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## Treasure Islands

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## Treasure Islands

James R. Hines Jr.

**I**n movies and novels, tax havens are often settings for shady international deals; in practice, they are rather less flashy. Tax havens are countries and territories that offer low tax rates and favorable regulatory policies to foreign investors. For example, tax havens typically tax inbound investment at zero or very low rates and further encourage investment with telecommunications and transportation facilities, other business infrastructure, favorable legal environments, and limited bureaucratic hurdles to starting new firms. Tax havens are small: most are islands; all but a few have populations below one million; and they have above-average incomes. Tax havens are also known as “offshore financial centers” or “international financial centers,” phrases that may carry slightly differing connotations but nevertheless are used almost interchangeably with “tax havens.”

The definition of exactly what makes a tax haven may depend on the type of investment and requires a degree of judgment, but fortunately, those who have considered the issue keep compiling very similar lists. For example, in Hines and Rice (1994), my coauthor and I identified tax havens based on their low business tax rates, self-promotion as financial centers, and whether they were identified as tax havens by other authoritative sources. OECD (2000) identified a similar list of tax havens (though one that omits OECD countries), as did Diamond and Diamond (2002) and the U.S. Government Accountability Office (2008). Table 1 offers a rather inclusive list of 52 countries and territories commonly considered to be tax havens. Taken together, they have a total population of about 50 million and a total

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Table 1

**Tax Havens**

Andorra	Guernsey	Nauru
Anguilla	Hong Kong	Netherlands Antilles
Antigua and Barbuda	Ireland	Niue
Aruba	Isle of Man	Panama
Bahamas	Jersey	Samoa
Bahrain	Jordan	San Marino
Barbados	Lebanon	Seychelles
Belize	Liberia	Singapore
Bermuda	Liechtenstein	St. Kitts and Nevis
British Virgin Islands	Luxembourg	St. Lucia
Cayman Islands	Macao	St. Martin
Cook Islands	Maldives	St. Vincent and the Grenadines
Costa Rica	Malta	Switzerland
Cyprus	Marshall Islands	Tonga
Djibouti	Mauritius	Turks and Caicos Islands
Dominica	Micronesia	Vanuatu
Gibraltar	Monaco	
Grenada	Montserrat	

*Note:* See text for the selection method.

GDP of about \$1.1 trillion—that is, roughly the size of the economy of New York State. However, three-quarters of that GDP lies in four countries—Hong Kong, Ireland, Singapore, and Switzerland—and 16 of these economies have national GDPs of less than \$2 billion.

The United States and other higher-tax countries frequently express concerns over how tax havens may affect their economies. For example, tax havens might erode domestic tax collections by permitting individuals to earn income through accounts in tax havens that they do not disclose to their home governments, or else by facilitating a situation in which business income actually earned in high-tax jurisdictions is reported for tax purposes as having been earned elsewhere. Tax havens could attract economic activity that is arguably lost to higher-tax countries where the activity might otherwise have located. Some worry that corporate and banking secrecy offered by tax havens could facilitate criminal activities, including crimes by dictators, and terrorist and drug-related activities. Confidential accounts in tax havens might reduce the transparency of financial accounts and thereby impede the smooth operation and regulation of legal and financial systems around the world. Finally, differences between the policies of tax havens and those of other countries may contribute to the problem, if it is one, of excessive international tax competition.

These concerns are all plausible, albeit often founded on anecdotal rather than systematic evidence. They are buttressed by a sense, held by many, that there is something distasteful in the kinds of financial transactions for which tax havens are best known.

Yet tax haven policies may also benefit other economies and even facilitate the effective operation of the tax systems of other countries. Tax havens change the

nature of tax competition among other countries, very possibly permitting them to sustain high domestic tax rates that are effectively mitigated for mobile international investors whose transactions are routed through tax havens. By differentiating tax burdens in this way, countries are able to maintain sizable domestic tax bases in the face of growing international competition. The financial and other business activity taking place in tax havens is likely to contribute to economic activity elsewhere, since tax havens themselves are largely intermediaries, with rather small economic sectors relative to their financial footprints. The presence of a nearby thriving tax haven financial sector seems to increase the competitiveness of a country's banking sector. In fact, countries that lie close to tax havens have exhibited more rapid real income growth than have those further away, possibly in part as a result of financial flows and their market effects.

While historically tax havens were associated with corporate anonymity and bank secrecy, initiatives by the OECD and other international coalitions have prompted every country, including now all of the tax havens, to agree to information exchange for tax enforcement purposes. Furthermore, some intriguing recent evidence (reported by Sharman in this issue) suggests that large wealthy countries such as the United States and the United Kingdom may have become locations of choice for those interested in establishing anonymous accounts. Tax havens are far from being rogue dictatorships that sponsor international terrorism and related activities; instead, tax havens typically score very highly in measures of democratic governance.

This paper evaluates evidence of the economic effects of tax havens, starting with the international investment flows associated with tax havens and the concerns they raise. This is followed by analyzing the impact of tax havens on capital markets and foreign direct investment, and the likely effect of tax havens on tax policies elsewhere. The conclusion considers economic growth patterns associated with tax havens and their implications for developing countries in particular.

## **Tax Havens and International Investment**

By every measure, tax havens receive large capital flows from other countries. Standard practice divides private international capital flows into direct and portfolio investment. Direct investment is the accumulation of ownership claims in a foreign entity in which the investor has a controlling interest, almost always defined as 10 percent or greater ownership shares. Hence, if an American multinational firm invests \$10 million of equity capital in its wholly-owned French subsidiary or loans \$10 million to the same subsidiary, this is recorded as \$10 million of U.S. direct investment in France. Portfolio capital flows reflect investments in which the investor does not have a controlling interest as defined by the 10 percent criterion; thus, if an American individual spends \$1,000 to purchase stock in a publicly-held German corporation, this represents \$1,000 of portfolio investment from the United States to Germany.

