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The Effects of Corporate Tax Rates and Foreign Investment on Unemployment in Tax Haven Nations

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Abstract

Corporate tax haven nations are infamous for offering corporations lower tax rates so that they can operate at lower costs and increase their profits. How the tax policies of tax havens impact the citizens of those nations is seldom discussed. This paper aims to determine if the policies undertaken by tax havens to increase foreign investment benefit the welfare of the citizens of those nations in terms of employment rate. Using a small preliminary sample of havens and non-havens, an inverse relationship is observed between corporate tax rate and foreign direct investment, and corporate tax rate and employment. A larger sample was used to run a regression between unemployment and our other variables, and no significant relationship was observed. The lack of a relationship shows that lowering corporate tax rates with the intent of increasing foreign investment in tax haven nations will not have an impact on employment levels in that nation.

Introduction

Offshore financial centers (more commonly known as tax havens) have built themselves a negative perception that has been highlighted in recent years by journalistic exposures of financial records such as the release of the Panama Papers (Fitzgibbon, 2022). Much of the activity revealed in these records pertains to the management of personal wealth, but the debate over what to do about tax havens has often focused on the use of offshore financial facilities for corporate tax avoidance.

Secrecy and complexity play a large role in tax avoidance, but the basic mechanics of corporate tax havens is clear. As one standard definition puts it:

> [these] countries offer low tax rates in the belief that, by doing so, they attract greater investment and economic activity than would otherwise have been forthcoming. Countries with low tax rates permit investors to retain most of their locally earned pre-tax income; other considerations equal, therefore, countries with lower tax rates should be expected to offer a broader range of attractive opportunities, and therefore draw larger volumes of foreign investment, than countries with higher tax rates (Hines, 2008).

Thus, from one point of view, countries that intentionally lower their lower tax rates for corporations are simply competing with other nations for foreign direct investment (FDI) which is defined as cross-border investment in which a foreign entity establishes or invests into a long-lasting enterprise in another nation (OECD iLibrary, 2022). When given the opportunity to establish headquarters in a region with lower tax rates, many international entities would take advantage of this opportunity since it is an easy and effective way to reduce the amount of taxes they pay and therefore increase profits. So much so, that out of the largest two hundred

international companies in the world, about 90% of them have some presence in a tax haven (Oxfam International, 2019).

The negative perception of corporate tax havens comes from the idea that some nations are missing out on important tax revenue from these corporate entities that have moved their headquarters from their nation to another, tax-friendly nation (Oxfam International, 2019; Fitzgibbon and Hallman, 2020). Tax havens also have a reputation of permitting or even abetting criminal activity, with wealthy individuals and corrupt corporations hiding or funneling money through them to evade taxes and launder illegally earned money. While this can be true, when nations create tax-friendly environments, it can help to foster development of industries within those nations, and some research suggesting they can have a positive impact on the economies of surrounding nations (Hines, 2004).

One thing that is rarely discussed in the mainstream media is how, if at all, tax havens benefit the actual citizens of those nations. The decision by a government to lower their tax rates for corporations might have very few immediate direct effects on the nation's citizens since they pay different taxes, such as personal income tax which is taxed at a different rate. But when corporations begin to move their operations to tax havens to avoid high corporate tax rates, and international investors begin investing in entities in these nations, it becomes more likely that these citizens would experience at least some sort of change in welfare.

The question that this research seeks to answer is, "Does foreign investment in a nation due to their low corporate tax rate or tax haven status, improve the quality of life for the citizens of that country?" A deep dive into foreign direct investment data, corporate tax rates, and unemployment data will be used to determine if there is a relationship between these variables. If a positive or negative relationship is observed, it could show that becoming a tax haven can have

positive or negative impacts on the employment levels of the citizens of that country. If no relationship is found, then it would show that a tax haven's corporate tax rate or foreign direct investment has a minimal impact on the nation's unemployment level. This research builds on multiple previous works exploring the downfalls and benefits of tax havens on nations; it will make it possible to identify what policy implications are indicated by its results.

