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Migration, Taxation, and Inequality

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International migration is intimately intertwined with issues of taxation, inequality and public welfare benefits, both in home and destination countries. In home countries the emigration of workers, especially high-skilled workers, is often perceived to create a fiscal loss due to the cost of educating these workers and foregone tax revenues that may reduce the fiscal resources available for income redistribution. On the other hand, remittances, when well spent, can create multiplier effects and contribute to increasing domestic demand and growth, as well as increasing tax collections. In destination countries, immigration raises other challenges, especially when poor and undocumented workers are perceived as taking more from the government budget in the form of social welfare and health care benefits than what they contribute in the form of tax revenues. This note discusses some of the current issues around migration and taxation including how to compensate home countries for the fiscal losses of high-skilled emigration, how to bring immigrants into the tax system and make them net contributors, whether or not to tax inward, cross-border remittances, and designing appropriate tax incentives to encourage diaspora investment in the home country.

International migration is intimately intertwined with issues of taxation and public welfare benefits, both in home and destination countries. The emigration of workers, especially high-skilled workers, is often perceived to create a fiscal loss—when considering the cost of educating these workers and foregone tax revenues for the home country. Furthermore, losses from high-skilled emigration may contribute to increased income inequality and reduce the fiscal resources available for income redistribution.

Immigration also raises challenges for policy makers in destination countries, especially when immigrants—often poor and undocumented workers—from developing countries are perceived as taking more from the government budget in the form of social welfare and health care benefits than what they contribute in the form of tax revenues. Natives in destination countries, especially countries with high levels of redistributive

policies—in the form of generous social welfare benefits—may resent the burden of providing social services to poor migrants.

Finally, remittances, the money that migrants from developing countries send home (over \$370 billion annually [Ratha and Silwal 2012]), when well spent, can create multiplier effects and contribute to increasing domestic demand and growth. This may also lead to additional indirect (sales) tax collections in the recipient countries. Since the income of migrants has, in principle, already been taxed once in the host country, it is important to ensure that those transfers are not taxed again in the recipient country. In addition, remittances should not be considered as a substitute for official aid for reducing poverty (World Bank 2006) because they typically benefit only a small minority.

Some of the debates around migration and taxation involve how to compensate home countries for the fiscal losses of

high-skilled emigration, how to bring immigrants into the tax system and make them net contributors, whether or not to tax inward, cross-border remittances, and designing appropriate tax incentives to encourage diaspora investment in the home country. A range of ideas has been proposed to deal with the effects of migration—from a so-called “Bhagwati tax” on emigrants, to issuing taxpayer identification numbers (TIN) to undocumented migrants, to facilitating “portable” pensions and social insurance benefits for returning migrants (Desai and others 2009).

Nonetheless, cross-border migration raises myriad challenges for tax authorities, such as appropriately determining residence status and avoiding double taxation when transnational migrants have economic interests both in their home country and in the host country. Most countries have chosen practical and rational policies instead of being legalistic—most notably, resisting the temptation to directly tax cross-border remittances, which may drive them into informal channels, and instead relying on indirect taxes, even though these are known to be more regressive.

Fiscal Consequences of High-Skilled Workers' Emigration

The emigration of high-skilled individuals such as doctors, engineers, and scientists (who are often the highest income earners) has sometimes given rise to fears that the already incurred costs of educating these workers and subsequent foregone tax revenues represent a “fiscal drain” for the home country. For example, India feared fiscal losses as a result of the increase in high-skilled emigration to the United States, which rose in the 1990s to reach almost half of the U.S. temporary work (H1B) visas issued in 2001 (Desai, Kapur, and McHale 2004). Desai and others (2009) estimate (after controlling for the counterfactual earnings of the high-skilled migrants, the loss of direct and indirect taxes, and the use of government benefits) that the emigration resulted in a net annual fiscal loss of 0.5 percent of gross national income (GNI), or 2.5 percent of overall government revenues by 2005.

In addition, high-skilled emigration may have a particularly severe impact on the health sector in regions with supply shortages, such as Africa, because the emigration of doctors and nurses may reduce the ability to provide essential public services at home (Ratha and others 2011).

