In praise of tax havens: Income shifting and offshoring in a globalizing world

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Introduction

Two sides of globalization and corporate tax policy:

1. reduction in transport costs can make production facilities more mobile
   - real investment more sensitive to corporate tax differentials?
2. financial innovation and liberalization makes income shifting activities more profitable
   - rise in offshore tax havens facilitates income shifting
   - in an exemption country (Canada), foreign source income may escape taxation altogether
   - you don't really have to move to engage in international tax avoidance anymore?

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2. new view: in face of income shifting:
   - high-tax host countries may increase statutory tax rates
   - residents of high-tax countries may be better off with (some) income shifting
   - an exemption for foreign source income of residents may be optimal

Income shifting: A brief introduction

Non-arm's length transactions give a number of opportunities for international tax arbitrage:

- transfer pricing between affiliates in high-tax countries and tax havens
- relocation of intangible assets/payment of royalties to tax havens
- use of haven affiliates to avoid repatriation taxes in countries operating foreign tax credit systems
- related party borrowing/indirect financing structures

An example of debt shifting from a high-tax host country:

- HoldCo lends to Opco in host country to finance investment K, which pays interest rK to HoldCo
- if both countries operate classical, territorial tax systems, the arbitrage gain is $(t_O - t_H)rK$
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More sophisticated indirect financing structures do even better:

- HoldCo in an exemption country borrows K to inject equity in a haven affiliate, which lends to OpCo
- OpCo's and HoldCo's interest are tax deductible, while dividends accrue tax-exempt in haven affiliate
- Hence marginal investment may be subsidized by current tax treatment

Investment and income shifting: Survey of evidence

Evidence on role of income shifting:

- Hines (1994): a 1 per cent tax rate increase in a haven causes reported earnings there to drop 7 per cent
- Bartelsman and Beetsma (2000): a 1 per cent tax rate increase haven causes reported earnings to drop 2.7 per cent
- Grubert and Slemrod (1998): investment in Puerto Rico by US MNCs is concentrated among those with a large ratio of intangible to tangible assets
- Mintz and Smart (2004): sensitivity of taxable income to tax rate differentials between provinces is greatest among separately incorporated affiliates (elasticity -4.9) rather than among firms that allocate income (elasticity -2.3)
- Desai, Foley and Hines (2004): existence of a haven affiliate increases investment in neighbouring high-tax countries

A theory of income shifting, investment, and tax policy

A brief summary of joint work with Qing Hong (U of T).

Consider a country with:

- a multinational sector that produces output $F(L_m, K)$ from domestic labour and imported capital with constant returns to scale, and
- a domestic sector that produces output $G(L_d)$ from domestic labour and entrepreneurial capital.

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Rate of return to imported capital is fixed at r (small open economy). Equilibrium wage rate $w(K) = \partial F/\partial L_m = \partial G/\partial L_d$ is increasing in K.

Both sectors pay corporate income tax at statutory rate t. Revenues paid to workers as lump-sum transfer.

Government maximizes weighted sum of consumption of domestic workers and domestic entrepreneurs.

Case 1: No income shifting

Capital imported by MNC must earn pre-tax "hurdle rate":

$$F_K(L_m, K) = \frac{r}{1-t} \equiv METR^0$$

In this small open economy, tax on MNCs is shifted backward to domestic workers, and it discourages inward investment and lowers wages (bad). But tax permits redistribution from domestic entrepreneurs to workers (good).

Implication of this tradeoff: a corporate tax is desirable if (Proposition 2) the multinational sector is relatively labour intensive.

Case 2: Income shifting by multinationals

Suppose MNCs may finance a fraction $b > 0$ of inward investment by borrowing from an affiliate in a tax haven, yielding arbitrage gain of $trbK$. Hurdle rate for MNC investment falls to:

$$METR = \frac{r(1 - bt)}{1 - t} < METR^0$$

Income shifting reduces the investment-deterrent effect of the corporate tax.

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- if income shifting entails real costs, there is an interior optimal thin-capitalization rule (Proposition 7)

Conclusion: Policy implications

- a race to the bottom?
  - not if investment enhancing effects of income shifting dominate revenue erosion effects
  - alternative explanations for secular decline in statutory rates in OECD
- anti-avoidance measures
  - perceived reluctance of high-tax countries to control income shifting – because of positive investment effects?
  - but in the presence of deadweight costs of shifting ("Parmalat costs"), some restrictions are desirable
- taxation of foreign-source income
  - rise in tax havens calls into question Canada's tax exemption for (most) foreign-source corporate income – contributes to offshoring?
  - but experience of crediting countries suggests avoidance opportunities remain plentiful ...