Table 2

**International Portfolio Investment, 2002 and 2007**

Country	Portfolio investment		GDP	Population
	2002	2007	2006	
	In millions of dollars			2006
United States	3,284,387	7,347,223	12,738,526	298,442,420
United Kingdom	1,368,065	3,649,266	1,887,495	60,609,153
Germany	1,359,512	3,213,623	2,513,585	82,422,299
France	846,926	2,411,138	1,850,544	63,292,515
Netherlands	824,709	1,687,390	550,650	16,491,461
Italy	737,610	1,543,029	1,651,612	58,133,509
Japan	509,922	1,467,298	3,892,954	127,515,169
Spain	335,783	1,355,310	1,223,615	40,397,842
Luxembourg	648,876	2,133,046	35,280	474,413
Cayman Islands	534,553	1,827,291	2,415	46,663
Ireland	240,389	1,234,862	164,008	4,062,235
Switzerland	230,987	665,090	274,697	7,523,934
Bermuda	138,916	515,387	3,130	66,436
Hong Kong	68,929	341,900	281,730	6,940,432
Jersey	47,364	320,968	5,100	91,812
Netherlands Antilles	70,026	223,143	3,141	223,016
Singapore	42,265	170,916	184,854	4,492,150
British Virgin Islands	24,499	86,915	1,107	24,150
Guernsey	16,628	78,933	2,742	65,632
Panama	13,731	40,136	27,355	3,206,481
Cyprus	1,877	28,166	18,882	784,301
Bahamas	13,851	27,424	8,306	303,770
Marshall Islands	484	14,151	436	60,451
Bahrain	32	10,146	18,377	698,585
Liberia	2,805	8,546	1,127	3,043,979
Isle of Man	194	6,764	2,942	75,715
Mauritius	640	6,401	23,809	1,253,425
32 other tax havens	7,926	20,283	171,246	17,792,778

*Sources:* For portfolio investment, the IMF (see <http://www.imf.org/external/np/sta/pi/cpis.htm>); for GDP and population, the Penn World Tables, version 6.3 (<http://pwt.econ.upenn.edu/>), supplemented, as needed, by information from the U.S. Central Intelligence Agency (CIA, 2009).

*Notes:* The table presents year-end 2002 and 2007 portfolio investment levels in (for the top panel) countries with at least \$1 trillion of portfolio investment, and (for the bottom panel) tax havens with at least \$5 billion of portfolio investment in 2007. Information for “32 other tax havens” includes every other country listed in Table 1, except St. Martin, for which data are unavailable.

Tax havens receive large gross flows of portfolio investment from other countries. Table 2 reports data from the IMF (described in Lane and Milesi-Ferretti, 2010, and available at <http://www.imf.org/external/np/sta/pi/datarsl.htm>) on total stocks of inbound portfolio investment at year-end 2002 and 2007 in the eight non-haven countries with more than \$1 trillion of inbound investment in 2007 and all tax havens with at least \$5 billion of inbound investment. The table also presents

figures for population and GDP in 2006, drawn from the Penn World Tables (Heston, Summers, and Aten, 2009) and supplemented for very small countries with data from the CIA (2009). Among the eight large countries in the top panel of the table, inbound portfolio investment levels at year-end 2007 are of the same order of magnitude as their GDPs, but that is not true of many of the tax havens in the bottom panel, whose portfolio investment is well out of proportion to income or population. For example, Luxembourg has greater inbound portfolio investment than Japan, which has more than 250 times the population of Luxembourg; more dramatically, the Cayman Islands has the sixth-largest portfolio capital inflow in the world, despite having the population and income of a medium-sized American city. Volumes of portfolio investment in these and other tax havens have grown substantially, more than tripling between 2002 and 2007. Of course, these figures represent gross rather than net capital inflows, and almost all of this inbound capital was subsequently invested elsewhere; but by any measure, tax havens process large volumes of capital transactions.

As locations for purely pass-through financial entities, tax havens are hard to beat. Financial flows through tax havens are typically not subject to local taxes, which means that certain kinds of tax obligations—such as stamp taxes, capital gains taxes, and withholding taxes—can be avoided or deferred. Tax havens are loath to impose currency restrictions or capital controls on international flows. Financial companies in tax havens are often easier and less expensive to establish than are intermediaries elsewhere, with lower filing and annual registration fees, and fewer regulatory constraints on financing and corporate organization. Furthermore, there is often considerable local legal, accounting, and financial expertise available to assist investors.

For most tax havens, nearby countries are the largest sources and destinations of their capital flows. Table 3 presents regressions in which the dependent variables are U.S. dollar volumes of portfolio capital flows between tax havens and non-havens. The dependent variable in the regression reported in column one is the magnitude of capital flows in millions of U.S. dollars at year-end 2006 into tax havens in other countries. The “Distance” from a tax haven to another country is constructed as the distance between the geographic centers of each country (reported by CIA, 2009) minus an adjustment for country size.<sup>1</sup> In the first column, the insignificant  $-0.1115$  coefficient reflects that tax haven GDP has little discernable effect on the magnitude of inbound capital flows, whereas the  $5.0326$  coefficient indicates that (not surprisingly) the size of the economy in the source country has a large effect: a \$1 billion higher income in a country adjacent to a tax haven is associated with \$5 million greater gross investment in that haven. The  $-0.3509$  coefficient in the first column indicates that nearby countries receive the most investment: 1,000 kilometers of greater “Distance” reduces the effect of GDP by roughly 7 percent ( $0.3509/5.0326$ ),

<sup>1</sup>The adjustment for country size in calculating “Distance” treats each country as though perfectly round in calculating an approximate distance from the country center to the border; specifically, the adjustment equals the square root of the ratio of country land area (reported by CIA, 2009) and  $\pi$ .

*Table 3*  
**Tax Haven Investment and Proximity**

	<i>Dependent variable: Investment (millions of dollars)</i>		
	<i>In havens</i>	<i>From havens</i>	<i>Sum between haven and non-haven pairs</i>
Constant	437.3752 (652.9881)	512.6290 (513.0470)	3479.5200 (2631.0560)
Haven GDP ( <i>in billions of dollars</i> )	-0.1115 (1.2932)	-0.3641 (0.6022)	-2.6231 (3.4568)
Non-Haven GDP ( <i>in billions of dollars</i> )	5.0326 (0.4583)	7.7363 (0.4510)	17.3779 (1.5653)
Distance * Non-Haven GDP	-0.3509 (0.0613)	-0.5617 (0.0565)	-1.1668 (0.2067)
Number of observations	1,575	1,948	688
R <sup>2</sup>	0.0837	0.1537	0.1792

*Notes:* The table reports coefficients from regressions in which the dependent variable is portfolio investment in millions of U.S. dollars at year-end 2006. The dependent variable in the regression reported in column 1 is investment in tax havens; the dependent variable in the regression reported in column 2 is investment from tax havens to non-haven countries; and the dependent variable in the regression reported in column 3 is the sum of investment between non-haven and tax haven pairs. GDP is measured as billions of 2006 U.S. dollars. "Distance" to a tax haven equals distances between geographic centers of each country, minus an adjustment for country sizes that treats each country as though perfectly round, and equals the square root of the ratio of country land area and  $\pi$ . The variable "Distance \* Non-Haven GDP" is the interaction of "Distance," in thousands of kilometers, and GDP of the non-haven country, in billions of dollars. Standard errors are in parentheses.

