Tax Havens: Consequences and remedial

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Abstract: *Tax havens have attracted increasing attention and scrutiny in recent years from Policymakers. The interest in tax havens reflects their disproportionate role in the world economy and in particular their central position for many of the important current policy debates in taxation, including international tax competition and tax avoidance activity by corporations. This paper provides an overview of the problems created by these tax havens and the remedial steps needed to curb these problems. The Paper begins with the characteristics of the tax haven destinations. Then it covers various problems that emerge due to the tax havens and these problems are more drastic for underdeveloped countries because of their less developed taxation system and more need of tax revenue for development purposes. Finally, this paper concludes with the measures needed to avoid these problems which require international cooperation most.*

Keywords: *Shell Subsidiaries, Financial Disclosure, Money Laundering, High Tax Countries, Capital Flow, Zero Tax Regime.*

I. INTRODUCTION

There is a continuous increase in movement of goods and services, of capital, of factors of production and of technology as well across international borders. This is induced by 'reduced tariffs and trade barriers and by low cost transportation facilities'. Now this world is an integrated economy. Integration is being further helped by new technologies of communication like computers and the internet. Now it is very easy for enterprises and corporate houses to work across many countries simultaneously. With these enterprises, especially private actors are highly sensitive regarding the tax rates in different countries. So countries with lower tax rate became the natural destination of capital accumulation for these multinational companies at the cost of other countries. These companies create illegal means to avoid their tax liabilities in the original countries from where income has been created with the help of tax havens.

Tax Havens are that destinations in which tax rates are very low, i.e., near zero especially for some kinds of transactions. The OECD has defined four factors in the identification of tax havens: No or only nominal taxes, lack of effective exchange of information, lack of transparency and no substantial activities. (OECD, 1998):-

- No or only nominal taxes-it means that there is no or nominal tax on the relevant income, usually capital. This is the first necessary condition to identify a tax haven, but it is not sufficient condition because a country may be competing fairly or adopting a preferential regime.
- Lack of effective exchange of information-tax havens typically have in place laws or administrative practices under which businesses and individuals can benefit from strict secrecy rules and other protections against scrutiny by tax authorities thereby preventing the effective exchange of information on taxpayers benefiting from the low tax jurisdiction.
- Lack of transparency-e.g. the details of the regime and/or its applications are not apparent, or there is inadequate regulatory supervision or financial disclosure. Lack of transparency may be attractive for those who want to hide the origins of their income or keep them undeclared in their source countries.
- No substantial activities-the jurisdiction facilitates the establishment of foreign owned entities without the need for a substantive local presence. This is what makes doubtful how small islands can host billions of dollars in foreign direct investment if they apparently do not have the necessary resources to yield production.

Some individuals, organisation or companies show their income in these destinations and they pay low taxes. Hence, they succeed in avoiding tax at their original destinations. Usually they establish shell subsidiaries or move themselves in these destinations. A report by British Tax Justice Network has estimated "at least $21trillion of unreported private financial wealth was owned by wealthy individuals via tax havens at the end of 2010. This sum is equivalent to the size of the United States and Japanese economies combined. There may be as much as $32 trillion of hidden financial assets held offshore by high net worth Individuals." Tax Justice Network (2012). Now the normal tax rate as in India (30 percent) would give a huge amount of public revenue. Not a one time tax, but tax on capital gains on this amount would also provide income to the nation.

Problems Created by Tax Havens

Tax Haven had created many problems for the real income generating countries. Some of these could be summarised.

Tax haven support secrecy and this is the foremost reason of tax evasion and tax avoidance in other countries. The financial secrecy that many tax havens provide facilitates grand corruption, money laundering, the hiding of political conflicts of interest, the manipulation of markets, etc. It is behind this veil of secrecy that tax evasion and avoidance by individuals and companies takes place. The same veil of secrecy permits the proceeds of crime and corruption to be hidden. These destinations avoid information and transparency that shows their self means of maintaining stock of black money from other countries.

These destinations are the places where individuals and corporate houses hide their black money. Hence, problems associated with black money are indirectly being supported by tax havens. By supporting this black money they discourage the provision of public goods so produce unfavourable effects on the welfare. Slemrod and Wilson (2009) viewed tax havens as “parasites” on the tax basis of high-tax countries and thus decrease public good provision. Therefore, the elimination of tax haven activities can certainly increase tax revenues and improve social welfare.

By providing support to illegal wealth tax heaven also increases opportunities for corruption. The illicit financial flow out of developing countries, almost all through tax havens/secrecy jurisdictions, have grown unchecked over the last decade, rising at an average rate of 6.5 percent a year from 2004 to 2013 reaching a total of US$1.1 trillion in 2013. As an average from 2004 to 2013 China, Russia, Mexico and India remain on top four positions. Of that sum 3-5 percent is corruption by government officials and the like, 30 per cent is criminality such as drug trafficking and the balance-some 65% or so-is by commercial organisations, most relating to tax-related issues. (Global Illicit Financial Report: 2015). But important is that all of it is corrupt. And it flows through tax havens because of the deliberate veil of secrecy they create. Raymond Baker estimated in early 2000's that $1 trillion "dirty money" cross border annually. (Raymond 2005). This is a clear looting of developing countries by a group of elite, multinational enterprises and by multinational financial institutions.