Literature Review

The literature on tax havens and foreign investment is extensive, with many authors searching for relationships between employment and foreign investment, as well as determining effects of both on other factors.

Dharmapala and Hines (2009) examines factors that influence nations to become tax havens. This paper gives a good understanding as to what a tax haven is and gives a list of the top tax havens in the world. This paper uses data from 37 different international, non-profit, private, and university datasets, specifically related to the gross domestic product (GDP) of the nation, and the governance quality of the nations. The authors find that nation's that are small, affluent, and have a high quality of governance are the most likely to be considered tax havens.

Inflows of foreign capital are categorized under two headings: FDI and FPI (foreign portfolio investment). Humanicki et al. (2017) explores the relationship between FDI and FPI and whether they are similar enough to be considered substitutes, or if they should still be considered independent measures of capital flows. FDI and FPI data is collected only from Poland and analysis is conducted for the years 2002-2013. Previous literature cited in this paper claim FDI to be a longer-term investment with the intention of growing the nation's GDP while FPI is considered to be "hot money" and is more liquid. The authors find that there is a strong

and significant substitutability between the two variables. While this analysis is only preliminary, it is still interesting since FDI and FPI have generally been treated as two distinct flows.

Wu, Li, Selover (2012) attempts to explore the effect a nation's governance environment has on foreign direct and portfolio investment. The paper focuses on three different levels of a nation's governance, "rule-based," where people rely on laws and government regulations, "relation-based," which is more informal and relies more on public laws and informal networks, and "family-based" governance environments, which have a very low level of generalized trust within the community at large. The authors use data from the World Bank, International Monetary Fund, Freedom House, and the World Value Survey. The study determines that family-based and relation-based countries tend to attract more FDI as opposed to FPI since investors try to be more involved in the management of their investments in these nations. While there are many other variables at play, governance environment is determined to be an important factor in the type of foreign investment that a nation attracts. Since according to Dharmapala and Hines (2009) tax havens are generally well governed, it makes sense that these nations are more likely to be bringing in large amounts of FDI.

Sahu (2021) examines how foreign direct investment can impact a developing nation's economic growth. The paper uses data collected from the United Nations Conference on Trade and Development and the World Bank for 45 developing nations for the period 1990-2014. The authors determine FDI to have a significant positive impact on the economic growth of developing nations and that it is more important for these developing nations than it is for developed nations. They also find that the two key factors behind the economic growth of developed countries are the natural recourses available and the quality of the political regime.

This paper does not examine factors of growth or improvement for individual citizen's welfare, only for growth of the nation's economy.

Levine (2012) explores the relationship between economic growth and unemployment, unemployment during post-war periods, and the outlook for unemployment in the United States. This research finds that there is little to no relationship between these two variables in the short run, but in the long run there appears to be an inverse relationship between GDP growth and unemployment. The author relates this to a very famous and well-accepted concept in economics known as Okun's Law. Okun's law states that there is a negative relationship between a nation's unemployment rate and its real economic growth rate. The general rule of thumb for this law is that a 1% decrease in unemployment is associated with real GDP growing at a 2% faster rate than the potential GDP (Sharkey, 2022).

Johnny, Timipere, Krokeme, & Markjackson (2018) uses data from The Central Bank of Nigeria, the National Bureau of Statistics, the World Bank and other secondary sources from the years 1980-2015 to try and determine if foreign direct investment or capital formation has an impact on unemployment in Nigeria. The authors determined that FDI has a negative but insignificant impact on unemployment, and capital formation has a significant positive relationship. Other variables that were observed in this study include exchange rate, trade openness, interest rate, and total factor productivity. This paper is only a preliminary analysis since Nigeria is the only nation examined.

