The Future of Offshore Finance as a Global Policy Problem

Robert T. Kudrle

Orville and Jane Freeman Professor of International Trade and Investment Policy
Hubert Humphrey Institute of Public Affairs and the Law School
University of Minnesota

Prepared for the seminar on “Deconstructing Offshore Finance”
St. Peter’s College, Oxford
September 2-3, 2013
The Future of Offshore Finance as a Global Policy Problem -- Robert Kudrle

Some observers see offshore finance as the epitome of all of the ills of global capitalism. Even those skeptical of so broad an indictment usually acknowledge that it plays a critical facilitating role in apportioning the corporate income tax capriciously, both domestically and among national jurisdictions, and that it allows massive tax evasion by many persons of high income and wealth. In addition, a few have tried to link the offshore system to financial instability and crisis. However strong the case against offshore in these and other dimensions, the prevailing political climate current period is unprecedentedly propitious for a maximum public policy attack on practices regarded as abusive.

All governments are now scrambling for revenue, and the close association of offshore with the wealthy generates special anger as income and wealth inequality increases. But revenue and inequality are not states’ only concerns. Economic growth has also flagged in the rich world and in many mid and lower income countries as well. Across the OECD growth between 1950 and 1980 was approximately twice as high as in the thirty years following. Reducing marginal tax rates to spur activity now lacks political feasibility almost everywhere—indeed, independently of mixed empirical support for its efficacy. Attention to the efficiency of the fiscal system in other dimensions should be more important than ever.

This paper makes several arguments: The Offshore Financial Centers (OFCs) will provide minimal barrier to improved prudential regulation aimed at financial stability. The competitive erosion of the corporate income tax in which the OFCs are heavily involved will continue although the OFC role may shrink substantially. A regime aimed to sharply decrease tax evasion will likely succeed among the developed countries and much of the developing world; this implies a diminution in funds now passing through the OFCs. Nevertheless, the
OFCs might play an increasing role in tax escape by persons of high income and wealth as personal mobility replaces secrecy.

**What does “Offshore Finance” mean?**

“Offshore” is widely used as if a common understanding prevailed. The term originated during the Bretton Woods system when nearly all states attempted to control access or use of foreign exchange.¹ Major states, most importantly the U.S., saw the national advantage of allowing its firms to avoid some domestic financial controls by “offshore” operations. Most current policy use of the term does not focus on the now convertible currencies involved or even on differing regulations except as they relate to the dominantly important concern of taxation. But there is a thread that connects much usage over time. This paper will define “offshore” as any jurisdiction through which financial claims pass to avoid policy constraints elsewhere; offshore finance refers to those claims.² The legal constraints are avoided by one or more offshore elements: lower, sometimes discriminatorily lower, taxation; opacity; insubstantial activity; and lighter regulation.

From that starting point, attention can move in two directions. One focuses on those jurisdictions where such activity is conspicuous relative to the economy a whole and the other on significant offshore elements wherever they occur regardless of the size of the intermediating economy.

The IMF notes that an “offshore center” is most commonly used to refer to “a center where the bulk of financial sector activity is offshore [non-resident] on both sides of the balance sheet...where the transactions are initiated elsewhere, and where the majority of the institutions

---

¹ One leading textbook defines an “offshore deposit” as a bank deposit denominated in a currency other than of the country where the bank is located and “offshore banking” is similarly defined (Krugman, Obstfeld, and Melitz, 2012: 592)

² The IMF notes that offshore finance can mean “the provision of financial services by banks and other agents to non-residents.” (IMF, 2000:2)
involved are controlled by non-residents.” (IMF, 2000:2) An IMF official attempted to identify offshore centers quantitatively in 2009 by identifying jurisdictions with atypically large net financial exports relative to GDP. His 26 outliers were largely a subset of the several dozen OFCs developed by others using less formal means (Zorome, 2007). But there were interesting differences. First, some states known for international financial activity but with local economies of substantial size such as Costa Rica and Lebanon did not stand out statistically. On the other hand, the United Kingdom, with roughly the same ratio as such recognized OFCs as Malta and Cyprus, was identified.

The IMF definitions stress “what” and not “why.” International trade in both goods and services generally rests on differing productivities at the state or firm level somehow defined or else on a unique product. In sharp contrast, most of the OFC literature discounts any real advantages, using “offshore financial center” and “tax haven” interchangeably— for good reason. What this essay will call “pure” OFCs import (in real time) the lion’s share of the financial expertise informing the activity booked there, and success rests almost entirely on zero or low taxation supported by a trustworthy institutional regime that has historically shielded financial activity from the eyes of foreign authorities. Some OFCs feature some combination of substantial local expertise, a more complex economy and higher tax rates; they will be referred to as “mixed” OFCs. But this paper also argues that other jurisdictions can embrace degrees of offshore as they permit or encourage various offshore elements. Hence the absolute versus relative importance of various kinds of financial activity involving foreigners produces ambiguity in the use of both “OFC” and “tax haven.” It can flag either pure and mixed OFCs or

---

3 Hines (2010:103) for example, apparently sees little problem with using the terms interchangeably.
4 “Pure” OFCs correspond closely with what Hines and Rice (1994) call “dots,” small jurisdictions typically with little other domestic economic activity beyond tourism.
5 An extreme example is Switzerland which has built its reputation on secrecy; it has unremarkable tax rates: a 21 percent corporate rate and a 40 percent personal rate.
all jurisdictions that facilitate the avoidance of taxation or regulation with an otherwise redundant jurisdictional layer between investors and the final use of funds.

**Where the Funds Are**

One typical recent list of recognized OFCs arranged by region suggests the critical importance of geography:

_Countries Listed on Various Tax Haven Lists*

<table>
<thead>
<tr>
<th>Region</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Caribbean/West Indies</td>
<td>Anguilla, Antigua and Barbuda, Aruba, Bahamas, Barbados, British Virgin Islands, Cayman Islands, Dominica, Grenada, Montserrat, Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent and Grenadines, Turks and Caicos, U.S. Virgin Islands</td>
</tr>
<tr>
<td>Central America</td>
<td>Belize, Costa Rica, Panama</td>
</tr>
<tr>
<td>Coast of East Asia</td>
<td>Hong Kong, Macau, Singapore</td>
</tr>
<tr>
<td>Europe/Mediterranean</td>
<td>Andorra, Channel Islands (Guernsey and Jersey), Cyprus, Gibraltar, Isle of Man, Ireland, Liechtenstein, Luxembourg, Malta, Monaco, San Marino, Switzerland</td>
</tr>
<tr>
<td>Indian Ocean</td>
<td>Maldives, Mauritius, Seychelles</td>
</tr>
<tr>
<td>Middle East</td>
<td>Bahrain, Jordan, Lebanon</td>
</tr>
<tr>
<td>North Atlantic</td>
<td>Bermuda</td>
</tr>
<tr>
<td>Pacific, South Pacific</td>
<td>Cook Islands, Marshall Islands, Samoa, Nauru, Niue, Tonga, Vanuatu</td>
</tr>
<tr>
<td>West Africa</td>
<td>Liberia</td>
</tr>
</tbody>
</table>

The geographic clustering is pronounced, and this should not surprise. Despite its frequent neglect by economists, the marked locational pattern of international economic activity, particularly as illuminated in some version of the gravity model based on bilateral economic size and distance stands confirmed in a broad range of studies (Bergstrand and Egger, 2011). And recent work has refined the gravity approach in a particular way. Stein and Duade (2007) in their study of foreign direct investment conclude: “in most of the specifications used we find that, once we control for time zones, distance is no longer significant.” (Stein and Duade, 2007:98) They motivate their finding by the role of time zone similarity in minimizing the transactions

---

6 Adapted from Gravelle (2013:4).
cost of real time interaction. Similarly, research for this paper found a very strong relation between total estimated private financial wealth and the portfolio liabilities of recognized OFCs in the same time zone. A simple regression of the log of OFC liabilities on wealth in the same zone yields a very high $R^2$ of .87.\footnote{Private financial wealth was calculated from Credit Suisse, 2012; OFC portfolio liabilities data are from IMF, 2013, Table 13.}

Despite the need to focus much attention on the pure and mixed OFCs, it makes little sense to condemn activity deemed antisocial when relatively important but to give it less attention when diffused across a larger set of economic activities. So while the focus of what follows heavily involves activity in widely recognized OFCs, policymakers facing problems of regulation, avoidance, and evasion must confront those challenges across all jurisdictions.

