

# To avoid another Cyprus style crisis, the EU must understand how it helps to create tax havens.

 [blogs.lse.ac.uk/europpblog/2013/04/05/how-eu-creates-tax-havens/](http://blogs.lse.ac.uk/europpblog/2013/04/05/how-eu-creates-tax-havens/)

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*The recent Cyprus crisis has thrown the problems posed by tax havens into sharp relief. But what determines which countries become tax havens? [Achim Kemmerling](#) argues that tax havens tend to occur when small countries stand to benefit from aligning their legal framework with that of a larger country. For countries such as Cyprus, EU accession and the adoption of the EU's legal framework has greatly aided the transition to tax haven status.*



Tax Havens are not randomly distributed in this world. Rather, tax havens live in a symbiotic relationship traditionally with a nearby larger country that has a huge financial sector; the Caribbean islands for the U.S., the Channel Islands for the U.K., or Liechtenstein for Switzerland. The small country has a regime that attracts huge inflows of capital with zero levels of income taxation. Since this foreign capital cannot really be invested in these small countries, or else rates of return would go down, it flows immediately on to a larger financial market where profits and returns are made.

Who can become a tax haven and who cannot? It [turns out](#) that not all countries have the structural conditions that are required to easily specialize in this way. Two major factors are the size of the country and the predictability of its legal framework. Let's first turn to the size argument. It is well established in the literature on tax competition, that smaller countries are more likely to gain from competition. The reason is that if you are small, or very small in the case of some tax havens, it does not really affect your domestic tax base very much if you lower the tax rate to zero. The domestic tax base is minuscule compared to the tax base attracted from other countries. Tax havens can live with zero tax rates, because they make their money with licenses, indirect taxes and other types of revenues.



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More important for an understanding of the Cyprus crisis is the second issue, the predictability of the legal framework. Private firms are concerned about the so-called hold-up problem. They don't trust any type of government, since investors are afraid of future expropriations. In the economics literature, this is a well-known problem of credible commitment: How can governments of prospective tax havens assure private investors that they won't violate property rights, once the investors have made their decision to invest?

There are no easy solutions to this problem, but a certain type of semi-sovereignty can act as a commitment device. Like Ulysses binding himself to the mast, some countries give up having a legal framework of their own but fully subscribe to that of a foreign country. Many of the Caribbean Islands are either still overseas territories of former colonial powers or have semi-dependent status. Guernsey and Jersey don't have to provide a credible legal framework since they are directly connected to the British legal system. Liechtenstein and Switzerland share an economic and currency union. These types of semi-sovereignty are an effective solution to the hold-up problem. Private investors know that, say, Guernsey, cannot and will not easily expropriate foreign investors. This makes such countries enormously popular destinations for huge inflows of capital.

In the European Union (EU), the problem does not stop here. If we apply the same logic we see that the EU has

generated additional tax havens. To be fair not all tax havens are the same, but countries like Cyprus, maybe Latvia, and even Ireland share structural characteristics: they are small, and until recently they had a problematic track record of legal predictability, and in a larger perspective, prudent macroeconomic management. However, these countries have seen a tremendous inflow of foreign capital with EU accession. And not any type of capital flows but those suspicious ones that flow in and in many instances directly out again.

Why is that? Well many factors may play a role here. For instance, political transition has stabilized in many Eastern European countries and made them economically attractive destinations for capital inflows. Yet, in most cases the real boost comes with the adoption of the *acquis communautaire*, i.e. the legal framework of the EU, and eventually EU membership. Similar to Guernsey borrowing legal safety from the UK, Cyprus or Latvia borrow legal guarantees from member states with a better track record in avoiding explicit expropriation or expropriation by stealth such as high inflation.

The EU creates this problem arguably without intention. Capital flows to poorer countries are welcome, catching up will benefit also the older member states. But this is not true for any type of capital flows. To avoid these, the EU first needs to acknowledge that an unintended consequence of its enlargement strategy was to create excessive flows of certain types of capital. Second, it needs to build up a framework that differentiates between types of capital flows, monitors them carefully, and sanctions them way before a new Cyprus needs to receive a bail-out.

*Readers may also be interested in the article:* Genschel, P., Kemmerling, A., & Seils, E. (2011). '[Accelerating Downhill: How the EU shapes corporate tax competition in the Single Market.](#)' *Journal of Common Market Studies*, 1-22.

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