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DETERMINANTS OF TAX HAVEN: OVERVIEW OF PAST STUDIES

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Abstract

Until now there is no unanimously accepted definition of the term tax haven, yet there are irregular features that help facilitate and define what a tax haven globally entails. Although, the rationale behind tax havens is still seen as minimizing and avoiding tax liability via an undisclosed identity channel. This study aimed at providing insight into the determinants of tax haven and their effects. In addition, the study has attempted to identify the major difference between tax haven and offshore financial centers as well as their respective features. It has also identified the determinants of tax haven from several perspectives. Therefore, findings suggest that the main determinants of tax haven region are not only the ones enshrined in OECD criteria but others such governance index, institutional weakness, substantial amount of GDP from service industries etc. Finally, this study recommends that stringent control measures and penalties for tax-resistant behaviors should be put in place by the international regulators like the World Bank and International Monetary Fund (IMF) so as to enable them checkmate and minimize the activities of this wild predators through their offshore financial centers.

Key words: Tax Haven, Offshore Financial Centers, Multinational Enterprises.

* Introduction

Since 2008 global financial crises effects on the public finances of the developing economies, the issues of tax haven as committed by the multinational enterprises (MNEs) has attracted the interest of several policymakers and regulatory authorities such as G-20 Industrialized Nations, political pressure, civil society organizations like the OECD and various tax authorities and governments across the world. Thus, in the recent years the issue of tax haven has been subjected under difficult scrutiny by the policymakers and regulatory authorities, due to the extent of the effects it has on both the developed nation and particularly the developing nation which are the targeted tax haven territory. Recently, it has been estimated that over US$160bn is being lost from less developed and poorer countries (i.e., tax haven territory) annually due to the activities of offshore financial center which is worth two times more than the amount received from international aid (Mugarura, N. 2017). The Guardian newspaper (UK) also reported that the targeted third world country loses as much as US$50bn (£33bn) annually from offshore financial centers which is perpetrated by government syndicates and MNEs illegal business activities (The Guardian, 2015). Similarly, the results of African Union (AU) research in 2001 indicates that the unauthorized transfer of moneys from African countries in 2001 was estimated to be worth US$20bn which obviously had tripled due to offshore financial centres (OFCs) activities (Mugarura, N. 2017).

One of the prominent determinants of tax haven is the due the activities that transpires in the Offshore financial centers such as banks secrecy coupled with committers unwillingness to exchange information with the tax authorities. The conduit by which this tax haven is being perpetrated is usually via offshore financial center or service. In other words, tax haven is mostly being perpetrated in the service industry compared to manufacturing industries (Hebous, & Johannesen, 2015). Hebous, & Johannesen, (2015, p4), justify this view by stating that "Firstly, the specific institutions developed by tax havens may create a comparative advantage in the service industry. Secondly, service trade may serve as a tax evasion strategy for multinational firms".

Based on the commonly established standard for any country that has been enlisted and described as a tax haven region or having tax haven status. According to OECD, the main determinants of such places/regions include among others; a place with little or no tax, or no substantial activities, and that lacks transparency as well as effective information exchange. Examples of such regions or countries are basically Islands and developing poor countries such as Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cyprus etc. even though according to the list of OECDS, they are much more than that. And the channel by which tax haven activities are being arranged are basically in the service industry via OFCs activities such as shadow economy, mispricing and BEP (Base Erosion Profit Shifting), bank secrecy, and transfer pricing through the help of some batteries of professionals, such as bankers, accountants' lawyers etc. (Jalan, & Vaidyanathan, 2017). However, there is significant number of studies that argued that, besides the criteria outlined by OECD regarding countries with tax haven status, there are other salient factors that determines tax haven. Hence, this paper aims to uncover the determinants of tax haven critically reviewing extant literatures that relates to the study and can suitably answer the issues at hand. Specifically, this study attempts to validate the fact that besides the main determinants of tax haven and what actually constitutes a tax haven, there are other factors that determines tax haven status.

The remainder of the study is structured as thus: section 2 commences with an overview of offshore financial centers, followed by section 3 tax haven and the characteristics of tax haven, next section is regulatory reactions to tax haven, section 5 is discussion, section 6 is conclusion, and lastly section 7 is recommendations.