Economists recognize the negative fiscal externalities that can result from independent tax and regulation setting, but the combination of sovereignty and differing preferences across states renders cartel-like behavior generally infeasible—even if it were desirable. What then is unacceptable behavior by a state\footnote{This paper will generally employ the term “state” instead of “jurisdiction,” for brevity, but, as argued later, the policies of many of the most important OFCs are ultimately controlled from London.} with respect to financial activity involving foreigners? Two extreme positions have failed to gain traction in most policy discussions. One sees all tax or regulatory attraction of activity from one state to another as a negative element of globalization that should be countered. The opposite position regards the factor mobility of globalization as a welcome escape from “Leviathan” that should be encouraged.\footnote{The former position seems close to that of Shaxson (2011), while the latter is widely held on the libertarian right. See, for example, Litan and Niskanen (1998: 41).} Rejecting both of these positions, the OECD suggested indicia of offense in its Harmful Tax Competition of 1998 (OECD, 1998): low or zero taxation combined with a lack of transparency; a lack of the collection and sharing of tax information; and either insubstantial domestic activity or “ring
fencing,” the application of different rules to locals than to foreigners. The legitimacy of setting non-discriminatory tax rates at any level chosen nationally was explicitly affirmed, so low taxes alone do not constitute grounds for foreign complaint.

Much of what follows is a story of how varying acceptance of the OECD criteria have been operationalized in national policy and international cooperation. Any forecast of the future must rest on that foundation. At the national economic interest level, some states benefit negligibly from any of these practices and experience only losses, while other states gain almost unambiguously from one or more of the suspect practices. The most interesting cases involve states that may appear to benefit from some haven attributes but lose from others; this gives leverage to big domestic gainers in their struggle to influence national policy.

An important dimension of both past and future policy turns on the efficacy of independent, largely non-cooperative, national action. What follows will argue that some cooperation is necessary for effective regulation, that international corporate tax policy rests on long standing practices that will generally continue to reflect national differences and therefore cannot prevent rate and rule competition, and that the effective prevention of evasion calls for intense, but highly focused, international cooperation.

**Offshore Finance and Regulation**

Offshore was born from the avoidance of rules promulgated elsewhere, and issues beyond taxation have inevitably attracted attention. The OFCs were subject to scrutiny by the G7’s Financial Stability Forum (FSF) in 1999 following the Asian Financial crisis that renewed attention to the contagion effects of unsound financial practices. Assessments of 44 jurisdictions conducted by the IMF, which absorbed the Forum in 2000, produced three groups of states: several of the largest pure OFCs were represented in the weakest category: those least adequately
served “by infrastructures and supervisory practices, and /or a level of resources devoted to supervision and cooperation relative to the size of their activity” (Financial Stability Forum, 2000:2). In response, the IMF made monitoring of pure OFCs an integral part of its financial sector surveillance work in 2003. Although every OFC specializes in a different mix of financial activity and received different comments and advice, several of the largest OFCs were recognized in the following years for substantially improving their regulatory systems. Some of the largest OFCs in particular moved to high levels of regulatory oversight. (Milner, 2011; Foot, 2009:40)

What should the outside world expect of OFC regulation? OFC defenders suggest that elaborate regulation geared to retail investing is inappropriate, and that comparisons based on resource inputs are meaningless (Morriss and Henson, 2013). Whatever the merits of that argument, little concern has been expressed by authoritative observers recently about weaknesses in OFC prudential regulation that could threaten global financial stability. The principal misgivings by outsiders about non-tax OFC practices in recent years seem to be continuing transparency problems related to money laundering and terrorist finance first flagged by the OECD’s Financial Action Task Force as early as 1989 (FATF, 2006). These problems, however, greatly overlap the tax matters treated later in this article.

Some observers have implied an important role for the offshore centers in the financial collapse of 2008 and its aftermath. Indeed, components of the shadow banking structures that made the global financial system vulnerable were specialties of offshore. For example, the

---

10 The original set of categories and jurisdictions was not updated. In March 11, 2005, the FSF declared that the original list was “no longer operative.” (FSF, 2005)

11 China joined the FSF in 2008. All other members the G20 joined the FSF efforts in 2009 when the organization became the Financial Stability Board (BBC, 2009).

12 They are typically brief and general, e.g. Rodrik (2009). A seeming exception is a list of ten particulars from the Tax Justice Network, which concedes that the OFCs didn’t “cause” the crisis “but contributed powerfully to it.” (Tax Justice Network, 2013). But these criticisms appear either vaguely stated or of questionable relevance or magnitude.
Cayman Islands boasts of its leading role with Structured Investment Vehicles (Maples and Calder, 2003). Such arrangements used short-dated commercial paper to make purchases of securities linked to U.S. mortgage products; liquidity problems in such vehicles were among the earliest difficulties of the global crisis. Yet the central problem was not that the funds were offshore but that they were off balance sheet (Loomer and Maffini, 2009), a major characteristic of the onshore shadow banking system centered in London and New York as well as the target of a raft of reforms over the past several years including the central bankers’ Basel II and III, Dodd-Frank in the U.S., the Financial Stability Committee in the U.K, and the EU’s European Systematic Risk Board (Giustinini and Thornton, 2011).

Most OFC activity involving the management of large funds heavily involves the United Kingdom because it takes place in former colonies with which close ties have been maintained. Of the largest OFCs ranked by portfolio investment assets, two of top five and four of top ten are British Overseas territories or Crown Dependencies (IMF, 2013 Table 13). The U.K. Turner Review of 2009, directed by the chairman of the U.K. Financial Services Authority, concluded that “it is important to recognize that the role of offshore financial centers was not central in the origins of the current crisis” (Financial Services Authority, 2009:74). This is implicitly supported by other important discussions of the causes and course of the crisis that fail even to mention offshore (Volcker, 2011; Shin, 2010). Nevertheless, the Turner Review stresses that onshore reforms must be extended to the offshore centers and that vigilance will be necessary to prevent arbitrage as onshore regulation is improved (Financial Services Authority, 2009:74).

