds of tax evasion. Their role in facilitating individual and corporate tax planning, which is entirely legal but politically controversial, has also come under the spotlight.

- However, OFCs play an important economic function. By mitigating instances of double and triple taxation, offshore centres raise aggregate investment. Their existence is also associated with better economic outcomes in the countries that surround them.

- The recent growth in the number and size of OFCs can be explained by three developments: an increase in the stock of investable capital, new investment opportunities outside Western Europe and North America, and the growth of tax and regulatory intervention by governments.

- As more investment capital is allocated across a diverse range of jurisdictions from investors around the world, the potential for multiple taxation increases. The role of OFCs in eliminating excessive taxation has a positive impact on investment returns which compounds over time.

- There is no evidence that the rise of OFCs has adversely affected the revenue-raising ability of other countries. For example, corporate tax revenue as a share of all taxes collected has grown slightly in the average OECD country since 1980.

- Nor is it true that OFCs levy no taxes: their average tax revenue as a share of national income is only six percentage points lower than across the OECD. OFCs do, however, rely on indirect (e.g. consumption) taxes rather than direct (e.g. income) taxes for revenue. Indirect taxes are often less distortionary.

- The popular account of offshore centres is an outdated caricature that bears little resemblance to how OFCs in fact operate. Undermining their existence would harm investment, economic growth and international capital flows, while the promised benefits from intervention are unlikely to materialise.

Nothing would at first seem to affect private life less than a state control of the dealings in foreign exchange, and most people will regard its introduction with complete indifference. Yet the experience of most continental countries has taught thoughtful people to regard this step as the decisive advance on the path to totalitarianism and the suppression of individual liberty.

F. A. Hayek, *The Road to Serfdom*

They [the opposition] say they will eliminate capital controls. Ah, but of course! That's the ploy of the bourgeoisie, and of imperialism. Because it's very easy for the imperialists to have the dollars come in… They take out the oil, the dollars come in and the next day they take [the money] out again… to foreign accounts. […] With freedom of exchange, they are the ones who have the money. They take out the dollars. And then they start playing with devaluation.

Hugo Chávez, 2012

Introduction

No country likes to be called a tax haven. The term evokes exotic and secretive locations where the rich and corporations stash away their surplus funds. Offshore financial centres (OFCs) are alleged to be hotbeds of tax evasion. Lately, their role as facilitators of individual and corporate tax planning, which is entirely legal but politically controversial, has come under scrutiny. Under the aegis of the OECD, which brings together some of the world's richest countries, there have been efforts to limit what some term 'aggressive tax avoidance' (OECD 1998).

So much of public policy on international tax is driven by sensational reports of (unrepresentative) individual cases and the misuse of statistics that the actual role of offshore jurisdictions remains unknown to most people. That Ireland, the Cayman Islands and Switzerland are, respectively, the third-, fourth- and sixth-biggest foreign holders of US debt (US Treasury 2018) cannot be because residents of these countries are the biggest US creditors. Rather, these figures underscore the countries' crucial role in international financial intermediation. So does the fact that most pension funds, including the UK parliamentary pension scheme, hold a share of their assets in offshore entities (Pickard 2017).

Offshore finance serves several purposes, the most salient of which is the efficient allocation of capital. Some of this activity is tax-related, aimed at raising after-tax investment returns. If it were not for offshore jurisdictions, much foreign investment would be vulnerable to double or triple taxation.[1] Because, under such punitive rates of tax, some of this investment would not take place, the existence of offshore centres has real positive effects on economic activity alongside the (plausibly) negative impact on the tax revenue of individual countries.[2] These welfare gains have been amply documented (Hines 2010).

1 Teather (2005) gives a detailed account of the ways in which OFCs facilitate international investment.
2 This is not a disingenuous qualification. The standard assumption is that tax planning lowers tax revenue in the countries where the taxpayer resides, but if removing tax planning harmed domestic economic activity enough, the overall effect would plausibly be a lower tax take.

Beyond their impact on aggregate investment, research shows that the existence of an OFC is associated with better economic outcomes in neighbouring countries. Contrary to the popular narrative, these jurisdictions are well-governed and peaceful (Dharmapala and Hines 2009). Who, after all, would wish to use intermediaries in places where investors were regularly expropriated or harassed? OFCs are also increasingly transparent and ready to share information with other tax authorities. They are hardly secretive, either by comparison to other jurisdictions or in their relationship with foreign authorities.

