

Whose 'Treasure Islands'? The Role of Tax Havens in The Global Economy

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Two recent works with the same title suggest radically different views of the role of tax havens in the global economy. In late 2010, James R. Hines Jr. (2010) made the case for a largely beneficial role. According to Hines, the tax havens improve markets: they facilitate direct investment by improving the attraction of high-corporate-tax states for real investment, and they may shore up rather than degrade corporate tax collections by high-corporate-income states such as the U.S. They also seem to improve the competitiveness of national financial institutions and hence facilitate portfolio capital provision in both rich and poor countries. A book by Nicholas Shaxson (2011), which appeared shortly after Hines's article, presents an utterly different assessment. In Shaxson's account, tax havens permit the superrich in high-income countries to evade their tax responsibilities, place a huge additional burden on rich-country taxpayers by allowing vast corporate profits to go untaxed, and facilitate the drain of capital from poor countries.

The works differ in four main areas:

- the jurisdictions considered;
- the practices examined;
- the evidence employed; and
- the implications for policy.

Jurisdictions and Practices: A Preliminary

Hines begins his discussion by dismissing the popular view of tax havens:

In movies and novels, tax havens are often settings for shady international deals; in practice they are rather less flashy. Tax havens are countries or territories that offer low tax rates and favorable regulatory environment to foreign investors. . . . Tax havens are also known as "offshore centers" or "international financial centers," phrases that may carry slightly differing connotations but nonetheless are used almost interchangeably with "tax havens." [P. 104.]

Hines goes on to note the high level of concurrence among various tax haven lists, and he focuses on the question: What do people generally mean when they use the term "tax haven"?

Shaxson, in common with many other writers, shifts the focus away from what people mean by "tax haven" toward what they ought to mean. Shaxson is concerned with practices, not jurisdictions. He offers a "loose description" rather than a definition: "It is a place that seeks to attract money by offering politically stable facilities to help people or entities get around the rules, laws, and regulations of jurisdictions elsewhere" (p. 11). Indeed, his introduction to the fast-moving tale of perfidy that is *Treasure Islands* begins with a lurid vignette involving Gabon, which he notes is "on no list of tax havens anywhere" (p. 6). Shaxson's real subject is what he calls the "offshore system" of "banks and financial service industries" (p. 7). This is reflected in the book's subtitle: "uncovering the damage of offshore banking and tax havens." Unfortunately for the sake of

clarity, the “offshore system” comes to mean pretty much anything about economic globalization that Shaxson does not like.

Shaxson writes, “The common feature of tax havens is that they offer secrecy” (p. 6). Time and again in the book he identifies “secrecy” as the principal common factor of what he opposes, but he also notes that these jurisdictions offer escape from “many other rules and regulations too” (p. 6). Shaxson paints in broad strokes. He attacks regulatory differences and corporate tax avoidance, both of which can be — though often are not — quite transparent, creating difficulty with treating “tax haven” and “secrecy jurisdiction” as synonymous. If secrecy were greatly diminished, corporate leeway would be reduced for certain practices, but as long as corporate income rates and jurisdictional claims are not controlled, there is nothing to prevent either continuing competition for real investment in the developing world or the siphoning off of profits into relatively low-tax-rate jurisdictions (which might also seriously compete for real investment). And “offshore” banking typically just means the business that banks conduct outside their home countries (for example, Krugman, Obstfeld, and Melitz, 2011: 592). The problems that arise from “offshore” may be largely independent of either secrecy or tax issues and can result from incomplete and uncoordinated national regulation among major states as was the case in the recent crisis (Shin, 2010; 2011a).

The IMF tries to distinguish the broader meaning of offshore from one that focuses on nonnational dominance of both assets and liabilities — what most writers mean by the traditional tax havens (IMF, 2000). Shaxson offers a definition of his own: “When I say ‘offshore,’ I am talking about the artificial movement of *money* across borders, and about the jurisdictions, commonly known as tax havens, that host and facilitate this activity” (p. 12). Artifice is apparently in the eye of the beholder,¹ and this allows Shaxson to use “offshore” as he chooses.

The Shaxson book stresses practices not jurisdictions, and a central message, conveyed repeatedly, is that antisocial financial secrecy has been consistently sponsored by the U.S. and the U.K. He makes a strong case that for many foreign governments, businesses, and individuals, the U.S. is the most important tax haven.

Definitions and Applications

Nothing in Hines’s definition of a tax haven formally precludes Shaxson’s case for broadening the scope of concern beyond the jurisdictions traditionally regarded as tax havens. All one need look for is juris-

¹“Money” is also ambiguous. Shaxson never deals clearly with the distinction between real and financial movements across borders.

dictions that “offer low tax rates and favorable regulatory environment to foreign investors.”² Much of the divergence between the two works considered here is that Hines does not stay with this definition but instead restricts the usage further just as Shaxson broadens his beyond secrecy. Hines implicitly incorporates an additional assumption — shared by many writers — that the identifying activity plays a large relative role in the jurisdiction’s overall economy. In contrast, Shaxson makes an effective case that if behavior is objectionable when it is relatively large, it should be objectionable when it is absolutely large as well. Hines largely avoids confronting this distinction by focusing on corporate tax matters.

Despite the elasticity of Hines’s definition, “tax haven” is often used even more broadly; indeed it is so used by Shaxson. For example, the U.K. — and especially London — has been viewed as a tax haven, not only because of its role in drawing direct or portfolio *investment* but because “non-domicile” foreigners have been enticed by certain tax-related regulations to live and hence make large *consumption* expenditures and associated tax payments there. Indeed, Shaxson seems to imply that all tax advantages designed to lure foreigners — whether alloyed with secrecy or not — make the state a tax haven.

