Implications Of Tax Havens On Government Revenue

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Abstract: The contribution of government expenditure to the level of economic growth cannot be underestimated. Unfortunately, resources for the governmental expenditure, though limited, find their way out of the coffers. This paper tries to elaborate on the adverse effect of the existence of tax havens on government expenditure that seek to promote economic growth in developing countries. Literature indicates that high tax rates are a fundamental reason for the proliferation of government developmental funds-taxes, being syphoned to tax havens. Corrupt officials in government are also deemed to aid the intended government tax in reaching tax havens. In the end, international integration of tax bodies within governments and economies may lead to the strengthening of tax laws and downward review of tax rates can make tax obligations conducive and compelling, for economic growth.

Keywords: tax havens; government expenditure; economic growth

1. Introduction

Taxes are a major source of funding for development. Inadequate means of tax collection simply result in insufficient taxes for development. Developing countries are, unfortunately, at the fore front of all these inefficiencies, being a result of higher levels poverty and inequality. The undeniable role of progressive taxation, as a redistributing element of wealth, is geared towards the narrowing of the inequality gap and enhancement of economic development. This gap is seen to be widening, despite a recorded increase in the growth rates of these countries, according to Beckett[1]. Though a progressive tax system may not be the only panacea to bridging the inequality gap, it has proven to be very effective in most developed countries.

A paraphrased quote from Mahatma Gandhi suggests that, the wealth of the earth is enough for the need of every man, but not the greed of any man. The arguments about the widening inequalities, especially in developing countries, have been rampant in recent forums seeking global economic development. A new dimension, spearheading the cause of inequalities and under development, is the ability for wealthy individuals and corporations to siphon huge sums of money, away from the purview of authorities, to offshore accounts and less or no tax imposing jurisdictions-tax havens. Some known examples of such tax havens may include Ireland, Luxembourg, Hong Kong, Singapore, Switzerland and other nations in the Americas.

Today, about over sixty percent of government expenditure of developing countries is financed by both domestic and international debts[2]. The supposed major revenue generating system for these governments, taxation, has been seen to be lacking behind due to certain factors. The inadequate nature of records, an inefficient supervisory body on revenue mobilization and the cunning attitude of individuals and corporations, are the few but dominant reasons for the retarding
growth of developing countries. The adverse impact of tax havens is greatly faced by developing countries as sources of government revenue are limited. In Africa, “revenue trends have barely risen over several decades” as put forward by Kumar[3]. According to the Oxfam’s 2016 report on the world richest few, “global network of tax havens further enables the richest individuals to hide $7.6 trillion”. This figure is agreed to be underestimated as more of it may not be in the public domain-after all it is an estimate. The chunk of revenue made by international corporations as well as wealthy individuals are siphoned away from the jurisdiction of operations, where unfortunately is characterized by high corporate and income taxes[4].

The effective distribution and the allocation of resources are some of the known benefits a nation can derive from a progressive and efficient tax system[5]. Formulated tax policies by governments are geared toward providing a sustainable environment as well as improved standards of living for their citizenries. Progressive spending is also encouraged to provide the basic needs that could be referred as pro-poor. Though this goal may be achievable by developing countries, as seen in developed countries, it seems to be a wind chase. Many governments have tried to formulate policies in order to robe in all taxable avenues, in the quest to have enough revenue for government spending, and the settlement of debts borrowed majorly from the OECD countries. Data show that most of the taxes collected by developing countries, citing Ghana as an example, is concentrated on the income taxes of the few workers in the formal sector. These taxes from income are supported by the other indirect taxable elements such as Value added taxes (VAT). Regrettably, the redistributive prospective of the tax system has been predominantly ignored in most developing countries, especially sub-Saharan Africa. According to previous studies on the subject and related matters, this can be partly explained by the fact that, the high illegal financial flows from the continent make taxation of wealth very challenging, resulting in a constraint on government spending, thus under development[6]. The question of tax evasion, via the use of tax havens, is predominantly linked to multinational corporations which may have a solid grip on the resources of the countries in which they operate.