This paper examines the role of offshore finance in the global economy. It considers how economic theory can explain its emergence and increasing importance. It finds that offshore jurisdictions as they operate at present do not meet the OECD's definition of a 'tax haven'. They tax their residents to an extent comparable with Western Europe and North America; they are transparent with foreign tax authorities and comply with international tax treaties; and they add substantial value to economic activity by facilitating capital flows and international investment.

OFCs are a vital part of the modern global economy. It is difficult to imagine the process of globalisation that has taken place over the last fifty years, bringing hundreds of millions of people out of poverty, happening without the robust financial and legal framework which offshore jurisdictions provide for investment. It would be counterproductive, for both the developing and the rich world, to undermine their essential functions.

Why 'tax haven' is a misnomer

Offshore financial centres (OFCs) are popularly referred to as tax havens. It is unfortunately common in economic debates that central ideas become difficult to discuss objectively because they are described with loaded terms: 'trickle-down economics', 'neoliberalism', 'casino banking', and so on. 'Tax haven' is another such term. Thus we must begin by explaining why it does not apply to offshore centres.

'Tax haven' suggests, firstly, that the raison d'être of OFCs is the evasion of tax obligations and, secondly, that the funds which find their way into offshore centres sit there idly, out of the reach of the tax man.

In fact, the unique selling point of OFCs is the cheap and reliable intermediation of funds. Offshore centres tend to be small, in area and population, meaning that domestic investment opportunities are limited. Thus, a negligible portion of the financial intermediation in an OFC has its final destination in that OFC. For example, Cowsill (2017) reports that only two per cent of wealth managed by Jersey-based entities has the island as the ultimate investment destination.

The vast majority of funds managed offshore are put into instruments that hold investments in third countries. Funds domiciled in the Cayman Islands, one of the largest OFCs, had assets worth US$5.7 trillion in 2015-16 (CIMA 2016). Thus, retrieving funds from OFCs would not only undermine the rule of law, but it is also bound to disrupt capital flows beyond that individual jurisdiction.

The accusation that tax minimisation is what spawned OFCs is also misleading. Investment, whether domestic or international, would not take place if the cost were prohibitive. Investors care about the after-tax return on investment. Tax therefore acts as a cost of doing business. To the extent that OFCs are lowering investment costs, they facilitate capital formation and its deployment around the world. That is the rationale for offshore finance.

Clamping down on offshore centres will not raise tax revenue and preserve existing levels of investment. Rather, it will change the pattern of investment flows in a different direction, shaped less by investment opportunities and more by political factors. In the longer run we would expect less investment than otherwise would have occurred. The net effect on tax revenue is uncertain. But reduced investment would make societies less productive and prosperous, and this effect would compound over time.

The role of offshore finance

An allegory

Consider two big cities, Atlantis and Pacifica. Between them lies a town called Molineux. For decades, a narrow road had been linking the two metropolises. The road went right through Molineux, which meant that Molineuvian customs officers could charge tariffs on the merchandise passing through, and local merchants could sell food and wares to travellers on their way. This was good business for Molineux, but the narrowness of the road, the costs of trade and the hazard of roving bandits meant that relatively little commerce occurred between Atlantis and Pacifica.

Then, a visionary by the name of Steve Dobbs came up with an idea: to build a wide, high-speed motorway linking the two cities without having to go through intermediate points. The motorway would be well-lit and adequately policed. Its construction and operating expenses would be paid for by a small fixed toll charge, plus revenue from advertisers and retailers eager to set up shop along the motorway. There would be no customs tariffs.

The motorway was a success and Atlanto-Pacifican trade boomed. Not everyone was happy, though. Most Molineuvians had benefitted from the motorway’s construction, because they could now travel more quickly and cheaply to both cities, access markets previously beyond their reach, and even take advantage of the marketing opportunities on the motorway itself. In fact, the motorway led to a perceptible increase in tourism to picturesque Molineux. But a few prominent Molineuvians fumed, notably the customs officers whose activity had dwindled and the small merchants who, for lack of entrepreneurial foresight or luck, missed out on the business opportunities created by the motorway.