What Practices Are Objectionable?

Most writers who are critical of “harmful tax practices” in the international economy reject claims made by the libertarian right that their real target is tax competition. The pioneering work of the OECD does not suggest coordinating tax rates or preventing jurisdictions from offering generally low rates (OECD, 1998). Instead, the project’s original report identifies three objectionable characteristics of a low-tax regime that mark it as a tax haven: the absence of effective information exchange with other jurisdictions, a lack of transparency in legal and administrative matters, and “no substantial activities” (OECD, 1998: 22-23) — although these concerns were not initially implemented in a way that was either evenhanded or effective (Sharman, 2006). In considering the practices of its own members, the criteria were similar except that “ring-fencing” — tax discrimination to lure foreign real or financial investment — replaced “insubstantial” activities (OECD, 1998: 26-27).

Ring-fencing asks whether a tax regime treats foreigners differently from domestic agents. Such practice

²This is not an unusual definition. Hines’s Michigan colleague Joel Slemrod writes: “A tax haven is a jurisdiction that levies no or only nominal taxes and offers itself as a vehicle for non residents to escape tax — legally or not — in their country of residence” (2010: 857). While this definition can be read to imply intent, plenty of such intent can be found in the record of, for example, the United States in its deliberation over whether to report U.S. untaxed interest earnings to foreign governments.

has been condemned as “tax poaching.” Put simply, if, say, Ireland wants to attract new business activity through a low corporate income tax rate, it must offer the rate to domestic firms as well, but the rates themselves should be not be a matter of international concern (except perhaps within the EU).³ For non-OECD jurisdictions the attraction of overwhelmingly financial (rather than real) investment, unrelated to any local efficiency, was regarded as an indication that a jurisdiction was practicing abuse. Under pressure from international business, the OECD first greatly diluted the definition of insubstantial activities and dropped it completely in 2001 at the insistence of the Bush administration (Kudrle, 2008).

The secrecy and transparency criteria are those that receive the greatest attention from Shaxson and virtually none from Hines. Until very recently a prime element of most tax havens’ favorable regulatory environment was a failure to collect information on investment in the jurisdiction and an unwillingness to share that information with other states even if available.

Despite the OECD’s influence on the global tax debate, many observers would reject one or more of the identifying antisocial characteristics. Libertarians, who regard international factor mobility as a major barrier to majoritarian predation, would reject all of them. Traditional tax haven secrecy retards the ability to collect taxes on savings and wealth derived from income that was (presumably) already taxed once, a practice that many non-libertarian economists also regard as either unfair or unwise. Some observers would regard tax rate discrimination in an attempt to attract real activity as no more objectionable than uniformly low rates⁴; especially as such activity could accelerate the demise of the corporate income tax, which is seen as a destructive relic. Finally, many writers — including Hines — have identified the largely financial activities of the tax havens as improving the efficiency of the world economy. However, Shaxson challenges “a common idea that it is ok for one jurisdiction to exercise its sovereign right to get rich by undermining the sovereign laws and rules of other places” (p. 12). As with his treatment of “offshore,” this is a subjective characterization rather than an attempt to establish useful criteria.

The OECD’s “harmful” practices raise varied legal issues. None is against general international law, but secrecy largely abets tax evasion, which is now a crime in nearly all jurisdictions and a felony in most. The use of selective enticements to attract investment violates EU standards aimed at an internally level playing field,

but the WTO has failed to gain agreement on global norms. The use of tax havens as financial switching stations for corporate activity largely supports legal tax avoidance, although some practices, if sufficiently “aggressive,” can be declared evasion under national law.

A huge difference in narrative emphasis follows from the two authors’ differing effective definitions. However inadequate Hines’s neglect of havens’ secrecy function, he finds much to say — and defend — in their “insubstantial” activity that he traces to problems in the corporate income tax. Hines’s arguments and evidence — much of it based on his own previously published work — should be given much more serious consideration than Shaxson and many other tax haven critics give them. Much of the literature attacking the tax havens pays no attention to tax incidence and efficiency arguments of any kind and implicitly assumes not only that corporate taxes are borne by shareholders, but also that any form of business tax competition and responses to it mainly indicate moral failing on the part of the competing government or the responding agent. Shaxson’s book, for example, seems to assume that corporate taxes are paid only by the well-off (p. 32), and economic efficiency is scarcely considered except as rhetoric from defenders of practices he opposes.

Tax Havens as an Escape From Bad Policy

The works differ sharply in approach. Shaxson, as perhaps befits a popular work, is extravagantly polemical, and he is often quite casual in argument, evidence, and policy suggestions. Hines presents a defense of the tax havens, but, for the most part, he makes his arguments clearly and often acknowledges the weakness and ambiguity of available evidence. The article presents no policy suggestions whatever.

Hines ends “Treasure Islands” with a somewhat cryptic observation: “If tax policy and financial regulation in the world were ideal, then there would be little scope for the policies of tax havens to improve matters elsewhere and greater reason to be concerned about their possible effects” (p. 124). One cannot be sure just what he means here, but elsewhere he endorses a graduated consumption tax to replace both the personal and corporate income tax. Even most economists who favor the retention of a tax on all income favor a dramatic change in business taxation to eliminate the corporate tax.⁵ They join with those favoring an emphasis on consumption taxation to attack a revenue source with few attractive properties. The corporate income tax has uncertain incidence, but one representative recent study found that the share of a one-dollar increase in the corporate tax burden that is

³This criterion somewhat parallels the “national treatment” standard advocated for trade and investment policies.