How likely are any major OFCs to resist future regulatory reform and cooperation? Past cooperation on prudential regulation is encouraging, and the U.K. seems to be increasingly accepting responsibility commensurate with its ultimate legal authority over its overseas
territories and dependencies (Bergin, 2013). These OFCs and many others are also highly vulnerable to action by the United States. It seems vanishingly unlikely that any of them would resist clearly defined regulatory standards aimed at system stability. In addition, two of the largest recognized OFCs, Luxembourg and Ireland, are subject to EU authority and another, Switzerland, claims to be at the cutting edge of prudential regulation. China’s interest in stability is served by cooperation from Hong Kong and Macau. Other major offshore centers such as Singapore have announced cooperation on taxation and seem most unlikely to act as a renegade on regulatory matters.

None of this suggests that the lighter regulation of various financial activities by individual OFCs in the future may not result in problems for investors but merely that any downside risks from regulatory lapses will not be large enough to cause significant problems for the larger global system.

Offshore Finance and Taxation

Highly publicized episodes of evasion abetted by major banks and the low effective tax rates of many MNCs in the context of government financial crisis have generated more demand for government action since 2008 across many countries than in all previous years combined. The current situation can be considered with Kingdon’s (1984) classic conditions for policy change: the confluence of a perceived problem, a set of developed policy remedies, and a political configuration conducive to action. The use of offshore as a tax dodge by both individuals and corporations has been widely recognized as a problem in many countries for more than a decade. Moreover, the political climate is propitious: Politicians of both left and right in many countries have declared the use of tax havens to be illegitimate and declared a determination to act. But

13 And not just in high income countries. Tax havens are a staple of the press in India, Brazil, and many other countries.
the third condition, appropriate corrective policy, appears much more clearly defined for evasion than for avoidance. Moreover, Kingdon, whose work rests on the unique dynamics of the U.S. political system, stresses the transitory nature of the “policy window” which opens only when all three streams favorably align—and then often abruptly closes for an indeterminate period.

Special attention to the U.S. political system seems appropriate despite it differences from almost all others. U.S. relative power has declined marked, yet it remains by far the most important single actor for policy issues discussed here—in large part because the EU cannot move with much cohesion on taxation. More specifically, many formal studies of international taxation have successfully modeled the U.S. as a “Stackelberg leader:” an actor that chooses its policies with the assumption that other actors will adapt in a predictable fashion (Swank, 2006; Swank and Steinmo, 2002; Tanzi, 1996).

**Corporate Tax Avoidance**

The corporation income tax is a slice of firm net revenue taken by governments before distributions are made to shareholders. While the right of a state to tax all activity in its jurisdiction has a firm foundation in international law, a bilateral treaty system numbering thousands has developed since the interwar period with the aim of avoiding investment-choking double taxation that was seen as damaging to both home and host countries.

In 2013, the nominal rate of corporate income tax ranged from about 40 percent in the U.S, over 20 percent in most other high income countries, ten to fifteen percent in many of the countries of central and eastern Europe and zero in many OFCs (KPMG, 2013). Pure OFC corporate activity almost always faces a zero rate because the competitive advantage of such OFCs rests on minimum local costs of any kind. In most cases, only modest flat rate fees are charged for what amounts to the sale of jurisdiction. This leads some to designate all low
corporate income tax jurisdictions as tax havens although some such states aim mainly at encouraging real direct investment. It also blurs the critical distinction between tax avoidance and tax evasion. Lack of transparency can facilitate tax avoidance by major firms, but it is essential for tax evasion. The difference is sometimes lost because individuals typically operate through companies or corporations for personal tax evasion (Sheppard, 2013a).

A small and diminishing group of home countries, most notably the United States, embrace a global system that credits the payment of taxes on foreign income—on an aggregate rather than a country-by-country basis—against home corporate tax liability, while most states employ a territorial system that simply exempts active business income from home taxation altogether subject to various rules. The U.S. allows the payment of any remaining tax liability by a subsidiary to be deferred until dividends are brought home so long as earnings are deployed in active business activity abroad. Because such deferral in essence functions as an indefinite interest-free loan from the U.S. government, abuse is inevitable. Moreover, whether a state credits foreign taxes or exempts foreign income, it must be alert to firm incentives to shunt what would be properly accounted as home country income to jurisdictions with lower taxes. But avoidance policy challenges necessarily differ on the global versus territorial dimension alone.

Corporate income tax issues loomed large in the OECD’s original Harmful Tax Competition project of 1998 that attacked “insubstantial” activity in a jurisdiction that a corporation claimed as its location for tax purposes (OECD, 1998).14 International business lobbied against such a restriction as arbitrary and unworkable. It was removed from consideration as the project refocused on tax evasion by end of 2001 (Kudrle, 2008).

---

14 This was one of the characteristics, along with low or zero taxes, a lack transparency and an unwillingness to gather and share tax-relevant information that was used to identify a “tax haven.” An intra-OECD “harmful tax regime” substituted “ring-fenced” foreign activity—different rules for foreign agents than domestic—for insubstantial activity.
The corporate abuse of tax havens was easy to decry but hard to define with much precision—how much local activity was “substantial?” Moreover, it was never clear why the abuse of home country tax rules by a corporation was appropriately addressed by obliging the tax havens to turn business away rather than expecting home countries to tighten the supervision of their own firms. But each home country had different tax practices, both rules and rates, and this included each member of the EU separately. And each state had powerful domestic players arguing that the national welfare was threatened by any increased handicap in their struggle for world markets. Very significantly, the EU, which established a (very low) minimum VAT rate in 2006, has yet to deal with member state variety in corporate rates and in many rules.

The high income countries have differed substantially in their overall tax practices, but their bilateral tax treaties have also incorporated many commonalties. They adopted the principle that the valuation of international transactions within the firm should be based on the value that would be struck by a seller and buyer operating independently. This seemingly reasonable “arm’s length” principle had major weaknesses. Many transactions within the firm are unique, and the firm controls all the relevant information and its processing so that tax officials are almost inevitably overmatched.  

The considerations just outlined along with the draining of firm profits from high tax areas through loans from haven affiliates produced an extraordinary growth of U.S. corporate income booked to offshore centers in recent years. One study found that tax shifting ranged from 57 to 90 billion dollars in 2008 or up to 30 percent of all U.S. corporate tax receipts (Clausing, 2011; see also Gravelle, 2013). The complaint has grown ever louder that measures originally devised to prevent double taxation were abetting double non-taxation. Although the

---

15 In addition, at a theoretical level, intra-firm transactions should be seen found just where they are overall resource-saving; this means a “correct” transfer prices lower than in an open market for the same good or service.
OECD has no estimates of the losses across its membership overall (OECD 2013a), there is evidence not only of considerable tax shifting within Europe (Weichenrieder, 2006) but also from Europe to lower tax jurisdictions (Dischinger, 2007; Deloitte, 2009).

Beyond the broad divide between territorial and global approaches, clamping down on corporate tax avoidance confronts conceptual ambiguities that far exceed those of personal tax evasion. The corporate tax itself rests on no clear normative foundation. It was introduced in the United States and elsewhere with the idea that corporations are primarily owned by rich people who should bear an increased payment for government activity. But the corporate tax’s limitations even in a closed economy have long been apparent. All corporate earnings are taxed, not just abnormally high returns, one segment of business is taxed arbitrarily relative to the rest with an inefficient impact on final prices, and, over time, as some capital shifts to the less highly taxed sector, some impact of the corporate tax shifts with it.

Globalization raised the specter of a far worse outcome: complete capital mobility implied that a national attempt to tax it at a higher rate than it could earn abroad would simply drive capital out until returns gross of tax rose so that net returns become internationally competitive. This, in turn, would leave labor bereft, implying lower wage rates.