Singhania and Saini (2018) investigates the determinants of FPI in both developed and developing nations. The study uses Bloomberg panel data from 19 countries from the years 2004-2013 to determine which factors have the strongest impact on FPI. Factors observed in this study include FPI as a percent of GDP, GDP growth, imports to reserve ratio, interest rate

differential, trade openness, freedom index, stock market index, US stock market index, and exchange rate. For developed nations it was found that interest rate differential, and the stock market performance of the host country as well as the US played a large role in determining FPI flows, while for developing nations their freedom index, trade openness, interest rate differential, and stock market performance were the largest factors in determining FPI inflows.

Rose and Spiegel (2006) use data from the Coordinated Portfolio Investment Survey from 2001 and 2002 to explore how tax havens impact their surrounding nations. Some believe that offshore financial centers can have a negative impact on their surrounding economies due to the fact that local investments from those countries may be funneled into the tax haven in the form of foreign direct investment. With lower levels of domestic investment, the economies of these neighbor nations could end up being worse off. This paper finds that being within proximity of an OFC will lead to a more competitive banking sector for the local economies and can be beneficial for nearby nations. This paper does not deeply explore how tax havens impact the welfare of their own citizens.

Hines (2004) explores the economic success of tax havens and how economies with low corporate tax rates have performed. Data used in this paper comes from the Bureau of Economic Analysis and Penn World Tables. The paper suggests that tax haven economies have performed very well and have even stimulated economies of neighboring nations. The paper cites Ireland as being a nation that has gone from a low-income nation to a very prominent nation after bringing in large amount of foreign investment. The authors also find that both GDP and GNP grow at a much faster rate for tax havens than for non-tax havens of countries of similar size. Interestingly, the paper finds that government spending is about 10% lower in tax havens than it is for nations of similar size.

Data and Methodology

The data for this research was taken from several different databases. All the foreign investment data was retrieved from the International Monetary Fund's database "Balance of Payments and International Investment Positions Statistics." This dataset provides extensive data on Balance of Payments (BOP), International Investment Positions (IIP), and other financial data for IMF nations. Unemployment data was drawn from the World Bank and is calculated as a percentage of the total labor force in that nation. The data for the control variables in the second set of regressions was also drawn from the World Bank. The largest source for the corporate tax rates was a report on national and local corporate tax rates put together by Deloitte, a multinational tax, audit, and consulting firm.

The process of selecting tax havens for this research was a little more complicated since there was a variety of factors at play. The main resource used to select the nations was the "Offshore Financial Centers IMF Background Paper" (2002). This paper was prepared by the Monetary and Exchange Affairs Department and seeks to give background information on these offshore financial centers and in doing so identifies a well-researched list of offshore financial centers. The list is split into 3 groups. Group I consists of OFCs that are highly cooperative with international standards, Group II are OFCs that fall below their international financial standards, and Group III being OFCs in which there is no attempt to adhere to any set of standards.

While the IMF list is a great start, it is not perfect. Many of the nations and territories on the list are not IMF members or are regions under the control of another nation. Because of this some of them do not have the necessary data available and could not be used for this research. The goal for the regression was to collect data for ten nations in order to perform an exploratory or diagnostic test of this paper's assumptions. Four of the eight nations in Group I, (Ireland,

Luxembourg, Singapore, Switzerland) were selected since they are all IMF members with the proper data available. Bahrain, Cyprus, Mauritius, Panama, and Seychelles were listed in Groups II and III, and since the necessary data was available for these nations, they were also selected. The 10th nation that was used in the regression, Georgia, was selected due to its low corporate tax rate, as well as the consensus among experts that it is a tax haven (Offshore Protection, 2022).

A group of non-haven nations was also selected as a control group to compare against the tax-haven group. The 10 non-haven nations selected were based on their national corporate tax rate, taken from the report from Deloitte on 2022 Corporate Tax Rates. All non-haven nations selected had a national corporate tax rate of at least 25% and have a wide variety in both geographical location and economic size. The nations selected for this group were Austria, Belgium, Bolivia, New Zealand, South Africa, Columbia, Brazil, Dominican Republic, Australia, and Argentina.

