EUROPEAN
COMMISSION

Brussels, 6.12.2012
SWD(2012) 403 final

Volume 6/14

COMMISSION STAFF WORKING DOCUMENT

IMPACT ASSESSMENT

Accompanying the document

the Communication from the Commission to the European Parliament and the Council - An Action Plan to strengthen the fight against tax fraud and tax evasion

the Commission Recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters

the Commission Recommendation on aggressive tax planning

{COM(2012) 722 final}
{SWD(2012) 404 final}

ANNEX 6 – Tax havens: literature review and quantitative estimates

Definition of tax havens used in economic data

The economic literature often uses a broad definition of tax havens. A tax haven in this respect can be defined simply as a country, which imposes low or no tax on corporate income with a goal of attracting capital (Gravelle, 2009). Estimates on profit or investment flow, and revenue losses related to tax haven operations are generally based on this broad definition.

When the broad definition is used, the list of tax haven jurisdiction is quite long. The famous list of Hines and Rice (1994) contains 41 countries, many of which are small island states in the Caribbean or elsewhere, or other small countries, and also includes a few European countries, such as Ireland, Cyprus, Malta, Luxembourg and Switzerland. These countries also appear in a list of 50 countries of Gravelle (2009), which is a combination of various lists[1].

The **analyses of tax planning and profits shifting operations of multinational companies** in economic literature are based and the broad definition. These operations, which aim at the reduction of taxes, but within the limits of existing law, are often labelled **tax avoidance**. Tax havens in a broad sense play an essential role in tax avoidance behaviour of multinational companies. Operations, which are criminal or illegal, often **labelled tax evasion or fraud**, require secrecy and non-transparency, and therefore a narrower definition of tax havens would be more relevant in the analyses of these operations. According to Gravelle (2009) a large part of tax haven operations of multinational companies can be characterized as tax avoidance, while some of them are in the limit of tax evasion. Tax haven operations of private individuals have more a character of tax evasion and are hence associated with a narrower definition.

The estimates of profit and investment flows and tax revenue losses associated with tax havens depend also on the definitions used. Most existing estimates of these flows are based on the broad definition, and thus include both tax avoidance and tax evasion.

[1] Organization for Economic Development and Cooperation (OECD), *Towards Global Tax Competition*, 2000; Dhammika and James R. Hines, "Which Countries Become Tax Havens?" December 2006; Tax Justice Network, "Identifying Tax Havens and Offshore Finance Centers: http://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf; The OECD's "gray" list as of April 2, 2009, http://www.oecd.org/dataoecd/38/14/42497950.pdf.; GAO Report, *International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions*, GAO-09-157, December 2008.

Evidence on international tax planning

There are no precise estimates of the extent of income shifting to tax havens, but indirect evidence suggests that it is fairly massive. Revealing evidence is presented in Gravelle (2009). According to this paper the amount of US foreign company profits relative to GDP in G-7 countries is between 2.6% and 0.3 % (weighted average 0.6%). In larger countries often included in tax havens lists (including Luxembourg, Ireland, the Netherlands, Switzerland, Cyprus, and a few Asian and Caribbean countries) the amounts are higher, reaching 18.2% in Luxembourg, 7.6% in Ireland and 4.6% in the Netherlands. In small island states and other small countries often figuring in tax haven lists these amounts are still many multiples: for instance Bermuda 645.7%, British Virgin Islands 354.7% and Cayman Islands 546.7%, Jersey 35.6% and Guernsey 11.2%. These numbers suggest that some multinational companies indeed locate their profits in so-called tax havens (although these numbers do not indicate how much taxes are avoided through these operations).

The EU is a very important source of FDI in tax havens worldwide. In 2010, the total FDI stock in tax havens originating from the EU (768 bn USD) was almost as high as the stock originating from the US (824 bn USD)[2]. This suggests that the EU is approximately as relevant as an economic partner to tax havens worldwide as the US is. In relative terms, 21% of all FDI US outwards FDI stocks are directed to tax havens whereas this figure is 14% in the EU.

