COMBATING FINANCIAL FRAUD AND EMPOWERING REGULATORS

RECOMMENDATIONS ON TACKLING THE TAX GAP

COFFERS D7.5 POLICY BRIEF WP1 I
NOVEMBER 2018

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Summary of recommendations

1. All tax authorities should prepare annual shadow economy and tax gap estimates
2. Tax gap estimates should cover all taxes
3. Tax gap measures must cover all user needs and not just be tax authority efficiency measures
4. Jurisdictions should prepare annual estimates of their tax expenditures
5. Tax authorities should be funded to close tax gaps
6. There must be effective registers of companies and trusts

The shortage of tax revenues

It can be reasonably argued that shortage of tax revenue has been one of the most important factors in European politics over the last decade. Since 2010 most EU member states have in various ways and varying degrees run economic policies best described by the term austerity. These policies have demanded three things. First, that governments seek to balance their books, meaning that government spending be covered by taxation revenues. Second, that government spending is reduced, if necessary, to achieve this. Third, and alternatively, taxation revenues are expected to be increased if expenditure cannot be reduced.

This brief does not discuss whether taxation really funds government expenditure or whether balanced budgets are actually necessary. As such, it does not discuss whether austerity policies were necessary. It does instead proceed on the basis of the prevailing political narrative that suggested austerity was required.

It notes that at the same time that austerity was assumed appropriate, many European governments assumed that opportunities to increase taxes were limited. Whether this was true is, again, not an issue discussed here. The fact was that many governments felt politically constrained in the environment that they faced after the financial crisis and unable to increase taxes. This left them with politically constrained in the environment that they faced after the financial crisis and unable to increase taxes. This left them with a plan their fiscal policy on the basis of raising fixed amounts of tax revenue.

We stress that tackling the tax gap does not necessarily mean that more tax revenue must be raised. Given that many jurisdictions have reached its limits. The rise of populism in many EU member states suggests that voter willingness to endure further reductions in services supplied in exchange for continuing tax demands has reached its limit. Consequently, the obvious factor to address in this political economic equation is the tax gap.

The tax gap

The tax gap is defined as the difference between the amount of tax that would be collected by a jurisdiction if current legislation was enforced in the way that its tax authority considers appropriate, and the sum actually collected.

There are three reasons why the anticipated sum is not collected. The first, and most commonplace, is the result of tax evasion. Tax evasion is a taxpayer chosen behaviour. Taxpayers decide to either not report a source of income to tax authorities on which a tax liability should arise, or they claim allowances, expenses and reliefs to which they are not entitled in law.

The second reason for expected tax not being paid is tax avoidance. Again, this is taxpayer determined behaviour where the taxpayer decides to submit a tax return and declare their tax liabilities based on an interpretation of the applicable law that the taxpayer knows may be unacceptable to the tax authority of the country in question. They do so knowing that the risk of their potential misinterpretation of the law being discovered is limited and so the chance of appearing to reduce their liability in ways they claim to be legal, whether that is true or not, is sufficiently high for them to justify the risk of doing so.

Finally, the tax gap includes tax liabilities that a taxpayer has declared but which are not actually paid, usually because of taxpayer insolvency before the money can be collected.

Measuring the tax gap

Each of these three dimensions of the tax gap is important, and requires a different reaction from a tax authority. However, and most importantly for the recommendations made in this policy brief, unless the scale of each of these tax gaps has been appropriately estimated then the chance that effective action can be taken is low.

This is an issue of significant political economic importance. We suggest that a government that has set its tax-raising target as the sum it plans to spend in a period has three choices if there is risk that this objective might not be achieved. It can raise more tax. It can cut spending. Or it can collect more of the tax legally due but currently uncollected. This is the limit to the available choices.

We have already noted that in most cases tax increases have been deemed politically unacceptable. Now austerity is proving to have reached its limits. The rise of populism in many EU member states suggests that voter willingness to endure further reductions in services supplied in exchange for continuing tax demands has reached its limit. Consequently, the obvious factor to address in this political economic equation is the tax gap.

We stress that tackling the tax gap does not necessarily mean that more tax revenue must be raised. Given that many jurisdictions plan their fiscal policy on the basis of raising fixed amounts of taxation, overall, tackling the tax gap need not mean raising more tax. Instead it could mean that compliant taxpayers might see their tax rates decline as the yield from non-compliant taxpayers increases. This could be achieved by reducing the tax rate or tax base in areas chosen by a government in ways designed to meet its social and other economic objectives. For example, it may reduce economic inequality between those who are law-abiding and those who are not. But, we stress, if a balanced budget is the objective and that is not being achieved, increased overall yield might be achieved from a reduced tax gap.

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Table 1

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>TAXES COVERED</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>VAT</td>
</tr>
<tr>
<td>Denmark</td>
<td>Not known: the OECD suggest work is being done</td>
</tr>
<tr>
<td>Estonia</td>
<td>VAT, income tax and social security</td>
</tr>
<tr>
<td>Finland</td>
<td>VAT</td>
</tr>
<tr>
<td>Germany</td>
<td>VAT and corporation tax</td>
</tr>
<tr>
<td>Italy</td>
<td>VAT, income tax and corporation tax</td>
</tr>
<tr>
<td>Latvia</td>
<td>VAT, income tax and social security</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Not known: the OECD suggest work is being done</td>
</tr>
<tr>
<td>Poland</td>
<td>VAT</td>
</tr>
<tr>
<td>Portugal</td>
<td>VAT</td>
</tr>
<tr>
<td>Slovakia</td>
<td>VAT</td>
</tr>
<tr>
<td>Slovenia</td>
<td>VAT</td>
</tr>
<tr>
<td>Sweden</td>
<td>Not known: the OECD suggest work is being done</td>
</tr>
<tr>
<td>UK</td>
<td>VAT, income tax, corporation tax, social security</td>
</tr>
</tbody>
</table>

Given the apparent significance of this issue it is then surprising that it appears that no more than fourteen EU member states are at present undertaking any tax gap analysis. These countries are as follows, with an indication of the taxes for which they are preparing estimates. We stress that not all these estimates are published. We draw attention to the exceptional approach of the UK, although it is also fair to note that a significant number of elements in its data are described as ‘illustrative estimates’.