⁴Such discrimination has long been an accepted practice of many low-income countries.

⁵As one recent thorough study of the U.S. corporate tax put it: “There is no economic justification for its existence. . . . And this is the almost universally accepted view among economists, both Republican and Democrat” (Sullivan, 2011: 25).

borne by labor lies on the range of 42 to 60 cents (Liu and Altshuler, 2011). Leaving distribution aside, the tax creates huge estimated allocative distortions (Jorgenson and Yun, 2001). Finally, its administrative and compliance cost is higher than almost any other tax — and has expanded greatly with globalization. Much of Hines's article is implicitly an examination of how the havens may help diminish the corporate tax's economic damage.

The corporate form facilitates activity that would otherwise be impossible, but that can be seen as a general societal benefit and not a gift to corporations. And it is hard to make a case that corporate businesses' "fair share" is different from that of unincorporated business. Most arguments of this type seem to intend that shareholders are not paying enough, but it is hard to argue for a higher tax rate for individuals based on where their money is invested rather than their circumstances.⁶

The investor perspective suggests why the first-round "double taxation" story is just the beginning. Although the corporate tax certainly captures some noncompetitive profit and adjustment mechanisms are complex (Auerbach, 2006), there is no reason for an investor to take a lower rate of return based on the use of capital, so any increase in capital cost generated by a corporate income tax⁷ will cause product prices to rise and activity there to shrink, shifting capital to the noncorporate sector until net returns corrected for risk have equalized across the economy and capital as a whole bears the burden of the tax. But this is the old scenario; globalization has brought a new one. Capital now has the option of shifting, not just to the noncorporate sector of the home country, but to the corporate sector of another country with a lower corporate tax rate. When this happens, the national capital stock is not just misallocated within the country with some attendant loss of overall economic welfare. Instead, the problem becomes far more serious: The departure of real capital lowers the income of all cooperating national factors of production, most notably labor.

Much capital moves internationally through corporations, but much moves as noncontrolling portfolio investment as well. It has long been recognized that alternative global investment opportunities mean that non-ownership capital will tend to earn the same net rate of return (corrected for risk) everywhere. This implies that loans are reduced by high borrower country tax rates until the pretax return rises sufficiently so that

the net return matches global alternatives. This has led most small countries and many large ones to abandon such loan taxation entirely. Both economic logic and evidence suggest that a messier version of the same mechanism increasingly operates for corporate taxation as well,⁸ and Hines's work in international taxation has dealt extensively with this issue. Much of that work is summarized in "Treasure Islands."

Virtually all current international corporate tax practices antedate the capital mobility that marks globalization, they differ widely by country, and, Hines argues, they can seriously jeopardize national welfare. The basic idea is straightforward and can be illustrated with the current U.S. situation. Unlike most high-income countries, the United States merely credits the corporate taxes paid to foreign governments rather than exempting foreign corporate income. If the foreign rate is 20 percent and the U.S. rate is 30 percent, then 10 cents on every dollar of profit is still owed. This burden is lightened but not removed by allowing active foreign income⁹ to remain untaxed by the U.S. until it is repatriated as dividends. Increasingly, however, U.S.-based corporations attempt to circumvent the remaining corporate tax liability by reincorporating the firm in a more favorable tax environment. This has incurred the ire of Congress, which has made several attempts to stanch the outflow. But such action can only be palliative.

Suppose Congress effectively blocks the departure of firm headquarters from the U.S. Then firms based in lower-taxed countries would have a competitive cost advantage against their U.S. rivals, and nothing would prevent U.S. investors from shifting their investment to such firms. There will also be a tendency for firms to begin their operations in low-corporate-tax jurisdictions with an associated competitive pressure on high-corporate-tax states to reduce their rates. In theory, this dynamic could be countered by an international agreement on a minimum corporate tax rate (and associated income classifications), but because so many states are now actively attracting international business with low but widely varying rates, this appears to be a non-starter. This view suggests that corporate income tax rates and ultimately receipts will simply erode globally.¹⁰

⁸The "messiness" comes in part from the unevenness of profit rates across industries, but firms in the same industry can be expected to be drawn to locations where taxes are lower, all else being equal. The extent of this tendency is an empirical issue — just what Hines among others has been investigating.

⁹"Active" here is contrasted with "passive" income from noncontrolling financial investment; the latter is taxed by most non-U.S. home governments as well.

¹⁰This has not happened yet in the high-income countries. While rates have dropped, a broadening of the corporate tax base has sustained or increased revenues in most rich countries

(Footnote continued on next page.)

⁶Getting rid of the corporate income tax does not imply a lower tax rate on those with high incomes; without the corporate layer, the tax rate could be geared to each shareholder's economic circumstances.

⁷Some of the impact of the tax falls on profits (rent), but this also reduces the amount to be bargained over with organized labor (Arulampalam, Devereux, and Maffini, 2009; Alison and Hines, 2009).

Under the current international corporate tax regime anchored by the OECD model tax treaty and transfer pricing guidelines, transactions among affiliates are to mimic the prices of unrelated firms. These prices are difficult to estimate for many reasons, and extensive research has unsurprisingly established that firms have wide latitude in transfer pricing to accumulate profits in affiliates located in low-corporate-tax areas.¹¹ Intra-firm discretion also tempts firms to finance subsidiaries in high-corporate-tax jurisdictions with minimal equity and large debts to affiliates in low-tax jurisdictions. A third well-documented practice involves the migration of intellectual property from high-tax to low-tax areas (Slemrod, 2010).