Even though Molineux was on the whole better off thanks to the motorway's construction, local merchants resented the newfound ability of foreign competitors to sell to their customers on the motorway, without paying local sales or corporation tax. They began agitating for measures to counter what they termed 'aggressive tax avoidance' on the part of foreign merchants who sold on the edges of the motorway, right in front of their noses.

OFCs as vital modern infrastructure

The global economy resembles the sketch above more than might at first be apparent. There is, on the one hand, a constellation of largely independent national tax jurisdictions. On the other hand, there are tens of thousands of transnational corporations – transnational because they sell to customers in countries other than where they reside, and because some of their production (including finance, administration, and patents) takes place in foreign jurisdictions. Additionally, an increasing number of households around the world have savings they are willing to invest for profit, whilst people in unstable countries want safe locations for some of their wealth (Cowen 2017). None of this activity is illegitimate or illegal.

Three developments have increased the importance of the functions performed by OFCs in the global economy. Firstly, demand for reliable investment intermediaries has grown as the global stock of capital has expanded. Secondly, more investment opportunities have arisen outside the historical focal points of industrialised Western Europe and North America since the middle of the twentieth century.

Thirdly, the involvement of national governments in tax and regulatory policy has grown without interruption since 1919. Before World War I, governments played only a small role in economic activity, rarely taking up shares of national income in excess of 15 per cent during peacetime (Crafts 2002). After the Great War, they took upon themselves ever larger fiscal and administrative functions, notably trade restrictions and capital controls (Capie 2002). They acted unilaterally for the most part, with little regard for the cross-border implications of their interventions.

Like other financial innovations, from money market funds to platform-based lending, offshore finance emerged in response to the shortcomings of national tax and regulatory policy. In a context of punitive marginal tax rates, constrained capital movements and with the modern framework of international tax treaties still in the future, OFCs were vital to the revival of cross-border trade and investment after World War II (Hollis and McKenna, forthcoming). Without stable intermediary jurisdictions with robust rule of law and low taxation, much international investment would have been too costly, whether because of the associated tax burden or the risks of expropriation and inflation.

More recently, as capital accumulation has come within the reach of a larger number of households, professional financial advice, tax and estate planning, and collective investment vehicles such as mutual funds have become more important. J. P. Morgan and J. M. Keynes had the time, funds and knowledge to invest on their own account; John Doe has neither.

The mechanics of offshore finance

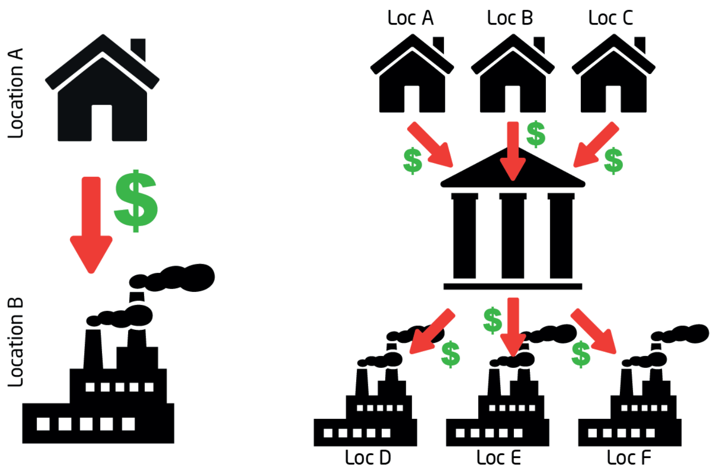
The basic model of international investment posits funds flowing from capital-rich to capital-hungry locations. But most investment at present follows a somewhat more circuitous route. The savings of large numbers of people are in the first place aggregated by a range of financial institutions, from asset managers and hedge funds to insurance firms and pension funds. These intermediaries then allocate the funds across a range of short-term and longer-term instruments, both bonds and stocks, to meet the preferences of investors and their fiduciary obligations.

For example, insurers and pension funds are interested in liquid but long-term investments that will yield an adequate return to ensure they meet their day-to-day obligations. Therefore, they tend to favour long-term bonds and equities with a large market capitalisation. Hedge funds tend to be more short-term-oriented and speculative, whereas asset managers cover the full spectrum between low-risk, low-return assets and higher-risk instruments.