The first step in the analysis of this data began with taking a subset of the data and seeing if there were any emerging patterns that could guide subsequent research or analysis. A twin-axis scatterplot was constructed with foreign direct investment and unemployment rate as the vertical axes and corporate tax rate as the horizontal axis. Switzerland, Ireland, and Luxembourg were selected out of the tax haven nations. Austria, South Africa, Columbia, and Brazil were selected out of the non-haven nations.

Following this scatterplot, OLS regressions were used for the next step of this research, and they were ran using Microsoft Excel. In the first regression that was run, unemployment was the dependent variable with foreign direct investment and corporate tax rate being the independent variables. The observations for this regression were the 10 tax haven nations. The

second regression that was run used non-haven nations as the observations, to try and determine if haven nations had stronger or weaker results compared to non-havens. After observing the results of these first two regressions, two more regressions were run with more control variables to try and see if more variables would have an impact on the results at all. The variables that were added for these regressions include: GDP per capita, total government expenditure, net government lending/borrowing, and total investment as a percent of GDP. These were the variables selected since they are known to be variables with an important impact on the economic development of nations.

Results

The first graph produced (Figure 1) was a double axis scatter plot, showing the relationship between FDI and corporate tax rate on the left-hand axis, and unemployment rate and corporate tax rate on the left-hand axis. Since this graph was not a regression and was only a preliminary look into this relationship, the full set of nations was not used. The figure shows that there exists a negative relationship between FDI and corporate tax rate. The equation for the line of best fit is ($y = -101{,}019.33x + 3{,}690{,}423.83$), indicating the negative relationship is strong. This relationship is not surprising since investors are much more likely to invest in businesses where they pay less in taxes on their profits, so nations with lower corporate tax rates would be expected to see high levels of foreign investment. The scatterplot also shows a positive relationship between unemployment and corporate tax rate with the equation for the line of best fit being ($y=0.4637x – 0.3664$). This is very interesting since it could mean that having a lower corporate tax rate can lead to a nation having a lower unemployment rate. Lower unemployment is indicative of a stronger economy and a population that is better off financially, which confirmed that, there was strong reason to move forward with the regression.

The first two regressions (Figures 2 and 3) were run with unemployment rate as the dependent variable and corporate tax rate and foreign direct investment as the independent variables. The results were as follows:

Tax Havens:

Unemployment = 3.270666739 -0.00000049568 (FDI) + 0.219144 (corporate tax rate)

Adjusted R^2: 0.133252252

Non-havens:

Unemployment = -6.3848994 -0.000004513 (FDI) + 0.5919705 (corporate tax rate)

Adjusted R^2: -0.1760617

Both regressions yielded miniscule coefficients for FDI and very small coefficients for corporate tax rate. This shows that a change in either of these variables would have an extremely small effect on the unemployment rate of each country. The results are especially small for the group of tax havens, meaning that there is even less of an effect in tax havens than there is in non-havens. The adjusted R^2 values are also extremely small, indicating that these independent variables are not strong variables for explaining unemployment. The p-values for all the coefficients are very low, showing that the values are not statistically significant.

The second two regressions (Figures 4 and 5) were the regressions that included the additional control variables (GDP per capita, total government expenditure, net government lending/borrowing, and total investment as a percentage of GDP). The results for these two regressions are as follows:

Tax Havens:

Unemployment = 3.9313594 + 0.000003329 (FDI) + 0.05244747 (corporate tax rate) – 0.000184 (GDPPC) + 0.0967244 (government expenditure) + 0.3781646 (net government lend/borrow) + 0.1140272 (total investment)

Adjusted R^2: 0.0045868

Non-Havens:

Unemployment = 106.4868226 + 0.00000867327 (FDI) – 0.946561308 (corporate tax rate) + 0.0000858968 (GDPPC) - 0.579025777 (government expenditure) + 1.692390247 (net government lend/borrow) - 2.284008795 (total investment)

Adjusted R^2: -0.155706847

These regressions resulted similar in similar outcomes, in that the coefficients for FDI and corporate tax rate are both small and statistically insignificant. The adjusted R^2 is again small and indicates these variables do not have a strong impact on unemployment. Even with more control variables, based on these regressions it appears that foreign direct investment and corporate tax rate do not have significant impacts on the unemployment of tax haven nations.