Tax havens through secrecy jurisdiction successfully redistribute wealth in favour of the rich. Gap between rich and poor is increasing continuously. One of the main reasons is accumulation of wealth by big corporate houses through legal and illegal means. Tax Havens helped these houses in doing so. They facilitate only those who want to evade their tax liabilities and could afford this service by offshore financial services. The Result is that richest and largest companies pay less or no tax while the other averages have to pay full taxes. So they became relatively poorer. Tax havens create an uneven playing field. Some multinational companies are well positioned to take advantage of tax havens, but other businesses, whether large domestic companies or smaller businesses, are unable to do the same. "In 2015, just 62 individuals had the same wealth as 3.6 billion people-the bottom half of the world. This figure is down from 388 individuals as recently as 2010. The wealth of the richest 62 people has risen by 45% in the five years since 2010-that's an increase of more than half a trillion dollars ($542bn), to $1.76 trillion. Meanwhile, the wealth of the bottom half fell by just over a trillion dollars in the same period-a drop of 38%. Since the turn of the century, the poorest half of the world’s population has received just 1% of the total increase in global wealth, while half of that increase has gone to the top 1%." (Oxfam 2016).

All this capital movement that is towards tax havens directly results loss of revenue in various corners of the world due to unpaid taxes. Obviously, it has a huge impact on the development in underdeveloped regions. Though there is uncertainty about the estimates of data regarding tax havens, yet some estimates quantify this amount. The highest estimate of individual wealth hidden away in ‘secrecy jurisdictions’ suggests a range of $21–32 trillion by Tax Justice Network in 2012. If this unreported $21-32 trillion earned a modest rate of return of just 3%, and that income was taxed at just 30%, this would have generated income tax revenues of between $190-280 bn. This amount is almost twice the amount OECD countries spend on all overseas development assistance around the world. Inheritance, capital gains and other taxes would boost this figure considerably. (Tax Justice Network 2012). While developing countries are hit the hardest by corporate tax dodging, it is important to note that rich countries also suffer. Even developed countries with state-of-the-art tax legislation and well-equipped tax authorities cannot stop multinationals dodging their tax.

Tax havens have contributed to reinforcing tax competition by offering secrecy rules and fictitious domiciliary positions combined with “zero tax” regimes. Tax competition makes the national tax base more tax sensitive. Some people have feared that tax competition will lead to a “race to the bottom”, where tax rates become so low that countries with large public sectors must make dramatic cuts in their welfare systems. Generally speaking, tax competition has led to higher taxes on immobile tax objects and lower rates on mobile objects. A particular decline has been seen in taxes on capital income, which has been offset by higher taxes on other tax objects. This change in tax base composition resulted in two ways. One, the tax burden has been shifted in the society. Reduction in capital tax means owners of capital pays a reduced share of total taxes and wage earners pay an increased share. Two, this could result in an increase in the social cost of taxation if reduced capital taxes are offset by higher taxes on other objects. The costs of tax competition affect all countries, but are higher for developing countries because they derive the larger part of their tax revenues from capital. This means that they face a greater threat of losing tax revenues and must accordingly reduce public sector investment, for example. Since poor countries have a different structure for their tax revenues and a far greater need for public sector investment than rich countries, they suffer more harm from tax competition.

Due to the secrecy of tax havens ability of financial regulators also suffer to identify and minimise the risks taking place in capital markets. This factor has contributed significantly to the financial crisis that started in 2007. The deliberate and systematic exploitation of financial secrecy to circumvent capital market regulation provided the basis for higher profits in the short term for the few at the cost of crisis for many. Tax haven has imposed various costs on the international capital market by increasing risk, uncertainty and complexity through new financial instruments, such as the transformation of mortgage debt into convertible financial instruments, which were placed in funds located in secrecy jurisdictions. This made it difficult for investors to understand the risk profile they were acquiring. Registering funds in secrecy jurisdictions also created uncertainty because third parties were denied information about the actual position of counter parties. Financial crisis led to the collapse of big banks. It meant that banks have no mutual confidence in each other's financial strengths. This uncertainty, lack of confidence increases with lack of transparency and regulation. Tax havens have contributed to information asymmetry between various players in the financial markets. They have increased the risk premium on financial transactions in the international financial market. This results in bigger stock exchange fluctuations when players in financial markets try to eliminate this risk.

