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Five myths about tax havens

Nicholas Shaxson

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News broke this month of an unprecedented data leak: Some 11.5 million documents containing detailed, confidential information about more than 200,000 offshore companies involved with Mossack Fonseca, a Panamanian law firm, had fallen into the hands of the International Consortium of Investigative Journalists via an anonymous informant. Collectively known as the Panama Papers , the files revealed just how widespread the abuse of offshore tax havens is among the world's elite politicians and business people. Still, myths persist about the supposed benefits of offshore tax havens, both for the countries that stash wealth there and for the havens themselves. Here are a few:

1. Tax havens protect vulnerable people against despotic governments, unjust laws and political turmoil.

One benefit of tax havens, to listen to economists such as Cato Institute senior fellow Daniel Mitchell, is that they help shield oppressed groups from greedy and corrupt regimes. The "financial privacy laws" that govern tax havens make them especially "attractive to people who live in nations plagued by incompetent and/or venal governments," Mitchell argued in a 2008 Cato-produced video titled "The Moral Case for Tax Havens." The most famous version of this myth was first peddled in 1966 by the Schweizerische Kreditanstalt (today's Credit Suisse), suggesting that Swiss bank secrecy was set up to protect Jewish money from the Nazis.

In reality, Switzerland's famous banking secrecy law of 1934 was triggered by a French tax-evasion scandal involving several wealthy elites, and Swiss secrecy wound up protecting a ton of Nazi loot. Tax havens shield the money of rich people, not vulnerable ones. Indeed, the Panama Papers revealed offshore accounts associated with several dictators and members of oppressive regimes from around the globe, and few linked to ordinary citizens. When tax havens assist kleptocratic elites in hiding their cash with impunity, they don't guard against corruption and despotism — they help perpetuate them. Tax havens provide an escape route from laws that is available only to a rich minority that can afford to use it, thus removing from the equation the constituency with the greatest power to push for reform.

2. Tax havens are good for high-tax nations.

According to economics professor James Hines, tax havens serve as healthy competition for high-tax countries, nudging them toward less-restrictive financial policy. By providing alternatives to tightly controlled financial sectors, Hines wrote in a 2010 paper, tax havens discourage regulations that act as “a drag on local economies.” That claim has been echoed by others, including Cato’s Mitchell.

But “tax haven discipline” has terrible effects. Capital is much more mobile than workers are, so when countries try to compete with havens, they cut taxes on capital to lure it in — but they don’t cut taxes on workers. The result is steeper inequality. Capital flight to havens also hurts investment and jobs. Further, it is well-established that high-tax countries such as Sweden, Denmark and Finland enjoy similar or better economic growth and human development outcomes than their lower-tax peers. Stealthily undermining the tax base from offshore is a poor recipe for prosperity.

3. Besides Switzerland, most tax havens are small tropical islands.

“Offshore tax haven” probably summons to mind tiny palm-fringed countries in the Caribbean — “sunny places for shady people,” as Britain’s former secretary of business, Vince Cable, put it. But this notion is slowly giving way to a more accurate — and more alarming — picture.

Among the world’s biggest tax havens is the United States, which hosts vast sums of foreign wealth under conditions of strong secrecy. States including Delaware and Nevada allow shell companies whose owners are not identified, providing cover for foreign cash. And while most havens have signed on to a strong global transparency scheme for sharing banking information (called the Common Reporting Standard) that will take effect in 2017, the United States isn’t playing ball, meaning it will continue to serve as a haven for secretive foreign money.

Britain is perhaps even worse. It runs a network of some of the world’s largest havens, from the Cayman Islands to Bermuda to Jersey. These places, the last remnants of the British Empire, are partly independent (and yes, some are quite sunny). But their legislation is approved in London, Queen Elizabeth II appoints their governors and her head graces their stamps and banknotes. A Financial Secrecy Index ranking the world’s biggest tax havens by secrecy and scale — a project I’ve been involved in — puts the United States in third place, after Switzerland and Hong Kong. If Britain were lumped in with its offshore network, though, it would rank first.

4. Being a tax haven makes a country rich.

Most of the world’s tax havens are prosperous, stable countries — a fact interpreted by some to mean that their wealth is a result of their tax policies. “Tax havens are rich,” researchers at Germany’s Jacobs University observed in a 2013 paper. “Why do not all countries cut their capital taxes to get rich?”

The answer: because it wouldn't work. Wealth flows to countries that are already rich and stable; that is why tax havens are rich countries. Particularly in small havens such as Bermuda or the Cayman Islands, the "trickle down" from offshore finance flows mostly to foreign expatriates. So headline figures for tax havens' per capita wealth massively overstate the benefits to locals. Meanwhile, high-salaried finance jobs in havens undermine other economic sectors such as tourism, mostly by sucking skills and talent from them. When crisis hits — when other countries crack down on tax-haven abuse, for instance — there is no Plan B. The British tax haven of Jersey is now in dire straits for just this reason.

5. Cutting corporate taxes helps nations compete with tax havens.

Reducing corporate taxes to attract wealth back from tax havens sounds plausible — "Republicans call [tax inversions] the inevitable consequence of a flawed tax system," Bloomberg View recently observed, "and say the only solution is a full revamp of the tax code, including lowering the corporate rate and limiting taxes on foreign profits." But it doesn't work that way. Tax cuts at home don't persuade corporate bosses to ease up on tax avoidance, and there are always more lucrative shelters abroad.

As U.S. corporate tax rates have plunged over the past 40 years, corporations have shoveled ever-rising quantities of money offshore. In the early 1990s, corporations paid an effective tax rate of nearly 35 percent, and revenue losses to offshore tax havens were hardly a problem. Now effective rates are below 20 percent, and revenue losses are running at an estimated $100 billion annually and rising. The key reason is not high taxes but the proliferation of havens, loopholes and advisers.

Corporate tax cuts also attract the wrong kind of investment — activities like profit-shifting that don't result in real benefits to the broader economy. Recent research from Congress's Joint Committee on Taxation shows that tax-cutting by the United States isn't even good at attracting those investments, anyway. There simply is no beating offshore tax havens in their race to the bottom: They will always zip down the slope faster. The solution is not to cut taxes but to crack down.