It is worth to take into account that FDI from the EU is highly important for tax havens: For the entire set of the 45 economies, the EU-originated FDI stock is equal to 55% of their combined GDP. The maximum value (for Bermuda) is 2130% meaning that the EU-originated FDI-stock for this country is more than 21 times higher than its GDP.

The share of tax havens in receiving FDI from the EU is particularly high on the European and the Northern American continent. Within non-EU Europe 65% of FDI stock originating from the EU countries is in tax havens (Switzerland, Liechtenstein, Andorra, Gibraltar, the two Channel Islands, Isle of Man and San Marino). Disregarding Switzerland, the figure is still 26% for non-EU and non-Switzerland Europe. For North America and the Caribbean (including US which is the single largest recipient of EU outward FDI) this amounts to 10% of all EU-originated FDI.

Gumpert – Hines Jr. –Schnitzer (2012) provide some evidence on tax haven behaviour of German companies. They find that German manufacturing firms, which, unlike US companies, do not have the tax deferral motivation for using tax havens, are more likely to invest in tax havens when they also have investments in high-tax locations, and vice versa,

[2] FDI stock data published by the OECD and the Eurostat are used. The tax havens taken into account are the ones listed by Gravelle (2009), apart from the four EU Member States which are included there (CY, IE, LU, MT) and Monaco for which no data is available. This leaves 45 countries. 2010 data are used apart from some unavailable entries where 2009 or 2008 figures are taken. Note that the FDI data published for most EU MSs disregards the investments made by through special purpose entities (SPE), leading to a marked underestimate of total EU-originated FDI.

investment in a tax haven makes an investment in a high-tax location more likely. The interpretation is that tax havens are used to reallocate profits between foreign affiliates away from high-tax jurisdictions.

The role of wealthy individuals and bank secrecy

Also wealthy individuals all over the world make extensive use of tax havens. The purpose of these operations is to hide income from tax authorities in order to avoid domestic income taxation. These operations are often illegal and thus characterized as tax evasion rather than avoidance. The simplest form of such operations is to open a bank account in a tax haven under a false name (in the name of the company located in the tax haven) and deposit money in that account using electronic transfers. The extent of these operations is less known than the tax avoidance operations of multinational companies, but anecdotal evidence suggests that the money flows related to these operations are at least as important than those of MNCs.

Bank secrecy is essential for the success of these operations. In recent years international efforts have been taken to end the bank secrecy by compelling tax haven to conclude the exchange of tax information agreements (e.g. G20 initiative, OECD initiative, EU Savings Directive). A recent paper by Johannesen and Zuckman (2012) examines the effect of these agreements on banks deposits in tax havens. They show that the number of bilateral treaties allowing for information exchange between tax haven and non-tax haven countries has increased very significantly since 2009, but cross-border deposits in tax havens have remained stable in the same period as a whole. There was, however, some reallocation between tax havens is a way that the havens that signed many treaties have lost deposits at the expense of havens that have signed few treaties. The authors conclude that information exchange treaties are a relatively inefficient way of fighting tax evasion. The main reasons for this are that there are too few bilateral treaties leaving many countries outside the exchange of information, and secondly that the exchange of information is often not automatic, but only upon request, which is a relatively tedious way of detecting tax evasion.

Estimates on tax revenue losses

Some estimates on tax revenues losses caused by tax haven operations exist for the US (but not for the EU countries). Gravelle (2009) presents some of these estimates, which have a relatively wide range of variation. **Corporate tax avoidance** could cost to the federal government up to $60 billion (in 2004), if it is assumed that 35% tax rate is applied on $180 billion corporate profits shifted out of the US. There are also estimated of the revenues gain that could be obtained by eliminating the deferral in the US tax system. These estimated, that vary between $11 billion and $26 billion, give also an indication of the revenue cost from profit shifting by US companies.