Booth and Zuluaga (2018) discuss in detail the functions of financial institutions. Here it suffices to say that financial intermediaries perform crucial functions – such as payments, maturity transformation, risk transfer and diversification, matching of borrowers and lenders, monitoring and corporate governance – which households and even firms could only partially do on their own and at much higher cost. Indeed, curtailing the operations of the financial services sector would have regressive effects, since it is poorer households who benefit most from being able to acquire diversified, low-cost retail financial products.

OFCs have emerged to harness the benefits of a modern financial system – diversification, risk transfers and maturity transformation – when doing international business in a world of sovereign nation states. Financial intermediation, however, adds an administrative layer to the process of capital flows, making it susceptible to taxation. Rather than a world in which the household in location A invests in a business in location B (Figure 1(a)), a more realistic scenario involves households in locations A, B and C placing their funds in a financial institution, which then allocates these funds among firms in D, E and F (Figure 1(b)).

Figure 1: Direct (a) vs. intermediated (b) investment



Assume each location has its own tax policy. Even if there are deductions for foreign tax, the investment vehicle would like to locate somewhere which will neither impair its ability to serve households in A, B and C nor preclude it from investing in D, E and F. There are at least two levels at which investment returns will typically be taxed: at the firm level as corporate profits (and, in some jurisdictions, interest income) and at the household level as income, capital gains and dividends.

The question is whether returns will also be taxed at the level of the fund, whose job is only to intermediate between owners of capital and users of capital. In a regular jurisdiction such as any of A, B, C, D, E and F, returns will typically be taxed at all three levels unless each of the three (household, collective vehicle and firm) share the same location (Teather 2005).

What is the impact of that additional layer of taxation? Consider a simplified situation in which an investment of $1,000 goes into a firm.[3] The investment generates $150 worth of profit, which is taxed at 20 per cent in the firm's jurisdiction. Of the remaining $120, $60 are reinvested in the business and

3 We omit the volatility of portfolio returns, which diversification helps to reduce, because it would complicate the analysis without changing the effect we wish to illustrate.

$60 are returned to the investment fund as a distribution. The fund faces a dividend tax rate of 20 per cent in its jurisdiction of residence, leaving $48 which is entirely distributed to fund shareholders as a dividend and taxed at 20 per cent in the owner's residence. The final return is $60 (reinvested) plus $38.4 (net dividend) for an after-tax rate of return of 9.84 per cent.

Now assume the collective investment vehicle, the fund, is located in a jurisdiction with no taxes on income, dividends or capital gains. The net return in this case is $60 (reinvested) plus $48 (net dividend), for an after-tax return to the household of 10.8 per cent. Over ten years of investment, the absolute gap in returns compounds. Note also that we have assumed relatively low tax rates, but the higher the marginal rates the greater the wedge that triple (relative to double) taxation drives into the investment decision.

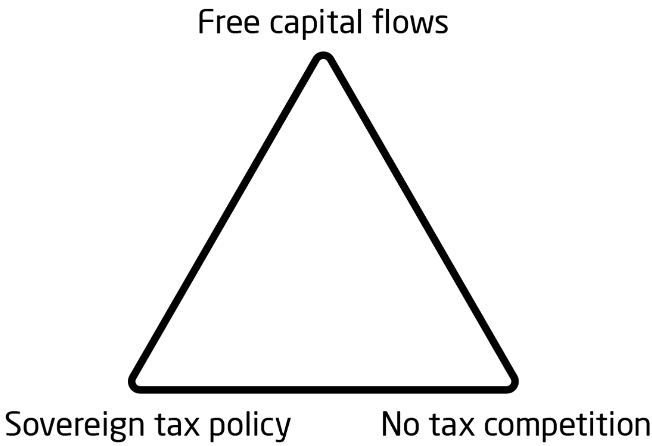
It becomes clear that taxation at the level of the investment vehicle creates powerful disincentives to investment. Put differently, the additional layer of tax offsets some of the benefits from diversification and economies of scale provided by funds, and it encourages investment to remain invested domestically at suboptimal rates.