For the last quarter of 2016, Ghana’s debt to GDP ratio is estimated to be over 69%, according to the Ministry of Finance, Ghana. Due to the insufficient revenue available from taxes, heavy indebtedness hung around the necks of most developing countries in the sub-Saharan region. As afore mentioned, governments rely, in terms of taxes, heavily on indirect taxes and little on both income and corporate taxes, which are few. As a result, higher taxes are levied on income and corporate profits, just to create more revenue. Quite recently in 2016, the finance cabinet of the government of Ghana proposed that investment revenue be taxed. This proposal was vehemently protested against and finally suspended if not totally dropped. The existence of tax havens is partly to be the cause of this insufficiency. “Almost a third (30%) of rich Africans’ wealth – a total of $500bn – is held offshore in tax havens. It is estimated that this costs African countries $14bn a year in lost tax revenues. This is enough money to pay for healthcare that could save the lives of 4 million children and employ enough teachers to get every African child into school” according to Hardoon et al[5] in an Oxfam Briefing Paper.

The arguments for and against the existence of tax havens, as a hub for illicit financial flows and ultimately evasion of tax or otherwise, lingers on. Tax havens may be, as its advocates have described, a haven for tax avoidance which are deemed not illicit. However, according to a Christian aid report, “financial secrecy provisions make it harder for tax authorities to obtain their fair share of tax.” This is then said to reduce the government revenue for developmental projects, which then impedes any effort to bridge inequality gaps and improve the standards of living. The issue here is to understand how the existence of tax havens and low tax areas deprive developing governments of revenue to self-sustainability.
2. More On Tax Havens Implications

The cost of implementing and maintaining public services, which can be deemed ever increasing due to increasing population, can be seen as a reason for increase in government funding, therefore increment in taxes and debt in at least developing countries. Radu[7] postulated that, despite the need to have more revenue from taxation in order to sufficiently provide economic development, higher taxes cause greater economic losses. This is due to the ease of capital mobility from high tax jurisdictions to low tax jurisdictions or tax havens. Most developing countries, Ghana for example, have higher tax levels than the international average. Not only does high taxes dampen economic development and stifle the poor through insufficient revenue mobilization by governments, it deters the attraction of foreign investors who have a prime motive of profit making. International tax laws have the tendency to influence the investment patterns and behaviours of corporations and individual entrepreneurs and this ultimately results in the direct manner of the location of businesses and international investments of economic activities, (European Commission 1997 and OECD 1998)[8]

A recent study published by the International Monetary Fund (IMF) reiterated what previous studies allude to, that foreign direct investments are inversely affected by the level of taxation in a particular jurisdiction. The argument of how much taxes to charge on income then come to a consensus that if international capital flows are becoming more sensitive to the variations in the levels of taxation, tax reductions are then very likely to serve as a stimuli of domestic and foreign investments in the same direction. Countries that continually have the intention to overtax or impose higher taxes on profits earned by large domestic and foreign investors will have reduced levels of income from taxes, which evidently will be lower than those who did not [9]

In another study, Crivelli, De Mooij and Keen[10] used a panel data for 173 countries over a 33 year period and focused mostly on developing countries. The study explored the extent to which the impact of one country’s tax policy was affected by the tax bases of other countries through real decisions and through avoidance. The study also considered the impact of these policies on revenue. The results from their study suggested that spill over effects of the tax levels of tax-haven jurisdictions on other tax bases were a greater concern for non OECD countries or developing countries than for advanced. These impacts were significant as well. The study indicated that these effects may operate less through effects on real investment decisions, other than through profit shifting. In other words, profit shifting had greater impacts. The revenue losses through avoidance activities associated with tax havens also seem to be more of a concern for non-OECD members.