thereby effectively reducing investment by that fraction. A similar pattern appears in column 2, in which the dependent variable is the portfolio capital flow from tax havens to non-haven countries. Tax haven GDP again has an insignificant effect on capital flows, whereas the 7.7363 coefficient in column two indicates that adjacent countries receive an additional \$7.7 million in portfolio capital flows from tax haven neighbors for every \$1 billion of their (non-haven) GDP. The estimated -0.5617 coefficient implies again that proximity strongly influences capital flows; indeed it has a stronger effect on investments from tax havens to non-havens than for capital flows from non-havens to havens. The third column reports estimated coefficients from a regression in which the dependent variable is the total volume of gross inbound and outbound capital flows between tax havens and non-havens, the -1.1668 coefficient indicating that 1,000 kilometers of "Distance" is associated with \$1.2 million reduced total inbound and outbound investment for every \$1 billion of non-haven GDP.

Given the ability of portfolio capital to flow to anywhere in the world, it is striking that proximity has such a substantial effect. Part of the explanation surely lies in the extent to which private sector professionals, and indeed the tax havens themselves, cater their practices, procedures, and regulations to clients from nearby

jurisdictions, developing appropriate expertise and marketing their services through the development of business connections. But also, the underlying IMF data are potentially incomplete, so it is possible that the data to a certain degree reflect that nearby transactions are more apt to be reported than are other transactions.

Tax havens are also major recipients of direct investment from high-income countries. Direct investment is undertaken almost entirely by multinational corporations, and the most ample foreign direct investment data are reported for U.S. investment by the U.S. Department of Commerce's Bureau of Economic Analysis (BEA). Table 4 presents direct investment data for 2004 as reported in BEA (2008); 2004 is the most recent year for which the most comprehensive BEA data are available. The table presents aggregate information for U.S. multinational firms investing in each of 27 tax havens in which U.S. assets exceeded \$50 million in 2004, with the category "United Kingdom Islands, Caribbean" encompassing the Cayman Islands, the British Virgin Islands, Turks and Caicos Islands, and Montserrat, and the category "haven total" consisting of the 46 tax havens for which there are BEA data. The tax havens as a group had 0.84 percent of the non-U.S. world population in 2004 and 2.30 percent of non-U.S. world GDP, reflecting their high average incomes and the contribution of foreign investors to their economies.

The foreign activities of American firms are more concentrated in tax havens than their economic sizes would ordinarily warrant: tax haven operations had 6.06 percent of the foreign employee compensation (and 5.55 percent of foreign employment) of U.S. firms in 2004. Tax havens similarly had 6.49 percent of the foreign property, plant, and equipment of American firms in 2004. These patterns reflect the attractiveness of putting income-earning activities in such low-tax jurisdictions and the somewhat greater capital intensity of operations that should be expected in an environment in which profits, which are largely returns to capital, are lightly taxed. The BEA data do not include information on the location of intangible assets, such as intellectual property, but if they did, they would surely show that ownership of such assets is also strongly concentrated in tax havens. Among the tax havens, employment together with property, plant, and equipment is concentrated in the larger jurisdictions of Hong Kong, Ireland, Singapore, and Switzerland.

The financial operations of American firms in tax havens are also reflected in the numbers in Table 4. American multinational firms locate 27 percent of their foreign gross assets in tax havens, despite the relatively small sizes of these economies, and report that 42 percent of their foreign incomes are earned in tax havens. The income figure can be easily misinterpreted to suggest that American firms misreport their foreign earnings, as it seems incongruous that operations with only 6 percent of foreign employment or property, plant, and equipment could account for 42 percent of foreign income. However, most of the income reported in tax havens arises because multinational firms commonly use tax haven affiliates as conduits for investment in other foreign affiliates; for example, an investment from the United States to France might be routed through Luxembourg to avoid certain French taxes. When the French affiliate remits some of its foreign profits in the form of interest and dividend payments, the income is first received by the



Table 4

**U.S. Direct Investment in Tax Havens, 2004**

<i>Country</i>	<i>GDP</i>	<i>Total assets</i>	<i>Net PPE</i>	<i>Sales</i>	<i>Net income</i>	<i>Value added</i>	<i>Employee compensation</i>
<i>In millions of dollars</i>							
Aruba	2,139	2,344	714	(D)	(D)	430	88
Bahamas	7,512	16,701	719	4,069	495	359	72
Bahrain	15,725	246	17	773	20	71	36
Barbados	6,307	19,659	235	3,944	2,221	1,856	30
Belize	2,525	151	20	147	5	44	5
Bermuda	2,909	455,281	4,712	47,878	28,492	5,700	218
Costa Rica	40,685	7,565	831	3,478	406	987	403
Cyprus	17,500	1,065	42	702	55	219	23
Hong Kong	245,455	165,598	5,412	63,534	6,854	7,977	3,760
Ireland	145,882	345,052	13,751	134,379	39,266	35,957	4,569
Jordan	26,649	206	61	148	9	35	21
Lebanon	29,462	465	17	204	13	31	15
Liberia	993	2,644	613	2,520	260	419	115
Liechtenstein	2,474	1,153	2	341	2	46	12
Luxembourg	31,640	519,147	1,213	12,409	42,540	952	575
Malta	7,422	1,310	53	129	94	44	20
Marshall Islands	423	2,485	1,232	835	437	526	66
Mauritius	21,618	3,190	31	402	-272	50	9
Netherlands Antilles	2,883	60,167	28	549	12,340	-8	10
Panama	23,441	6,890	1,213	3,410	495	585	238
Singapore	159,251	138,284	9,996	133,944	15,076	14,229	3,709
St. Lucia	1,773	77	18	56	14	21	4
Switzerland	258,934	317,023	6,825	135,897	26,041	17,096	5,681
United Kingdom Islands, Caribbean	3,170	284,563	2,051	20,004	13,973	1,814	423
Haven total	1,056,772	2,351,266	49,806	569,752	188,836	89,440	20,102
All countries (U.S. not included)	45,983,540	8,688,553	766,865	3,312,531	450,760	818,256	331,593
Haven percent	2.30%	27.06%	6.49%	17.20%	41.89%	10.93%	6.06%

*Source:* Bureau of Economic Analysis (BEA) (2008).