Concerning the revenue cost of **individual tax evasion** Gravelle (2009) presents some estimates found in literature. In the case of the USA estimates are based on the value of individual net worth invested outside the US being $1.5 trillion. Depending which rate of return and tax rate is applied on the net worth, the estimates of tax revenue losses vary from $50 billion to $15 billion. The Tax Justice Network has estimated that the worldwide revenue loss from individual tax evasion for all countries would be $255 billion, using the tax rate of 30% and the rate of return of 7.5%. It the same rate are applied on the US case, the revenue loss would be $33 billion.

As already mentioned, there are no direct estimates of the revenue loss effect of tax planning in the EU. However, for purely indicative purposes, it is worth taking into consideration the fact that the EU has a similar amount of foreign direct investment (FDI) stocks in tax havens as the US does[3]. FDI stocks in tax havens are closely related to corporate income arising in these jurisdictions, which are in turn often affected by tax planning. The extremely high profits generated by foreign owned corporations in tax havens compared to the GDP of these territories (indicated above) also suggest that investment into tax havens is motivated by tax planning opportunities. For these reasons, while taking into account the differences in tax planning incentives of US and EU actors due to the different tax regimes in the two territories, the similarities in the volume of US and EU FDI in tax havens can be taken as an indication that the magnitude of the revenue loss estimates available for the US is representative for the EU, too.

The impact of tax havens on non-haven countries

Are the tax haven operations of multinational companies harmful for non-haven countries? In this respect two different views are presented in economic literature.

According to the first view tax haven operations are wasteful, they erode the tax bases in non-haven countries and distort competition. The paper by Slemrod – Wilson (2006) is the best known representative of this view. They show with a help of a theoretical model that tax havens induce a welfare loss, since they intensify tax competition and force the non-haven countries to set lower tax rates, and hence the lower supply of public goods, than would be the case without tax havens. Tax havens are wasteful, since tax avoidance operations require a lot of resources form the companies, and also impose an administrative burden on the governments, who try to prevent these operations. Hence, much more resources are needed to collect the same tax revenue than would be the case without tax havens. All the countries would be better-off, if they could agree to increase their tax rates and lower enforcement, in other words, cooperate more in preventing tax haven operations.

A positive view on tax haven, presented, for instance in Dharmapala (2008) and Desai – Foley –Hines Jr. (2005) is the following.

[3] See also Bilicka and Fuest (2012) who use FDI to proxy economic links between economies.

All capital is not equally mobile across borders. Tax havens allow lower effective tax rates on mobile capital, and thus setting higher tax rates on immobile capital. In this way tax haven in fact mitigate tax competition, which is welfare enhancing. The evidence supporting this view id that 40% of US MNCs do not have affiliates in tax havens (in 1999), indicating that not all companies are equally able to make use of tax havens. Dharmapala (2008) also demonstrates that corporate income tax revenues in the US have not declined in 1994-2006 in spite of massive FDI flows to tax havens in the same period. Hence, tax havens seem not to have eroded the CIT base in the US. This argument should be, however, more qualified since the development of CIT revenues may depend also on many other factors. For instance, in the EU CIT revenues have remained relatively stable in spite of substantial reductions in statutory corporate income tax rates, but this is explained by base broadening and the increase of incorporation of domestic firms (see, de Mooij and Nicodème, 2008). Hence, without tax havens the increase of CIT revenues could have been faster.

This issue thus remains controversial and would require further investigation.

