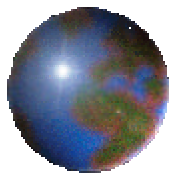


# The Use and Abuse of Tax Havens

NBER-NCAER Conference  
January 2006

Mihir A. Desai  
Harvard & NBER



## The Rise of Tax Havens

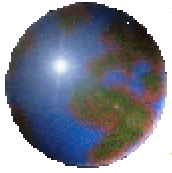
Many governments, particularly those in economic federations, are concerned about the increased usage of tax havens

**Table 4: Share of Foreign Manufacturing Activity in Low-Tax Countries, 1990-2000**

Panel B: Share of Activity in Twelve Low-Tax Countries

	Share of All Foreign Affiliates in Manufacturing	Share of Foreign Manufacturing Assets	Share of Foreign Manufacturing Receipts	Share of Foreign Manufacturing Earnings and Profits
1990	11.01%	10.15%	9.68%	20.72%
1992	11.77%	11.27%	10.32%	30.36%
1994	12.44%	13.54%	12.06%	25.80%
1996	12.25%	15.93%	14.51%	29.12%
1998	14.17%	23.73%	18.37%	40.89%
2000	15.29%	31.17%	21.38%	46.83%

Notes: The two panels present the share of foreign activity in DOT Haven Countries (Bahamas, Barbados, Bermuda, Cayman Islands, Luxembourg, and Netherland Antilles) and in Twelve Low-Tax Countries (DOT Havens and Hong Kong, Ireland, Netherlands, Panama, Singapore, Switzerland). Data was provided by the IRS. In both cases, all entities are classified as being in Manufacturing (SIC, 1990-1996) or Goods Production (NAICS, 1998-2000). The sample is limited to the manufacturing or goods CFCs that are part of the 7,500 largest CFCs in each year; reported profit figures may include income from indirectly owned affiliates.



## What should we do about it?

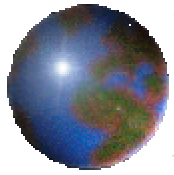
This has motivated various calls for greater “coordination” against “harmful tax competition” - OECD

Part of a larger concern on the rise of corporate tax avoidance...

GAO (2004): in 2000, 53% of large (>\$250 million in assets) firms had minimal if any tax obligation

Understanding haven use can also shed light on aggregate capital flows which now have macroeconomic implications

Temporary relief from repatriation taxes has fueled in excess of \$200 billion in repatriations



## Underlying Questions

This has raised a host of related questions....

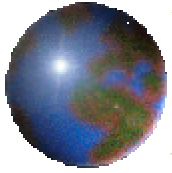
What determines the demand for havens? What determines the ability to access avoidance opportunities?

What do firms use havens for?

How do haven operations interact with non-haven operations?

Does economic activity in tax havens come at the expense of activity in other countries?

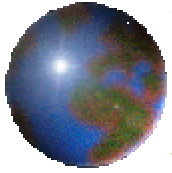
Are there other aspects of haven use and corporate tax avoidance that we should be concerned with?



## More on havens and non-havens interact...

Does economic activity in tax havens come at the expense of activity in other countries?

- If there is a certain (fixed) amount of total world economic activity, locations are substitutes.
- Total world economic activity may not be fixed - greater activity in one place might then stimulate greater activity elsewhere. How?
  1. Tax haven affiliates might provide valuable intermediate inputs used by operations elsewhere.
  2. The use of tax havens to facilitate tax avoidance may reduce the tax cost of operating in high tax places, and thereby make them more attractive than they would otherwise be.



## Some efforts to answer these questions...

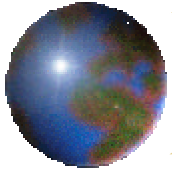
The Demand for Tax Haven Operations – DFH – JPubEc

Do Tax Havens Divert Economic Activity? – DFH – EconLetters

Corporate Tax Avoidance and High-Powered Incentives – DD –  
JFE

Degradation of Reported Corporate Profits – D – JEP

Theft and Taxes – DDZ – NBER WP 10958



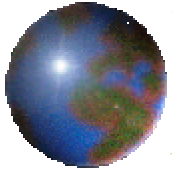
## Approach

Using data on U.S. multinational firms, examine characteristics that are associated with a demand for tax haven operations

Separately consider the distinctive role of larger tax havens in order to identify effects of profit reallocations to havens and their effects within regions

Given that the effect of haven operations on non-haven operations is the same as non-haven operations on haven operations, look for an instrument for non-haven operation growth and examine effects on haven use

- This will tell us how the use of havens affects non-havens...

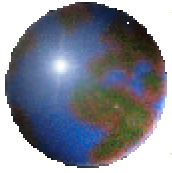


## Data

Confidential data for U.S. firms with detailed financial and operating reports on their activity

1982-1999, with greater coverage in 1982, 1989, 1994, and 1999.