Discussion and Conclusions

The original motivation behind this paper was to try and determine if the citizens of tax haven nations see benefits from a nation's tax haven status and the foreign investment that comes with their investor-friendly tax structure, or if benefits are limited to the government entities and foreign corporations. While the first graph that was created showed some evidence of there being a loose relationship between nations with low corporate tax rates, and unemployment, the results of the regression show that there is no positive or negative relationship that exists between unemployment and corporate tax rate or foreign direct investment. Based upon this, it can be determined that when a nation lowers their corporate tax rate with the intent of bringing in

foreign capital, it may not necessarily improve the welfare of the citizens of that nation, at least in terms of employment rate.

While this research has important implications about tax havens, there are limitations to what was able to be done and the conclusions that we can draw. The sample of tax havens observed was limited to only IMF nations, limiting both the number of observations as well as which tax havens were available to be observed. There are tax havens such as the British Virgin Islands and the Cayman Islands which are technically considered territories of Great Britain and are not independent nations. These jurisdictions did not have the necessary data available, so they were not included in the regression, even though they are very important tax havens. There are also limitations since tax havens can bring in capital in other ways besides foreign direct investment. While it was determined by Humanicki et al. (2017) that foreign direct investment and foreign portfolio investment can be considered substitutes, it still could have been interesting to observe FPI, or other forms of foreign capital, to see if there are capital flows that are more important than others.

Further research on this topic is necessary to determine whether or not lowering the corporate tax rate is beneficial for the citizens in other ways. Employment level is a good metric to start with, but there are other ways to measure people's overall welfare. Some other factors of citizens' welfare that could be observed include poverty rate, happiness index, and educational attainment. By understanding how other factors such as these respond to foreign investment, one would be able to get a better sense of just how important FDI is to citizens' overall welfare.

Other research should also be done to determine how governments of tax haven nations use the tax revenue that is brought in through their tax-friendly policies. It would be interesting to see where this revenue is being allocated and could provide an interesting look into a

government's motivation for becoming a tax haven. While it is likely that different tax haven nations would increase government spending in different sectors based on the specific nation's economy and their needs, it would be interesting to observe if there are any consistencies in where the increase of tax revenue was being spent. This research could also reveal which tax havens are spending their tax revenue on things beneficial to their citizens, such as education or social services, and which are spending the revenue on things that do not benefit their citizens, such as government salaries or defense spending.

An important question to ask while looking at this research is "What policy recommendations can we make based on these findings?" This is a difficult question to answer since there isn't necessarily a policy currently being addressed in this research. Since it was determined that the amount of foreign investment a nation receives doesn't have an impact on the employment levels of nations, it could be beneficial to enact a policy in which a percentage of tax revenue from foreign businesses are reallocated to create new jobs for the local population. This could be through generating more infrastructure, building more schools, or giving stimulus money to local businesses to promote employment. This kind of policy would help to ensure that the benefits of being a tax haven nation are not exclusively kept to the government and foreign investors. There is no reason that the people of tax haven nations shouldn't see benefits from the large amount of foreign capital coming into the country.

Overall, this research continues to explore tax havens and their impact on society. Even though the regression found no significant relationship between unemployment, corporate tax rate, and foreign direct investment, this is still indicative of an important discovery. Without a relationship present, it raises the question "What benefit do lower corporate tax rates have on the people of tax haven nations?" If unemployment levels are not directly impacted by the tax

strategies of tax havens, then further research should try to uncover which ways they do benefit the people, if at all. Tax havens will continue to be an important factor in the world's economic discussions, and whether that discussion is positive or negative relies heavily on how their policies impact the people who live and work within their borders.