The simple model is cautionary, but it is also seriously incomplete. Corporations typically generate above-competitive returns, and the extent to which the national corporate taxation drives down the overall rate of return to domestic capital has remained uncertain. Moreover, there is great uncertainty about how much the corporate tax affects direct investment flows and MNC activity. Most of the literature on the multinational corporation as well at the
new economic geography rests on imperfect competition and differentiated products,\(^{16}\) thus diminishing the role of capital cost as a determinant of firm location and profitability.

All of these factors leave models focused solely on capital flows somewhere between incomplete and totally misleading. Territorial taxation itself reflects a national conviction that the apparent loss of more immediate revenue and more capital by exempting foreign corporate earnings instead of just crediting them was more than overbalanced by the increased competitive advantage given to national firms in the struggle for overseas markets. This in turn allows for rents on public goods within the firm and can increase home country prosperity. Sweden has maintained such a policy throughout the postwar period (Bergsten, Horst, and Moran, 1978:38–40).

The realities of international business also drain meaning from attempts to match corporate income tax practices with traditional normative criteria. The public finance literature’s discussions of economic welfare juxtapose alternative standards of tax neutrality based on differing simplifying assumptions which, at all events, are focused on transnational firms as conduits of real capital.\(^ {17}\) The most recent and compelling criterion, capital ownership neutrality (Desai and Hines, 2003), suggests that the global tax system should function so that the most efficient set of resources, whatever their jurisdic- tional provenance, should be employed in all economic activity anywhere. As a practical matter this could be accomplished only by the abolition of the corporate tax, which is most economists’ first choice anyway (Sullivan, 2011).

The incidence of the corporate income tax remains contested, but one recent U.S. study found that the share of a dollar increase in the corporate tax burden that is borne by labor lies on the range of 42 to 60 cents (Liu and Altshuler, 2011). Leaving distribution aside, the tax creates

\(^{16}\) In particular, the competitive advantage of a firm typically has public good qualities (Caves, 1971; Dunning, 1997). And a firm’s competitiveness must be analyzed independently from its national location Baldwin (2009).

\(^{17}\) The clearest early statement of alternatives may be Musgrave (1969).
huge estimated allocative distortions (Jorgenson and Yun, 2001). Finally, administrative and compliance costs—greatly increased by the complications of globalization—are higher than almost any other tax.

While increased personal taxes on those with high incomes could raise revenue both more progressively and more efficiently than the corporate tax, such a substitution would constitute a radical and politically impossible change almost everywhere. Corporate taxes now account for an average of 8.6 of total revenue across the OECD; the tax base has broadened as rates have steadily dropped so revenue has been maintained and even somewhat increased as a proportion of GDP. In sharp contrast, the ratio has dropped in much of the rest of the world, especially in Africa, as falling rates have not been accompanied by a broader base (Keen and Simone, 2004).18

Each nation state sees corporate tax reform parochially, and this is encouraged by the great conceptual and empirical uncertainly that surrounds the tax. Policy makers considering reform see disagreement among national analysts on such issues as the impact of both current and proposed policies on the overall encouragement of foreign versus domestic investment; the competitiveness of individual firms; the overall growth of the national economy; the revenue raised by the corporation income tax as a whole relative to modifications of it; the revenue raised by the tax on foreign income alone; and the repatriation of foreign earnings.19

While evidence confirms the theoretical prediction that small states will generally have lower corporate income taxes due to a more elastic supply of foreign investment (Hines and

---

18 It is important to distinguish a corporate income tax from natural resource taxation although they are often conflated in policy. Resource taxation can be an essential and efficient source of development finance (Smith, 2012).

two conceptually distinct phenomena should be distinguished. One involves firms actually shifting real operations from one state to another in response to taxes. The other reflects the incentive merely to claim profits in low tax areas such as OFCs with minimum impact on real activity. This second category is widely seen as abusive and provides a politically salient benchmark for reform viewed from the standpoint of home countries. But national interest calculations for home countries are not straightforward. Just as some states have long employed a territorial tax regime with the goal of assisting national firms to compete more effectively in foreign markets, the use of an essentially sham jurisdiction in a global system can also increase the competitiveness of domestic firms or serve to shift what would otherwise be foreign profits back to the home country (Hines, 2010).

The U.S. has grown increasingly isolated in recent years in its adherence to a global corporate tax regime. Of the 34 members of the OECD, eight adopted a territorial system after 2000, and the U.S. is now one of only seven states that maintain the global approach. Despite great uncertainty about both the effects of current policy and changes in it, current dissatisfaction with the offshoring of corporate profits and unease about the increasingly uncompetitive U.S. nominal rate have led to a bewildering variety of proposals for policy change. Some proposals include a much stricter version of the application of the global principle that disallows deferral and insists on country-by-country crediting in the context of an overall corporate tax rate reduction. Others move the U.S towards a version of the territorial tax. Each proposal is sold as promoting the national economic welfare, and many claim to increase both competitiveness and revenue (Sullivan, 2013).

---

20 This is true despite the tendency of smaller states to have larger public sectors (Rodrik, 1998). Overall, across all states corporate investment has been estimated to be quite responsive to corporate tax rate differences (elasticity estimates range from -.6 to -3.5. (Hines and Summers, 2009:130).
The U.S. is not alone in targeting corporate abuse of OFCs for renewed policy attention. In fact, one of the main political drivers of the OECD’s recent study, *Addressing Base Erosion and Profit Shifting* (OECD, 2013a) was European anger at the avoidance of taxation in major EU markets by U.S. firms that have successfully avoided sufficient presence to trigger local corporate taxation. Overall the study addresses a variety of problems identified by various members. One common problem is the manipulation of financing and valuation that allows nationally developed technology to “reside” in low income tax jurisdictions, a concern that the U.S. shares not just with high income countries but virtually all non-OFC states. A related problem is inconsistency among national policies that allow specific transactions or even entire business entities to be seen variously from different jurisdictional perspectives with the possible result not only of zero taxation but of corporate entities whose very existence is nominal!

These problems were vividly displayed in the 2013 U.S. Senate Hearings on Apple, which provided great visibility to findings in a Senate memorandum and generated bipartisan anger (Levin and McCain, 2013). The firm, which held $102 billion in liquid financial assets “offshore” (the report’s term), deployed intra-firm finance to develop intellectual property that drew almost entirely on U.S. activity but was held abroad and the profits from which were assigned on basis of worldwide sales, which essentially left only the profits on U.S. sales declared as U.S. income. Moreover, all immediate non-U.S. sales revenue was booked into Ireland even though little “active” business took place in Ireland on that front either—it was directed from the U.S. and took place mainly at the site of final sales. This was possible because Apple was able to structure its affiliates so that everything done through Ireland could be anointed as “active” due to some genuine business activity at the top-level Irish subsidiary.\(^\text{21}\)

\(^{21}\) The flexibility is given through a process called “check the box,” which was introduced administratively in 1996 to simplify reporting for domestic firms, but it inadvertently allowed MNCs to easily circumvent a complex set of
The U.S. Congress is considering a number of proposals aimed specifically at OFCs; one direction of change with considerable support in both major political parties is to allow for tax-free dividends from foreign subsidiaries combined with a back-up tax to be applied to those jurisdictions with local taxation below a certain level (Sullivan, 2013). This would move the U.S. towards territoriality and closer to the practice of most other major states—both the U.K. and Japan have shifted to a territorial system in recent years, and many states have various restrictions on the use of OFCs. Some alternative reforms move in the direct of jurisdiction-specific and fact-intensive determinations about business purpose and substance while others focus on penalty taxes on excess returns to intangibles in low tax jurisdictions. Proposers of nearly all political stripes want to be seen opposing phantom OFC activity.