Coverage is close to complete, particularly for large firms

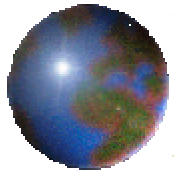


## Empirical Results on Demand for Havens

Size, level of globalization, R&D intensity, Intrafirm trade all contribute to the demand for havens – all happen to also be increasing in importance. Havens and their uses are here to stay

Tax motivations are more complex than reallocations of profits from high-tax areas – havens also figure into avoidance of U.S. repatriation taxes

Regional effects are large



## Effects of Regional Tax Havens – Empirical Setup (1)

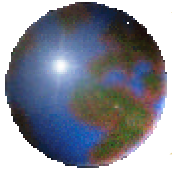
Are haven and nonhaven operations complements or substitutes?

All foreign operations are jointly determined – need an instrument

Ideally, would instrument for changed costs of using a haven and then use predicted values in second stage to see how changed haven use affects non-haven growth

Such instruments are hard to find

Complementarity and substitutability are symmetric properties, so the effect of tax haven operations on non-haven activities can be estimated by examining the effect of non-haven operations on tax haven activities



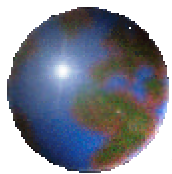
## Effects of Regional Tax Havens – Empirical Setup (2)

Estimate this in first differences: change in tax haven operations as a function of the change in non-haven activities

Non-haven economic growth rates (the weighted average within a parent) can be used to predict non-haven activity growth rates in the first stage

Predicted values of non-haven activity growth rates can be used to investigate the relationship to haven usage in a second stage

Similar approach used to understand effects of foreign activity on domestic activity



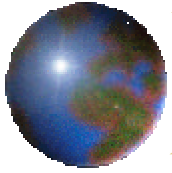
# Effects of Regional Tax Havens - Second Stage Results

Table 7

The Relationship between Haven and Non-Haven Activity, Within Regions

Dependent Variable:	Haven Use Dummy				Haven Use Dummy	
					Europe	
	(1)	(2)	(3)	(4)	(7)	(8)
Constant	0.0173 (0.1388)	-0.1358 (0.2336)	-0.0154 (0.1434)	-0.1011 (0.2200)	-0.0303 (0.2285)	-0.1157 (0.2515)
Affiliate Sales Growth in Non-Havens	<u>6.5934</u> (1.3346)	<u>8.4789</u> (3.7516)			<u>7.9395</u> (2.6879)	
Affiliate Net PPE Growth in Non-Havens			<u>6.2493</u> (1.3145)	<u>7.2020</u> (3.1900)		<u>7.5724</u> (2.8271)
Period Fixed Effects?	Y	Y	Y	Y	Y	Y
IV with GDP Growth and Initial Levels?	Y	N	Y	N	Y	Y
IV with GDP Growth?	N	Y	N	Y	N	N
No. of Obs.	816	817	817	817	320	321
Log Likelihood	-531	-543	-534	-543	-208	-210

Predicted values from this first stage regression are associated with the onset of haven usage – by symmetry, lowered costs of haven usage stimulates nonhaven activity

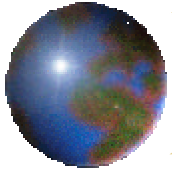


## Implications

Open economies have incentives to tax mobile multinational firms less heavily than they do other firms given relative elasticities

It is very difficult to differentiate tax burdens in this way for political and practical reasons

Regional tax havens may permit countries to maintain high corporate tax rates that they effectively impose at different rates on domestic v. multinational taxpayers.

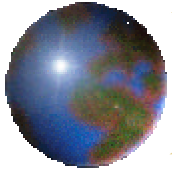


## The Darker Side of Haven Use

Tax avoidance requires obfuscation – obfuscation, in turn, shields managerial misdoings

This alternative view of tax avoidance/haven use has increasing empirical support.

Tax avoidance and haven use can quickly morph into a vehicle for managerial self-enrichment

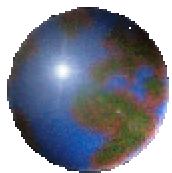


## The Darker Side of Haven Use

Anecdotal evidence indicates that nexus between tax avoidance and managerial misbehavior is common feature of major corporate scandals – Enron, Tyco, Xerox

- Accounting benefits from tax avoidance critical
- The may provide a reason to revisiting the dual reporting system

Valuation of tax avoidance is zero on average for U.S. firms and only fully valued for well-governed firms



## An example of a shelter using a haven by Enron...

Effect: \$112 million deductions 1997-2001

\$65 million book net income, 1997-2001

NB. Not a taxpayer at the time so no economic benefits

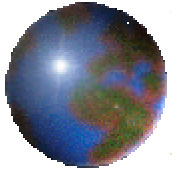
Cost: \$10 million (lawyers, bankers, accountants)

Stated Business Purpose:

"Enron's purported principal business purpose for the transaction was to generate financial accounting income."

Motivation:

"There is not much, if any, interest for the tax benefits alone but if the transaction were redesigned to provide for financial accounting benefits, as well, then corporate clients would be extremely interested and would pay a substantial fee....other less expensive alternatives exist to generate equivalent tax benefits."



## Conclusions

Havens have grown, and will continue to grow, in importance and have a number of underappreciated, salutary effects for non-havens

- the ability to discriminate amongst investors
- the ability to facilitate activity in non-havens that won't cut rates

The adverse consequences of havens are more likely to center on the cover they provide for managerial diversion and accounting manipulations...