In addition to the above nationally generated data the EU does commission an annual estimate of the tax gap with regard to Value Added Tax each year. This now covers all member states. The EU VAT gap estimate does not indicate the whole tax gap, but it does imply the scale of the so-called ‘shadow’ or ‘non-observed’ economy in a jurisdiction. Using this estimate and that from two academic sources, two members of the Coffers Horizon 2020 team estimated tax gaps for all EU member states as follows:

Table 2 – suggested size of the EU tax gap

<table>
<thead>
<tr>
<th>EU sourced GDP data 2015</th>
<th>EU reported tax yield as a proportion of stated GDP 2015</th>
<th>Tax gap estimate based on average grossed up GDP</th>
<th>Tax gap estimate based on reported GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>€’bn</td>
<td>%</td>
<td>€’bn</td>
<td>€’bn</td>
</tr>
<tr>
<td>344.5</td>
<td>43.2%</td>
<td>13.4</td>
<td>12.3</td>
</tr>
<tr>
<td>410.3</td>
<td>45.2%</td>
<td>33.0</td>
<td>27.8</td>
</tr>
<tr>
<td>45.3</td>
<td>29.1%</td>
<td>4.3</td>
<td>3.2</td>
</tr>
<tr>
<td>44.5</td>
<td>37.1%</td>
<td>4.0</td>
<td>3.0</td>
</tr>
<tr>
<td>17.7</td>
<td>33.2%</td>
<td>1.8</td>
<td>1.3</td>
</tr>
<tr>
<td>168.5</td>
<td>34.0%</td>
<td>9.5</td>
<td>8.1</td>
</tr>
<tr>
<td>271.8</td>
<td>46.5%</td>
<td>18.7</td>
<td>16.2</td>
</tr>
<tr>
<td>20.3</td>
<td>33.7%</td>
<td>1.5</td>
<td>1.2</td>
</tr>
<tr>
<td>209.6</td>
<td>43.9%</td>
<td>11.4</td>
<td>10.0</td>
</tr>
<tr>
<td>2194.2</td>
<td>45.6%</td>
<td>124.9</td>
<td>110.9</td>
</tr>
<tr>
<td>3043.7</td>
<td>38.4%</td>
<td>132.1</td>
<td>118.1</td>
</tr>
<tr>
<td>176.3</td>
<td>36.6%</td>
<td>22.9</td>
<td>16.8</td>
</tr>
<tr>
<td>110.7</td>
<td>38.8%</td>
<td>10.0</td>
<td>8.1</td>
</tr>
<tr>
<td>262.0</td>
<td>23.4%</td>
<td>7.3</td>
<td>6.5</td>
</tr>
<tr>
<td>1652.6</td>
<td>43.0%</td>
<td>216.3</td>
<td>165.5</td>
</tr>
<tr>
<td>24.3</td>
<td>30.1%</td>
<td>1.9</td>
<td>1.5</td>
</tr>
<tr>
<td>37.4</td>
<td>28.9%</td>
<td>3.5</td>
<td>2.6</td>
</tr>
<tr>
<td>52.1</td>
<td>37.2%</td>
<td>1.7</td>
<td>1.5</td>
</tr>
<tr>
<td>9.5</td>
<td>32.1%</td>
<td>1.0</td>
<td>0.8</td>
</tr>
<tr>
<td>683.5</td>
<td>37.4%</td>
<td>23.1</td>
<td>21.2</td>
</tr>
<tr>
<td>430.1</td>
<td>32.4%</td>
<td>38.9</td>
<td>30.2</td>
</tr>
<tr>
<td>179.8</td>
<td>34.4%</td>
<td>12.0</td>
<td>10.0</td>
</tr>
<tr>
<td>160.3</td>
<td>28.0%</td>
<td>19.2</td>
<td>13.2</td>
</tr>
<tr>
<td>78.9</td>
<td>32.1%</td>
<td>6.1</td>
<td>4.7</td>
</tr>
<tr>
<td>38.8</td>
<td>36.6%</td>
<td>2.9</td>
<td>2.3</td>
</tr>
<tr>
<td>1080.0</td>
<td>33.7%</td>
<td>66.4</td>
<td>53.5</td>
</tr>
<tr>
<td>449.0</td>
<td>43.1%</td>
<td>18.1</td>
<td>15.6</td>
</tr>
<tr>
<td>2602.1</td>
<td>33.1%</td>
<td>91.9</td>
<td>83.0</td>
</tr>
<tr>
<td>14798.0</td>
<td>36.1%</td>
<td>897.6</td>
<td>749.1</td>
</tr>
</tbody>
</table>

The figures vary depending upon the way in which GDP is treated. If it is presumed that the shadow economy is included in GDP estimates already then the lower tax gap estimate is appropriate. If only part of the shadow economy is included in GDP, as likely, then the higher figure might be a better indication. In practice, a figure between the two is entirely possible.

These figures are estimates; they are at most mid-points in a range and could be improved if better data (and increased cooperation from individual EU member state tax authorities) was made available for the purposes of their estimation. The scale of them does however encourage us to offer a range of recommendations on how this issue might be better addressed to achieve a fourfold goal of a) improving the delivery of government fiscal policies; b) upholding the rule of tax law; c) delivering greater economic equality to those who are compliant with tax law and raising revenue (if that is thought appropriate) and d) delivering balanced budgets in ways that do not require austerity to defeat much of political populism.

Recommendation 1 - All tax authorities should prepare shadow economy and tax gap estimates

If tax authorities are to properly undertake the tasks expected of them by governments, and so populations, on behalf of whom they act, then it is vital that each prepares a tax gap estimate for each year to assist and guide their work as well as to measure its effectiveness.
Recommendation 2 - Tax gap estimates should be comprehensive

Most tax gap estimates are only prepared for VAT. This is a good place to start: VAT is a tax on turnover in an economy and the VAT tax gap does, as a result, provide a good estimate of the shadow economy, which might in turn inform estimates made of other tax gaps. However, those other tax gaps are also important, not least because VAT is not the biggest revenue generator in most economies. That role falls to income taxes and social security charges, which share many of their tax bases in common. It is, then, essential that tax gap estimates be extended to these taxes.

Thereafter, given the political economic significance of non-payment of corporation tax by multinational corporations, we suggest that the tax gap with regard to corporation tax is addressed. If work was then taken further losses from excise duties, tariffs and related taxes are likely to have the next priority, at which point much of the tax gap will have been appraised, leaving other areas to be addressed as operating priorities and local situations deem appropriate.

Recommendation 3 - Tax gap methodologies must be comprehensive to ensure all user needs are met

Tax gap data has three primary uses. In the first instance it can be used to appraise the effectiveness and efficiency of a tax authority. Secondly, it can be used to measure inequality arising from the failure to apply tax law in an even handed manner. Thirdly, it can measure the effectiveness, or otherwise, of the delivery of fiscal policy in a jurisdiction. These needs require tax gap estimates based on two differing bases, both of which are already found in use, albeit not consistently.

The primary tax gap measure to appraise the efficiency of a tax authority is called a ‘bottom up’ measure. Here, three errors are measured. The first is the efficiency of the tax authority in collecting tax return data. Clearly, if a tax return is not submitted to an authority when it should be there is prima facie tax evasion taking place, giving this measure particular significance. This requires significant sampling of populations not submitting tax returns to determine causes, and likely losses arising.

Second, the error rate within submitted tax returns should be estimated. These errors can arise from both tax evasion and tax avoidance. Since each requires a different management response estimates for each by tax, with causes being identified wherever possible, need to be prepared.

Thirdly, bad debt must be monitored i.e. the amount of tax declared but not collected has to be recorded and reported.