Optimal taxation policies for dealing with the increase in international labor mobility have been examined by Bhagwati (1976) and Bhagwati and Wilson (1989). Bhagwati proposes a citizenship-based tax—the so-called “Bhagwati tax”—which would involve raising tax revenues from citizens abroad to partly compensate for the fiscal losses to the home country. Although some countries, such as the Philippines, have tried such citizenship-based taxes, their experiences with implementation are not encouraging (Pomp 1989; World Bank 2006). The

lack of success is partially because of the difficulty in designing and administering such taxes; creating a tax structure appropriate for the different levels of incomes in each of the destination countries and aligning these with local tax brackets would be difficult. The implementation of such a tax would require cooperation of each of the host countries of migrants, who might need to make significant changes to their existing tax procedures (Pomp 1989). These changes might involve efforts to compile special rolls of foreigners subject to the tax, revisions to existing tax forms and procedures, creation of special withholding tables and instructions relevant for each home country, and special taxpayer education programs for migrants. Few destination countries are likely to be willing to undertake such costly measures. Moreover, the prospect of such taxes may discourage migrants from returning to their home country and thereby reduce diaspora remittances and investments.

Some host countries, such as the United States, have signed reciprocal tax treaties with migrant-sending countries. These treaties allow the United States to tax the income of foreign residents or citizens at a reduced rate, or exempt certain items of the income they receive from sources within the United States from U.S. taxes, in return for similar tax treatment of U.S. citizens in these foreign countries (IRS 2011). The United States also has a citizenship-based tax on worldwide income and requires citizens to file taxes irrespective of location.

Migrants: Tax Contributors or Drains on Social Services for Host Countries

The question of whether migrants benefit relatively more from social services provided in host countries than they contribute to taxes, both directly and indirectly, has become even more relevant with the increase in international labor mobility (World Bank 2006) and the hardening of attitudes toward immigrants in destination countries after the recent global crisis. Despite the well-documented benefits of migration, the public in some destination countries sometimes believes that, by increasing demand on public services, immigration can result in an increased fiscal burden, even if migrants make some contributions to tax revenues. However, several studies, including a recent United Nations human development report, find that fears about migrants placing an unwelcome burden on local services or costing taxpayers more money than they are paying in taxes are generally exaggerated (UN 2009).

Immigration typically leads to an increase in welfare in the destination country, because it increases the supply of labor, which usually leads to more employment, production, and thus higher gross domestic product (GDP; Ortega and Peri 2009). Economic simulations suggest that a small increase in south–north migration (equivalent to 3 percent of the labor force of destination countries) would produce substantial income gains for both home and destination countries in the long run; these income gains could exceed the gains from compre-

hensive trade liberalization (World Bank 2006; Anderson and Winters 2008; van der Mensbrughe and Roland-Holst 2009).

The fiscal impact of immigration depends on how extensive the social safety nets and welfare services are, to what extent migrants are allowed to access them, and their contributions as taxpayers (Ratha, Mohapatra, and Scheja 2011). The U.S. Congressional Budget Office estimated that comprehensive immigration reform including legalization of undocumented immigrants would increase federal revenues to an extent similar to the increase in federal spending on social security, health care, and other benefits for the immigrants (CBO 2006). In the United Kingdom (Gott and Johnston 2002; UNDP 2009) and New Zealand (Nana and Williams 1999), immigrants have done well in the labor market and have made a positive contribution to public finances.

Contribution of Remittances to Tax Revenues via Multiplier Effects

In developing countries, remittances contribute to tax revenue in the form of sales taxes paid on consumer goods purchases and indirectly through multiplier effects. Remittance flows to developing countries exceed \$370 billion annually (World Bank 2011). These flows account for about 2 percent of GDP in middle-income countries and 6 percent of GDP in low-income countries, and reach over 10 percent of GDP in some countries. These transfers are spent mostly on consumption (Ratha and others 2011) and contribute to taxes through sales or consumption taxes.

Some studies have found that remittances have a multiplier effect, whereby the increase in domestic income is some multiple of the remittance income. For example, each dollar sent by Mexican migrants residing in the United States was estimated to boost Mexican GDP by \$2.90 (Adelman and Taylor 1992; World Bank 2006). Remittances can also have multiplier effects due to increasing returns, typically because the expansion of one sector increases the optimal size of other sectors (World Bank 2006).

Regarding effects on inequality, evidence suggests that remittances tend to be received by higher-income families that originally had the resources to migrate, which may initially increase inequality. But, as migration networks are established and the cost of migration falls, lower-income groups are also able to migrate, and in this way, migration also contributes to reducing inequalities (Ratha and others 2011).