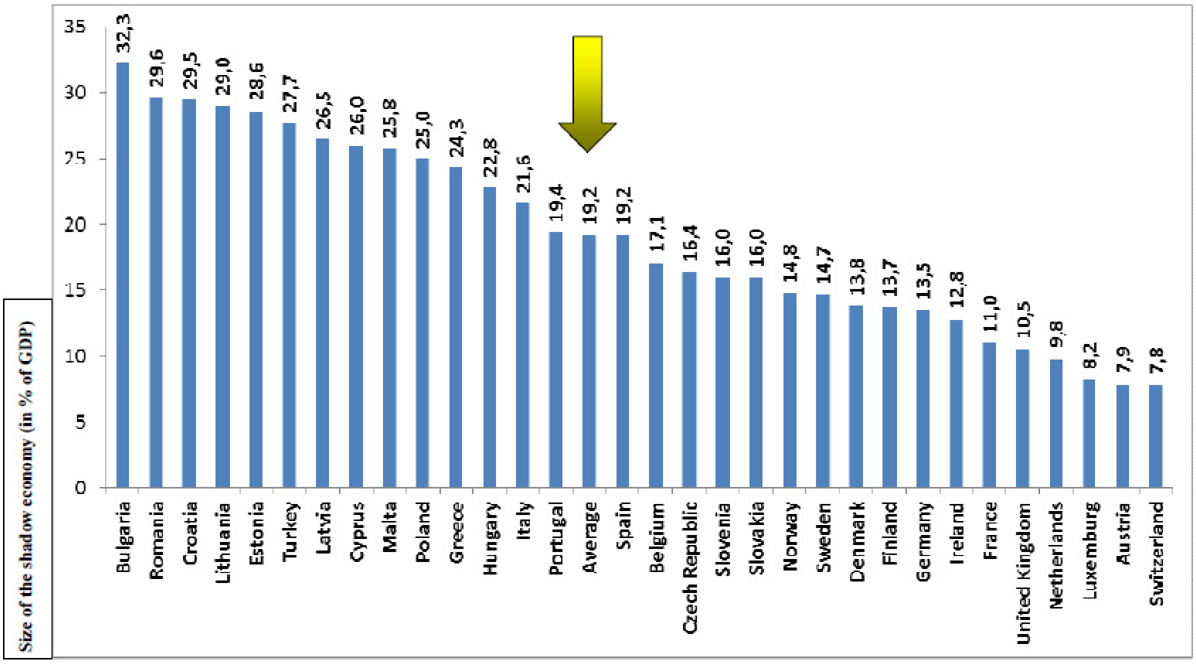
Tax havens and the shadow economy

Tax havens have several links with the shadow economy, although such links are difficult to demonstrate because of their very nature. It seems at least that without 'tax havens' it would be more difficult for undeclared activities and profits to be concealed to the tax authorities of EU MS through opaque legal and corporate structures.

The shadow economy includes those economic activities and the income derived thereof that circumvent or avoid government regulation or taxation. The major component (about two thirds) is undeclared work, which refers to the wages that workers and business don't declare to avoid taxes or documentation. The rest is represented by business underreporting profits to avoid tax regulation[4].

[4] Schneider (2011), The Shadow Economy in Europe 2011

Figure 1: Size of the shadow economy of 31 European Countries in 2012, % of GDP



Source: Schneider, F. (2011), "Size and development of the Shadow Economy from 2003 to 2012: some new facts ".

Table 1: Size of the shadow economy of 31 European countries over 2003 – 2012, % of off. GDP