What does current practice imply for the national welfare of various states? The United States could increase its competitive advantage in foreign markets by exempting foreign-earned income. This would accelerate foreign investment by U.S. firms. This outflow, accompanied by lower tax receipts, could lead to lower American welfare, and some analysts believe that it would (Gravelle, 2010). But the matter is vexed empirically, and many economists believe that it would generate more world earnings from the unique assets that U.S. firms already possess than it would cost in an immediately reduced capital stock. Indeed, Hines presents evidence that increased capital outflows accompany greater overall firm success and also result in greater capital investment at home (p. 117). A similar presumption about some of these factors likely underlay the exemption of foreign earnings by European states, including those governed by Social Democrats, for decades before there was substantial evidence to support a beneficial impact of outgoing direct investment (Bergsten, Horst, and Moran, 1978: 38-40).

Since a majority of high-income countries already exempt foreign corporate income directly related to a firm's operations abroad, a central question is whether the level of corporate income taxes prevailing within their own territory retards capital accumulation by driving capital abroad or failing to attract it. Hines (2005: 5) has reviewed research by several investigators, including himself. Most of the studies find a tax elasticity greater than 1: A 10 percent (not percentage point) increase in the corporate income tax rate reduces capital investment by at least 10 percent. This mechanism suggests a possibly important role for tax havens: The ability of firms to siphon part of what would otherwise register as higher profits out of a

(Auerbach, 2006). Revenues have dropped in developing countries (Keen and Simone, 2004). There is the alternative of some kind of formula apportionment to be discussed later in this article.

¹¹Some states are stricter about the use of tax havens as mere switching stations than is the U.S., so comparing international corporate tax burdens by across states is difficult. See Avi-Yonah, 2009.

high-corporate-tax jurisdiction partially offsets what could be the negative impact of the tax on discouraging the presence of mobile corporate capital in the first place. This allows governments to collect more tax revenue than they would otherwise from the same capital stock by allowing for an effectively higher tax rate on immobile capital. In sharp contrast, Shaxson claims — with no supporting evidence — that “corporate tax rates are a relatively minor factor in business location in most areas of business” (p. 160).

Both Hines and Shaxson declare a special interest in the welfare of developing countries. One study cited by Hines suggests that developing countries attract more foreign investment when tax havens are nearby than they would otherwise (Blanco and Rogers, 2009). But even if the quantitative estimates of this study are accepted, any inference of a favorable impact on tax havens on development would be inappropriate. The empirical work does not establish what price in corporate tax revenue a jurisdiction might pay for such an increase in foreign direct investment (FDI) inflow. Moreover, the results do not take into account the phenomenon of “round tripping,” which involves domestic investors that use tax havens to disguise true ownership in order to take advantage of various incentives offered to foreign investors. This phenomenon looms large in FDI in both India and China and has caused recent Indian revisions in its tax treaty with its most proximate tax haven, Mauritius.

Putting the round-tripping argument aside, outsiders have seen a chronic shortage of profitable investment opportunities in many low-income countries; this suggests that a lowering of the effective tax rate on FDI is not likely to draw much additional activity. Much of the FDI in very poor countries is connected with resource extraction, and the taxes due are geared to the profitability of specific projects. Is the pro-haven argument really that more is invested because resource rents are divided less favorably with the host country? It is more likely that the availability of tax havens to multinational corporations often increases the difficulty of effectively taxing a limited set of activities that respond little to the tax rate.

Because Hines focuses on the tax haven role in reducing corporate taxes, he largely misses their importance for capital flight and other outflows at the behest of residents of low-income countries. Poor countries often have exchange controls and other legal limitations on capital outflows that Hines does not mention. Whether such controls contribute to or detract from economic development is certainly open to debate. When Indians illegally move their money abroad, however, the critical tax haven function is secrecy, and, despite the impression left by Hines, the secrecy problem is far from being solved.

Hines also reports evidence suggesting the positive effect of tax havens on banking and financial service competition, with the accompanying observation that

“countries with monopolized banking sectors, and accompanying underdeveloped financial sectors, exhibit slow rates of productivity growth and low per capita incomes” (p. 114). But other means for increasing competition in the local banking sector are not considered, and the significance of any tax havens in abetting the violation of domestic law is ignored.

Hines’s arguments and evidence deserve to be seriously considered: In large part he sees tax havens as useful devices that essentially protect governments from themselves — or perhaps citizens from their governments. This is only one perspective, but it cannot be dismissed in a world in which less than half of the population lives in a democracy and in which high levels of corruption dominate the policy environment for many more.

Hines is a proponent of a new perspective on the international corporate income tax called “capital ownership neutrality” (Devereux, 1990; Desai and Hines, 2003). This perspective, developed to consider the contemporary world in which both real and financial investments are highly mobile, suggests that the most appropriate welfare yardstick for the application of the corporate tax is whether the most efficient sets of global factors can compete for a market without impediment. This criterion highlights the state’s long-term strategic tax challenge. Much of a jurisdiction’s differentially high corporate income tax burden will ultimately be avoided through competition-driven mobility: some combination of real capital departure, reincorporation, and firm-level competition.