Recommendation 4 - Estimates of tax expenditures

Tax expenditure is the term used to describe those parts of an available tax base (such as income, or corporate profits) that a government decides not to collect by its own choice. This might, for example, be because it decides to offer low rates of tax in some cases, or grants allowances (such as the annual tax free sum that most governments provide within their income tax systems to any individual resident in their country) or provides incentives to encourage certain types of behaviour e.g. pensions saving. The use of such allowances and reliefs is a normal part of the fiscal management of most countries, but can be significant. For example, the major tax reliefs provided in the UK amounted to £406 billion in its 2016/17 tax year\(^1\), compared to total tax revenues of £672 billion\(^2\) (60% of tax collected). The sheer scale of this spend would appear to demand effective management. Yet, despite the passing of EU legislation requiring their annual appraisal the EU Commission Director General of Taxation does not collect data on their annual cost, and nor, it seems, does anyone else. Therefore an essential element of the data required to properly appraise top down tax gaps is not readily available in most countries, or available to politicians and others to inform their decision making. We believe that the European Commission should ensure that this data is prepared by each member state on an appropriate and comparable basis each year. The results should be published by tax by country each year, including by the Director General of Taxation.

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**Recommendation 5 - Effective funding of tax authorities**

Our research has indicated that there is at present little apparent correlation between the tax gaps of EU member states and the amount that they spend on their tax authorities as a proportion of either GDP or tax collected. In principle this finding is disappointing. In practice it implies that there might be considerable scope for improving the effective allocation of resources within many tax authorities if only data to direct the allocation of such resources was available. We believe that both well prepared bottom-up and top-down tax gap estimates would considerably assist this process. These tax gaps estimates might also better indicate the potential yield available from investing appropriately in tax collection in EU member states, and help determine the basis for such spending against expected yield outcomes. We strongly recommend that decision-making on tax authority expenditure be moved to this basis and that resources be provided to tax authorities able to make effective use of them if data suggests that might be appropriate.

**Recommendation 6 - Creating effective registers of companies and trusts**

Considerable attention has been given to the need to create effective registers of companies and trusts in recent years, and EU legislation in this area is developing rapidly. These moves are welcome, but need effective translation into local law across the EU member states. There are considerable difficulties in using data from such registers at present, either because many such registers do not exist as yet (at least in the case of trusts) or because the registers are dispersed, hard to access, and rarely interface readily with the tax system. Nor is there, in most cases, any third party verification of the data that these registers hold. As a result we suggest that all registers for a jurisdiction must be consistently prepared and be accessible through one portal.

In addition we recommend that the requirement that banks hold data on the activities of their customers and their beneficial ownership be exploited to provide the data required to verify that the data held on public record for these entities is reliable. This can be done by requiring banks provide details annually to a domestic tax authority and company and trust registry on all those they think might have a beneficial claim upon that entity; who manages it and what sum in the preceding year was deposited in the bank accounts that it maintains on its behalf, net of transfers. The first two types of data could very easily be matched with public records, and so provide evidence of the accuracy of registers. The last has a different purpose.

There is evidence that corporate entities are used to undertake tax evasion activities and that those perpetrating this abuse can get away with crimes because beneficial ownership data and accounts of companies are frequently so poorly recorded. If there was no filed data for an entity but a bank account has been advised to exist then it should be the legal duty of a jurisdiction’s tax authority to assess that entity for the likely tax liability arising on that income, with the directors being liable for the sum owing in the absence of payment by the company itself. Limited liability is a privilege that should not be used to evade tax owing.
CLOUDS ON THE HORIZON: EMERGING ISSUES IN TAX AND REGULATION

COFFERS D7.5 POLICY BRIEF WP1 II
NOVEMBER 2018

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Introduction

The decade following the 2007-2008 had been arguably the most significant period in the international battle against tax evasion and avoidance. Following the mix successes of previous efforts of the OECD at combatting harmful tax competition (OECD, 1998) and the introduction of tax information exchange agreements (TIEA) (Lang et al., 2015), the OECD is developing a system of Common Reporting Standards (CRS) in support of Automatic Exchange Agreements. The OECD has launched its ambitious base erosion and profit shifting program (BEPS) (OECD, 2013) which includes, among other action point, country by country reporting. The US introduced its wide-ranging set of rules under FATCA (McGill, 2013), followed by Europeans versions of ‘mini-FATCAs’ (Lang et al., 2018). The EU has commissioned a number of in-depth studies in aggressive tax avoidance (ATP), schemes with the aim of further tightening regulation (TAXUD, 2018).

These regulatory efforts are not taking place in a vacuum. For every action there is a reaction, and every new set of national and international rules and regulations are likely to stimulate whole series of adaptations, innovation and niche seeking behaviour on the part of various stakeholders. Sometimes the response of actors affected by regulations are direct: they will seek to marshal political forces to resist the introduction of new rules. Often response is more subtle, taking the form of innovation, niches, rule arbitrage and even sector hoping. Our working assumption is that irrespective of the current flurry of regulatory efforts, the ‘demand’ for avoidance tax is unlikely to have subsided. On the one contrary, the number of HNWI have increased dramatically during the past decade; the corporate sector is as centralised as ever, with two of the largest firms in the world in capitalization, Apple and Amazon, surpassing if only briefly the US$1 trillion mark. There is no evidence for the decline in what is now described as the ‘enablers industry’ that consists of range of offshore financial centres and accounting and legal firms, onshore and offshore.

The interplay of various stakeholders, each innovating and adapting to changing circumstances, ensures that complex regulatory environments, such as the European fiscal regulatory environment are like organisms, evolve and adapt typically in unanticipated directions. Rarely if ever, however, is it possible to anticipate reaction to a new regulatory environment. In seeking to anticipate likely response to the new fiscal regulations, we assumed that existing opportunities for arbitrage, or ‘pressure points’ would be ceased upon by stakeholders. We focused on three potential systemic ‘pressure points’ that were likely bear the brunt of the countermeasures to the new regulatory environment.

Finance

Post-ante investigations into the financial meltdown of 2007-9 revealed that banks, including largest financial houses in the US, have been developing and employing sophisticated financial instruments in facilitating tax evasion and avoidance. In 2011, the Government Accountability Office (GAO) in the US released the first, and so far the only, in-depth analysis of the use and potential abuse of financial instruments for tax avoidance by the US corporate sector. GAO established that financial derivatives are the main tools multinational corporations (MNCs) employ for tax non-compliance purposes (GAO, 2011). The majority of market actors we interviewed tend to agree with GAO’s findings, believing that sophisticated financial instruments such as swaps and derivative contracts, are the biggest ticket item of tax abuse.

