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Doing away with tax havens—good or bad?

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People often object to multinational corporations' shifting profits to so-called tax havens, or locations that allow companies to reduce their corporate tax burden. Such practice, the critics argue, deprives countries from revenue and hurts their taxpayers. Few, however, have asked whether legislative and policy initiatives that limit opportunities for profit shifting have negative impacts on domestic economic activity and labor market outcomes. In a recent article titled "Unintended consequences of eliminating tax havens" (National Bureau of Economic Research, July 2018), economist Juan Carlos Suárez Serrato makes the case that such impacts do exist, and that they are sizable.

Serrato's study takes advantage of a natural experiment, examining the economic effects of the 1996 repeal of Section 936 of the Internal Revenue Code, a legislative move that eventually ended the opportunity for corporate profit shifting to tax-exempt affiliates in Puerto Rico (a U.S. territory treated as a foreign country in the analysis). The author derives his theoretical predictions from a model in which, because of cross-country tax differentials and tax complementarities, restricting access to tax heavens is posited as an effective increase in the cost of firm investment in the domestic (high-tax) economy. The model expects that placing barriers to profit shifting would stifle investment and employment, while encouraging affected firms to move money to low-tax locations abroad.

Using firm-level data, the author finds that these predictions mirror what unfolded in the aftermath of Section 936's repeal. Multinationals that lost the flexibility previously afforded by the section's provisions reduced global investment by 23 percent and domestic investment by 38 percent, while increasing their share of foreign investment by 17.5 percent. Domestic employment suffered as well, with affected firms shedding about 1 million jobs, an employment decline of 9.1 percent. What is more, these impacts were uneven across geography, with U.S. locations that hosted a greater number of affected firms being particularly hard hit in terms of economic growth, tax revenue, employment, wages, and real estate prices.

Serrato recognizes the possibility that the overall benefits accrued to taxpayers from policies that limit profit shifting may outweigh the economic costs of reduced investment. Still, his study challenges the one-sided view that doing away with tax havens is always a good strategy. What is needed, the author argues, is a more nuanced analysis of the unintended consequences of such policies, with special attention to region-specific impacts. To the extent that countries embark on initiatives that limit profit shifting, they should do so multilaterally, an approach already championed in proposals made by both academics and international organizations.