Shaxson gives little attention to the general phenomenon of corporate tax competition beyond strong disapproval of those who respond to it. At the end of the book, he suggests consideration of formula apportionment of the corporate tax internationally (p. 227). A firm’s worldwide activity would be considered with a formula that apportions the corporate tax base across states on the basis of national shares of the firm’s sales, employment, and property, much as now done subnationally in the U.S. and Canada.¹² Because most tax havens scarcely register in these dimensions, their role would collapse, which Shaxson applauds. But such a change would still leave most of the negative elements of the corporate tax intact and would not retard, nor halt, corporate tax competition. It would likely add distortions of its own as some of Hines’s research has shown (Hines, 2009). Moreover, even some of the early proponents of international formula apportionment now doubt if either a unilateral or multilateral shift is feasible (Avi-Yonah and Benshalom, 2010). Corporate tax competition will almost certainly continue, and nearly all states rich and poor seek FDI flows. They ignore Hines’s arguments and evidence at their peril.

¹²Various alternatives along these lines are now being considered within the EU.

Tax Evasion

Hines’s view of the tax havens as a kind of ameliorating institution that may partly protect both rich and poor countries alike from their own corporate tax policy follies will leave many readers unpersuaded. Another aspect of Hines’s account, his almost total inattention to the use of tax havens for the evasion of personal income taxes, will strike many more readers as inadequate. He makes two arguments. First, the evidence available is “anecdotal” (p. 104), and second, whatever problems have existed until recently are being sorted out by the OECD and the G-20. The main evidence for his apparent optimism seems to be Jason Sharman’s (2010; 2011) highly original investigation that found it easier to form opaque business entities and open bank accounts in the U.S. and the U.K. than in several well-known havens. But that scarcely puts the matter to rest. The most important issue is not *differential* difficulty across jurisdictions but overall difficulty for agents determined to cover their tracks. The problem everywhere remains effective policy.

If one is seeking anecdotal evidence for evasion, Shaxson’s book offers plenty. It also presents an indictment of high-income states and their policies that is so broad that specific argument is sometimes hard to pin down. Nevertheless, the book also reports some quantitative estimates related to tax evasion that seem never to have been effectively criticized. There are estimates of the offshore wealth holding of “high net worth individuals”; these, along with estimated rates of return and applicable tax rates, can produce a range of personal tax losses. What results is obviously only approximate, but the Tax Justice Network’s estimate of worldwide losses at \$255 billion early in the new century appears reasonable. This implies about \$33 billion for the U.S. alone (Gravelle, 2009: 22). This is a considerable figure and is likely much higher now. But, even if it stayed the same, the number represents about 10.4 percent of total individual income taxes paid by the top 1 percent of all payers in the United States in 2009 or 6.5 percent of all payments by the top 5 percent (Tax Foundation, 2011).

Shaxson’s account is particularly detailed in its indictment of U.S. and British policy that for decades sought to promote investments that were known to be largely undertaken to avoid domestic taxation in other jurisdictions. Shaxson explains in detail how the Caribbean tax havens served as feeder stations for funds transmitted through London to the benefit of the City of London’s prosperity as a financial center. The U.S. succumbed to a parallel temptation in the 1980s when the need to finance an ever-growing national debt led the Reagan administration successfully to allow tax-free investment in U.S. government securities, although bank interest had been similarly tax free since 1924 (as it had been in many other countries as well). Similarly, the United States separated its concern that its own citizens not escape the

IRS by developing a system of the “qualified intermediaries” in foreign financial institutions to certify that accounts were not owned by Americans. This left anonymous tax-free access to the U.S. financial market for all manner of foreign investors.

Shaxson’s account of many of these developments is particularly detailed and clear, and it puts the U.S. and U.K. policy in the same light as Austria, Belgium, and Liechtenstein vis-à-vis the rest of Europe before the EU insisted on either information exchange or withholding on foreign interest as part of the EU savings directive. The general lesson is important, if expected: A state will put almost no weight on the welfare of other states in designing its foreign economic policy unless led to do so by reciprocity or imposition.¹³ Moreover, in the present case, whoever first takes advantage of the gains of not asking questions of foreign depositors sets in motion a prisoner’s dilemma dynamic that only an explicit agreement is likely to turn around. Blocking the inflow into one capital market simply increases the attraction of others.

Shaxson says repeatedly that “secrecy is the problem,” but the term gets used in various ways that appear to extend all the way to the ubiquitous smoke-filled room. More fundamentally, the book attacks with seemingly uniform indignation policies rendered ineffective by coordination problems, policies that are insufficiently generous to other states, policies that place the national interest ahead of foreign interests, policies that put foreign (or outside interests) ahead of national (or local) interests, and policies that serve one internal group at the expense of the welfare of the whole — or perhaps just benefit one group disproportionately. For example, those persuaded by Shaxson’s relentless and unqualified attack on the City of London need reminding that it is the center of what *The Economist* describes as “Britain’s most successful industry: its biggest exporter, taxpayer and provider of well-paid jobs” (*The Economist*, 2012). Similarly, he seems to argue both that the inflow of anonymous capital was not really a benefit for the U.S.¹⁴ and that the benefit came at the expense of others.¹⁵ And he

is never clear about whether the typical citizen of Delaware benefits from its dodgy incorporation laws.

The citizen of a jurisdiction can gain from incoming financial activity for two quite different reasons. A substantial inflow of real capital will raise the area’s total product independent of fees or taxes. Alternatively, a financial inflow may do little to increase the jurisdiction’s product but it may simply generate government revenue. Or it may do both. In either case there is, in principle, more for an average citizen regardless of to whom the income first accrues. This is, of course, formal economic reasoning, but it is important for sorting out the general from special interests, as well as clashes and potential complementarities, among jurisdictions.¹⁶ In Shaxson’s account no one really gains from the behavior he associates with tax havens except a small group wearing black hats. This continually entertains, but it can impede analysis.