*Notes:* The table presents data reported by BEA (2008) on U.S. direct investment in the 27 tax haven countries in 2004 with assets of at least \$50 million ("U.K. Islands, Caribbean" includes the Cayman Islands, the British Virgin Islands, Turks and Caicos Islands, and Montserrat); "Haven total" includes all 46 countries for which BEA data are available. Table entries are aggregates for all U.S. investment in each country. Total assets are total gross assets; Net PPE is the book value of property, plant, and equipment. Entries that are deleted to preserve survey respondent confidentiality are denoted (D).

Luxembourg affiliate, which then pays it to the American parent company in the form of a dividend. Hence, a sizable fraction of the income reported in tax havens is in fact income earned by other foreign affiliates that American parents invest in

indirectly through tax haven operations. This is reflected in the sizable difference between the tax haven share of the foreign net income (42 percent) and value added (11 percent) of American multinational firms. Value added equals sales minus purchases from other firms, thereby excluding financial income, and the much smaller contribution of tax haven affiliates to total value added reflects that tax haven affiliates are used as intermediaries. The effect of financial ownership is also evident in the figures for affiliates located in the financial centers of Barbados, Bermuda, Luxembourg, the Netherlands Antilles, and the Caribbean U.K. Islands, which together report financial and nonfinancial income of \$99.6 billion, or 22 percent of the total income of American foreign affiliates in 2004, along with employment expenses of just \$1.256 billion, representing 0.38 percent of the total foreign employee compensation of American affiliates that year.

Several patterns are evident from the data in Table 4. Tax havens attract significantly greater U.S. direct investment and employment than their small economic sizes would ordinarily merit, though they nonetheless account for a modest share of the total foreign operations of U.S. companies. American operations in tax havens are reported to be extremely profitable, though on closer examination most of this unusual profitability is illusory, reflecting financial income from assets held in other countries through tax haven affiliates. It is clear that significant amounts of capital flow through business operations in tax havens.

## **Concerns and Reactions**

Capital flows to tax havens raise two types of concerns: first, that reported flows are so large; and second, that the reported flows are not large enough, in that some investment goes unreported. The first concern is that capital flowing through tax havens thereby avoids regulation or taxation by other countries. Indeed, the use of tax haven locations by portfolio investors or multinational firms is in many cases motivated in part by the ability to structure transactions in a way that is not subject to local taxation. This reduction in taxes can be achieved in several ways.

In the case of multinational firms, a common use of tax haven intermediaries is to permit foreign direct investment to be financed with greater amounts of debt rather than equity, in order to benefit from the tax deductibility of interest payments. Thus, for example, an American firm investing in its wholly-owned affiliate in a high-tax foreign location (such as Japan) might first invest the funds in a tax haven affiliate, which then invests only a small portion of the funds in equity in the Japanese affiliate and loans the rest to the Japanese affiliate. The benefit of this arrangement is that the Japanese affiliate thereby pays interest from Japan to the tax haven; the interest payments are deductible against taxable income in Japan and are taxable (in principle) in the tax haven, though since the tax haven may have a tax rate of zero this is relatively unimportant. Properly structured, this arrangement need not trigger U.S. taxes at the time of interest payments, though the United States taxes the foreign incomes of American corporations when returned to the United States,

so some U.S. taxes will be due on this income when ultimately remitted from the tax haven affiliate to the U.S. parent company.

In this example, the ability to structure transactions reduces Japanese tax obligations and increases the attractiveness of investing in high-tax Japan. From the standpoint of Japan, this is problematic to the extent that firms finance their investments with excessive debt; though Japan along with most other countries (including the United States) imposes taxes on cross-border interest flows and also limits the ability of foreign investors to deduct interest payments to related parties. Consequently, Japan has the ability to reduce the benefits of investments structured through tax havens if it is concerned about the use of tax haven intermediaries. From the standpoint of the United States, it is generally beneficial for American taxpayers to avoid foreign taxes, since doing so improves their after-tax rates of return and facilitates U.S. tax collections. The United States taxes the repatriated foreign incomes of American companies but grants credits for foreign taxes paid, thereby effectively taxing U.S. firms on the difference between the U.S. and foreign tax rates. Lower foreign tax rates entail smaller credits for foreign taxes and greater ultimate U.S. tax collections (Hines and Rice, 1994). Dyreng and Lindsey (2009) offer evidence that U.S. firms with foreign affiliates in certain tax havens pay lower foreign taxes and higher U.S. taxes than do otherwise-similar large U.S. companies. A countervailing consideration is that the use of tax haven structures to avoid foreign taxes might make foreign investment too attractive to American firms, and thereby reduce investment in the United States.

A more aggressive form of tax avoidance is available to business taxpayers who adjust the prices used for intercompany transactions in order to exploit tax rate differences between countries. An excessively transparent method of doing so would be to sell a paper clip from an affiliate in a tax haven to an affiliate in a high-tax location, charging a price of \$1 million. This creates a tax deduction of \$1 million in the high-tax buying country, and taxable income of \$1 million in the tax haven, thereby reducing total taxes. To prevent such behavior, governments have adopted arm's length pricing rules requiring that the prices used for intercompany transactions must be the same as those that would have been chosen by unrelated parties transacting at arm's length. Clearly, the arm's length pricing standard addresses \$1 million paper clips, but there is widespread concern that the difficulty of applying the arm's length standard to many ordinary cases—to say nothing of complex transactions involving sophisticated financial instruments or intangible property such as patents and trademarks—leaves ample opportunity for tax avoidance.

There is extensive evidence that reported after-tax profit rates of multinational firms are higher in low-tax-rate countries (for example, Desai, Foley, and Hines, 2003; Huizinga and Laeven, 2008; Clausing, 2009). This evidence is consistent with the data in Table 4 indicating that American firms report that 10.93 percent of their foreign value added is earned in their tax haven operations that account for roughly 6 percent of their foreign employment and property, plant, and equipment. This pattern is consistent with incentives to adjust transfer prices in a tax-sensitive

manner, though this evidence must be interpreted cautiously, since it is also consistent with adept but fully legal business and tax planning.

Because tax havens have very low tax rates, they create some of the strongest incentives for transfer price adjustment designed to reallocate taxable income away from high-tax jurisdictions. Indeed, some advocacy groups criticize tax havens for allegedly preventing the developing world from effectively taxing foreign investment in their countries. Christian Aid (2009), for example, argues that the transfer pricing opportunities provided by tax havens cost developing countries \$160 billion a year in lost tax revenue, thereby being responsible for the deaths of 1,000 children a day. While such estimates are not consistent with other statistical evidence, they nevertheless reflect a widespread public concern about tax havens, and in particular their effect on vulnerable developing countries.