The prevailing method of host country taxation of subsidiary profits challenges lower income hosts much more than richer ones. The UN model bilateral tax treaty is quite similar to that developed by the OECD, although it is more generous to home countries on issues such as the level of activity necessary to trigger local corporate taxation and on the taxation of royalties. Treaties between rich and countries often combine elements of the two. The greatest North-South divide lies in administration. While MNC profit-shifting—typically of OFCS—plague rich hosts, they often completely defeat poor ones.22

Some writers have argued that firm flexibility to shift profits protects lower income host country from unwise policymakers by encouraging larger volumes of FDI (Blanco and Rogers, 2009; Hines, 2010:115–116). The contrary position, that host welfare is presumptively lowered, provided much of the impetus for a UN sponsored report in 2001 that urged consideration of a complete change in international corporate taxation: a move to formula apportionment (UN, rules originally designed to assure that only income from active business abroad escapes immediate U.S. taxation. It was later turned into law with lobbyists arguing that it made U.S. firms more competitive.

22 In response, Brazil, with a 34 percent corporate rate, dictates some transfer prices.
The global tax base of each MNC would be divided across jurisdictions using some combination of physical assets, employment, and sales as is done in the U.S. states and Canadian provinces. Most economists have not embraced the departure; any formula devised would encourage important inefficiencies while also spawning cottage industries in evasion.

Under formula apportionment, states that are large, rich, or both would experience the greatest immediate gains. The OFCs would stand substantially bereft, especially if the location of intellectual property assets were subject to careful scrutiny. But exactly because the shift in tax base would be so radical and the outcome of either unilateral or multilateral action so uncertain, anything much beyond continuing UN rumination appears vanishingly unlikely. The slow and difficult path of policy development on formula apportionment in the EU suggests the virtual impossibility of an agreement on a scheme acceptable to a broader range of influential countries. The OECD Base Erosion study flatly rejects formula apportionment as a general approach but leaves open the possible employment of formulas for some payment streams.

Individual states will continue to adjust their international corporate tax practices, but they differ so much now that any really consequential international agreement is most unlikely. The OECD may succeed in its declared quest to develop more consistent approaches to various entity and transaction classifications so that double non-taxation can be more easily attacked, and more information about corporate activity will likely be required in a common format to facilitate enforcement with more of it made public. Intellectual property earnings may be assigned more closely to their jurisdiction of actual development. And the policy issue that most divides U.S. interests from virtually everyone else’s, the minimum criteria for local operation

---

23 Kimberly Clausing and Reuben Avi-Yonah (2007), among others, have suggested that the U.S. lead the drive for formula apportionment.
24 There is a vast literature covering the (inefficient) incentives of various formulas. See Altschuler and Grubert (2010).
25 The approach that would leave the OFCs most completely in the cold would be one based on (final) sales alone.
sufficient to trigger corporate taxation, may be adjusted (OECD, 2013b, 2013c), although the
U.S. will strongly resist substantial change. Nevertheless, no real policy equilibrium will be
established. Corporate tax competition will continue, and independent or loosely cooperative
national government measures to avoid the impact cannot succeed. In fact, many aspects of
reforms proposed for the U.S. and across the OECD will likely accelerate rate erosion because
they diminish the ability of states to price discriminate with corporate taxation between domestic
firms and MNCs.

What does all of this imply for offshore finance? Minimum taxation and various anti-
avoidance measures could dramatically decrease the role of OFCs as they are currently used by
major corporations. Just how much diminution will take place and where cannot be forecast with
confidence. Some centers boast genuine local expertise, and low local costs—including non-
corporate tax differences—will determine much of the outcome. An important market segment
is the estimated third of hedge fund investments in OFCs that involve tax-exempt organizations
seeking lowest real service costs.

The diminution of the OFC role in corporate finance will follow hesitant, piecemeal
policy adjustments by major home and host governments, each wary of putting national firms at
a disadvantage or driving real resources away. The great variety of corporate rates and rules will
continue with each state’s decision-makers attempting to estimate the national economic interest
while pressured by lobbies with very clear ideas about what they want. Publicized data on

---

26 For example, the U.S. appears to have thwarted the wave of corporate “inversions” of earlier in the century in
which U.S. firms shifted their headquarters to OFCs by threats of punitive taxation and ineligibility for government
contracts (Shaviro, 2010). It could go further by attempting to redefine “home” nationality on the basis of location
of effective firm direction as the U.K. does or by declaring nationality for tax purposes where majority stock
ownership is held. But these can only retard an erosion of real activity or tax revenue due to an uncompetitive
effective corporate tax rate. However national firms are defined and controlled, means could be devised to keep
U.S. ownership thresholds from exceeding whatever limit is set. At all events, non-national competitors cannot be
reached.
corporate funds in OFCs serves to keep the policy window open, and it is almost certain that the
corporate tax role of pure OFCs will diminish markedly as offshore finance becomes more
connected with the real activities of the firm. This will result from firm response to new rules
and closer scrutiny about insubstantial activity and suggests a diffusion to mixed OFCs and to
other jurisdictions.

**Personal Tax Evasion**

The offshore tax evasion problem differs from the avoidance issues just discussed in many ways.
First, tax evasion is a far clearer concept. States have traditionally differed in their precise
definition and in the degree of criminality that tax evasion represents, but these differences pale
by comparison with avoidance responses and their relation to fundamental differences in
corporate taxation. Open and transparent behavior by host country governments supports a
tightening of policies against avoidance; it is absolutely essential for the detection and
prosecution of tax evasion. Finally, the competitive aspect of thwarting evasion creates different
national incentives from those of avoidance. States have a continuing interest in preventing
evasion by their residents or citizens while ignoring or encouraging it by those in other states. So
far, they have been able to tighten the grip on their own with little fear of citizen or resident
departure, but as the final section of the paper argues, this may change in the future.

All countries with substantial personal income and wealth taxes have long faced tax
evasion based on the secret holding of foreign investments. The problem grew more serious with
the digital revolution. Such secret investments allowed the earnings to go untaxed and the
principal transferred to others without gift, estate, or general wealth taxation—as it also allowed
assets to be protected from others with legal claims. The amounts involved in tax evasion both
through the OFCs and more generally can only be roughly estimated, but one recent source puts
the annual tax loss at $189 billion globally (Henry, 2012:42). Tax experts often stress that the importance of evasion—much more than avoidance—holds significance far beyond the amounts actually not paid. Such activity undermines public confidence in the integrity of the tax system and makes other evasion more likely.