State Size and Policy

Much policy in states such as the U.K., U.S., and Switzerland aims to treat citizens differently from foreigners. But both Hines and Shaxson also deal with the particular incentives facing relatively small jurisdictions that must, or otherwise do, treat foreign and domestic economic agents with similar rules; neither develops the implications fully. Not surprisingly, the implication of Shaxson’s account stresses the special qualities of being absolutely small: a tendency for special interests to get their way because the opposition is thin and the number of opposing agents can be more easily bamboozled or bought off — the Caymans, Delaware, and Jersey are favorite examples. But however unattractive his picture of the associated politics, Shaxson fails to emphasize enough that the real reason there is so little resistance may be rational self-interest of those not directly making the decisions while still benefiting from them.

Shaxson writes that a tax haven is “captured by financial interests from elsewhere” (p. 201), but he produces copious evidence that “capture” may play little role in the basic mechanism. The logic facing a relatively small actor in each case is the same. The benefit of a policy is the total increase in nominal activity drawn to the low-tax (or lax regulation) jurisdiction. Because the amount of nominal activity that can be booked typically bears no relation to the size of the enticing jurisdiction, the potential per capita benefits linked to a small gain per unit of that volume may be huge, while the only per capita costs are those of

¹³Or possibly shame. This ignores the sacrifices involved to enhance or maintain hegemony; the present case involves no such stakes. In the U.S. case, it has soured relations with many governments, particularly in Latin America.

¹⁴“The inflows have made matters worse for ordinary U.S. taxpayers” apparently because they “delivered massive rewards to a small financial elite, while helping Wall Street to gain its too-big-to-fail stranglehold on the U.S. economy and the politicians in Washington” (p. 21). If the promotion of such inflows kept interest rates low and a higher value for the dollar, the policy could be judged unwise, but it did not lead in any direct way to a cost to the U.S. taxpayer.

¹⁵In discussing capital flight, a component of capital inflow to the U.S., he quotes Raymond Baker as concluding that “for every dollar that we have been generously handing out across the top of the table, we in the West have been taking back some \$10 of illicit money under the table” (p. 29).

¹⁶For example, if the U.S. national interest is increasingly seen to involve cooperation to effectively remove account secrecy in general as part of a global bargain to decrease tax evasion, but the citizens of Wyoming and Delaware see benefit from the status quo, the U.S. government can invoke federal supremacy — but perhaps at considerable political cost. Such legislation has been introduced by Rep. Barney Frank, D-Mass.

adopting the same policies locally (and sometimes even that is not necessary). For example, however large the volume of incoming financial investment resulting from a zero corporate income tax, the price paid in forgone corporate income taxes goes up only with the volume of indigenous corporate activity. This mechanism is hinted at in Shaxson's account, but it is buried in more colorful, but less relevant, material on local corruption and lack of democratic participation.

Hines presents a very different picture by making much of the apparently high quality of tax haven governance and stating flatly that "there are almost no poorly governed tax havens" (p. 118). The external significance of reliable governance is understandable; a lot of money is at stake. Hines also notes that the traditional havens score high on "voice and accountability." But why should the natives be restless? To the extent that the traditional tax havens succeed, they are a variety of *rentier* state; the asset providing the rent is sovereignty itself¹⁷ intersecting with a credible commitment to dependability and discretion.

Despite his emphasis on relative rather than absolute size, Hines's treatment of the size dynamic does not come through clearly either. He places the explanatory power for low haven taxes on the highly elastic supply curves for outside capital that they face as relatively small actors in the global economy without emphasizing enough how little real capital gets invested in the jurisdictions levying the low taxes. They are just getting a very small payment for a huge volume of funds that come in one door and out the other. For example, the 2004 ratio of U.S. property, plant, and equipment investment to total U.S. investment across all countries is 8.8 percent, but in the 24 tax havens listed by Hines it is 2.1 percent, and in the U.K. island category that includes the Caymans, it is only 0.7 percent. What is real is barely a whiff of what is assigned. If it were suggested that the elaborate activity underlying such a figure represents resource-wasting monkey business, Hines might respond that it is unfortunately necessitated by the crazy quilt of corporate tax regulations that may disappear in importance with the tax itself.

Is Economic Globalization Good?

The follies of the corporate income tax and the ingenuity of various agents to minimize its impact on them provide the central theme of "Treasure Islands." And the article offers no view about personal taxes and the problems of collecting them beyond the suggestion that the OECD is cleaning things up. Overall, it seems

¹⁷In fact, local legal discretion would be a better term than sovereignty. As Shaxson cogently explains, many of the most important havens are still subject to some degree of British jurisdiction. And within the U.S. — although this may be changing — state control of business law has led to various kinds of opportunism.

fair to conclude that Hines approves of economic globalization and the role of tax havens in it. Moreover, his expressed preference elsewhere for a progressive spending (consumption) tax would, if legacies were exempt, largely remove the threat of the secrecy havens — but only for the United States.¹⁸

In most of *Treasure Islands*, Shaxson offers little comment about specific taxes except to decry the evasion and avoidance of them.¹⁹ His view of an appropriate global economy is far from clear. Much of this can be attributed to the historical approach to globalization in which "offshore" has indeed played an important role. This leads to a failure to distinguish between the connection of co-development and a "but for" argument. The book is rife with documented association that seems to imply more than is actually demonstrated. Offshore by a variety of definitions may be hopelessly mired in much of what is objectionable about globalization, but that is a completely different argument from a claim that doing away with the offshore system would remarkably change the world.