Portfolio investment in tax havens raises somewhat different concerns. Investments routed through tax havens generally avoid certain comparatively minor taxes on gross transactions, such as stamp duties and withholding taxes on cross-border flows, but on the whole, taxpayers are generally unable to defer home-country tax liabilities on foreign portfolio investment. As a result, there is little, if any, incentive for investors living in high-tax countries to earn portfolio income in low-tax foreign jurisdictions, as such income is immediately taxed by their home governments.

With regard to portfolio investment, the primary concerns are that it can be difficult for governments to monitor and regulate foreign portfolio investments, and that individuals can hide money in anonymous accounts set up in tax havens. Tax havens are the locations of choice for anonymous accounts, so the thinking goes, both because they collect little or no tax on investment returns and because many have traditions of protecting investor privacy. Recent revelations of significant numbers of European individuals with unreported Liechtenstein bank accounts and American individuals with unreported Swiss bank accounts contribute to these concerns. Some advocacy groups like Oxfam (2000) argue that the ability to hide funds in anonymous tax haven accounts contributes particularly to the problems of developing countries, whose corrupt leaders, they argue, make extensive use of such accounts.

The international reaction to tax havens has focused on the OECD, which in 1998 introduced what was then known as its Harmful Tax Competition initiative (OECD, 1998), and is now known as its Harmful Tax Practices initiative. The purpose of the initiative was to discourage both OECD member countries and certain tax havens outside the OECD from pursuing policies that were thought to harm other countries by unfairly eroding tax bases. In particular, the OECD criticized the use of preferential tax regimes that included very low tax rates, the absence of effective information exchange with other countries, and “ring-fencing” (meaning that foreign investors were entitled to tax benefits that domestic residents were denied). The OECD identified 47 such preferential regimes, in different industries and lines of business, among OECD countries, most of which have been subsequently abolished or changed to meet OECD objections.

As part of its Harmful Tax Practices initiative, the OECD also produced a List of Un-Cooperative Tax Havens, identifying countries that have not committed to sufficient exchange of information with tax authorities in other countries. The concern was that the absence of information exchange might impede the ability of OECD members (and other countries) to tax their resident individuals and corporations on income or assets hidden in foreign tax havens. As a result of the OECD initiative, along with diplomatic and other actions of the G-7, G-20, and individual nations, all 38 countries and jurisdictions identified by the OECD, along with others, have committed to improve the transparency of their tax systems and to facilitate information exchange with tax treaties and tax information exchange agreements. While it remains to be seen just how effective some of these changes are in practice, the secrecy that was once a feature of certain offshore accounts will clearly be much more difficult to obtain in the future.

### **Tax Havens and Financial Market Competition**

Financial industries in tax havens compete with financial operations elsewhere. The financial sectors of economies in much of the world are tightly controlled by small numbers of firms and by governments, either through regulated monopolies or, most commonly, through state ownership of banks (La Porta, Lopez-de-Silanes, and Shleifer, 2002), quite apart from the government takeovers that followed the crash of 2008. This pattern particularly characterizes low-income countries and those lacking strong democratic institutions, where government ownership of the banking sector is the norm and where there is pervasive cronyism in the allocation of credit. The resulting absence of competition in credit markets can be expected to raise interest rates charged to consumers and businesses, and encourage credit rationing in which certain borrowers are effectively unable to obtain credit at any feasible price. Furthermore, absence of competition in banking is likely to influence the entire financial sector. As La Porta, Lopez-de-Silanes, and Shleifer (2002) document, countries with monopolized banking sectors, and accompanying underdeveloped financial sectors, exhibit slow rates of productivity growth and low per capita incomes.

Financial firms located in nearby tax havens have the potential to address some of the problems associated with uncompetitive financial sectors by providing competition. Rose and Spiegel (2007) document that commercial banks in countries close to tax havens have lower interest rate spreads (that is, lower differences between the borrowing rates banks charge and the rates that depositors are paid) than do other countries, which is a reliable indicator of greater banking competition. Their estimates indicate that, controlling for other observable factors, doubling a country's distance from the nearest tax haven is associated with interest rate spreads that are 1.63 percentage points larger (for example, an interest rate spread of 5.63 percent rather than a spread of 4.00 percent). Other variables offer similar evidence of the effect of tax haven proximity on financial market competition. The

banking sectors of countries located closer to tax havens are less concentrated than the banking sectors of other countries, in that the share of the market controlled by the five largest banks is smaller and the total number of banks divided by GDP is greater. Doubling a country's distance from the nearest tax haven is associated with a 6.91 percent greater share of the country's banking sector controlled by the five largest commercial banks. This along with the larger total number of commercial banks in countries close to tax havens may reflect the difficulty of monopolizing a domestic banking sector when investors have alternatives nearby.

The market competition associated with proximity to tax havens has observable effects on the financial sectors of affected countries. Rose and Spiegel (2007) report that, compared to other countries, the private financial markets of economies with nearby tax havens extend more credit to their private sectors; have greater aggregate market borrowing; and have higher levels of M2, a monetary aggregate that is partly the product of intermediation by the banking sector. All of these measures are consistent with high levels of private-sector financial activity.

Evidence of an association between financial market competition and proximity to a tax haven is open to multiple possible interpretations; after all, a jurisdiction may be more likely to become a tax haven if located near other countries with well-developed financial markets. Alternatively, factors such as political or legal systems common to certain regions of the world might also be associated with financial market development. But while it is difficult to know with certainty how tax havens affect nearby financial markets, the apparent competitive effects are consistent with what one might expect from entry into a monopolized or quasi-monopolized sector that otherwise charges above-market prices to consumers and businesses, that rations capital on the basis of personal relationships, and that thereby serves as a drag on local economies.

## **Tax Havens and Business Activity in High-Tax Countries**

There is widespread concern that low-tax jurisdictions impose costs on other countries in attracting investment, employment, and other business activity that would otherwise locate in nearby high-tax areas. However, no reliable estimates exist of the magnitude of such a diversion.

Indeed, the process may actually work the other way: that is, tax havens may reduce the costs of entering high-tax jurisdictions in a way that promotes investment and economic activity (Desai, Foley, and Hines, 2006a, b). An example is that the use of tax haven affiliates to facilitate debt financing of investments in high-tax Japan may encourage investment that otherwise would not locate in Japan. In addition, investors located in the United States and the few other countries that tax active foreign business income can use tax havens to facilitate deferral of home-country taxation of foreign income, which increases returns to foreign investments. Finally, financial services and other intermediate goods and services obtained at low after-tax cost in tax havens increase the productivity and competitiveness of

economic operations in high-tax countries, thereby increasing demand for production in those locations.

