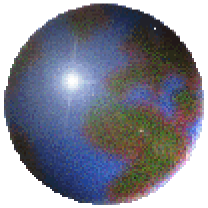

Which Countries Become Tax Havens?

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What are Tax Havens?

- Tax havens are countries and territories that offer favorable tax regimes to foreign investors.
- Tax haven status is very stable: the same countries that were major tax havens in 1980 continue to be major tax havens today.
- Tax havens (of which there are roughly 40) are mostly small countries.
- Despite their small size, tax havens play an important role in the world economy and are

Who are the major tax havens?

Andorra	Grenada	Nauru !
Anguilla	Hong Kong *	Netherlands Antilles
Antigua and Barbuda	Ireland *	Niue !
Aruba !	Isle of Man	Panama
Bahamas	Jordan *	Saint Kitts and Nevis
Bahrain	Lebanon *	Saint Lucia
Barbados	Liberia	Saint Vincent and the Grenadines
Belize	Liechtenstein	Samoa !
Bermuda	Luxembourg *	San Marino !
British Virgin Islands	Macao *	Seychelles !
Cayman Islands	Maldives	Singapore *
Channel Islands	Malta	Switzerland *
Cook Islands	Marshall Islands	Tonga !
Cyprus	Mauritius !	Turks and Caicos Islands
Dominica	Monaco	Vanuatu
Gibraltar	Montserrat	Virgin Islands (U.S.) !

! Not included in Hines-Rice tax haven list.

* Not included in OECD tax haven list.

Why become a tax haven?

- There are actually two reasons to do so:
  - To attract foreign investment, and the economic goodies that come with it.
  - A recognition that any attempt to impose tax burdens on foreign investors is ultimately futile, since foreign investors demand world rates of return. As a result, taxes on foreign investors are paid by local labor in the form of reduced real wages.
- Why isn't everyone a tax haven?
  - It may not work for everybody.