3. Discussions

The arguments surrounding the effects of the existence of tax havens are ongoing and gaining international recognition. Nevertheless, these effects are being felt, be they adversely or otherwise by most developing countries. Some have argued and maintained the stance that tax havens are in existence to foster beneficial tax competitiveness among countries. This argument stems from the notion that the use of tax havens signal to governments about their tax levels, which when high, should be reduced to retain investments in the country. This is because other countries would lose part of their tax base to the tax havens if they set tax levels too high.

Desai, Foley and Hines[11] also argued that, tax havens have a tendency to increase investment potentials in high-tax jurisdictions. They postulate that tax havens can contribute to higher levels of investments if foreign investors can transfer profits that are taxable to jurisdictions with very less taxes or no tax imposition. Furthermore, tax haven jurisdictions benefit from the transfer of profits from high-tax countries as well as the companies and individuals that maintain accounts in them. Tax haven countries benefit through the drawing of capital from non-tax haven countries.
into their banks and financial institutions. This mechanism, obviously, can form the foundations of a booming financial sector in the tax haven countries. Individuals and corporations benefit through tax savings resulting from tax rates ranging from zero to the low single digits versus relatively high taxes in their countries of citizenship or domicile, according to Dharmapala and Hines[12].

Despite the arguments raised in support for the existence of tax havens, there are some negative effects that are imminent threats to economic development, especially in developing countries. First and foremost, the ease with the mobility of capital and other assets, due to increased integration of markets, create a conduit for multinational firms to massively avoid, if not evade, taxes in a particular country is overwhelming. A Norad report indicated that the illicit capital flows from developing countries were estimated between USD 641- USD 941 billion, and this amount was way more than the support given to developing countries in terms of aids. This in effect, totally reduces the taxable income from which governments can source revenue for development. Profit maximization, though the financial goal of any profit making organization, should not be gotten at the detriment of others. Investors are certainly more concerned about their after tax earnings. According to an OECD report of tax competition, these earnings are then increased if profits can be moved to lower tax jurisdictions. The use of transfer pricing enables investors and multinational organizations to indulge in tax evasion which undermines the sovereignty domestic government in which these corporations operate.

Furthering the argument, the inefficiency in the allocation of investments is a burgeoning demerit in the excessive use of tax havens. Resources are skewed towards areas where they are less taxed. This distorts the relationship between private gains to the investor and the socio-economic gains to a country, which in all cases should be a par. This certainly affects the behavioral of investors, undermining the wellbeing of the deprived people. Again, tax havens are likely to make enormous gains from their status as tax havens more than the country where the money was generated. From administrative fees, for the preservation of anonymity of these investors and secrecy in financial records, tax havens may charge high costs for these services which then foster transfer pricing. Tax havens give investors conduit for tax evasion in their country of residence. This is very disadvantageous and detrimental to the world economy because it has no effect other than to damage national and international welfare while at the same time violating national rights to the tax base[13]. It is very clear from the forgoing that, low-tax or zero tax jurisdictions offer a haven for wealth and profits siphoned from around the world. Tax havens provide the legal apparatus for tax avoiders, and protection for illegal tax evaders, denying developing economies the public revenues needed for pro poor expenditure on hospitals, schools, and clean water and functioning transportation networks.

The ability of foreign investors to use tax havens has implications for the policies of high-tax countries and for the dynamics of tax competition. However the use of tax haven jurisdictions and their partners permit wealthy government officials and foreign investors of multinational corporations to avoid of the tax burdens imposed by countries with high tax rates, which are mostly developing countries. Advocates of tax havens argue that this helps in maintaining foreign investment at levels exceeding those that would persist if tax havens were unavailable. This consideration suggests an unrealistic hypothesis that high-tax countries might benefit from the existence of regional tax havens. This trend of thought then raises the argument if high-tax countries would not have done better by simply having to reduce their own tax rates on incoming foreign investments?