Figures

Figure 1: Double axis scatter plot showing FDI and Unemployment against Corporate Tax Rate

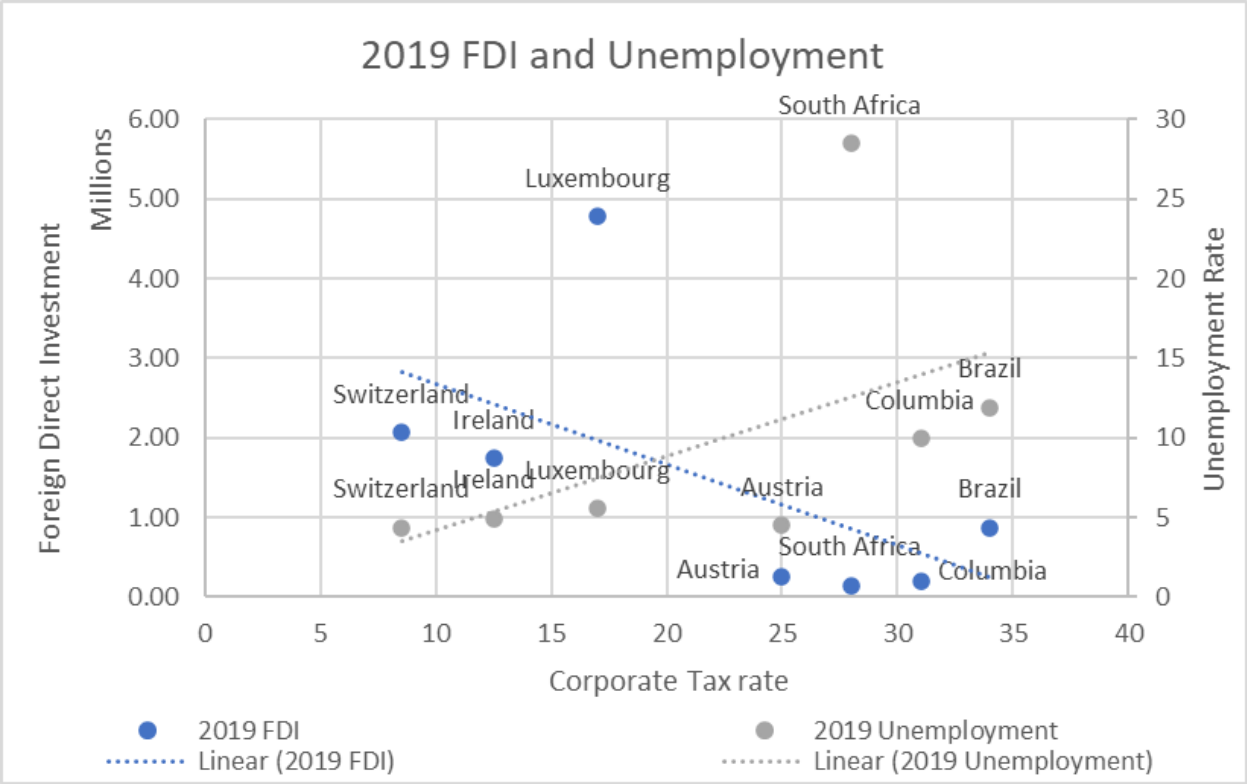

Figure 2: First regression of tax haven nations

SUMMARY OUTPUT — Havens

Regression Statistics	
Multiple R	0.570843992
R Square	0.325862863
Adjusted R Square	0.133252252
Standard Error	2.557896013
Observations	10

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	2	22.138614	11.0693069	1.691822	0.25154685
Residual	7	45.799824	6.54283201		
Total	9	67.938438			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	3.270666739	1.7939294	1.82318586	0.1110489	-0.9713023	7.5126357	-0.9713023	7.5126357
FDI	-4.9568E-07	5.763E-07	-0.8601804	0.4181731	-1.858E-06	8.669E-07	-1.858E-06	8.669E-07
Corporate Tax Rate	0.219144521	0.124581	1.75905258	0.1219709	-0.0754427	0.5137318	-0.0754427	0.5137318