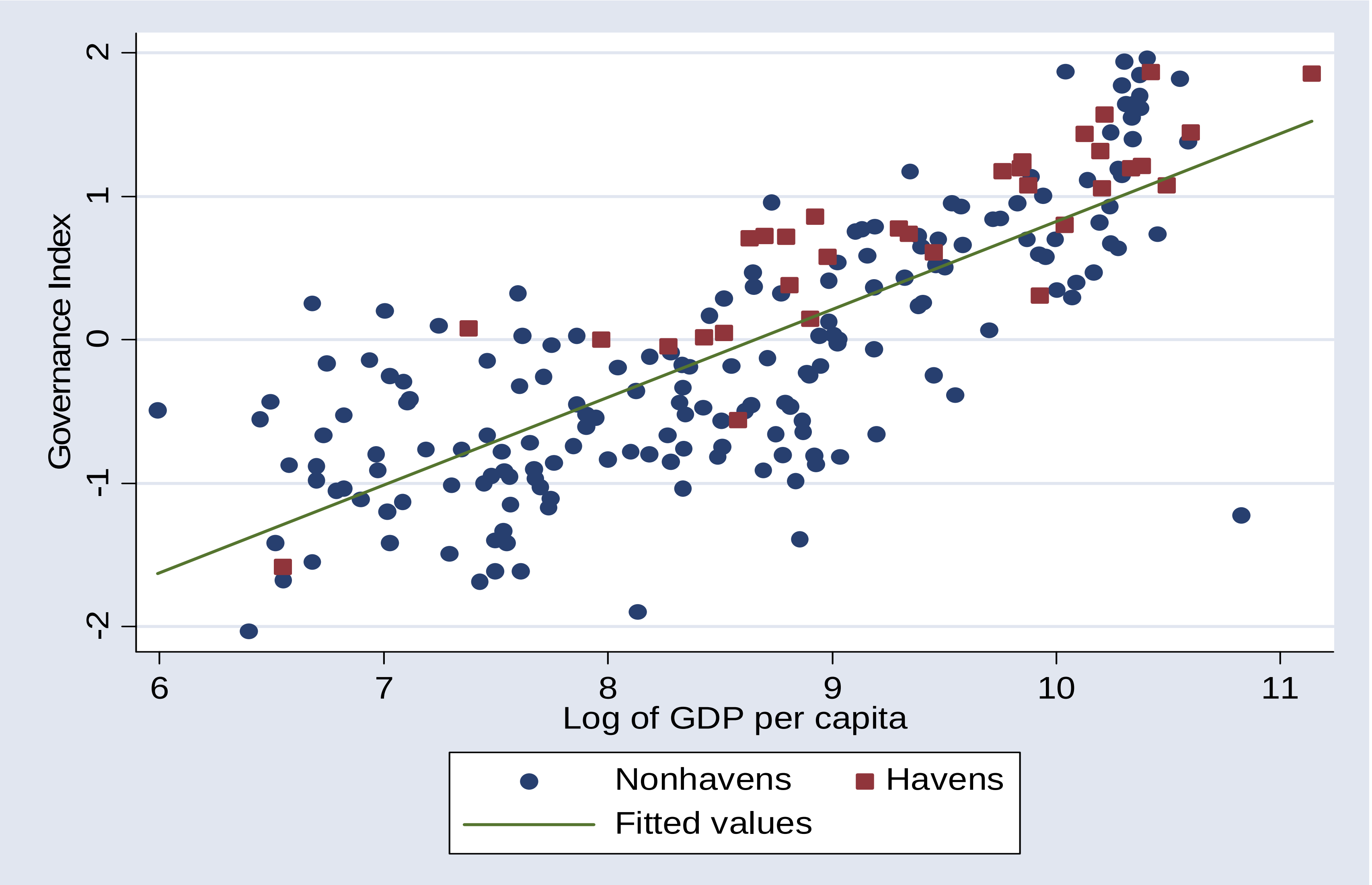
Characteristics of Tax Havens

Compared to other countries, tax havens are:

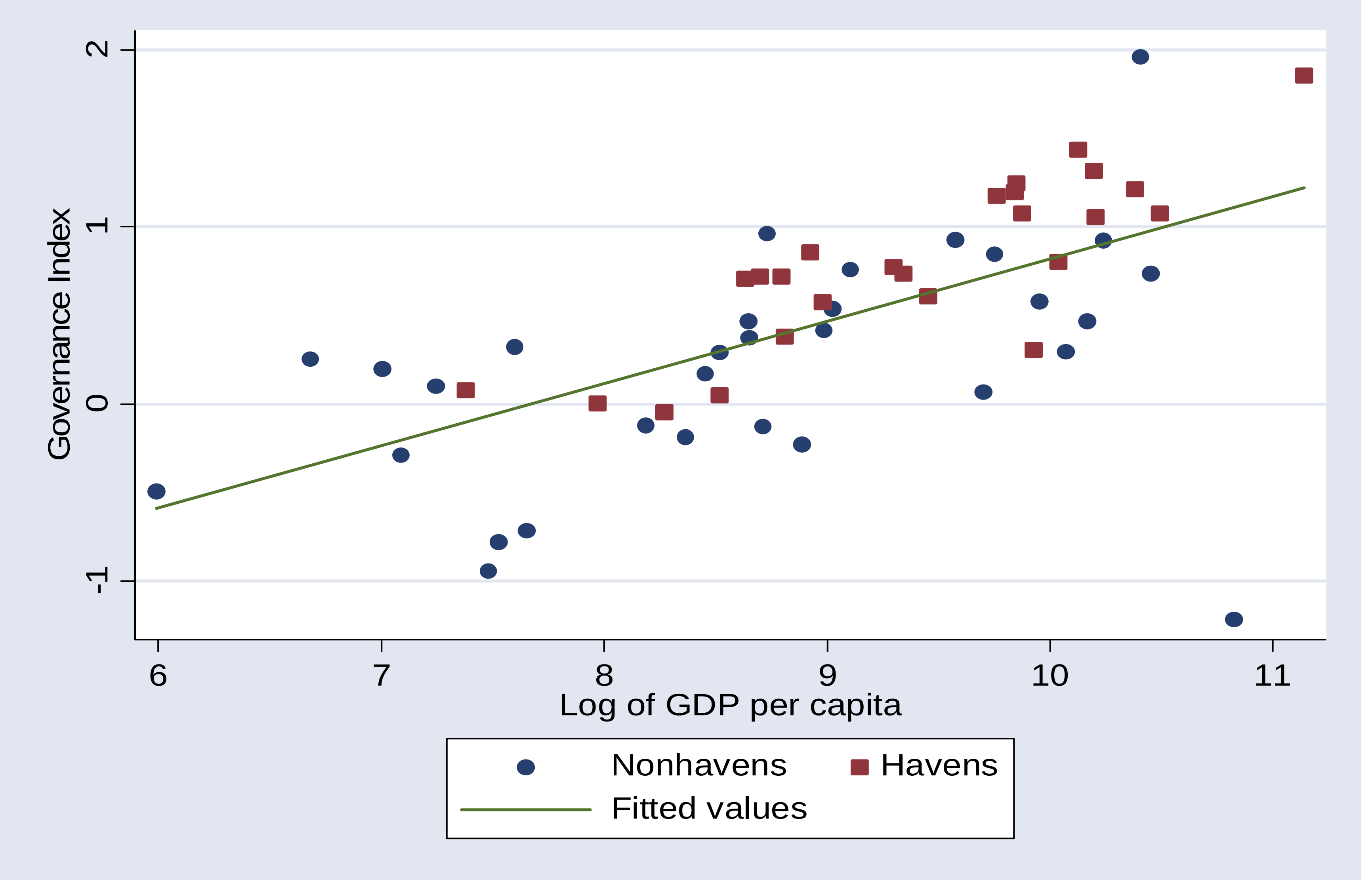
- Smaller (most below one million in population).
- More affluent (higher GDP).
- Much better governed, as measured by:
  - Political Stability
  - Government Effectiveness
  - Rule of Law
  - Control of Corruption
  - Voice and accountability

