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THE ECONOMICS OF TAX HAVENS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Taxation & Black Money

Tax havens, which help rich corporations and businessmen avoid paying high taxes on their income, have been vilified for supporting the illegal accumulation of wealth. Organisations like Oxfam have often characterised tax havens as “anti-poor” since they help the rich avoid paying taxes to governments. Several governments have also come together to crack down on tax havens, for only a collective effort can help.

However, a 2018 paper by Juan Carlos Suarez Serrato, titled “Unintended consequences of eliminating tax havens”, circulated by the National Bureau of Economic Research, makes the interesting case that critics may be committing a huge mistake by attacking tax havens. The paper tries to see if eliminating tax havens is good economic policy. To this end, the authors study the economic impact of repealing Section 936 of the Internal Revenue Code, a move that made it harder for American multinational corporations to avoid paying taxes to the U.S. government. Corporations had earlier made use of Section 936 to avoid paying high taxes in the U.S. by shifting their profits to tax havens like Puerto Rico that charged them lower tax rates. Serrato found that companies affected by the repeal of Section 936 shifted their investment abroad. This caused their investment in the U.S. to drop by 38% and led to the loss of 1 million U.S. jobs. In short, the existence of tax havens allowed corporations to invest in the U.S. despite the country’s high tax rates because tax havens helped to lower the effective U.S. tax rate. But with the crackdown on tax havens, corporations could no longer serve U.S. consumers.

Despite the crackdown on tax havens, the practice of shifting profits to avoid paying higher taxes continues unabated. According to another recent paper, “The missing profits of nations”, by Ludvig Wier and others, about 40% of the profits earned by multinationals each year continue to be shifted to tax havens. The authors argue that such profit shifting persists because tax authorities in high-tax countries have been unable to eliminate the influence of tax havens that compete against them for revenues. So these tax authorities have instead resorted to competing against other high-tax countries by allowing corporations to shift profits to their jurisdictions. In fact, according to the authors, such competition between tax authorities has caused the average global corporate tax rate to fall by more than half between 1985 and 2018.

This refers to the tendency to form friendships and other forms of interpersonal relationships with people we come across often in our daily lives.