* **Overview of Offshore Financial Centers (OFC)**

An OFC can be defined "as any financial center where offshore activity takes place" (Mugarura, N. 2017p5). Usually, the term OFC is described as "powerful global financial centers" (Mugarura, N. 2017p5). OFC are small Islands economies that are rented out to foreign MNEs that can decide to switch to another jurisdiction whenever the current government policy does not favor them. According to Mara, (2015, p1), "offshore finance is one of the main pillars on which tax havens lie down". Young, M. A. (2013) cited in Dowling (2004), that offshore financial center simply means investments that are located only in foreign jurisdictions. Similarly, Jalan, & Vaidyanathan, (2017) described offshore financial centres as a siamese twin and went further to explain that it does not mean the same thing as tax havens even though OFC is an integral part of tax haven. Specifically, OFC is a term that is used to describe "those commercial communities set up within tax havens to exploit the structures facilitated by its law to enable global taxpayers to circumvent their home country regulations" (Jalan, & Vaidyanathan, 2017, p8). It is composed of professionals such as taxation experts, accountants, bankers, lawyers, and their related trust companies that provides services to interested clients that wants to utilize their structures for tax haven activities. Thus, a major distinction between them is that while tax haven is confined to a geographical location, OFCs are more transient and movable.

*** Tax Haven**

From time immemorial tax haven had a long history that is characterized by complex evolution (Mara, 2015). There is variety of names attributed to this phenomenon called tax haven. The OECD was the one that actually created the name as "tax haven", FMI described as "offshore financial center", while (KPMG) view it as "states without taxation" or "states with low taxation.

There is no generally accepted definition of the term tax haven. According to Jalan, & Vaidyanathan, (2017, pg5) to define the term "tax haven is a hard nut crack". And that up until now there is no acceptable unanimous definition of the term, although there are irregular features that helps to facilitate and identify what tax haven entails universally. For example, in 1998, the Harmful Tax Competition issued by OECD defined some key aspect that serves as a guide in identifying what tax haven entails. Essentially, the main rationale behind tax haven is still perceived to be the minimization and avoidance of tax liability via undisclosed identity conduit. However, OECD (1998) described the four critical criteria for identifying tax haven as follows:-

1- No or only nominal taxes,

2- Lack of effective information exchange

3- Lack of transparency

4- No substantial activities

A tax haven jurisdiction refers to "a country or independent geographical area where taxes are levied at a low rate" when compared to other jurisdictions (Mugarura, N. 2017, p4). Literarily, tax haven also means shifting capital to a preferential or a selected tax jurisdiction (Jaafar, A., & Thornton, J. (2015). From layman perspective, Tax Haven simply means, a situation where MNCs evade or avoid paying tax by shifting the profit generated from a jurisdiction with high tax to one with lower tax jurisdiction. According to classical definition, tax haven refers to a country with very low taxation or even no taxation at all. Mara, (2015, p2) mentioned that "tax havens are not all about low or lack of taxation. They are also characterized by high levels of secrecy and the availability of a strong network of financial services that allows users sophisticated strategies for achieving their goals". Similarly, Jaafar, & Thornton, (2015, p2), described tax havens as "jurisdictions that imposes very low or no corporate taxes and hence provides firms with the ability to reduce their overall tax burdens in their home country". They also state that "the use of tax havens among multinationals is ubiquitous". Moreover, tax haven status "involves combining more favorable conditions in order to create that climate of great economic, political, fiscal, and infrastructure necessary for the development of tax avoidance tasks by using various tools and mechanisms such as offshore companies (Mara, 2015, p1).

Rohan, & Moravec, (2017) conducted a study titled "Czech taxpayers' reaction on concluding agreements concerning exchange of information in tax matters with preferential tax jurisdictions, the so-called Tax havens" used the Difference-in-Differences method to predict tax payers' behavior. Thereafter, their finding reveals that Czech MNEs are very much interested in tax havens not only because of the low tax rates per say but for the purposes of anonymity. Thus, the finding is in line with the theory of shifting offshore industry character from the usage of tax purposes to that of anonymity utilization purpose. Also, their findings corroborate that of Braun and Weichenrieder's (2015) and Krejčí, (2016). Similarly, using the data obtained from Compustat with a sample of 286 multinational U.S. companies over the period spanning from 2006 to 2012, Richardson, & Taylor, (2015), regression results indicates that transfer pricing aggressiveness, multinationality, thin capitalization and intangible assets were positively related to tax haven utilization