Moreover, the strength of tax havens' governance institutions goes beyond what would be expected on the basis of GDP.

Governance and GDP (All Countries)



Governance and GDP (Small Countries)



Summary Statistics: Small Countries (Pop < 1 million)

	Mean: Havens (N)	Mean: Nonhavens (N)	Diff. in Means (s.e.)
Governance Index	0.7974 (25)	0.2097 (31)	0.5876 (0.1519)***
GDP per capita (PPP; in thousands of US$)	18.46 (31)	11.34 (43)	7.12 (3.1474)**
Population (thousands)	181.62 (31)	271.34 (44)	-89.72 (56.20)
UN Member (=1)	0.6129 (31)	0.5227 (44)	0.0902 (0.1171)
Distance by air (km)	2921.77 (31)	5486.30 (44)	-2564.52 (570.84)***
Landlocked (=1)	0.0968 (31)	0.0455 (44)	0.0513 (0.0626)
Parliamentary System (=1)	0.7273 (11)	0.3571 (14)	0.3701 (0.1936)*
English as an Official Language (=1)	0.7407 (27)	0.4000 (40)	0.3407 (0.1164)***
Ethnolinguistic Fractionalization	0.1814 (16)	0.3673 (18)	-0.1859 (0.0956)*

Determinants of Tax Haven Status – Logit Estimates

	(1) All Countries and Territories	(2) UN Members	(3) Small Countries and Territories	(4) Common Support
	Dependent Variable: Indicator for Tax Haven Status (= 1 for Tax Havens)			
Governance Index	1.542 (0.592)***	1.710 (0.686)**	1.851 (1.032)*	1.586 (0.593)***
GDP per capita	0.013 (0.028)	0.016 (0.033)	-0.004 (0.029)	0.004 (0.029)
Population	-0.0003 (0.00009)***	-0.0004 (0.0001)***	-0.001 (0.001)	-0.0003 (0.0001)**
Distance by Air	-0.0004 (0.0002)*	-0.001 (0.0003)**	-0.0001 (0.0002)	-0.0003 (0.0003)
Other Controls, Regional Dummies?	Y	Y	Y	Y
Observations	208	190	56	99

Results

- Governance effect is positive and significant, even when
  - the sample is restricted to UN members.
  - the sample is restricted to smaller countries.
- The magnitude of the governance effect is substantial:
  - For a small country, holding all other variables at their means, raising the governance measure from 0 to 1 (approximately Brazil → Portugal) increases the probability of being a tax haven from 0.22 to 0.64.
- The effect of governance is statistically robust to:
  - Adding additional control variables.
  - Restricting the sample only to countries whose other characteristics might make them strong candidates to become tax havens

Interpretation

Why are tax havens well-governed? Two possibilities:

- Limited commitment: perhaps many small countries are potentially interested in becoming tax havens, but only those with stronger governance institutions can credibly commit to low future tax rates, market institutions, and protection of private property – and thereby attract investment.
- Decision making: more small countries would benefit from becoming tax havens, but only the better governed countries actually choose