The large size of remittance inflows makes them an attractive target for new taxes, but imposing taxes on remittances is not likely to be effective and could even be regressive. Some countries have recently implemented or proposed taxes on remittance inflows—for example, through compulsory conversion at an overvalued exchange rate in Cuba, or a 1 percent tax on outward remittances imposed by the state of Arizona in the United States. While a tax on remittances might appear to be a

new, untapped source of revenue, taxes on remittance inflows could increase the cost of remittance transfers and may not raise significant amounts of tax revenues because of potential diversion of remittances to informal channels. Effective targeting of remittance recipients is also difficult since most prefer to use cash-based money transfer services. Such remittance taxes may also constitute double taxation of migrants' earnings if they are taxed in both the host and home country.

Most remittance-receiving countries do not impose taxes on incoming remittances. There may be some implicit tax on remittances, however, in the form of a general financial services tax or on remittances in kind (such as food, clothing, electronic items, or vehicles). For example, the Philippines and India impose a small stamp or service tax on remittances. When Vietnam removed its 5 percent tax on remittances in 1997, it found that the flow of remittances through formal channels increased (World Bank 2006). In Tajikistan, the removal of the state tax on cross-border bank transactions in 2003 reportedly helped raise remittances from \$78 million in 2002 to \$256 million in 2003 (Olimova and Bosc 2003).

Similarly, forcing migrants to repatriate a certain part of their earnings—often at unfavorable official exchange rates—may be considered a form of taxation on remittances. The rationale for such forced remittances is to ensure that temporary migrant workers do not stay on, but return home after the end of their contract. These are usually a feature of temporary or seasonal worker programs: an early example is the Bracero guest program in the United States, where from 1942–49, a tenth of the wages earned by the Braceros was deducted from their pay by their U.S. employers and paid into accounts held by the Bank of Mexico, but resulted in the disappearance of this money for many Braceros. Similar programs are in place for Lao workers in Thailand, for temporary Mexican farm workers in the United States and Canada, and for mine workers in South Africa (TEBA 1995).

Taxes and Fiscal Incentives Can Encourage Diaspora Investment

Many countries offer favorable tax treatment to attract diaspora investment, and more recently, some countries are offering diaspora bonds. Many countries, most notably Israel and India, have successfully raised over \$40 billion from such bonds (Ketkar and Ratha 2009). Several other countries, including Nigeria and Rwanda, are seriously contemplating issuing diaspora bonds. Countries such as Ethiopia, Kenya, and India have exempted the interest earnings of diaspora bonds from income taxes.

Investments in the form of nonresident deposits or diaspora bonds may indirectly encourage remittances. Even when investments in these bonds are in foreign currency terms, after maturity, some portion is likely to remain in the country. Such schemes were a major factor behind the doubling of remittance flows to India between 2002 and 2003 (Chisti 2007).

Governments have, on occasion, offered matching grants for contributions from diaspora groups or home town associations (HTAs) to attract funding for specific community projects. The best known of these matching schemes is Mexico's 3-for-1 program, started in 1997, under which the local, state, and federal governments all contribute \$1 for every \$1 of remittances sent to a community for a designated development project. By 2002, the 3-for-1 program had established projects totaling \$43.5 million, two-thirds of which benefited labor-intensive agricultural economies in four high emigration states (IOM 2005). In addition to Mexico, the Salvadoran government partners with HTAs in rural development projects in El Salvador. However, when matching funds come from fiscally constrained governments, there is also the problem that they may be diverted from other—perhaps even higher priority—development projects, or from other regions with a greater need for assistance (World Bank 2006).

Cross-Border Migration of High-Skilled Workers to Avoid Income Taxes

Cross-border migration to avoid paying high taxes is mainly an issue in high-income countries and financial centers and involves high-paid professionals and entrepreneurs seeking residence in low-tax jurisdictions to avoid income taxes. According to available literature, marginal income tax rates are only one of several factors in the migration and location decisions of highly skilled workers. However, very high marginal tax rates can cause the highest-income earners to emigrate in search of low-tax havens—which in turn can reduce the resources available for redistribution and social welfare programs. Such tax-induced migration can reduce the tax base and potentially increase income inequality through the loss of the most productive members of society and their contributions to innovation, productivity, and growth. However, tax competition to attract and retain high-skilled individuals can lead to a “race to the bottom,” which can reduce tax revenues, leaving limited resources available for providing essential social services. Tax policy should strive to reach a balance between taxes on high-skilled workers and redistributive policies. Policies to improve the investment climate, business environment, and macroeconomic stability may be more effective in retaining high-skilled workers.

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