In light of increasingly recognised importance of financial innovation in enabling tax abuse, we asked whether derivatives and other financial instruments are used as techniques of tax avoidance and evasion by the European banking and corporate sectors as well. Our conclusions can be summarised as follows:

- There are inherent characteristics pertaining to financial innovation, specifically concerning the use of derivatives that make these instruments particularly fertile for engaging in aggressive tax planning practices.
- Initiatives like OECD’s Base Erosion and Profit Shifting (BEPS) and EU’s Aggressive Tax Planning Indicators (ATPI) are relatively comprehensive in their aims to tackle some of the pitfalls of MNEs straddling heterogeneous national taxation systems; yet they do not focus on the opportunities created by financial engineering with regards to tax avoidance or evasion.
- The reporting systems of derivatives in the US and in Europe are inconsistent, asymmetric, and indeterminate, creating a fertile ground for arbitrage. The situation appears to be worse in Europe due to the discretion afforded by the EU to individual Member States in the taxation of financial instruments reported by EU companies.
- Most tax authorities have increased the resources devoted to fighting derivative-facilitated tax avoidance by MNEs, and not one single tax authority has decreased resources.
- Despite the developing momentum, what we find is that regulatory reform has been slow to catch up with developments occurring at the intersection between financial engineering and aggressive tax planning.

Policy recommendations:

Current systems of regulations in Europe are not well equipped to address the threat of abuse through financial engineering. While the politics of vested interests goes some way in explaining the regulatory lag, we find that the lag and resultant blind spots in the EU specifically, may be the outcome of two different philosophies of regulation of financial and real sectors in the US and the EU: the former more granular and independent, the latter more systemic (though blind to ‘in-between’ spaces) and captured by industry. We believe the EU should initiate a thorough investigation of the use of financial instruments as techniques of tax avoidance, on par with the work that is currently taking place in the study of ATP.

The Fintech Sector: An Emerging Issue

Fintech is a technology-anchored universe that is changing very rapidly. The evolution of Fintech has been both fast and diverse, and it is clear that it can develop in any imaginable and as yet, unimaginable directions. Currently, the aspect of Fintech that rais-
es particular concern from the perspective of illicit finance and tax abuse involves crypto currencies, blockchain technology, data mining, peer to peer (P2P) lending, crowdfunding, money transfer services and smart contracts.

While technological progress and financial innovation tend to be as forces of economic improvement, Fintech poses an unprecedented set of challenges to governance and public welfare. According to Izabella Kaminska of the Financial Times, fintech is nothing but the Eurodollar market 2.0. It combines many elements, from encrypted transactions to hidden identities and e-wallets in cyberspace, each of which is perfectly geared to enable crime and tax evasion. Below we consider some of the potential for tax avoidance produced by the new technology.

The key problem with bitcoin and other copycat crypto currencies, Kaminska argues, lies in the security/access paradox. “If the sector is easily accessible (highly competitive) it’s not secure, and if it’s secure it’s not easily accessible. Put differently, the more entrants there are, the easier it is for criminal enterprises to exploit the sector for their own ends” (Kaminska 2016). And that is exactly what is happening in the cryptocurrency space. An Australian study estimates that about 47% of transactions involving bitcoin are conducted on the dark net. Litecoin, second-most popular cryptocurrency (after Bitcoin) preferred by Russians, is now accepted by nearly one third of all dark-web vendors.

The American IRS treat cryptocurrencies not as currency, but as a capital asset, subject to rules governing stock and barter transactions when exchanged for dollars. In other words, the IRS considers these currencies a speculative investment. The users of currencies tend to behave differently. In an investigation of one platform, the IRS showed the court that out of 14,000 customers, only 802 people reported gains or losses from Bitcoin in 2015. Early data from one popular tax preparation service shows that only a minuscule proportion—just 0.04%—of US tax filers have reported cryptocurrency gains or losses to the IRS in the first half of 2018. That’s far fewer than the 7% of Americans who are estimated to own Bitcoin or another cryptocurrency, and who are likely to owe taxes to the IRS on those investments. In addition, Bitcoin could theoretically allow wealthy speculators to complete complicated commercial transactions, such as tax-exempt stock and gold-swapping trades that involve buying agents acting as fronts by using local currencies to facilitate the exchange. And that is exactly what appears to be happening in response to first stage of regulations of cryptocurrencies.

Our study reveals similar problems with initial coin offerings (ICO) and initial token offerings (ITO) as well as Blockchains. This suggests that cryptocurrencies have the potential to become What University of California-Irvine law professor Omri Marian has dubbed ‘super tax havens’ (2013) (Marian, 2013).

Policy recommendation:

The EU has commissioned study entitled, Virtual currencies and central banks monetary policy: challenges ahead [http://www.europarl.europa.eu/cmsdata/149900/CASE_FINAL%20publication.pdf]. The study calls on the EU to pay greater attention to the development of cryptocurrencies. The study is focused specifically on the challenges to the financial system and central banking, but not on fiscal matters. We would join the authors of the study in alerting regulators of growing importance not only of cryptocurrencies but of the Fintech sector as a whole.

Smart Contracts and the Legal Entity Identifier

Developments in finance, combined with Fintech is generating another set of transformations, potentially of paradigmatic scale. The entire system of taxation is focused on taxable events visible through a stable contractual world. Until very recently counterparties would enter, for instance, into a financial swap arrangement recorded either on a platform or ‘over-the-counter’, i.e., as private agreements between two parties. Regulators were traditionally interested in achieving a great degree of transparency of the recorded contracts for a variety of reasons, to ensure stability and that due tax is paid. The world of smart contracts is introducing a change, however, in the nature of the contract itself. Increasingly, systems emerge where an algorithm pools together actors’ intentions and generates bespoke temporary contracts that cater to the actors’ wishes. The algorithm chooses optimal counterparties, often without prior knowledge of those counterparties. Furthermore, the algorithm may change counterparties during the life of the transaction as the choice of optimal counterparty changes constantly. This may result in a situation that whereby contracts are increasingly exposed to scrutiny, counterparties may change over time. Under such circumstances, the entire system of taxation, already under heavy pressure from finance and Fintech, many not be up to scratch.

What is needed is a system of reporting of tax liabilities through proper feed of these fluid contracts, i.e., who did what, when and under what conditions. As it happens, the best candidate to support such system has emerged already as solution to a different problem experienced during the financial crisis. The collapse of Lehman Brothers in 2008, made explicit significant shortcomings relating to the identification of market participants as legal entities. Because of the lack of a unique or uncontested identifier for legal entities engaged in financial markets transactions and an inability to see how legal entities related to one another in terms of the ownership of assets and liabilities, it had been impossible for regulators to have advanced warning of any concentration of liabilities via subsidiaries that a consolidating entity might be accumulating. The response of financial markets regulators, led by the US market authorities (SEC, CFTC) and channelled initially through the Financial Stability Board (FSB) and then the G20, was to propose

1 Back in the late 1950s, the Eurodollar market, a market that emerged in London almost by accident, had swiftly plugged a hole in the entire post-war regulatory regime known as the Bretton Woods system.
the institution of new market-wide and cross-jurisdictional identifica-
tion standard for the uncontested and unambiguous identification of legal entities engaged in any kind of financial markets transactions across asset classes and trading venues. The design of a standard identifier format was developed in conjunction with the International Standards Organisation (ISO) (Financial Stability Board 2012, International Standards Organisation 2012), the mandating through regulations and other legal instruments of the use of the identifier in the reporting of financial markets transactions, the establishment of an issuance and maintenance infrastructure for the data linked to the identifier, and associated governance arrangements (Legal Entity Identifier Regulatory Oversight Committee 2015). All this would collectively form what is now referred to as the Global Legal Entity Identifier System (GLEIS).