In Desai, Foley, and Hines (2006b), my coauthors and I consider the effect of tax havens on investment in high-tax countries by examining the complementary effect of investment in high-tax countries on demand for tax haven operations. For this purpose, we use foreign economic growth rates as instruments for foreign investment by American firms. Thus, for example, if Italy's economy grows at 3 percent per year and Spain's economy grows at 1 percent per year, American firms will tend to expand their operations more rapidly in Italy than in Spain. In this example, some American firms start with significant Italian operations and others with significant Spanish operations. As long as a firm's initial distribution of foreign investment in 1982 can be treated as random, then the subsequent differential growth rates of their economies can be used to predict non-tax-haven investment. These predicted growth rates are then matched to the likelihood of the same firms creating or eliminating tax haven affiliates between 1982 and 1999. The results indicate that greater sales or investment activity outside of tax havens is associated with greater demand for tax haven affiliates. For the typical American multinational firm, a 1 percent greater likelihood of establishing a tax haven affiliate is associated with 0.5 to 0.7 percent greater sales and investment growth outside of tax havens. The theory of the firm implies that complementarity is symmetric, so if foreign investment makes the use of tax havens more attractive, it follows that the use of tax havens makes foreign investment more attractive (Desai, Foley, and Hines, 2006a).

A study by Blanco and Rogers (2009) draws similar conclusions from its analysis of the effects of foreign direct investment in tax havens on foreign direct investment in low-income countries in the same regions. Using country-level data on aggregate foreign investment flows from 1990–2006, this study reports that investment in developing countries is positively associated with proximity to the nearest tax haven and to the level of foreign investment in the nearest tax haven. This evidence is a reminder that the ability of investors to use tax haven operations need not divert activity from nearby high-tax jurisdictions, instead suggesting that firms facing reduced costs of establishing tax haven operations respond in part by expanding their foreign activities in nearby high-tax countries.

There is a closely related question about the effect of foreign direct investment on economic activity in home countries. If tax havens encourage foreign direct investment in even high-tax foreign countries, might that not divert economic resources that would otherwise be devoted to producing jobs and activity at home? Put differently, how should the government of a capital-exporting country view institutions that contribute to international capital investment?

It is far from clear that greater levels of outbound foreign direct investment come at the cost of economic activity at home, since there are countervailing substitution and productivity effects. Substitution reflects that output can be produced either at home or abroad, so for a fixed total output, any additional foreign production then necessarily reduces domestic production, and foreign investment comes at the cost of domestic investment. The productivity effect reflects that increases

in foreign investment have the potential to raise the return to domestic production, stimulating demand for domestic activity and domestic output. Firms might, for example, find that foreign operations provide valuable intermediate inputs at low cost or that foreign affiliates serve as ready buyers of tangible and intangible property produced at home. In either of these cases, the ability to exploit foreign opportunities increases total demand for domestic factors of production.

Several recent studies suggest that greater outbound foreign direct investment may not reduce the size of the domestic capital stock, and more likely increases it. This conclusion emerges from time-series evidence of the behavior of U.S. multinational firms (Desai, Foley, and Hines, 2005); aggregate evidence for Australia (Faeth, 2006); industry-level studies of Germany (Arndt, Buch, and Schnitzer, 2007) and Canada (Hejazi and Pauly, 2003); and firm-level evidence for the United States (Desai, Foley, and Hines, 2009), the United Kingdom (Simpson, 2008), and Germany (Kleinert and Toubal, 2007). The difficulty confronting all of these studies is that foreign investment reflects economic conditions that very likely also directly influence domestic investment, making it difficult to identify the pure effect of greater foreign investment on domestic economic activity.

Detailed firm-level evidence indicates significant causal effects of foreign investment on domestic activity. In Desai, Foley, and Hines (2009), my coauthors and I evaluate the extent to which increased foreign activity by U.S. manufacturing firms influenced their domestic activities between 1982 and 2004. We construct firm-specific foreign GDP growth measures, which can be used to generate predicted growth rates of foreign activity that are then used to explain changes in domestic activity. This empirical procedure effectively compares two U.S. firms, one whose foreign investments in 1982 were, for example, concentrated in Britain, and another whose foreign investments were concentrated in France. As the British economy subsequently grew more rapidly than the French economy, the firm with British operations should exhibit more rapid growth of foreign investment than would the firm with French operations. If the domestic activities of the U.S. firm with British operations grow at different rates than the domestic activities of a similar U.S. firm with French operations, it may then be appropriate to interpret the difference as reflecting that foreign business expansions stimulate greater business activity at home.

Foreign economic growth rates are strong predictors of subsequent foreign investment by U.S. firms, which can then be compared to changes in domestic activity. The estimates reported in Desai, Foley, and Hines (2009) imply that 10 percent greater foreign capital investment triggers 2.6 percent additional domestic capital investment, and that 10 percent greater foreign employee compensation is associated with 3.7 percent greater domestic employee compensation. There are similar positive relationships between foreign and domestic changes in assets, and numbers of employees. Furthermore, 10 percent greater predicted foreign sales growth is associated with 6.5 percent greater exports to foreign affiliates and 5 percent higher domestic R&D expenditures. These estimated relationships suggest that firms combine home production with foreign production to generate final output at lower cost than would be possible with production in just one country, making each



stage of the production process more profitable and therefore more abundant. Hence the simple substitution story, in which firms have fixed investment stocks that can go either to one place or to another, is inconsistent with this evidence. As a result, it may well be that tax havens facilitate foreign investment—and thereby indirectly also stimulate economic activity in capital exporting countries.

## **Tax Haven Governance**

The central characteristics of countries that become tax havens are by now well understood: tax havens are small, typically below one million in population, and are generally more affluent than other countries. In addition, new evidence (Dharmapala and Hines, 2009) shows that tax havens score very well on the World Bank's cross-country measures of governance quality that include measures of voice and accountability, political stability, government effectiveness, rule of law, and control of corruption. These World Bank governance quality measures are reported by Kaufmann, Kraay, and Mastruzzi (2005), who compile 352 different underlying governance-related variables reported in 37 different data sets collected by international organizations, private firms, nonprofits, and universities.