Having reviewed prior studies, Jalan, & Vaidyanathan, (2017), findings suggests that the determinants of the pervasiveness of base erosion and profit shifting (BEPS) is largely as a result of suppliers of tax haven activities which involves corporate decisions that are divided into operational and strategic. Also, using the case study approach data on tax haven and OFCs were drawn from newspaper reports to explain how syphoned funds are bundled to a tax haven jurisdiction for safe custody. Mugarura, (2017) found a close connection showing that bank secrecy regulations in OFCs increases the rate of financial offenses like money laundering and tax avoidance around the world. Similarly, Choy, Lai, & Ng, (2017), used an event study that was conducted on the largest publicly-listed companies based in United Kingdom. Findings of the study revealed that government reputation, scrutiny, and investor sentiment were the possible means and conduit for the negative impact. Furthermore, in terms of the role tax haven plays in international trade with services, Hebous, S., & Johannesen, N. (2015), employed a firm-level dataset that contains the comprehensive information regarding service trade with foreign affiliates for almost all MNEs in Germany. Here, findings indicate that in as much as tax haven with service trade may reflect a genuine specialization in the service industries, there by suggesting that institutional attribute such as lower tax rates, low regulatory standards and secrecy creates a comparative advantage in service industry. Moreover, their findings provide various categories of service trade such as intellectual property (trademarks and patents) and headquarter services (management, administration, and advertising) which are regarded as partly reflecting a mispriced affiliate trade conduit aimed to shift profits to the targeted tax havens.

Mara, (2015) adopted the work of Dharmapala, Dhammika and Hines, James R., (2006) in his study titled "Which countries become tax havens?" even though his findings contradicted theirs. His main findings show that governance index is not the main determinant of tax haven (as in the case of Dharmapala, Dhammika and Hines, James R., (2006) findings) nor a place with little or no taxation at all, but only the countries in which a substantial amount of their GDP comes from service industries are most likely to be regarded as having tax haven status. Conversely, Jaafar, A., & Thornton, J. (2015), used a sample of private and public domiciled 14 firms in European Union with their respective financial statement information to enable them estimate their various effective tax rates. Findings from their study indicates that tax haven activities are related with low effective tax rates both for public and private firms and that private firms are more affected by lesser effective tax rate than the public firms. Their findings also show that home country characteristics like financial and tax conformity, worldwide tax reporting system, and high corporate tax rates are basically the main determinants of effective tax rates both for public and private firms that has tax haven status. Similarly, Chari, M., & Acikgoz, S. (2016), tries to find out "what drives emerging economy (EE) firm acquisitions in tax havens?" Using data that relates to cross border acquisitions listed in SDC Platinum, their arguments indicates that besides the four motives that drives acquisition of tax haven status as identified in the international business literature as "market seeking, resource seeking, low cost seeking, and knowledge or strategic asset seeking" the main acquisitions motives is determined by low taxes in the host country and institutional weaknesses in the home country.

Jones, & Temouri, (2016) conducted a study on the determinants of tax haven FDI, adapted the firm-specific advantage–country-specific advantage (FSA–CSA) framework to analyze a database covering 14,209 MNEs in 12 OECD countries found that the impact of home country corporate tax rate is minimal, there by suggesting that corporate tax liberalization is not likely to discourage MNEs from carrying out their activity. Additionally, their findings show that MNEs that are from the high technology manufacturing countries with high levels of intangible assets from the services sectors are most likely to have tax haven status.

1- Characteristics of Tax Haven

In a broader parlance, Mara, (2015, p3) argued that "beyond low taxation, the profile of a tax haven can be summarized as a well-governed, small country, with low population enjoying a high GDP per capita and where services have a very large share in GDP". Thus, one of the ways to identify a tax haven is based on the quality of governance, and population is mostly below one million of which are not recognized as members of any international organizations (cited in Dharmapala and Hines 2006). Also, one distinctive attribute that drives a country to entertain tax haven is when such a country is not endowed with natural resources and a favorable fertile condition that will support agriculture, hence such a country may resort to buying the idea of tax haven by establishing a service sector that will serve as a conduit for tax haven (Mara, 2015). Moreover, Jalan, & Vaidyanathan, (2017) went much further than OECD description of what constitutes tax haven region; thus, they summarized the characteristics of tax haven as:-

1- Little or no tax on some income categories
2- Banking/commercial secrecy:
3- Bank secrecy
4- Ownership secrecy
5- Barriers to information exchange
6- non-substantial activity
7- Right to creation of legislation
8- Dominance of financial institutions
9- High marketing and/or promotion
10- No controls for foreign nationals

* **Regulatory reactions to the threat of tax havens**

The issues of tax haven have led to the introduction some tax administrator's instruments that will help in curbing the issues of tax haven. The framework of Raposo, & Mourão, (2013), indicates that control reactions may be considered into two dimensions, that is unilateral/Bilateral and multilateral measures. Arrangement with countries regarding Bilateral and multilateral instruments are put in place to facilitate information exchange concerning residents that are staying overseas with the aim of avoiding double taxation/double non-taxation.