The value of OFCs is their willingness to refrain from taxing returns at the fund level, thereby enabling capital allocation beyond what would take place in a world where triple taxation was unavoidable. The illustration above also goes some way to explain why offshore jurisdictions tend to be small and overwhelmingly focused on financial services. Larger jurisdictions with other comparative advantages will normally not find it politically worthwhile to forego the immediate tax revenue from triple taxation, even if taxing funds was on the whole harmful.

The tax policy 'trilemma'

The 'unholy trinity' of monetary policy is a key concept in macroeconomics. It posits that countries cannot simultaneously have fixed exchange rates, free capital mobility and a sovereign monetary policy (Mundell 1963). Since 1980, an analogous trilemma has come to the fore of international tax policy. Theory and evidence suggest that countries may have any two of free capital mobility, an independent tax policy and no tax competition (Figure 2). But they cannot have all three.

Figure 2: The tax policy 'trilemma': you can't have all three



In principle, countries favour all three of them. Free capital flows mean domestic savings can chase the highest risk-adjusted return worldwide, whilst domestic industry has access to a larger pool of capital, typically at a cheaper price. A sovereign tax policy means countries can decide on the mix and level of taxes as they see fit. Furthermore, it means they can treat foreign and domestic income, whether personal or corporate, differently in different contexts.[4] No tax competition means that jurisdictions do not need

4 For example, the United States taxes the worldwide personal income of its residents and, until the 2017 tax reform, it did so for corporate income, too. On the other hand, many small jurisdictions have found a competitive advantage in assuring foreign residents that their foreign-source income shall not be taxed. The UK non-domiciled regime is an example. Non-domiciled taxpayers generated tax revenue of £9.3 billion in 2014-2015 (HMRC 2017a).

to worry about the second-order effects of tax policy, namely taxpayer flight and shifts from investment to consumption in response to adverse changes in tax policy towards capital.

Consider what might happen if a country attempted to pursue all three objectives at the same time. A change in, for instance, corporate tax policy would immediately change the after-tax return on investment in the country, triggering capital movement until risk-adjusted rates of return across different countries became equal. This is just the first set of responses, since it is likely that other jurisdictions would react by changing their own tax treatment of corporate income, either by seeking to attract the displaced capital or by matching the first location's increase.

The impact in a dynamic context is transparent: given free capital flows, national governments are constrained in their ability to tax. Not only that, but jurisdictions will emerge which specialise in creating a low-tax environment for mobile capital whose physical location does not much affect other firm costs. No country is wholly free to tax if capital is free to move. There are always trade-offs.

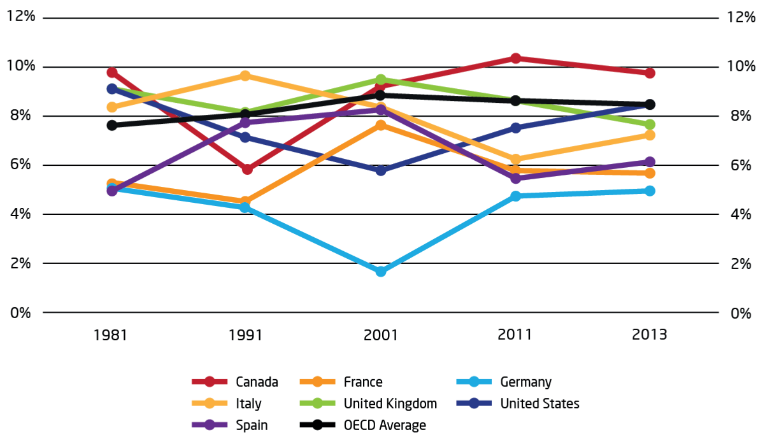
From capital controls to capital mobility

The status quo before 1980 was that countries would control capital flows, in turn benefiting from tax autonomy and reducing the impact of tax competition in the short run. In the longer term, restrictions on capital mobility had a more limited effect on tax revenues as firms and individuals adjusted their investment plans in response to expectations of domestic tax policy. As McLeod (1993) shows, even draconian measures have historically failed to stem capital outflows in the face of domestic uncertainty.