At the centre of the GLEIS is the Global Legal Entity Foundation (GLEIF), not-for-profit consortium that oversees the operation of the system. GLEIF, among other things is responsible for issuing and validating LEI identifiers to those who apply for them through Local Operating Units (LOUs) around the world. GLEIF’s business model for the LEI’s IDI is premised on the free use of an ostensibly open infrastructure through a cost-recovery model whereby the promoters of the infrastructure justify their strategic positioning as guardians of accuracy and integrity and charge accordingly, through the costs that are recovered, for their service. It is clear from our interviewing that GLEIF is interested in widening the scope of LEI. GLEIF and SWIFT are already working on a cross-referencing and mapping of LEI and BIC datasets, while the BIS is also considering the inclusion of the reporting of LEIs for all legs of correspondent banking transaction and the OECD allows for the use of the LEI for the automatic exchange of information (AEoI) for tax purposes as an alternative to UTIs.

Policy recommendations:

Since GLEIF is a non-profit organisation and its cost recovery model does not generate obvious conflict of interest and its data appear to be the most accurate among the limited number of relevant data sets that are available, we believe that the LEI technology can help redress some of the challenges to taxation introduced by smart contracts. We recommend that the EU consider widening participation of EU corporate entities in the LEI process and support efforts for the cross-referencing and mapping of datasets around a unique cross-jurisdictional identifier such as the LEI.

Conclusions

Just as anticipated, considering that the demand for avoidance is not subsiding, regulatory tightening is in danger of having the squeezed balloon effect: squeeze the balloon on one side, and it inflates on another. There is little doubt that the latest regulatory efforts of the OECD, the US and the EU are having an effect. But just as traditional venues of avoidance are becoming more difficult, an issue that had remained largely under the radar for many years, the use of financial instruments for tax avoidance, is rearing its head. As the traditional banking industry was put on the spot, and compliance powers increased tremendously, an alternative venue is emerging through the FinTech industry which creates the danger of ‘democratizing’ avoidance and evasion. And just as technologies of information identification, certification and exchange are being improved, certain potential ‘gaming’ of the system is evolving through the introduction of smart contract technology. As a result, therefore, that are new clouds visible on the horizon and great care and vigilance will be required in the future.

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WHAT TO DO ABOUT FINANCIAL SECRECY AFFECTING THE EUROPEAN UNION?

COFFERS D7.5 POLICY BRIEF WP2
NOVEMBER 2018

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Introduction

A global industry of financial secrecy has developed over recent decades that involves the world’s biggest banks, law practices, accounting firms and specialist providers. These service providers design and market secretive financial structures that can be used by clients to circumvent countries’ tax laws and financial regulations. Financial secrecy structures such as shell companies and banking secrecy laws enable corruption, money laundering, tax evasion and the financing of terrorism and have been shown to have played an important role in the 2008 economic collapse.

To identify which jurisdictions supply the greatest share of global financial secrecy, the Tax Justice Network developed the ground-breaking Financial Secrecy Index, which ranks countries by their contribution to global financial secrecy. While the Financial Secrecy Index has helped policymakers identify the worst contributors to financial secrecy on a global level, questions remained on how policymakers can use the data from the Index to identify the jurisdictions from which their countries suffer the greatest supply of financial secrecy.

In response, the Tax Justice Network has developed the Bilateral Financial Secrecy Index which builds on and complements the Financial Secrecy Index. The Bilateral Financial Secrecy Index addresses the receiving side of financial secrecy, providing each country with a breakdown of the greatest suppliers of financial secrecy to its jurisdiction. For example, while Switzerland is ranked as the top contributor to global financial secrecy on the Financial Secrecy Index, Switzerland is only the ninth greatest contributor of financial secrecy targeting Portugal. The top contributor of financial secrecy to Portugal is the Netherlands, which is ranked 14th on the Financial Secrecy Index. The Bilateral Financial Secrecy Index is available for download as an excel file here.

This policy brief complements a full policy paper (Janský/Knobel et al. 2018) and an academic paper (Janský/Meinzer et al. 2018) published as a working paper in the Charles University (Prague) Institute of Economics Working Paper Series (“Is Panama really your tax haven? Secrecy jurisdictions and the countries they harm”). That policy paper uses the Bilateral Financial Secrecy Index to evaluate the success of the EU tax haven blacklist and the use of automatic exchange of information treaties in safeguarding against the main providers of financial secrecy targeting EU member states. Jurisdictions blacklisted on the EU tax haven blacklist supply just 1 per cent of the financial secrecy structures targeting EU member states, making the current blacklist ineffective at identifying and safeguarding against the vast bulk of suppliers of financial secrecy to the EU. The Bilateral Financial Secrecy Index shows that EU countries are responsible for 34 per cent of the financial secrecy affecting the EU as a whole, with four EU countries (the Netherlands, Luxembourg, Germany and France) ranking among the top 10 suppliers of financial secrecy to the EU. The US is the top supplier of financial secrecy to the EU, responsible for 4.7 per cent of financial secrecy to the EU. The US is not only the top offender in terms of financial secrecy affecting the EU as a whole, but is also the only country that appears on the top 15 financial secrecy providers affecting each EU country. The EU’s tax haven blacklist heavily relies on the OECD’s global transparency ratings, which considers the US a “largely compliant” jurisdiction despite criticism from the international community of the US’s poor track record on transparency and cooperation. The Bilateral Financial Secrecy Index shows that almost half of financial secrecy targeting the EU originates from OECD countries.

EU member states have been much more successful in using automatic exchange of information treaties to safeguard against financial secrecy. EU member states have on average covered 82 per cent of the financial secrecy targeting their jurisdiction by having automatic exchange of information treaties in place with the countries supplying financial secrecy structures targeting them. This 82 per cent includes the 34 per cent financial secrecy originated within the EU (based on automatic exchange of information taking place within the EU pursuant to DAC 2) in addition to automatic exchange of information with other countries, based on other EU agreements or the OECD’s Common Reporting Standard.

On average, EU member states have 82 treaties in place.

Nonetheless, not a single EU member state has been able to fully safeguard against the greatest contributor of financial secrecy to the EU, the US. In fact, the US does not provide any EU country with banking information at the beneficial ownership level. This means if an EU resident holds a bank account in the US through a company or trust instead of directly under their own name, the US will not share any information about the bank account with the EU authority to which the resident must pay tax. On top of this, with some EU countries, the US shares no banking information at all, regardless of whether the account is directly under an EU resident’s name or not.