Secrecy, profit shifting across jurisdictions, offshore banking, capital mobility, and prudential financial regulation are each important subjects that challenge national policy and international cooperation. But *Treasure Islands* is written as if their colorful and often sordid overlap matters more than their distinctive characteristics. This impedes thinking about the content of effective reform and the varying sets of undeniably powerful interests that oppose specific policy changes. The book tends to find an essential connection in every connection. And, while *Treasure Islands* is meant to be popular, Shaxson's boldest statements are often supported only by vivid anecdotes or somebody's personal opinion.

The bare bones of Shaxson's globalization history runs like this. Bretton Woods coincided with the "golden age of capitalism," and this golden age featured a heavy use of controls on capital movements. "Offshore," specifically dollar-denominated deposits in Europe, grew largely to work around those controls. Since the end of Bretton Woods, capital has moved ever more freely and, at the same time, growth has slowed and income inequality has increased (pp. 59-60). Although he qualifies this and similar observations by noting that other factors played a role, he seems to imply that they merely modify his argument rather than largely displacing it.²⁰

The thrust of Shaxson's story is that capital mobility and "financial globalization" are really the villains.

¹⁸Hines also attacks inequality: "We are a land of great inequality; how might it be transformed into a land of greater redistribution?" (McCaffery and Hines, 2010: 77).

¹⁹He suggests a land value tax at one point (pp. 224-225), but this appears incidental to the narrative.

²⁰On Europe's productivity slowdown, for example, see Eichengreen, 2006: 1-14.

Interestingly, in his policy recommendations at the end, he does not propose turning this around but merely making it work better. And this is to Shaxson's credit because despite his apparent admiration for Keynes's more autarkic ideas,²¹ he acknowledges that Keynes "passionately believed in markets and trade" (p. 51). Shaxson notes rightly that Keynes favored capital controls in the early postwar period of foreign exchange scarcity and fixed exchange rates. But as international production and trade have grown in volume and complexity unimagined by Keynes, so too has the demand and supply for transnational finance. Shaxson never makes clear just how much capital mobility he thinks should be permitted.

Capital Mobility and Poor Countries

Shaxson has far more space to consider the situation of developing countries than does Hines. Shaxson consistently sees capital mobility as a threat, but he draws no distinction between financial and real capital flows or between real capital flows and direct investment.²² He supports his skeptical view of the importance of capital inflows for growth with research by Rodrik and Subramanian (2008). But that study concerns the macroeconomic stability implications of unrestricted financial flows, which the authors sharply distinguish from FDI:

FDI is first and foremost a real transaction, involving the transfer of technology and skills, and we would agree that this is highly desirable for developing countries. But this real transfer may or may not be accompanied by a capital inflow. [Rodrik and Subramanian, 2008: 17.]

In fact, most FDI into low-income countries for substantial real activity does involve capital flow, and restrictions on the type and volume of financing are among those elements of national policy that Moran (2011) links to a reduction in FDI's growth impact.

Shaxson is understandably concerned with capital flight. Hines says nothing about this very important subject. How is this possible given the huge role that tax havens have been demonstrated to play in the departure of capital from low-income countries? A less than persuasive answer could be that much capital flight need not involve the traditional havens, and that their existence merely exacerbates the problem. But Hines never mentions capital controls either. Such controls are pervasive in low-income countries, and transfer price manipulation and trade mispricing are impor-

tant devices used to get money out. Recent estimates of the huge volume of capital outflows from low-income countries has been contested for accuracy (Fuest and Riedel, 2009), but it is hard to find a serious argument that such flows are not very substantial. The flows are variously motivated; Raymond Baker of Global Financial Integrity estimates that about 65 percent of estimated illicit outflows are for tax evasion and that much of this is through the transfer pricing policies of major multinationals.

According to Shaxson, poverty in Africa "cannot be understood" without considering the role of "offshore" (p. 131). African poverty appears highly resilient, and while the absence of foreign havens for kleptocrats should be a plus on all counts, observers can and do differ on the plausibility of various counterfactuals. Dictators and elites could well have wasted vastly more resources locally without an important difference in either poverty reduction or development. There is an attractive alternative scenario in which the absence of a capital flight option successfully focuses the attention of the most capable on local development, but so far that appears to exist mainly as a logical possibility.²³ Shaxson suggests:

Imagine if those elites had to keep their money bottled up at home, or at least account for their wealth, pay appropriate taxes on it, and submit to appropriate laws. Very soon they would understand why good government is directly in their interest. [P. 144.]

But it would take good government — or better government than scores of states now have — to develop and honestly administer "appropriate" taxes and laws in the first place. In fact, extraordinary levels of corruption have abetted capital flight, but they have also often maintained a social and economic environment of limited absorptive capacity for investment — both foreign and domestic. Some of the same scholars who decry capital flight have also documented this problem (for example, Ndikumana, 2006). And only a dramatic improvement in the investment climate could lure back the huge part of capital flight not regarded as criminal (Fofack and Ndikumana, 2009). Paul Collier has argued that before such an investment climate and infrastructural improvement, African countries should use their resource revenues to invest abroad: "When capacity is built, only then do you invest at home" (Collier, 2011). Therefore, a large part of responsibly marshaled resources might still not immediately be used to alleviate poverty. Indeed, the institutions of financial globalization could facilitate the gain of highest earnings abroad (Dixon and Monk, 2011).