This evidence indicates that there are almost no poorly governed tax havens. In part, this reflects that tax havens have above-average incomes, which tend not to be associated with poor governance. Furthermore, small countries may display different political patterns than other countries. But even after controlling for these factors, tax havens score highly on World Bank governance measures. In Dharmapala and Hines (2009), in regressions controlling for other observable variables including income, population, and aspects of geography, my coauthor and I find a large effect of good governance on the likelihood of becoming a tax haven: improving the quality of governance from the level of Brazil's to the level of Portugal's raises the likelihood of a small country being a tax haven from 26 percent to 61 percent.

Why are better-governed countries more likely than others to be tax havens? One interpretation is that the returns to becoming a tax haven are greater for well-governed countries: that higher foreign investment flows, and the economic benefits that accompany them, are more likely to materialize for well-governed tax havens than they would for poorly-governed countries that attempt to set themselves up as financial centers. In this interpretation, poorly governed countries do not forego potential economic benefits in not becoming tax havens, since few benefits would flow to them if they did. Evidence from the behavior of American firms is consistent with this explanation in that among poorly governed countries low tax rates do not prompt very much additional U.S. investment, whereas among well-governed countries there is a significant investment effect of lower tax rates (Dharmapala and Hines, 2009).

This interpretation of the evidence is not the only one possible; for example, perhaps the financial activity of tax haven economies, and resulting affluence,

improves local governance by encouraging media outlets, keeping citizens informed, and rewarding high-quality public service with the returns that can be earned in a market economy upon leaving government. Either way, having high-quality governance institutions and effective public servants is closely connected to effective operation as a tax haven.

The evidence that tax havens tend to be well-governed may seem inconsistent with the reputation of tax havens as locations in which investors can readily hide assets in order to launder funds, evade taxes, or avoid other financial commitments. As Sharman points out in this issue, anonymous corporations and bank accounts located in tax havens or elsewhere can be used for all sorts of purposes, including money laundering and tax evasion. Sharman approached corporate service providers in 22 different countries about the possibility of creating shell corporations, for which, in those cases in which anonymous companies were successfully established, he also attempted to create anonymous bank accounts. He was unable to establish anonymous corporations using corporate service providers located in commonly identified tax havens including the Bahamas, the British Virgin Islands, the Cayman Islands, Dominica, Nauru, Panama, and the Seychelles. By contrast, corporate service providers in countries including the United States, the United Kingdom, Spain, and Canada proved more helpful to his enterprise. He readily established anonymous corporations using these providers, with those in the United States distinguished by the ease with which they accommodated his request to create the corporations and set up bank accounts with unverifiable personal information.

The adherence of tax haven corporate service providers to established norms of documentation and transparency in the creation of corporations and bank accounts may have many sources, including the efforts of the OECD (recounted in Sharman, 2006) and various national governments. This, together with national aspirations and ability to wield effective government power with transparent democratic governance, may conspire to make tax havens more effective at enforcement and thereby much less attractive locations for money laundering and tax evasion than some of their larger brethren. Financial transparency has many attractive features—for example, it indirectly reduces opportunities for domestic and foreign corruption by making it difficult to hide the proceeds of bribery. Consequently, it may not be surprising that good governance and financial scrupulousness are associated among tax havens.

## **Tax Policies and Tax Competition**

Countries eager to attract foreign investment might compete with each other by reducing tax rates, as a result of which taxes, and therefore government expenditures, could be driven to inefficiently low levels. To the extent that tax havens contribute to this tax competition, either by offering investors low tax rates or by making investment more mobile, they might be responsible for some of the problems associated with excessive tax competition (Slemrod and Wilson, 2009). The

likelihood of such an outcome depends on the tax policies available to governments and the nature of the competitive environment.

It is noteworthy that international tax competition may also produce outcomes in which capital taxes are higher than they would be in the absence of competition. This can happen when there is foreign ownership of productive factors or when multiple governments attempt to tax the same income sources (Hines, 2006).

The case of foreign ownership is perhaps easiest to understand: governments that care only about the welfare of domestic residents have incentives to adopt policies that enrich residents at the expense of foreigners. Foreign ownership of local firms may encourage governments to raise local capital tax rates above the levels they would impose in the absence of economic openness because much of the tax burden is borne by foreign owners. Even foreign ownership of local land may trigger higher corporate tax rates if the burden of corporate taxes is in part borne by landowners in the form of lower property prices. If all governments respond to these incentives, then capital will be overtaxed by everyone.

The integration of world economies can contribute to the incentive that countries face to tax business income too heavily. Integrated business production may entail many stages in several different countries, all of which contribute to final output. In such a setting, taxes on one stage of production impose burdens on all the others by reducing the after-tax returns earned from producing final output. Taxpayers can avoid these taxes, but at a cost; and one method of avoidance is to scale back on production everywhere. As noted by Keen (1998) and others, the vertical nature of production in several countries gives incentives to impose taxes for which significant parts of the burdens are borne by other taxing jurisdictions—which leads to overtaxation.

Tax havens figure prominently in current debates over the scope and consequences of tax competition. Tax havens are widely believed to accelerate the process of tax competition between governments. However, a more likely possibility is that the tax avoidance opportunities presented by tax havens allow other countries to maintain high capital tax rates without suffering dramatic reductions in foreign direct investment. Hence, the widespread use of tax havens may retard what would otherwise be aggressive competition between other countries to reduce taxes in order to attract and maintain investment. In effect, what tax havens do is to permit governments to distinguish investments, subjecting relatively immobile domestic investment to higher tax rates than the highly mobile international investment. Keen (2001) and Hong and Smart (2007) identify the wide set of conditions in which countries benefit from differentiating tax systems in this way and the effect of such differentiation in improving the outcomes of tax competition.

Whatever incentives there may be to compete over tax rates, the tax burden on corporate income in OECD countries has fallen little, if at all, over the past 25 years (Griffith and Klemm, 2004; Hines, 2006). Corporate tax rates have fallen, but these declines have been at least matched by expansions in corporate tax bases. The use of tax havens by foreign investors helps to explain this evidence, as high-tax countries are able to maintain high-tax rates on domestic investment while continuing

*Table 5*  
**Tax Havens and Economic Growth, 1992–2006**

<i>Group of countries</i>	<i>Growth rate</i>
World	2.42%
G7	1.75%
OECD	2.26%
Non-OECD except China	2.17%
Tax havens	2.85%
Non-havens	2.39%
Countries close to tax havens (excluding tax havens)	2.56%
Countries far from tax havens (excluding tax havens)	2.14%

*Source:* The table presents average annual per capita real GDP growth rates between 1992 and 2006, based on country data from the Penn World Tables, version 6.3 (<http://pwt.econ.upenn.edu/>), and supplemented, as needed, by information from the CIA (2009).