The OECD’s Harmful Tax Competition project, redirected in 2001 to focus entirely on evasion, established a consultative body, the Global Forum, that developed a model bilateral Tax Information Exchange Agreement based on acceptance of the principles of transparency and information-sharing on mainly personal investments. The seeming high point of this activity was the London G-20 of April 2009 at which essentially universal agreement was announced on the goal of obtaining and recording beneficial ownership of financial assets booked in a jurisdiction and transmitting that information to other governments upon request. Many correctly judged that to be a shallow victory. The cooperation envisioned lacked a foundation of incentive compatibility: many of the states whose cooperation was seen as most essential—in particular the most of the pure and mixed OFCs—lacked motivation to perform beyond the level necessary to avoid the ire and retaliation of more powerful states. Moreover, authorities had to identify potential malefactors before seeking information about them. Unsurprisingly, early statistical studies suggested little if any impact on tax evasion (Kudrle, 2009; Johannesen and Zucman, 2012). But, in a series of developments that surprised many observers, the story did not end there.

The presence of many major developing states in the G-20 bolstered a determination in the OECD-initiated and G-20-embraced Global Forum on Transparency and the Exchange of Information for Tax Purposes (the reconfigured Global Forum) to devise a new form of international agreement. In 2010 the Forum adopted a revised version of the multilateral
The Convention on Mutual Administrative Assistance on Tax Matters developed by the OECD and the Council of Europe in 1988. This new instrument contains all the core requirements of the model bilateral information agreements, but it also covers a broader range of taxes, allows joint tax investigations and—most important—provides the option of automatic information exchange (OECD, 2013b). This new approach holds the potential to deter tax evasion substantially. The domestic tax literature demonstrates that earnings reporting to governments results in much higher levels of tax compliance than is seen otherwise.  

Another development also suggests that progress is likely on tax evasion. The Bush administration largely paid lip service to the idea of sharing information to cooperate to cooperate with the EU and the OECD and delayed action. The Obama government signaled a commitment to international cooperation, but its most important concrete action began as a unilateral initiative passed as part of stimulus activity in the wake of the financial crisis. The Foreign Account Transactions Compliance Act (FATCA) of 2010 (Trivedi and Kroh, 2012) will levy a withholding tax of 30 percent on all financial institutions placing investments from abroad into US markets beginning in 2014 unless those institutions report information on accounts with American connections (Grinberg, 2012). 

The unfolding of FATCA reveals some remarkable and telling features. Its initial logic seemed to be nationalist hegemonic assertion: the U.S. presented foreign institutions, not governments, with a choice: collect information to prevent tax evasion by Americans or face a high withholding tax. Many major trading partners of the U.S. strongly objected to FATCA at  

---

27 The OECD has always anticipated the possibility of automatic exchange of tax information internationally and has done work on the technical identification requirements necessarily for its facilitation (OECD, 2012). Nevertheless, such automatic information exchange was rare in bilateral tax treaties, which covered states with highly varied traditions of financial privacy.  

28 For example, in the U.S. federal tax compliance rates for personal income that is reported directly to the IRS falls within a couple of points of 100 percent. For independent, but not informal, sole proprietors it is estimated at 68 percent; for informal suppliers, 19 percent (General Accounting Office, 1997).
the outset both as unilateralism and as a threat to national laws of financial privacy. Many soon realized, however, that their own best interests were served by shifting the focus of cooperation from individual institutions to the national government and bargaining for reciprocal action from the United States. Such a nationalization of compliance became the basis for the intergovernmental agreement (IGAs) that have now been struck with many countries and are under consideration with dozens more (Temple-West, 2012). Once such agreements are struck, financial institutions have a powerful interest in assuring their own government’s cooperation to avoid foreign withholding.

U.S. international economic bargaining is always dogged by two complications that most of its counterparts lack: a major, independent legislative role in foreign policy and the prerogatives of the several states. Both characteristics cloud the future of FATCA. The standard language of a FATCA IGA states: “The United States is committed to further improve transparency and enhance the exchange relationship with [FATCA Partner] by pursuing the adoption of regulations and advocating and supporting relevant legislation to achieve such equivalent levels of reciprocal automatic exchange” (cited in Christians, 2013). In other words, the U.S. executive declares support for a degree of reciprocity but cannot assure it. As one objecting Republican legislator has pointed in a letter to the Treasury, however, parallel obligation was not part of the enabling FATCA legislation (Posey, 2013), although it certainly must have been anticipated by the Treasury and State Departments, which were also considering EU, OECD, and G-20 activity.

Congressional intent and concurrence restrain the executive, but so do the several states. Shell companies thwart transparency, and state law governs the formation and regulation of American businesses. Despite greatly differing political complexions, the states typically unite
to battle federal encroachment. Several states, including Wyoming and Delaware, require such little information on companies that they often serve as the weakest informational link in global webs of evasion. Federal legislation to require the collection and verification of beneficial ownership of firms has been introduced four times (most recently on August 1, 2013) without success partly due to opposition from the National Association of Secretaries of State (NASS) defending state revenues from business formation fees and resisting inadequately funded federal mandates. Significantly, the most recent NASS report devotes no attention to reciprocity or greater international cooperation (NASS, 2012). In sharp contrast, the proposed federal legislation makes the plaintive and somewhat devastating point that its passage would “... make U.S. domestic practices consistent with U.S. foreign policy.” (Cohn, 2013)

A few libertarian politicians such as Senator Ron Paul want to abandon FATCA altogether and reject the declarations of transparency made at the G8 and G20 meetings of 2013. Most of the Congress is now committed to some level of cooperation, however, although the U.S. will face protracted political difficulty to approximate the same level of information provision that its expects of others. Recent Treasury regulation changes obliging financial institutions to collect information on foreign accounts so they can be shared signal executive commitment (Sheppard, 2013).

Although uncertainty is still high, G-8 and G-20 activity along with the U.S. initiative may finally spell a dramatic diminution in the use of secret foreign investments to avoid taxes with a large impact on the OFCs. The OECD is serving as the secretariat for the G-20 in developing the technical elements of automatic information exchange as well as the boilerplate for incorporation of the new approach into national law. The entire project is being devised to
achieve legal and administrative congruence with both the European Savings Directive and FATCA (OECD 2013b:12–14).

The domestic as well as international politics of the demise of financial secrecy has been complex, but one general mechanism appears to explain a great deal. The pure OFCs have small populations and no income taxes. Thus, their role in promoting tax evasion by citizens and residents of other states has brought little cost beyond foreign opprobrium. Some other states with unremarkable levels of personal income tax have nevertheless permitted general secrecy in bank accounts and other personal investment because the gains from foreign dealing have been judged to be greater than the revenue losses from domestic evaders. This is true of smaller European countries such as Austria, Switzerland, and Luxembourg.

Both the United Kingdom and the United States employ payer reporting to the government on most earnings of the permanent residents within their jurisdictions, but London has attracted huge anonymous investments through the OFCs most closely affiliated with it (Shaxson, 2011), and those OFCs and others have also fed large amounts into U.S. capital markets. The UK was so closely connected with banking and other financial activities in its former colonies that its EU partners insisted on their participation in the EU account-sharing plans, and the UK apparently now sees no alternative to vastly greater transparency throughout.

Along with many other states, the United States has never taxed bank account earnings by foreigners and, in an explicit attempt to bolster its balance of payments situation, all foreign investment in government obligations was made tax-free in 1984. Thus no information on foreign owners was recorded so there was none to provide to other states. The current situation finds the federal government, nearly all Democrats and many Republicans committed to cooperative transparency pitted against libertarians, defenders of state prerogatives and budgets,
and business interests—including the American Bar Association and the Chamber of Commerce. These opposition groups continue to speak the language of the common law “Revenue Rule:” a state (originally its court system) has no obligation to help other states collect their taxes. Thus the U.S. states appear to be microcosm of the self-interested actors at the international level.