<u>Unilateral / Bilateral measures</u>: this suggests the participation of one state; as such the implementation process is relatively simple compared to multilateral measures implementation (Plate-forme Paradis Fiscaux et Judiciaires, 2007; Murphy, 2008; Ginevicius and Tvaronaviciene, 2010; Al-taie, Flayyih, Talab, & Hussein, 2017). This measure includes:-

1- Lifting of banking secrecy
2- Imposition of fiscal transparency on outland societies
3- Transfer prices adjustment

4- Regulatory prevalence of substance over form
5- Reversal of the onus of proof
6- Declaration of requirements and
7- Assortment of additional measures.

<u>Multilateral measures:</u> the implementation of this type of measures is more complex and they include:-
1- Tax harmonization
2- Information requests
3- Control of interbank electronic messaging
4- G20 and the European Union

*** Discussion**

The issue of lack political will and the unwillingness of MNEs to exchange valuable information has compounded and complicated every effort by policymakers and regulatory authorities to curb the threat of tax haven. Findings by Rohan, J., & Moravec, L. (2017) suggested that the issues of unwillingness to exchange vital information is because doing that will eventually expose and blow OFCs activities and their anonymity cover. Thus, the result Czech MNEs' behavior breeds more destruction on tax haven region through their OFCs of shifting profit, transfer pricing aggressiveness, thin capitalization etc. Moreover, this finding corroborates with that of Richardson, & Taylor, (2015), and Braun and Weichenrieder's (2015) as well as Krejčí, (2016).

Bank secrecy, OFCs, and particularly transfer pricing which Jalan, & Vaidyanathan, (2017, p16), described as "the devil in disguise" are the various conduit by which shadow pricing, mispricing of MNEs activities in the tax haven are carried out through the involvement of batteries of professionals with the support of government syndicates. This means MNEs in the developed country, in the bid to shift profit and avoid paying high tax establishes a service industry in the tax haven regions. Similarly, the findings of Choy, Lai, & Ng, (2017), in their study on the largest publicly-listed companies based in United Kingdom and that of Hebous, S., & Johannesen, N. (2015), on MNEs in Germany revealed similar results.

The determinants of tax haven have come under series arguments by several scholars. Besides the four criteria established by OECD and the one in the international business literature. Studies, such as Jaafar, A., & Thornton, J. (2015), found that tax haven activities are related with low effective tax rates both for public and private firms and that private firm are more affected by lesser effective tax rate than the public firms. They also added that home country characteristics like financial and tax conformity, worldwide tax reporting system, and high corporate tax rates are basically the main determinants of effective tax rates both for public and private firms that has tax haven status. Similarly, Chari, M., & Acikgoz, S. (2016), supports their argument by explaining further that the main motives that drives "emerging economy (EE) firm acquisitions in tax havens" is low taxes in the host country and institutional weaknesses in the home country. However, Mara, E. R. (2015) findings contradicted both the above findings and his adopted work from Dharmapala, Dhammika and Hines, James R., (2006) who found "governance index" to be the main determinants of tax haven. According to him the main determinants of tax haven is a place where the substantial amount of their GDP comes from service industries. He went further to explain that "offshore finance is one of the main pillars on which tax havens lie down" and that such a region is "characterized by high levels of secrecy and the availability of a strong network of financial services that allows users sophisticated strategies for achieving their goals". Similarly, Jones, & Temouri, (2016) study on the determinants of tax haven FDI also addressed related issues.

*** Conclusion**

This study aimed at providing insight into the determinants of tax haven and their effects. This study has attempted to identify the major difference between tax haven and OFCs as well as their respective features. It has also identified the determinants of tax haven from several perspectives. Thus, findings suggest that the main determinants of tax haven region are not only the ones enshrined in OECD criteria but others such governance index, institutional weakness, substantial amount of GDP from service industries etc. This study has also revealed that the conduit by which tax haven is being perpetrated is mainly via offshore financial centers (OFCs) which involve banks secrecy, transfer pricing (i.e., the devil in disguise) etc. Another issue that is met in the OFCs is the issue of unwillingness of the perpetrators to exchange information with tax authority and other interested agencies. Moreover, findings also indicate that despite the devastating effects of tax haven, several batteries of corrupt professionals and government syndicates contributes significantly in facilitating this heinous anti-tax practices by conjoining with MNEs from the developed nations to carry out their OFCs activities.

*** Recommendations**

Having discussed the main determinants of tax haven and its devastating effects, this study recommends that stringent control measures and penalties for tax-resistant behaviors should be put in place by the international regulators like the World Bank and International Monetary Fund (IMF) so as to enable them checkmate and minimize the activities of this wild predators through their offshore financial centers. Also, in other to increase the transparency of tax haven official reports from the government and financial entities of both the home and host countries there should be a memorandum of understanding (MoU) that will help in combating against fiscal crimes and fund laundering that mostly occurs through OFCs such as shadow economy, mispricing and BEP (Base Erosion Profit Shifting), bank secrecy, and transfer pricing.

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