²¹Some were penned in the depths of the Depression. See Keynes, 1933.

²²This leads to a bewildering claim that eliminating the double taxation of corporation profits did not increase international efficiency because it bolstered the offshore system (p. 130). Whatever Shaxson intends, this conflates real and financial capital mobility.

²³For example, see Torvik, 2009.

Additional Issues

Shaxson claims that “towering inequalities in the United States and Europe . . . cannot be understood properly without exploring the role of secrecy jurisdictions” (p. 131). Hines’s evidence, however, suggests that it is quite possible that the corporate tax discrimination facilitated by the tax havens has served to maintain the corporate tax receipts of high-income countries. And, however outrageous offshore tax evasion is by the very rich, it cannot be more than a minor factor among the causes of growing inequality within the developed states. This is true both because that inequality is largely manifest in before-tax earnings and because the amount of forgone revenue, however used, could not shift inequality substantially.²⁴

Shaxson considers the appropriateness of shoring up individual income tax collection in low-income countries through the sharing of tax information. Many of these states are not democratic, and even many nominal democracies are rife with corruption in all areas of public policy, including tax collection and expenditure. This raises a possible conflict between the state and its citizens. Shaxson considers such arguments, but he seems to dismiss them as secondary to the state’s need for revenue. He suggests only unspecified “appropriate safeguards” (p. 222). He offers no criteria to decide which governments — if any — would be bad enough to be ineligible for automatic exchange of tax information.

Finally, Shaxson wants to tie the most recent financial collapse to “offshore.” Many observers have noted that some of the lack of transparency and regulatory laxity in the havens may have played some role in worsening the global financial crisis, but Shaxson tells the “shadow banking” story in a way that puts the havens right in the middle. The shadow banking system is the marriage of short-term borrowing and lending outside traditional banking channels that made the system extraordinarily vulnerable to shocks (Shin, 2011a). Paul Volcker (2011) places the blame squarely on inadequate regulation in the rich countries without mention of “the offshore world.” His account of shadow banking implies that absent onshore regulatory changes that are entirely feasible with the traditional havens in place, the global financial system would be little changed in vulnerability if the havens disappeared tomorrow.²⁵

The accepted meaning of “offshore banking” is simply the foreign operations of a bank while “offshore

deposits” refer to deposits made in a currency that is not the local money where the bank takes the deposit. The economic globalization that Shaxson seems ultimately to accept depends on some form of multinational banking. Unfortunately, national opportunism (Shin, 2011b), various asymmetries, and a large number of states render satisfactory cooperation difficult. In particular, states benefit from the profits of their bank branches in other countries where excess leverage and other risky practices can pose macroeconomic danger far removed from the permissive state — with ensuing disasters underwritten by foreign taxpayers.

After all of the purple, if very artful, prose, many readers will be surprised that Shaxson’s specific policy recommendations concerning economic globalization are moderate²⁶ and that some of the better ones may be closer to acceptance than when the book appeared. He gives very rough treatment to the OECD’s Harmful Tax Practices program that succeeded in gaining commitments for information sharing from the traditional tax havens for the first time over the past decade (“the crackdown has turned out to be a whitewash,” p. 10). But the project has been bolstered by the imprimatur of the G-20; automatic information exchange is now being openly considered as part of a model treaty, and another of Shaxson’s priorities, country-by-country corporate reporting, has also seen increased support.

Shaxson’s attempt to put “offshore” at the center of the world’s economic ills can be detached from his basic message about secrecy. He makes no convincing case that the pattern of production, real investment, trade, or living standards in most of the world would be substantially different if the specific reforms he advocates were adopted. But such claims are unnecessary. It is enough to have documented the damage allowed by the secrecy practices of the past — and to a very great extent the present as well. If the book gives added impetus to their removal, it will have done much good.

Two Valuable Contributions

Both views of the Treasure Islands present important evidence and persuasive argument — but mainly about different matters. In fact, despite their contrasting tone and posture toward tax havens, they present largely complementary accounts. Hines brings together and evaluates a broad range of research on the role of tax havens in the behavioral and policy contortions

²⁴Shaxson blames lowered personal tax rates for increasing inequality, but he never tries to link this to the offshore system.

²⁵Shaxson cites one piece of research by the IMF to defend his position on the financial crisis. Among a series of practices that contributed to vulnerability, the study cites excessively leveraged subsidiaries that borrow from low-tax jurisdictions to shift profits away from those with higher taxes, but the importance of this phenomenon is not estimated (IMF, 2009).

²⁶Shaxson’s suggestion for a land tax has nothing directly to do with the subject of the book. By most accepted criteria such a tax would be inferior to a general wealth tax. On the other hand, his endorsement of a financial transactions tax, while viewed with great skepticism by many experts, is unremarkable. It seeks financial stability and, if introduced widely, which is likely impossible, could have some moderating effect on financial flows, albeit with probably highly regressive incidence (Johnson, 2010; Rogoff, 2011).

resulting from the corporate income tax. Shaxson documents the damage caused by financial secrecy and makes clear that efforts to reduce tax evasion have so far been woefully inadequate. The value of both accounts drops rapidly as they depart from their central messages.

Secrecy in the service of tax evasion finds few defenders, but the corporate income tax also has few supporters among those who have seriously considered the subject. In particular, evaluating the corporate income tax (or any other tax) simply on the basis of how much gets collected and unwarranted assumptions about who bears the burden provides a terrible guide to policy.

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