The breakdown of the Bretton Woods fixed exchange rate system eliminated much of the economic rationale for capital controls. Gradually, countries in Europe and North America came to realise the opportunities from more open capital markets. As controls were removed, it became easier and cheaper to transfer funds abroad but also to return them. In some countries, the liberalisation of capital movements was contemporaneous with a lowering of marginal tax rates on corporate income.

It has become received wisdom that this 'race to the bottom' of corporate tax rates led to a decline in tax revenues. Yet, as shown in an earlier paper (Zuluaga 2016), evidence from across the OECD shows no such trend. Figure 3, reproduced from that paper, shows actual revenue patterns for selected OECD countries and the OECD average between 1981 and 2015. Corporate tax revenue has fluctuated with the cycle, but the average OECD member country raises more from corporate profits today than it did 35 years ago.

Figure 3: Corporate tax revenue as a share of all tax revenue, OECD countries



The oft-implied relationship between marginal tax rates and tax revenues has failed to materialise. This is because governments can control tax rates, but they cannot control the behavioural responses to tax changes. Inevitably, sharp increases in taxation induce capital outflows and reduce economic activity and tax revenue. Reductions in tax rates, on the other hand, increase incentives for investment and, in some cases, can result in higher tax revenues.[5]

5 This is the case when ex ante rates lie beyond the Laffer Curve's revenue-maximising point, and when marginal rate reductions are accompanied by the elimination of deductions and credits.

The OECD and offshore finance

The OECD groups together 35 countries, most of them in Europe and North America. While there are significant differences among members, they tend to be higher-income and more highly taxed than the world average. They are home to a disproportionate amount of multinational firms and wealthy individuals. These features explain why, since the late 1990s, the OECD has taken an acute interest in offshore centres, in a bid to limit tax competition.

The problem is that offshore financial centres do not qualify as ‘tax havens’, even by the OECD’s (1998) definition. The OECD’s criteria to identify a tax haven are: 1) no or only nominal taxes; 2) lack of effective exchange of information; 3) lack of transparency; 4) no substantial activities. Offshore jurisdictions seldom meet one, let alone all, of these conditions.

No or only nominal taxes

The perception is that offshore jurisdictions levy little or no tax on their residents. But a look at the data suggests that tax revenue as a share of GDP in OFCs is comparable to many OECD countries, even if below the OECD average (Table 1).

Table 1: Tax revenue as a share of GDP compared: OECD (left) vs. OFCs (right)

Jurisdiction	Tax as % of GDP	Jurisdiction	Tax as % of GDP
Australia	28.20	Andorra	69.00
Austria	42.70	Anguilla	52.00
Belgium	31.70	Antigua and Barbuda	19.30
Canada	31.70	Aruba	27.60
Chile	20.40	Bahamas	18.80
Czech Republic	34.00	Bahrain	5.60
Denmark	45.90	Barbados	27.30
Estonia	34.70	Bermuda	19.50
Finland	44.10	Belize	27.30
France	45.30	British Virgin Islands	36.50
Germany	37.60	Cayman Islands	38.70
Greece	38.60	Cook Islands	35.60
Hungary	39.40	Cyprus	33.30
Iceland	36.40	Dominica	24.10
Ireland	23.00	Gibraltar	23.30
Israel	31.20	Grenada	25.10
Italy	42.90	Guernsey	20.60
Japan	30.70	Isle of Man	14.60
Korea	26.30	Jersey	18.30
Latvia	30.20	Liberia	31.70
Luxembourg	37.10	Liechtenstein	14.90
Mexico	17.20	Maldives	23.90
Netherlands	38.80	Malta	33.30
New Zealand	31.10	Marshall Islands	58.60
Norway	38.00	Mauritius	15.00
Poland	33.60	Monaco	14.60
Portugal	34.40	Panama	15.80
Slovak Republic	32.70	Samoa	23.60
Slovenia	37.00	San Marino	40.90
Spain	33.50	Seychelles	36.70
Sweden	44.10	St. Lucia	25.50
Switzerland	27.80	St. Kitts & Nevis	39.40

Turkey	25.50	St. Vincent and the Grenadines	24.20
United Kingdom	33.20	Tonga	20.80
United States	26.00	US Virgin Islands	24.10
		Vanuatu	24.20
Average	**33.89**	**Average**	**27.88**

Source: OECD (2016); Heritage Foundation (2016); CIA World Factbook (2017 est.)