With all the twists and turns of arguments on the benefits or adverse effects of tax havens, there is an international outcry on international tax laws in order to bring sanctity to the practices of multinational businesses and wealthy investors, be they local or foreign. The profit seeking motives of businesses may be misleading and push businesses to seek their parochial interests, neglecting the greater good of all. Non OECD countries and much more developing countries are at the heart of detriments caused by these havens of taxes. The field of reason for developing countries, focusing on sub Saharan African countries may attracted greater foreign direct investments as a result of resource
endowment and not necessarily reduced tax rates. High tax rates in developing countries result from the increasing demand on the socio-economic interventions from government. This expenditure is heavily financed by loans as well as taxes, though not enough. Tax havens see to it that these tax revenues do not reach their utmost levels. Governments in developing countries will definitely have to suffer this, as the powers that be in the international front may take a while to consider reforms that are aiding.

Curbing the dire impacts of reduced revenue, caused by the activities of certain individuals and some international corporations, governments should, first and foremost, formulate policies that will strengthen institutions that are responsible for the engagement of foreign investors. Better negotiations concerning investment portfolios, allowances and agreeable tax rates could be reached. With this, revenue generated by the firms will be in full disclosure and subsequently taxed appropriately. Again, improving on the institutional quality of the domestic country is very key. Lack of trust in the institutions in the domicile country by foreign investors may be a factor for the use of institutions in other jurisdictions. Proper tax mobilization and monitoring systems and an effective registry may help increase revenue generated from taxes.

Proponents of international tax reforms have proposed that a reduction in the tax rates of high-rate countries, which are apparently, mostly made of developing countries, can help increase the tax revenues generated from multinational corporations who seek the benefits of engaging tax havens. In an empirical study concerning the relationship between tax levels and investments, De Mooij and Ederveen[14] suggested that a ten percentage point in the reduction of a country’s average real tax rate would increase that country’s levels of FDI, and by over thirty percent on average and in the long run. To achieve this, the governments should increase the tax bracket in order to rob in more avenues for tax revenue. “Indeed, the Diamond and Mirrlees[15] analysis of optimal taxation, as interpreted by Gordon[15] and reviewed in Gordon and Hines[16], implies that countries facing elastic supplies of foreign investment should reduce tax rates on foreign investors below the rates that are imposed on less tax-elastic domestic investors. This policy can be however challenging to implement.”[11]

At the international basis, a proper assessment of regulatory systems on international tax reforms should be a foundation to correct the detriment caused by the existence of tax havens. Agreements that allude to international standards of taxation should include all countries willing to exchange information for full disclosure and accountability. This is to ensure that all “jurisdictions may adhere to the same high standard of international cooperation in tax matters.”[13]. The adherence to, and the cooperation to international tax matters by various jurisdictions is crucial to ensuring the administration and enforcement of countries’ tax laws as cross border tax evasion becomes easier with the liberalization and integration of financial markets

4. Conclusion

The impacts of tax havens on government revenue in developing countries are seen as more adverse in effect than favourable in the advocacy of tax reductions and associated benefits. For governments in developing countries, it is logical to say that high tax rates are a major cause for the use and thrive of tax havens. As afore discussed, a reduction in these taxes may be the best way to retain greater portions of profits of multinational corporations. However, due to political reasons, this action may not be easy to implement. Though the widespread use of regional tax havens may seem to offer a convenient alternative in such circumstances of political impediment to tax reduction, its detriment to the government purse far outweighs the benefits. Weak public finances is one of the key challenges in a number of developing countries, especially those in Africa. Unfortunately, the corrupt nature of some political officials and other high placed individuals create a conducive atmosphere for illegal routing of profits into tax havens, if they themselves do not undertake such acts. Tax havens are a peril to the less privileged by depriving governments of tax revenue for
development. Stronger institutional quality, compelling international tax reforms and collaboration among member states may be an antidote to this menace and is likely to help governments increase its revenue portfolio

References