Under the Foreign Account Tax Compliance Act, the US currently has an unequal relationship of information exchange where EU financial institutions are required to automatically share all information with US authorities (e.g. at the beneficial ownership level)
or face a 30 per cent withholding tax. Meanwhile, the US is under no obligation to share much information in return, if any at all. The Bilateral Financial Secrecy Index finds that the US alone is responsible for more than one-fifth of the financial secrecy targeting the EU that is not safeguarded against by an automatic exchange of information treaty. To address the risks associated with financial secrecy affecting the European Union, this policy brief makes three key recommendations:

**Policy recommendation 1: Replace the EU’s blacklist and greylist with a withholding tax policy**

The full policy paper (chapters 2 and 2.1) discussed why the EU’s blacklist is fundamentally flawed, how it is based on rules and assessments both bent and biased for major powers, and that it targets mainly lower and middle income countries. One immediate key policy response to this finding should be for the EU to evaluate the effects of blacklisting under the prism of the mandatory prohibition. The biggest concern for the EU, however, should be the United States. Instead of following the OECD approach and criteria (and bias), the EU shouldn’t ignore the US and the risks it creates. As this paper shows, the US is the largest provider of financial secrecy affecting the EU, with the US alone being responsible for close to 5 per cent (5520 out of a total Bilateral Financial Secrecy Index value of 117306 that affects the EU). The US is the only country that is among the top 15 financial secrecy providers of all 27 EU countries. And the US currently does not participate in automatic exchange of information. It only provides a trickle of data to some partners under FATCA (Knobel 2016).14

Given that the US has not committed to any timeline to ensure full reciprocity in information exchange, the EU needs to act now to address these secrecy risks and to overcome the US’s resistance to cooperation. The EU should introduce a withholding tax policy targeting any financial institution that is not engaging fully in automatic exchange of information with EU members, and with other relevant third parties. Similarly to the US FATCA law, the EU should impose a 30 per cent withholding tax on any EU-sourced payments to any financial institution that is not sharing sufficient information with the EU, or with any ‘fit and ready’ developing country. Tax Justice Network presented an outline for a withholding tax policy in 2016 (Tax Justice Network 2016).

This withholding tax should come as no surprise to the US, given that the US imposed the very same 30 per cent withholding tax threat against European financial institutions (and banks of every jurisdiction) to incentivize them to exchange all relevant financial account information with the US on an automatic basis. At the very least, the EU should respond with equal penalties against US financial institutions because they have proven to work.

**Policy recommendation 2: Require disclosure of public aggregate statistics on golden visas and automatic exchange of information**

In contrast to financial secrecy emanating from the US, financial secrecy from within the EU is at least mitigated by the framework on automatic exchange of information on financial account data, legislated through the EU Directive on automatic exchange of financial account information (“DAC 2”; Council of the EU 2015). Yet, the effectiveness of this regime is at risk because of various gaps and loopholes in the rules (Knobel/Meinzer 2014;Meinzer 2017).

Crucially, the availability of various golden visa and residency by investment schemes create opportunities for circumventing the automatic exchange of information regime. These opportunities create particularly high levels of risks for European tax revenues if they are coupled with an incomplete or low personal income tax system in the jurisdiction offering the schemes, as is the case in the EU for Cyprus, Ireland and Malta, and in Monaco among EU’s associated territories (Knobel/Heitmüller 2018). This combination of lenient rules entices wealthy individuals both from within and outside the EU to obtain a (fake) residency in such jurisdictions, while continuing to reside, live and work in their original jurisdiction of residency. These golden visa or fake residency certificates can be abused to open bank accounts elsewhere, pretending to be resident in those “golden visa” jurisdictions (e.g. Cyprus, Ireland, Malta or Monaco).15 The information exchange will in such a case be ineffective, as the account data would arrive in the wrong juris-

13 “The Union shall take account of the objectives of development cooperation in the policies that it implements which are likely to affect developing countries.” (extract from Article 208, see pages 186-187, in: Council of the European Union 2012).

14 Austria and Bulgaria are the only EU members that chose not to obtain even the trickle of information under FATCA agreements from the US. In the interest of revenue generation and tax fairness, these countries should renounce their “voluntary secrecy” and instead agree to not only send, but also to receive information from the US.

15 Both Ireland and Malta tax offshore income by non-domiciled residents only when it is remitted to the respective jurisdiction. Therefore, any non-resident from the EU who is interested to engage in offshore tax evasion in their home jurisdiction can access the residency permission in Ireland (by investing at least €1 million) or a citizenship by investment in Malta to then mislead their offshore bank in or outside the EU to sending the information to these “fake residency” jurisdictions. For details, see Knobel/Heitmüller 2018 and [https://www.financialsecrecyindex.com/database/Ireland_xml#b65](https://www.financialsecrecyindex.com/database/Ireland_xml#b65); and [https://www.financialsecrecyindex.com/database/Malta_xml#b65](https://www.financialsecrecyindex.com/database/Malta_xml#b65). 19.9.2018. A similar situation applies with respect to Monaco, which has no personal income tax whatsoever. While Cyprus does levy a personal income tax, it generally does not tax capital gains, except from income from the disposeable of immovable property. Nonetheless, the non-reception of information from outside of EU makes it a perfect gateway for offshore tax evasion for EU residents. As long as EU residents keep their offshore bank account outside of the EU/related territories, the information exchange under AEOI would not arrive in Cyprus. Therefore, Cyprus could not enforce its personal income taxation. See [https://www.financialsecrecyindex.com/database/Cyprus_xml#b65](https://www.financialsecrecyindex.com/database/Cyprus_xml#b65); 19.9.2018.
diction (eg Ireland, Malta or Monaco), where this income might be exempt from personal income or capital gains taxation.

Among the three EU member states (Cyprus, Ireland and Malta) which offer the combination of lenient residency/citizenship rules and incomplete personal income taxation, Cyprus poses particularly high risks. This is because Cyprus refuses to obtain any information collected on its residents from Common Reporting Standard exchange partners, by opting for voluntary secrecy under Annex A in OECD’s automatic exchange of information system. Annex A jurisdictions are known to be notorious tax havens which have no interest in obtaining offshore account information on their residents. By choosing this option, Cyprus is clearly pursuing a tax haven strategy, exposing European tax revenues from wealthy individuals to a high risk of erosion. Anybody obtaining a passport through Cyprus’ citizenship by investment scheme can evade taxes on their offshore wealth in their original home jurisdictions (and in Cyprus) by opening a bank account outside the European Union, registering as a (tax) resident of Cyprus.

Most importantly, the lack of public statistical disclosure exacerbates the risks stemming from this and other loopholes. The only way to ensure that the rules on automatic exchange of information are enforced properly is through the publication of statistics. Tax Justice Network prepared in 2017 a template and guide (Knobel/Meinzer 2017) that can be used to make public at an aggregate level the statistics needed to verify the amount of information being exchanged and detect tax avoidance schemes, without breaching individual confidentiality or privacy. Australia has already committed to publish statistics on automatic exchange of information.

These statistics on the automatic exchange mechanism should be complemented with public statistics on the golden visa and residency by investment regimes of at least the four jurisdictions creating the highest risk inside the EU and associated territories. These statistics should include details of the previous and current residencies, as well as citizenships of those individuals obtaining golden visas or residencies by investment. The EU should legislate furthermore the mandatory exchange of these individual’s identities with administrations of all previous and current residency and citizenship jurisdictions.