*Notes:* Group averages are constructed from country data using square roots of 1992 GDP as weights. Countries close to tax havens are non-haven countries located no more than 825 kilometers from a tax haven, with the measurement of distance including an adjustment for country sizes. In particular, “Distance” equals distances between geographic centers of each country minus an adjustment for country sizes that treats each country as though perfectly round and that equals the square root of the ratio of country land area and  $\pi$ .

to draw significant levels of foreign investment (Hines, 2006). The persistence of corporate tax collections does not imply an absence of tax competition, but instead that, in the modern financial world, competition takes a form that does not entail reduced corporate taxation.

## **Tax Havens and Economic Growth**

The policies of tax havens can affect their own economic fortunes and those of other countries, possibly influencing measured national economic growth rates—particularly during the recent period of expanded international trade and investment, when transactions facilitated by tax havens had the greatest volume and presumed impact. Table 5 presents information on per capita real annual economic growth rates for various groups of countries between 1992 and 2006. Group averages are constructed by weighting individual country growth rates by square roots of 1992 GDP—though other weighting methods, or using population rather than GDP weights, produce similar patterns, as does starting the growth rate calculations in 1982.

Table 5 shows that tax havens exhibit faster economic growth rates than do other countries. Tax havens averaged 2.85 percent annual per capita real economic

growth from 1992 to 2006, compared to 2.39 percent for the world as a whole. OECD countries (including the tax havens in the OECD) averaged 2.26 percent annual per capita real growth over this period, and non-OECD countries other than China (which is so large that it drives overall results) averaged 2.17 percent annual per capita real growth.

The bottom panel of Table 5 distinguishes (non-haven) countries by distance to the nearest tax haven. Ranked in order of “Distance,” the median country in the world is 825 kilometers from the nearest tax haven, so those located closer than 825 kilometers are designated “close,” others “far.” The data indicate that countries located closer to tax havens exhibited somewhat more rapid economic growth over these periods than did others further away: countries located close to tax havens had 2.56 percent average annual per capita real economic growth rates between 1992 and 2006, compared to 2.14 percent for the rest of the world. This difference hints at the possibility that tax havens contribute to economic growth elsewhere, though the omission of so many relevant variables and the nonrandom location of tax havens mean that the correlation of economic growth and proximity to tax havens must be interpreted with caution. Furthermore, the correlation of economic growth and proximity to tax havens may mean that, conditional on there being tax havens in the world, a country benefits from having one nearby—but that is not quite the same as saying that the country is made better off by the existence of tax havens. Still, this evidence is suggestive, and given the policy interest in the effect of tax havens on developing countries, it is worth examining whether this correlation persists when looking at a sample of developing countries and controlling for base-year economic conditions.

Table 6 presents estimated coefficients from regressions that explain national economic growth as a function of base-year population, per capita GDP, and distance from tax havens and the rest of the world. The sample includes observations for 76 countries that the United Nations Human Development Index (<http://hdr.undp.org/en/statistics/>) classified as having “medium” or “low” human development, and for which data are available. The  $-0.0155853$  coefficient in the regression reported in column 1 indicates that, controlling for base-year population and GDP, countries located closer to tax havens experienced more rapid economic growth: 1,000 kilometers of additional “Distance” to the nearest tax haven is associated with 0.016 percent slower annual per capita growth between 1992 and 2006. Including squares of base-year log population and log GDP as controls reduces the estimated magnitude of coefficient on tax haven “Distance” to  $-0.011707$ , reducing the estimated effect of 1,000 kilometers of “Distance” to 0.012 percent slower economic growth. Some countries are located far from tax havens because they are distant from other countries in general, and such distance might itself affect economic growth rates, though including a variable that measures a country’s (GDP-weighted) distance from all other countries has little effect on the estimated effect of distance to the nearest tax haven; likewise, considering growth effects over a longer (1982–2006) time range makes no important difference to these results.

*Table 6*  
**Determinants of Economic Growth Rates, 1992–2006**

Constant	-726.6743 (962.9270)	2,710.24 (1,900.5650)
Distance to haven (in thousand km)	-0.0155853 (0.0027)	-0.011707 (0.0025)
ln Population	0.017275 (0.0035)	-0.0596946 (0.0476)
ln GDP (in billion \$)	-0.0100822 (0.0025)	0.0319412 (0.0360)
(ln Population) <sup>2</sup>		0.001787 (0.0013)
(ln GDP) <sup>2</sup>		-0.0004544 (0.0008)
Number of observations	76	76
R <sup>2</sup>	0.8986	0.9243

*Notes:* The table reports coefficients from regressions in which the dependent variable is a country's annual per capita real GDP growth rate between 1992 and 2006 in billions of 2006 U.S. dollars. Observations consist of 76 developing countries that the United Nations Human Development Index (<http://hdr.undp.org/en/statistics/>) classifies as having "medium" or "low" human development. The coefficients are from weighted ordinary least squares regressions in which observations are weighted by 1992 GDP. "Distance" equals distances between geographic centers of each country, minus an adjustment for country sizes that treats each country as though perfectly round, and equals the square root of the ratio of country land area (reported by CIA, 2009) and  $\pi$ . "Distance to Haven" is measured in 1000s of kilometers. Population and GDP are 1992 values. Standard errors are in parentheses.

## Conclusion

Tax havens are successful players in the world economy. They draw large amounts of foreign investment; their per capita incomes and rates of economic growth exceed world averages; and they have well-functioning democratic governments. Despite low tax rates, the public sectors of tax havens appear to be well-funded, accounting for roughly 25 percent of GDP, a fraction that exceeds the world average, albeit lying somewhat below those of the most affluent countries (Hines, 2005).

Does tax haven affluence come at the expense of the rest of the world? The low tax rates available in tax havens can encourage tax avoidance by multinational firms that structure their transactions to reduce taxable incomes in the highest tax jurisdictions, and create incentives for others to funnel portfolio capital flows through tax haven financial affiliates and thereby sidestep local taxes and regulations. In public discussions, tax havens are commonly associated with banking secrecy and the ability of individuals and firms to hide their money abroad, though the evidence indicates that this may be largely a pattern of the past.

If tax policy and financial regulation in the rest of the world were ideal, then there would be little scope for the policies of tax havens to improve matters elsewhere and greater reason to be concerned about their possible effect. In fact, few countries can lay claim to having perfectly designed taxes or regulations, so the relevant question is the effect of tax havens in the world in which we live. The evidence indicates that tax havens contribute to financial market competition, encourage investment in high-tax countries, and may ultimately, in their little island ways, promote economic growth elsewhere in the world.

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