The apparent Realpolitik at work on transparency suggests how little attention has historically been paid to the welfare of states not in position to insist on meaningful reciprocity. Poorer and less powerful states saw from the beginning that the bilateral information-sharing regime, inadequate for even the most influential, would always leave them least well served when seeking assistance. And they face evasion challenges beyond those of the higher income states. Businesses and the well-off see tax collectors as their opponent everywhere, but this is greatly amplified by poor country governments, which typically try to control the economy more extensively and do so with far more corruption than is usual in the rich world. Among myriad regulations, most poor states maintain exchange controls. Therefore the secrecy motive for using offshore extends far more often to the protection of the assets themselves than is the case for rich world evaders. This makes the transparency stakes far higher for both the governments and the private entities involved.

While poor countries could potentially see a greater change in their fiscal fortunes from automatic information exchange than richer ones, a challenge of the emerging regime of automatic transfer of information turns on what level of probity a government must assure to be provided with such information. OECD documents encourage “exchanging information automatically with their treaty partners, as appropriate” (OECD, 2013b:8) making clear that the latter means the receiving country has the legal framework and administrative capacity and processes in place to ensure the confidentiality of the information received and that such
information is only used for the purposes specified in the instrument. While it is unlikely that states with most of the South’s population will be excluded from automatic information exchange, the denial of such information will inevitably be used as a political weapon.29

For some states, using information exchanged automatically will at first resemble trying to drink from a fire hose, and there will be unevenness in the production of such information by treaty partners. Nevertheless, the new regime can be expected to reduce evasion in the South considerably. Over all countries, rich and poor, what evasion remains is likely to be more varied and diffuse across jurisdictions than it is today. The OFCs will be subject to special scrutiny. Systematic failures of will or competence by any single state in the new regime will bring greater attention and—at least if the state lacks overall power—retaliation beyond anything yet seen. The Global Forum has not specified an enforcement mechanism, but when asked whether countries would be sanctioned for failure to share information, Michael Ralston of the Australian Tax Office, chair of the Global Forum, responded that “sanctions are a political question...countries have their own sanctions for partners that fail to cooperate.” (Sheppard 2011:343).

Some automatic information exchange now appears inevitable, but how smooth and comprehensive the implementation will be turns to great extent on the unpredictable vagaries of U.S. politics. FATCA provided major U.S. partners with an opening to demand reciprocity and the IGAs as well as U.S. concurrence with G8 and G20 declarations mean that a failure to respond to foreign expectations will have much greater political visibility at home and abroad than was the case in the Bush administration. Nevertheless, if the national political picture changes sufficiently before components of a new regime are firmly enough in place to be

29 And this may be reinforced or distorted by industry lobbying. For example, banks in Florida and their political representatives will assure that Venezuela remains ineligible for information sharing (Sheppard, 2013b).
anchored by path dependence, the policy window may shut with U.S. cooperation delayed indefinitely. This is an unlikely but possible outcome.

**Living Offshore: The Final Frontier?**

Will the advent of a new information exchange regime mean that at least the rich states may soon have the capacity to tax those of high income and wealth at any level they wish without the danger of tax escape? Perhaps not. The secret migration of asset claims across jurisdictions may be increasingly replaced by the open migration of persons. For example, some observers relate the dramatic increase of those abandoning U.S. citizenship—although it is still a small number—to the passage of FATCA. The first quarter figure for 2013, 670, was the highest such number in history and three quarters of the total for the entire year of 2012 (Browning, 2013).

Unfortunately, interpretation of the data is difficult because an unknown number of these persons may have already been living abroad and may have been pushed to cut all U.S. ties by the prospect of FATCA’s looming red tape more than higher taxes (Rampell, 2011).

Those in the British government who first devised the growth of the Caribbean tax havens as an economic development strategy also envisioned tax-motivated migration. Good transport and communications were essential for both financial activity and tourism. In turn tourism could lead some to change their permanent residence once the climatic and lifestyle advantages were experienced. This might increase the demand for the local provision of financial services as the newcomers invested (Hampton and Christianson, 2002:1664).

The extent of such OFC enticement appears modest so far. For newcomers from most countries permanent migration would involve an exit charge ranging from nil up to full capital tax liability on the estimated value of assets at time of expatriation (Langer and Gay, 2000). The global approach of the U.S tax system makes it an outlier. Just as most states do not levy tax on
corporate income from outside the country, most do not attempt to collect the personal income tax beyond those residing in the country. But the U.S. goes one step further. It taxes not just residents but the income of its citizens wherever they reside. Two major qualifications greatly reduce the difference between current U.S. practice and the rest of the world, however. Not only is there a very high tax exemption for those living abroad but, as with corporations, taxes paid to the foreign government are generally credited against U.S. liability.

Many have advocated that the U.S. adopt residence taxation to get in step with the rest of the world, but a case can be made that some version of the current U.S. approach could protect the integrity of many fiscal systems most effectively in the face of increasingly personal mobility challenges. Most modern tax systems everywhere are justified with the same textbook canons of fairness: Those with greater means should pay more (vertical equity), and those of similar means should pay the same amount (horizontal equity). These are conditioned by the benefit principle: those who benefit more should pay more, all else equal.

Michael Kirsch (2007) suggests personal protection, property protection, the right to vote, the right to enter, and past benefits as benefit justifications for citizenship taxation. Reuven Avi-Yonah claims these benefits are minor and argues: “As long as U.S. residents choose to live in the U.S. they should pay tax on their world-wide income, because that tax supports the benefits they receive. If they choose to live elsewhere, they receive far fewer benefits and should not have to pay the tax on foreign source income.” (Avi-Yonah, 2010:392)

In making this benefit argument Avi-Yonah parallels the approach taken by many international lawyers who cite the classic article by Charles Tiebout (1956) in their discussions.30

---

30 This includes both of the proponents of citizenship whose arguments Avi-Yonah is criticizing, Michael Kirsch (2007) and Edward Zelinsky (2011).
But Tiebout’s approach completely misleads in contexts that indissolubly involve obligation or vertical equity because the Tiebout model explicitly abstracts from such concerns. Tiebout deals with the efficient production of local public goods, leaving matters of income distribution assigned (by neglect) to higher levels of government. But in the international sphere there is no higher level of government. Thus, only those who reject any substantial redistributive role for government can take a truly Tiebout-like view of international personal mobility. Instead, the totality of obligations and benefits of citizenship would seem to constitute a legacy that cannot be abandoned through a simple present value calculation of prospective incremental costs and benefits as a person’s life progresses.

Policy concern about tax escape should focus on persons of very high income and wealth, who typically pay dramatically more in taxes than they receive in the estimated value of benefits in every modern state. More specifically, only a handful of taxpayers account for a substantial part of total personal income tax receipts. In 2007, IRS data show that the top .1 of one percent of all tax returns—only 141,000 people—paid about 20 percent of all U.S. personal income taxes (Tax Foundation, 2013). In the U.K. the top .04 percent of all taxpayers, about 8000 people, paid 7.9 percent of all personal income taxes in 2012 (Crossley, 2013).

Data such as these suggest that the difference in benefits received by high income citizens living abroad and at home is dwarfed by the massive difference between their tax bill and any estimate of the market value of benefits almost wherever they live in the developed world.