Figure 3: First regression of non-haven nations

SUMMARY OUTPUT — Non-Havens

Regression Statistics	
Multiple R	0.29203653
R Square	0.08528534
Adjusted R Square	-0.1760617
Standard Error	8.05298189
Observations	10

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	2	42.325317	21.1626583	0.3263298	0.73198089
Residual	7	453.95362	64.8505173		
Total	9	496.27894			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	-6.3848994	21.233399	-0.3007008	0.7723774	-56.593909	43.82411	-56.593909	43.82411
FDI	-4.513E-06	7.919E-06	-0.5698828	0.586573	-2.324E-05	1.421E-05	-2.324E-05	1.421E-05
Corporate Tax Rate	0.5919705	0.7760152	0.76283363	0.4704832	-1.2430139	2.4269549	-1.2430139	2.4269549

Figure 4: Regression of tax haven nations with extra control variables

SUMMARY OUTPUT

Tax Havens

Regression Statistics	
Multiple R	0.8174323
R Square	0.6681956
Adjusted R Square	0.0045868
Standard Error	2.7411842
Observations	10

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	6	45.396166	7.5660276	1.0069119	0.5426977
Residual	3	22.542272	7.5140907		
Total	9	67.938438			

	Coefficients	*tandard Erro*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	3.9313594	8.9873083	0.4374346	0.6913729	-24.67027	32.532986	-24.67027	32.532986
FDI	3.329E-06	3.961E-06	0.8404241	0.4623721	-9.28E-06	1.593E-05	-9.28E-06	1.593E-05
Corporate Tax Rate	0.0524747	0.2709722	0.1936535	0.8588175	-0.80988	0.9148291	-0.80988	0.9148291
GDP PC, current (BUSD)	-0.000184	0.0001661	-1.106876	0.3491256	-0.000712	0.0003447	-0.000712	0.0003447
Gen Govt Total Expenditure (as % of GDP)	0.0967244	0.1628686	0.5938802	0.5943954	-0.421596	0.6150449	-0.421596	0.6150449
General Government Net Lending/Borrowing	0.3781646	0.362993	1.0417957	0.3740784	-0.777041	1.5333704	-0.777041	1.5333704
Total Investment (as %of GDP)	0.1140272	0.1392098	0.8191035	0.47274	-0.329001	0.557055	-0.329001	0.557055

Figure 5: Regression of non-haven nations with extra control variables

SUMMARY OUTPUT Non-Tax Havens

Regression Statistics	
Multiple R	0.78406912
R Square	0.614764384
Adjusted R Square	-0.155706847
Standard Error	7.982988624
Observations	10

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	6	305.09462	50.849103	0.797907	0.6290329
Residual	3	191.18432	63.728107		
Total	9	496.27894			

	Coefficients	*tandard Erro*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	106.4868226	72.008738	1.4788042	0.2357337	-122.6771	335.65076	-122.6771	335.65076
FDI	8.67327E-06	1.194E-05	0.7265199	0.5200755	-2.93E-05	4.667E-05	-2.93E-05	4.667E-05
Corporate Tax Rate	-0.946561308	1.2752021	-0.742283	0.5117503	-5.004823	3.1117008	-5.004823	3.1117008
GDP PC, current (BUSD)	8.58968E-05	0.0002893	0.2968904	0.7859192	-0.000835	0.0010066	-0.000835	0.0010066
Gen Govt Total Expenditure (as % of GDP)	-0.579025777	0.6020492	-0.961758	0.4071193	-2.495015	1.3369635	-2.495015	1.3369635
General Government Net Lending/Borrowing	1.692390247	1.9108102	0.8856925	0.441016	-4.38866	7.773441	-4.38866	7.773441
Total Investment (as %of GDP)	-2.284008795	1.3750474	-1.66104	0.1952901	-6.660023	2.0920058	-6.660023	2.0920058

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