**Policy Recommendation 3: Improve targeting of automatic exchange of information partners**

The percentage of financial secrecy covered by automatic exchange of information treaties varies among EU members, ranging from 92 per cent (Spain) to 45 per cent (Cyprus). While the case of Cyprus is special (and discussed in the full policy paper), the coverage of some EU members could be improved by individual administrations using the Bilateral Financial Secrecy Index analysis to assess negotiation priorities. Annex A provides a table for each EU member state that details the member state’s top 15 secrecy providers. Secrecy providers highlighted in red are currently not signed up to an automatic exchange of information treaty with the receiving EU member state and should therefore become a priority for negotiating agreements.

EU members have been unsuccessful in securing automatic exchange of information agreements with some of the greatest suppliers of financial secrecy to the EU. Beyond the United States (discussed above), Turkey and Taiwan provide substantial unmitigated financial secrecy to the EU. For those secrecy providers ranging at the top, a joint negotiation position by the EU might be an option to consider.

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### Table 1: EU’s Top 15 Financial Secrecy Providers

<table>
<thead>
<tr>
<th>Rank</th>
<th>Jurisdiction</th>
<th>BFSI</th>
<th>Secrecy Score (adjusted)</th>
<th>EU black or grey list?</th>
<th>Lacking AEOI relation with how many “victim” EU countries?</th>
<th>% of BFSI with EU members uncovered by AEOI relationships?</th>
<th>Global AEOI Instruments?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>United States</td>
<td>5,520</td>
<td>59.8</td>
<td></td>
<td>27 (no AEOI relationships)</td>
<td>100%</td>
<td>-</td>
</tr>
<tr>
<td>2</td>
<td>Netherlands</td>
<td>4,729</td>
<td>64.7</td>
<td></td>
<td>0</td>
<td>0%</td>
<td>MCAA &amp; DAC2</td>
</tr>
<tr>
<td>3</td>
<td>Luxembourg</td>
<td>4,472</td>
<td>57.5</td>
<td></td>
<td>0</td>
<td>0%</td>
<td>MCAA &amp; DAC2</td>
</tr>
<tr>
<td>4</td>
<td>Switzerland</td>
<td>4,319</td>
<td>72.6 G</td>
<td></td>
<td>0</td>
<td>0%</td>
<td>MCAA &amp; EU-Agreement</td>
</tr>
<tr>
<td>5</td>
<td>Cayman Islands</td>
<td>4,014</td>
<td>72.3 G</td>
<td></td>
<td>2*</td>
<td>1%</td>
<td>MCAA</td>
</tr>
<tr>
<td>6</td>
<td>Germany</td>
<td>3,902</td>
<td>58.2</td>
<td></td>
<td>0</td>
<td>0%</td>
<td>MCAA &amp; DAC2</td>
</tr>
<tr>
<td>7</td>
<td>Japan</td>
<td>2,661</td>
<td>60.5</td>
<td></td>
<td>2*</td>
<td>1%</td>
<td>MCAA</td>
</tr>
<tr>
<td>8</td>
<td>France</td>
<td>2,647</td>
<td>51.0</td>
<td></td>
<td>0</td>
<td>0%</td>
<td>MCAA &amp; DAC2</td>
</tr>
<tr>
<td>9</td>
<td>United Arab Emirates</td>
<td>2,503</td>
<td>83.8 G</td>
<td></td>
<td>2* (Lithuania)</td>
<td>2%</td>
<td>MCAA</td>
</tr>
<tr>
<td>10</td>
<td>Hong Kong</td>
<td>2,456</td>
<td>71.1 G</td>
<td></td>
<td>7* (Austria, Belgium, Hungary, Portugal, Slovakia and Sweden)</td>
<td>18%</td>
<td>MCAA</td>
</tr>
<tr>
<td>11</td>
<td>Turkey</td>
<td>2,350</td>
<td>68.0 G</td>
<td></td>
<td>27 (no AEOI relationships)</td>
<td>100%</td>
<td>MCAA (no AEOI relationships yet)</td>
</tr>
<tr>
<td>12</td>
<td>Bermuda</td>
<td>2,317</td>
<td>73.1 G</td>
<td></td>
<td>2*</td>
<td>2%</td>
<td>MCAA</td>
</tr>
<tr>
<td>13</td>
<td>Jersey</td>
<td>2,223</td>
<td>65.4</td>
<td></td>
<td>2*</td>
<td>2%</td>
<td>MCAA</td>
</tr>
<tr>
<td>14</td>
<td>Taiwan</td>
<td>2,206</td>
<td>75.8 G</td>
<td></td>
<td>17 (no AEOI relationships)</td>
<td>100%</td>
<td>-</td>
</tr>
<tr>
<td>15</td>
<td>Guernsey</td>
<td>2,203</td>
<td>72.4</td>
<td></td>
<td>2*</td>
<td>3%</td>
<td>MCAA</td>
</tr>
</tbody>
</table>

Source: Authors

Notes: [The table uses traffic-light colour coding. Red = secrecy; orange = partial secrecy; green = transparency]. An asterisk (*) in red font indicates that AEOI relationships with Cyprus and/or Romania are not taking place because of these two countries’ choice of “voluntary secrecy” (to send, but not to receive information automatically from other countries) or shortcomings (failure to comply with confidentiality requirements that prevent them from receiving information from other countries). There is no certainty on each country’s case because the OECD doesn’t publish the reason but merely the fact that Cyprus and Romania will send, but not receive information from non-EU countries.

9 Adjusted to reflect the higher cooperation within EU countries and related territories. See footnote 8.

10 This column refers to relationships between a secrecy jurisdiction (e.g. the US) and every EU country that is suffering from financial secrecy originating in that jurisdiction, but not to all 27 EU countries. Taiwan, for instance, only provides financial secrecy to 17 EU countries, so only those 17 are considered here.
References


POLICY BRIEF: AUTOMATIC EXCHANGE OF INFORMATION IN TAX MATTERS AND DOMESTIC CAPITAL TAXATION

COFFERS D7.5 POLICY BRIEF WP3 NOVEMBER 2018

Leo Ahrens
Fabio Bothner
Lukas Hakelberg
Thomas Rixen

University of Bamberg
Executive Summary and Policy Recommendations

- Automatic information exchange is effective in fighting tax evasion and restoring maneuvering room for governments to democratically set domestic tax policies in an era of economic globalization.

- The European Union should use its economic power as one of the biggest markets to push for more effective international tax cooperation.

- The European Union must ensure strict compliance with the AEoI regime.

- Remaining loopholes in the current regime of Automatic Information Exchange have to be closed.

- The European Union should pressure remaining countries to participate in the CRS MCAA.

- Effective international cooperation has to be extended to the realm of corporation taxes.