31 Comprehensive studies of total taxes and total government benefits are rare, but a careful study by Wolff and Zacharias (2007) using U.S. data for 2000 found net beneficiaries through the seventh decile of the family income distribution and net payers only in top three deciles.
32 High income U.S. citizens living abroad in countries with higher personal taxes may well pay an even steeper cross-subsidy to their fellow residents, and, if so, they will not usually be liable for any substantial concurrent U.S. taxation.
33 It is not at all obvious that violations of horizontal equity in the relation of taxation to benefits is greater between U.S. citizens living at home and abroad than across those living within the U.S. Consider, for example the “marriage
This, of course, simply moves the argument away from the benefit principle and to the ability to pay.

Recognizing that creditable personal taxes are typically higher in most high income countries than in the U.S., Avi-Yonah argues: “We should not base a broad rule such as ability-to-pay taxation of nonresident citizens on the relatively few cases of citizens living overseas in countries that have no or low income taxes.” (Avi-Yonah, 2010: 393). If not for administration problems one might well ask: why not? The administrability of tax obligations by those living abroad will continue to be a problem, but earlier critiques of the feasibility of citizen taxation did not anticipate the kind of information sharing on foreign earnings that may now be imminent.34

Not only do a small number of persons pay a large share of the total income tax bill, but other important taxes are also threatened by jurisdictional mobility. Many have argued that wealth inequality is the most important policy-relevant cause of overall societal inequality (Batchelder, 2008; Freeland, 2012), and the 2011 Mirrlees Commission drew attention to the recent increase in wealth concentration in rich countries after a long period of decline (Atkinson, 2012:776). The long struggle against the “death tax” in the United States met with conclusive defeat (McCaffrey, 2012), and the tax is now levied on large estates at a maximum rate of 40 percent. In sharp contrast, nine other members of the OECD have no inheritance or estate taxes, and scores of other nations including most of the pure OFCs also lack such taxes.35 But given the global climate of concern about inequality that shows no prospect of abating, popular political support for estate and inheritance taxes may increase everywhere.

34 Lawful entry to the U.S. could trigger a reckoning with the IRS along with the currently possible enforcement through passport renewal. The latter could never suffice alone because so many affected persons hold multiple passports.

35 While some jurisdictions without an estate or inheritance taxes do tax assets as if they were realized at death, the effective rate may be quite low.
The U.S. conditions tax escape on the relinquishment of citizenship, a much bigger step than a change in residence. Only then does U.S. policy somewhat resemble that of many high income countries in levying the capital gains tax on a “deemed realization” of property, and there is some political sentiment to roughly double that rate for expatriation to avoid taxation.\[^{36}\]

Moreover, while other states allow a clean break, the U.S. follows the (remaining) property of the expatriate and levies a tax on future U.S. gift recipients or inheritors to compensate for the infeasibility of collecting the estate tax.

Overall, the U.S. approach stands in sharp contrast in both form and spirit with the residence principle, which essentially treats a change in permanent national residence as a mere transaction. For example, many residence taxation states allow those departing to spend up to half of each year in the original state without either penalty or stigma. As tax evasion becomes harder, why would an increasing number of high income or high wealth individuals not become non-resident if they could live in a jurisdiction with lower income and asset taxation (assuming that other taxes, the cost living, and other local conditions do not cancel the advantage)? This option is made ever more attractive by the continually falling real cost of travel and dramatically improved communication—the latter makes long periods of life abroad more compatible with the maintenance of complex interpersonal ties in the home country. The physical proximity of OFCs to private wealth was documented earlier.\[^{37}\]

According to the testimony of a highly respected international tax lawyer and expert on tax havens writing in 2005, “Millions of wealthy individuals with trillions of euros, pounds and dollars now live in or have retired to small countries with benign tax systems” (Langer 2005:1).

While this claim is unaccompanied by evidence, the OFCs, which typically have no personal

\[^{36}\] The U.S. taxes the entire value and not just appreciation while the owner was a citizen or permanent resident.

\[^{37}\] In fact, only longitude was considered, but the latitude distances are almost always unremarkable.
income or wealth taxes, might become increasingly attractive to high income citizens of residence taxation states and perhaps to some Americans as well.

Once again, the significance of an offshore attribute, low personal taxes, goes well beyond pure or mixed OFCs. Differences in income taxation and the frequently much greater differences in the taxation of wealth, will certainly attract increased migration by the well-off; the only questions are how much and how soon.

**Summary and Conclusion**

The very concept of offshore finance captures the frustration of many people about globalization. In fact, it embodies several characteristics: low taxes, minimal regulation, opacity, and the juridical harboring of insubstantial economic activity. Low tax rates alone cannot feasibility be the object of comprehensive international agreement. The international community’s legitimate concern with regulation in OFCs rests on external impact, and there is little well-founded concern now that prudential regulation is more deficient than onshore, nor that it is likely to lag dangerously in the future. The regulation of money laundering, terrorist finance and similar activities is closely related to the need for transparency that propels concerns about tax evasion.

The corporate income tax developed within two very different overall tax schemes, the global and the territorial, and while their actual implementation makes them more similar than they first appear, they share the common problem of an absence of compelling theoretical benchmarks for policy. This abstract limitation accompanies a host of empirical studies that suggest a high level of international capital mobility but which otherwise leaves many policy issues unresolved. Most economically trained commentators would end the taxation of corporations as such rather than attempting to mend the tax—something that international competition seems likely to accomplish despite various plans for reform. In fact, attempts at
reform that make it less feasible to tax international business at effective rates lower than paid by
domestic businesses will likely hasten the erosion of the corporate tax in national fiscal systems.
That erosion might be substantially slowed by the introduction of formula apportionment, but
many states, most notably the U.S., would strongly oppose such an innovation, and its adoption
is vanishing unlikely. At all events, political forces now seem aimed to reduce substantially the
role of recognized OFCs in corporate finance.

Tax evasion may finally be yielding to effective international cooperation. The
combination of more than a decade of consideration by the OECD and the current involvement
in the Global Forum of other members of the G-20 has yielded an organizational structure and a
multilateral convention that can be expected to both identify and deter evasion substantially.

This initiative has paralleled an unexpected and successful drive by the U.S. that began as
an attempt to address its own evasion problems but evolved into reciprocity. U.S. policy can be
subject to sharp discontinuities, however, and the most that can be said now is that the more
highly evolved the current pattern becomes, the less likely is a reversal. All of this together
spells a likely sharp diminution in funds parked in OFCs for evasion.

Migration to some OFCs was once seen positively as means of economic development.
It is quite possible that they may play an increasing role as refuge from the well-off as personal
mobility replaces secrecy as a means of avoiding personal taxes. More generally, migration to
avoid taxation suggests renewed national attention to personal income and wealth taxes as well
as to penalties for departure.

REFERENCES:

Altshuler, R., and Grubert, H. 2010. Formula apportionment: Is it better than the current system
and are there better alternatives? National Tax Journal 63:1145–1184.
Atkinson, A.B. 2012. The Mirrlees review and the state of public economics. Journal of
Economic Literature 50(3):770–780.


Crossley, L. 2013. Britain’s higher earners shoulder 60% of the country’s income tax bill. *Mail Online*. Published 08:43 EST, 3 February 2013. Updated 03:11 EST 4 February 2013.

Dell’Otte, 2009. Understanding corporate usage of British crown dependencies and overseas territories. A report to the independent review of British overseas financial centres