Tax havens also create inefficiency in factor allocations. To obtain the highest value creation, that investment destination should be chosen which yields the highest pre-tax return or where socio-economic returns are highest. But private investment in not concerned with pre-tax returns, but with post-tax returns, i.e. their disposable income. Therefore, tax design should ensure that private and the socio-economic investment decisions coincide with each other. But taxes influence investment decisions. Higher the difference between private and socio-economic returns, higher will be the efficiency loss. Tax havens can change investor behaviour and thereby increase the difference between socio-economic and private returns. Tax havens make it more profitable to pursue tax evasion and planning through instruments which encroach on the sovereignty of other countries. Tax havens can also influence which investments are the most profitable after tax, and thereby increase the gap between private and socio-economic investment criteria. This can lead to a redistribution of resources by the private sector away from activities which yield the highest pre-tax return to ones which give the best return after tax. This reduces the socio-economic return on the investments actually undertaken, so that tax havens have lowered overall value creation for society.

II. MEASURE TO CHECK CAPITAL FLOW TOWARDS TAX HAVENS

Tax havens made it costlier for developing countries to collect taxes, lead to inefficient use of resources, undermine the workings of the tax system and make it possible for the power elites to enrich themselves at the expense of the community. The most important damaging effect is perhaps that tax havens help to give power elites incentives to weaken public institutions, institutional quality and governance in their own country by encouraging corruption. Institutional quality in the broad sense is an extremely important factor for economic growth. The negative impact of tax havens on a country’s institutions accordingly contributes to ensuring that growth in poor countries is substantially lower than it could have been. The secrecy practiced in tax havens has also created information asymmetry between investors and consequently reduced the efficiency of international financial markets. That has led to higher risk premiums and thereby increased borrowing costs for both rich and poor countries.

There is a need to adopt measures which could contribute to a greater extent to identifying capital flows to and from developing countries via tax havens, and which could help to limit the illegal flight of capital and laundering of money from developing countries via tax havens.

First is strengthening initiatives which aim to improve tax systems in developing countries and official registries. These should be broad-based and deal with conditions related to tax administration, utilisation of various tax bases and the formulation of contracts between multinational companies and developing countries. Governments must ensure that industrial policy and the exercise of state ownership do not undermine development policy goals. This is particularly important in respect of large multinational companies and for investment institution.

Second, measures should go be adopted to increase transparency and to reduce corruption. Anti corruption measures should be broad based. Strong institutional and democratic control mechanisms are crucial for combating economic crime. The fight against the use of tax havens to conceal the theft of resources from developing countries must also be pursued by developing countries through a purposeful commitment to strengthening and building up institutions such as the efficient tax authorities, the judiciary and anti-corruption agencies. At the same time, it is important that developed states combat bribery committed by companies domiciled in their own jurisdictions but which have operations in developing countries.

Third, a cross-working group should be established mutually by countries to develop networks on reducing and eliminating the harmful structures found in tax havens with the aim to influence international development and financial institutions dedicated to helping poor countries.

Fourth, countries should for as many Tax Information Exchange Agreements as possible. This would result in the pressure on tax havens for improved standards of information sharing and pressure on tax havens to collect information for exchange would increase. But this could be achieved when there are multilateral information exchange agreements and information exchanges take place not just in the name of the recipient legal entity of the income streams referred to above, but also on the basis of the material beneficial owners of the entities in question, then the veil of secrecy created by tax havens would be shattered forever.

Fifth, corporate laws should be moulded to generate full knowledge of the companies. All information about beneficial owners of companies should be declared on public record and on tax returns and same for the nominees. Full account of companies and of their subsidiaries should be on public record. It should include all income generation for all branches of companies not only in domestic country, but also in foreign countries with all investment and sales details along with the source of these investments and sales.

Sixth is Country-by-Country Reporting, all countries should require multinational corporations to publicly disclose their revenues, profits, losses, sales, taxes paid, subsidiaries, and staff levels on a country-by-country basis as a means of detecting and deterring abusive tax avoidance practices. So that the information can be analysed by legislators responsible for fixing the profit-shifting problems. Since legislators alone will not have enough qualified people to adequately analyse the information necessary to make informed policy changes, publicly available country-by-country reporting will also allow experts from academia, civil society and the media to lend their analytical support.

III. CONCLUSION

Tax havens are used for sheltering illegal money and also for legitimate business because of their peculiar characteristics such as secrecy, lack of exchange control, good banking, communication and transport structure, tax advantages end up being their major attraction both to wealthy individuals and large corporations. The crimes that tax haven secrecy enables give rise to greater economic inequality and to less well functioning and competitive markets, to inefficiency in factor allocation, to capital flight from other, especially developing countries to tax havens, to greater political inequality through the corruption of systems of democratic representation. There is need to eliminate these tax havens so that real value creation and welfare could be increased in the world. The elimination of a sufficiently small number of havens will leave all countries better off (Slemrod and Wilson, 2009). But this cannot be done without fair international cooperation.

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