Interpretation

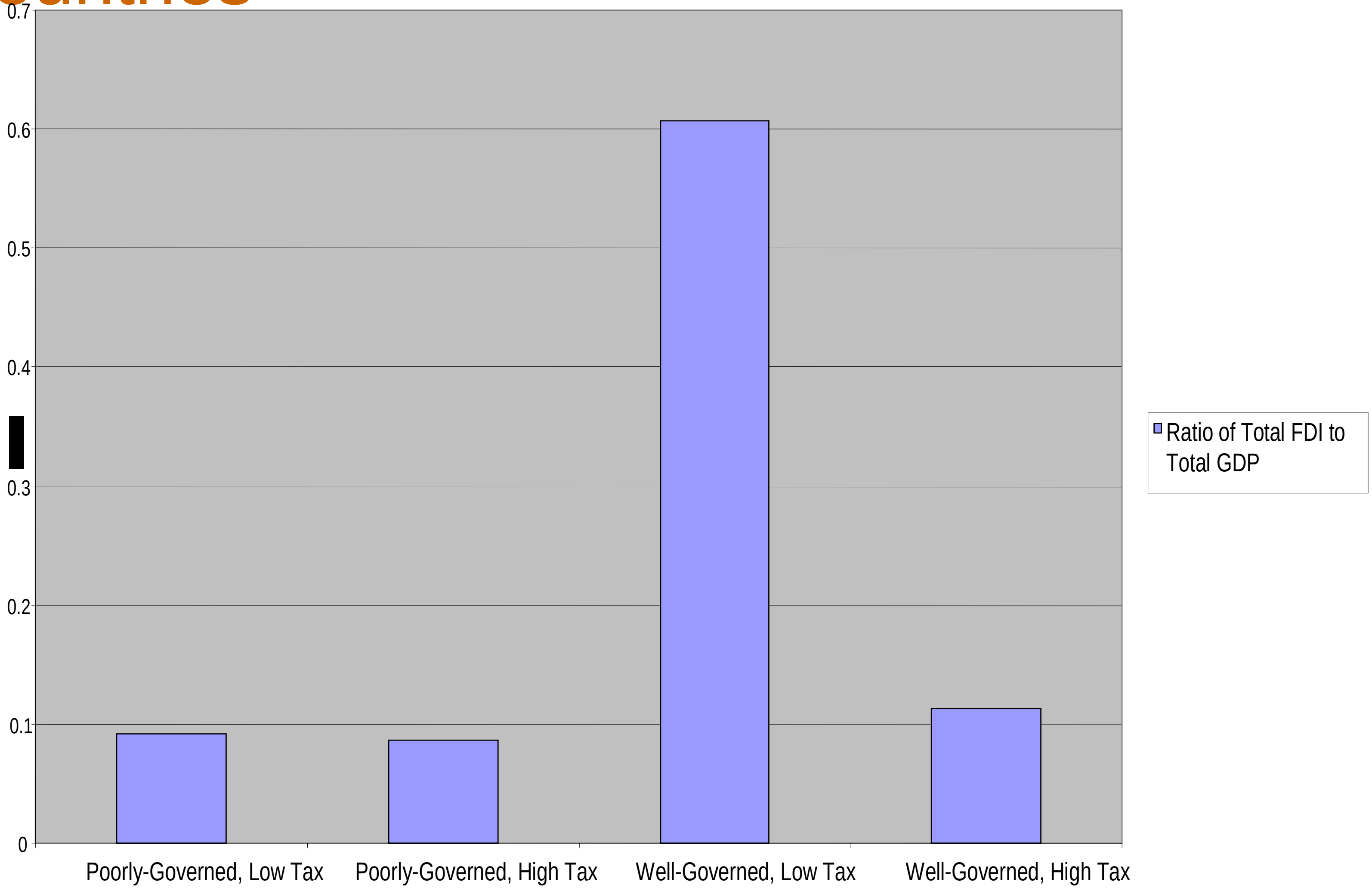
In order to test the first of these interpretations, we analyze the effect of foreign tax rates on U.S. investment in two groups of countries, those with high-quality governance and those with low-quality governance.

- Tax rate differences have a much greater effect on investment in well-governed countries.
- This evidence strongly favors the interpretation that poorly governed countries would have difficulty attracting large volumes of foreign investment even if they significantly reduced their

Governance and the Tax Elasticity of FDI

	(1) Well-Governed Countries	(2) Less Well-Governed Countries
	Dependent Variable: Log of Assets Owned by US Firms in 1999	
Constant	16.4437 (4.9307)***	9.5360 (2.3080)***
Tax Rate faced by US Firms in 1999	-0.0712 (0.0214)***	-0.0162 (0.0163)
Log of GDP per capita in 1999	1.4014 (0.2735)***	0.6014 (0.2110)***
Log of Population in 1999	-0.7224 (0.3900)*	-0.1608 (0.1626)
R-squared	0.6221	0.3463
Number of Observations	30	30

Ratio of US FDI to GDP for 4 Groups of Countries



Conclusions

- There is a sizeable, and statistically robust, association between tax haven status and the presence of high-quality governance institutions.
  - Controlling for other country characteristics, including size and affluence, better-governed countries are much more likely than others to become tax havens.
  - The effect of governance persists when legal origins are used as predictors of governance.
- There is evidence that lower tax rates are