It should be noted that some of the figures for very small OFCs come from the CIA World Factbook database, which includes ‘other government revenue’, such as charges and royalties, as well as taxes. Thus, the percentages for Anguilla and Andorra are probably an overestimate. But the point stands that most OFCs show tax revenues as a share of national income at levels close, and sometimes above, those of OECD member states.[6]

Where there is a qualitative difference between OECD countries and OFCs is in the way they raise revenue for public expenditure. Most OECD governments obtain the bulk of their funds from taxes on labour, corporate and capital income, as well as social security charges – all forms of direct taxation. OFCs, on the other hand, tend to tax income – whether individual or corporate – at a zero rate. Instead, tax revenue comes mostly from indirect levies such as sales tax and import tariffs. In the Cayman Islands, for example, most consumer imports are subject to a 22 per cent duty, generating nearly 20 per cent of government revenue. Another 25 per cent comes from company registration fees (Duncan 2016).

It is interesting that OFCs are often accused of aggressive tax avoidance when, for the most part, their tax policy is not one of rate minimisation but rather of shifting the tax burden from income to consumption, which is precisely what international bodies such as the IMF and the OECD advise (PWC 2013). Nevertheless, it should be said that import tariffs, a key source of revenue for OFCs such as the Bahamas and the Cayman Islands, are highly inefficient.

6 Indeed, there are overestimates for the OECD, too. The GDP figures for Luxembourg and Ireland are acknowledged to be inflated due to national income accounting conventions (see, for instance, Klein 2016).

Lack of effective exchange of information

Greater cooperation between tax authorities, whether offshore or onshore, has long been an objective of international bodies, including the EU, the G20 and the OECD. The goal is as much to minimise the incidence of multiple taxation, whereby the same income is inappropriately taxed more than once, as to curtail tax evasion. Tax treaties enable countries to mitigate both problems at once.

The UK, according to HMRC (2018), has the biggest worldwide network of tax treaties, covering 120 countries.[7] In addition, there are a number of tax information exchange agreements (TIEAs) in place based on an OECD template and, for EU countries, as EU legislation.

Whilst the OECD identified a number of non-transparent jurisdictions in its initial work on tax competition (OECD 2000), it has gradually removed them as each agreed to cooperate with foreign tax authorities. As of 2009, there are no jurisdictions on the organisation's list of uncooperative tax havens.[8]

Lack of transparency

It is hard to interpret what the OECD meant by this criterion that is not already covered by the exchange of information among tax authorities. The original report (OECD 1998) refers to 'a lack of transparency in the operation of the legislative, legal or administrative provisions', which does not much clarify matters.

The issue of transparency by offshore jurisdictions is often raised by critics.[9] But they typically fail to specify to whom and about what OFCs should be more transparent. There is an increasing amount of dialogue between tax authorities, including on taxpayer information and country-by-country reporting of the activities of multinational firms.

The case of Jersey is illustrative. In 2002, it signed its first tax information exchange agreement with the United States and has since signed more with other countries. Jersey complied with foreign tax legislation, including America's FATCA, the EU's directive on the taxation of savings, and the

7 See: https://www.gov.uk/government/publications/double-taxation-treaties-overview/double-taxation-treaties-how-they-work.
8 See: http://www.oecd.org/countries/liechtenstein/listofunco-operativetaxhavens.htm.
9 Even defenders of the role of OFCs have argued that more transparency is needed. See, for instance, Lesperance (2016).

various OECD initiatives against so-called profit shifting by firms. In their research on the leniency of various jurisdictions towards requests for the establishment of 'shell companies',[10] Findley, Nielson and Sharman (2014) ranked Jersey ahead of Britain and the United States.

This is not an atypical finding. Indeed, because international finance forms such a large share of the output of OFCs, and because these jurisdictions have long been under the spotlight, they would be expected to ensure compliance to a greater extent than more diversified economies where international finance is one sector among many, such as the UK and the US. This is precisely what Findley et al. find: Jersey, the Cayman Islands, the Bahamas, the British Virgin Islands, Hong Kong and Barbados (among other OFCs) all score far higher for compliance than either Britain or America.