Country / Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Austria	10.8	11	10.3	9.7	9.4	8.1	8.47	8.2	7.9	7.6
Belgium	21.4	20.7	20.1	19.2	18.3	17.5	17.8	17.4	17.1	16.8
Bulgaria	35.9	35.3	34.4	34	32.7	32.1	32.5	32.6	32.3	31.9
Cyprus	28.7	28.3	28.1	27.9	26.5	26	26.5	26.2	26	25.6
Czech Republic	19.5	19.1	18.5	18.1	17	16.6	16.9	16.7	16.4	16.0
Denmark	17.4	17.1	16.5	15.4	14.8	13.9	14.3	14	13.8	13.4
Estonia	30.7	30.8	30.2	29.6	29.5	29	29.6	29.3	28.6	28.2
Finland	17.6	17.2	16.6	15.3	14.5	13.8	14.2	14	13.7	13.3
France	14.7	14.3	13.8	12.4	11.8	11.1	11.6	11.3	11	10.8
Germany	17.1	16.1	15.4	15	14.7	14.2	14.6	13.9	13.7	13.3
Greece	28.2	28.1	27.6	26.2	25.1	24.3	25	25.4	24.3	24.0
Hungary	25	24.7	24.5	24.4	23.7	23	23.5	23.3	22.8	22.5
Ireland	15.4	15.2	14.8	13.4	12.7	12.2	13.1	13	12.8	12.7
Italy	26.1	25.2	24.4	23.2	22.3	21.4	22	21.8	21.2	21.6
Latvia	30.4	30	29.5	29	27.5	26.5	27.1	27.3	26.5	26.1
Lithuania	32	31.7	31.1	30.6	29.7	29.1	29.6	29.7	29.0	28.5
Luxemburg (Grand-Duché)	9.8	9.8	9.9	10	9.4	8.5	8.8	8.4	8.2	8.2
Malta	26.7	26.7	26.9	27.2	26.4	25.8	25.9	26	25.8	25.3
Netherlands	12.7	12.5	12	10.9	10.1	9.6	10.2	10	9.8	9.5
Poland	27.7	27.4	27.1	26.8	26	25.3	25.9	25.4	25	24.4
Portugal	22.2	21.7	21.2	20.1	19.2	18.7	19.5	19.2	19.4	19.4
Romania	33.6	32.5	32.2	31.4	30.2	29.4	29.4	29.8	29.6	29.1
Slovenia	26.7	26.5	26	25.8	24.7	24	24.6	24.3	24.1	23.6
Spain	22.2	21.9	21.3	20.2	19.3	18.4	19.5	19.4	19.2	19.2
Slovakia	18.4	18.2	17.6	17.3	16.8	16	16.8	16.4	16	15.5
Sweden	18.6	18.1	17.5	16.2	15.6	14.9	15.4	15	14.7	14.3
United Kingdom	12.2	12.3	12	11.1	10.6	10.1	10.9	10.7	10.5	10.1
27 EU-Countries / Average	22.3	21.9	21.5	20.8	19.9	19.3	19.8	19.5	19.2	18.4

Source: Schneider, F. (2011), "Size and development of the Shadow Economy from 2003 to 2012: some new facts" .

List of references:

Bilicka, Katarzyna Anna and Clemens Fuest: With which countries do tax havens share information? (unpublished), March 22,2012.

de Mooij, R.A. - G. Nicodème: Corporate tax policy and incorporation in the EU. International Tax and Public Finance, 4 (2008), 478-498.

Desai, M.A - C.F. Foley – J.R. Hines Jr.: Do Tax Havens Divert Economic Activity? University of Michigan and NBER, April 2005

Desai, M.A- C.F. Foley – J.R. Hines Jr.: the Demand for Tax Haven Operations. University of Michigan and NBER, March 2005

Dharmapala, D.: What problems and opportunities are created by tax havens? Oxford Review of Economic Policy (2008) 24 (4):661-679

Gravelle, J.E.: Tax Havens: International Tax Avoidance and Evasion. CRS Report for Congress, July 9, 2009.

Johannesen, N. – Zuckman, G.: The end of back secrecy? An evolution of the G20 tax haven crackdown (unpublished). January 16, 2012.

Maffini, G.: Tax Haven activities and the tax liabilities of multinational groups. Oxford Univeristy Centre for Business Taxation, WP 09/25, September 2009.

Rice Jr, J.R. –E.M. Rice: Fiscal Paradise: Foreign Tax Havens and American Business. NBER Working Papers 3477, October 1990.

Slemrod, J. –J.D. Wilson: Tax Competition with Parasitic Tax Havens. NBER Working Papers 12225, May 2006.