No substantial activities

It should be clear by now that the activities of OFCs are anything but insubstantial. Offshore jurisdictions facilitate investment that, at the margin, would be unprofitable without their existence. They enable owners of capital to protect their assets from corrupt and dictatorial governments. They act as reliable and low-tax locations for the intangible capital of firms. Furthermore, the subsidiaries to which they are home play an important role in financing other arms of multinational firms.

Critics object to the fact that firms' decision to locate these fundamental parts of their business in OFCs are mainly motivated by taxation. This is true in many cases. But it does not mark out OFCs. Even when onshore jurisdictions are concerned, tax is always a consideration in decisions about where individuals and firms will locate themselves. Consider the widely reported flows of high-income French workers into London after François Hollande's supertax was announced (Murphy and John 2014). Another contemporary example is the controversy around US corporate tax inversions, such as the ill-fated Pfizer acquisition of Allergan, before the recent tax reform lowered America's tax rate on corporate profits and turned the levy into a territorial rather than universal one (Neely and Sherrer 2017). Recent financial history is indeed peppered with examples of what economists have termed Tiebout competition: resources, not least

10 Shell companies are usually defined as entities with no ostensible purpose other than the concealment of beneficial ownership.

relatively mobile ones like capital and corporate executives, tend to move to those locations where they can yield the highest risk-adjusted after-tax return.[11] For mobile factors of production, the whole world is local.

11 After Tiebout (1956).

Conclusion: throwing out the baby and keeping the bathwater

The argument against offshore finance rests on the contention that offshore jurisdictions facilitate illegal activity, such as money-laundering, terrorist financing and tax evasion. It is difficult to estimate reliably the economic magnitude of such unlawful activities, because their perpetrators do not typically file annual statements. However, HMRC (2017b) estimated the 'tax gap' – the difference between tax owed and tax collected – at 6 per cent of tax liabilities, or £34 billion.[12] Notably, nearly half of the missing amount is due to underreporting by SMEs, and only 10 per cent is attributable to individuals not classified as criminals.

The OECD has estimated corporate tax avoidance at up to $240 billion per year globally (Solheim 2016). As we have seen, the avoidance of tax is a legitimate economic activity among rational people. Moreover, reducing its extent would invariably reduce the amount of productive investment. Still, it is worth putting this figure into perspective: it is equivalent to less than 1.5 per cent of US GDP, 10 per cent less than Britain's annual health and social care budget, and 30 per cent of Google's present market capitalisation (HM Treasury 2017; Yahoo Finance 2018).

That is the upper bound of worldwide tax avoidance. The reader is left to decide whether such an amount really merits the negative media coverage and political discussion that has surrounded offshore jurisdictions in recent years.

It is also worth asking whether curtailing offshore finance would in any meaningful way reduce illegal conduct. OFCs are neither the original source nor the ultimate destination of illegal financial flows. So long as there remain corrupt politicians, drug users and people willing to engage in terrorist acts, history suggests that some illegal financial activity will take place to make it possible. Furthermore, as we saw above, OFCs are as

12 Note that this estimate includes tax avoidance, which is not illegal.

a rule far more compliant and transparent in their prevention of unlawful activities than onshore jurisdictions, including the United States and the United Kingdom.

Shutting down offshore finance would thus not lead to the baby being thrown out with the bathwater. Rather, we would lose the baby (OFCs' central role in facilitating capital flows) and keep the bathwater of tax evasion and other undesirable and illegal activities. This recognition has often failed to percolate to critics of offshore finance, even those who recognise that there would be costs from closing it down.

More dangerously, an ominous alliance of revenue-greedy politicians, ideological campaigners and rent-seekers has emerged in recent years. Gradually, but relentlessly, they aim to dismantle the liberal financial order of which free capital movement is a fundamental component. Tax evasion and avoidance – conveniently conflated to inflate figures of what the public is led to believe is unambiguously bad – are just useful narratives in which to wrap the alliance's real goal: to eliminate tax competition and constrain the movement of capital in order to bring it under their control. The consequences of this effort would be long-standing and go far beyond a few tiny offshore financial centres.

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The Institute of Economic Affairs
2 Lord North Street
London SW1P 3LB
Tel 020 7799 8900
Email iea@iea.org.uk

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