Background

While tax evasion and avoidance have plagued governments for a long time, the fight against tax evasion gathered momentum following the widely publicized scandals surrounding the LGT and UBS. The international community subsequently enforced serval stringent measures to prevent tax evasion. The OECD made a first step by developing a blacklist of tax havens, establishing the Forum on Transparency and Exchange of Information, and deepening efforts to foster bilateral information-on-request (IOR) treaties. However, studies show that these efforts were not successful. The only approach not based on soft power, IOR treaties, could be easily circumvented by tax evaders since they could shift deposits to non-compliant havens or use sham corporations to conceal their identity (Hanlon et al. 2015; Johannesen 2014; Johannesen and Zucman 2014; Menkhoff and Miethe 2017). The failure of the OECD led the US to act unilaterally. They implemented an automatic exchange of tax-related information with participating countries under the Foreign Account Tax Compliance Act (FATCA). FATCA obliges foreign banks to exchange information on the foreign accounts of US residents with US tax authorities on an automatic basis. The US imposed the policy on all relevant tax havens who subsequently forfeited banking secrecy vis-à-vis the United States (Eccleston and Gray 2014). The initiative triggered a global push towards automatic exchange of information (AEoI). The OECD seized the renewed opportunity and developed the Common Reporting Standards (CRS), which aimed to implement a multilateral AEoI regime. It requires participating countries to obtain information about foreign account holders and exchange the information with the respective jurisdictions on an annual basis. The CRS are embedded in an international legal framework, the CRS Multilateral Competent Authority Agreement (CRS MCAA). Over 100 jurisdictions committed to the agreement by late 2018. In combination, FATCA and the CRS demarcate a new era in the fight against tax evasion.

The EU codified AEoI in its Administrative Cooperation Directive. These initiatives seem to avoid the shortcomings of prior cooperation against tax evasion.

Work Package 3 “Jurisdictions” of COFFERS studies AEoI agreements. In particular, we are interested in analyzing the effectiveness of AEoI. Given that in the past governments were constrained by international tax evasion and tax competition to lower taxes on capital income, we ask, whether AEoI enables governments to return to more progressive tax systems. Our research yields the following results.

Contrasting the fights against tax evasion and tax avoidance

A first study by Lukas Hakelberg (COFFERS deliverable D 3.2) contrasts the successful implementation of AEoI with the failed attempts to combat corporate profit shifting under the OECD’s BEPS project. It shows that dilemmas of international cooperation are easier to overcome in the fight against tax evasion than in the battle against tax avoidance. The reason for this discrepancy lies in the ability of affected interest groups in major developed economies to exert instrumental, structural and discursive power in the political process. Whereas tax evaders are constrained by the criminality of their deeds, multinational companies routinely point to the legality of tax planning, emphasize the additional investment and job creation a lower tax burden permits, and shift the blame for loopholes to politicians writing the tax laws.

The big bang – How AEoI affected tax evasion

Leo Ahrens and Fabio Bothner assess the effect of AEoI on cross-border tax evasion (forthcoming as COFFERS deliverable D3.5). The results suggest that AEoI reduced tax evasion by a rough estimate of 69%. Furthermore, tax evaders pulled their assets from havens long before information about their behavior would be collected and transmitted. Their reaction was driven solely by the international endorsement of AEoI treaties. While there is evidence for efforts to circumvent AEoI, the policy is certainly effective in the fight against tax evasion overall.

New room to maneuver – The impact of AEoI on capital taxation

Departing from the observation that taxes on capital income and corporate profits had generally declined in OECD countries since the 1980s, Lukas Hakelberg and Thomas Rixen identify a recent discrepancy between tax rates imposed on corporate profits and portfolio capital income (COFFERS deliverable D 3.3). Whereas corporate profit taxes continue to fall, portfolio capital taxes are on the rise in the OECD average since 2009. In a difference-in-difference regression design they show that this is the result of successful international cooperation against tax evasion, which enables governments to increase portfolio capital taxes. AEoI creates new room to maneuver for governments in portfolio capital taxation.

Further investigating the link between AEoI and domestic tax policy setting, Fabio Bothner, Lukas Hakelberg, Thomas Rixen and Leo Ahrens take a closer look at the variation across coun-
tries. In COFFERS deliverable D 3.4 they argue that each country faces individual investment environments and correspondingly a specific level of financial secrecy (depending on the stringency of the information agreements in the investment environment). They show that countries with less secret investment environments have more room to raise tax rates on portfolio capital income. A statistical analysis of dividend tax rates across countries and time suggests that financial transparency (more effective information exchange) positively affects them. More importantly, it is shown that transparency leads to political domestic influences such as governing party, budget requirements and the electorate's fairness considerations exerting more significant effects.

Policy recommendations

Our research shows that unlike efforts to curb tax avoidance by corporations, international cooperation against tax evasion proved to be successful. As a result, governments regained democratic control over their tax policies that had previously been lost to the constraints of tax evasion and tax competition. Nevertheless, we think that the fight against tax evasion is not over. Policy makers have to remain alert because pressing challenges remain. We have the following recommendations.

Recommendation 1: The EU must ensure strict compliance with AEoI

AEoI is a successful policy initiative and demarcates a new era in the fight against tax evasion. Its future success critically depends on the continuing commitment of participating jurisdictions. Tax havens have an incentive to act in bad faith by mere mock compliance. The EU must act as a global leader and ensure strict compliance with AEoI in the future. Firstly, participating countries must follow the rules of what information is transmitted. Secondly, the quality of provided data must be validated. The purpose and success of AEoI is undermined when tax havens transmit incomplete or phony information about foreign account holders. Lastly, the agreed delivery times must be respected.

Recommendation 2: Remaining loopholes must be closed

There are remaining loopholes that plague the AEoI regime. One problem are golden passport schemes. Several secrecy jurisdictions with low capital tax rates have started selling citizenship or confirmation of residency in recent years. This allows tax evaders to become citizens of countries that they never lived in. Golden passports threaten information exchange under AEoI because evaders can open foreign bank accounts with a deceitful citizenship, which circumvents information transmission to their resident tax authorities. In combination with the low tax rates, this allows owners of golden passports to evade taxes in their home country. The OECD already put such schemes on its agenda and compiled a blacklist of jurisdictions providing golden passports (OECD 2018). Additionally, they published guidelines that assist financial institutions in identifying correct residencies. However, it is crucial that the EU applies pressure to countries offering these schemes.

Recommendation 3: Remaining countries should be pressured to participate in the CRS MCAA

As much as 104 countries signed CRS MCAA by late 2018, but there are still countries that do not participate. Thus, it is still possible for tax evaders to circumvent information exchange by shifting assets to remaining non-compliant jurisdictions. While the most important tax havens participate in AEoI, remaining havens have a strong incentive to expand tax haven operations. The emergence of new tax havens is also a looming problem. This threatens the future success of AEoI. The EU must act and extend AEoI to non-compliant jurisdictions.

How can reluctant countries be brought to sign the CRS MCAA? The answer is pressure. With FATCA, the United States demonstrated that resistance usually crumbles after credible sanction threats. The EU certainly has the necessary market power to ensure remaining countries' compliance. Its domestic financial market is crucial for banks all over the world, which empowers the EU to follow the US and threaten non-compliant countries with withholding taxes.

The United States oblige foreign banks to transmit information about the accounts of US residents but do not share information with foreign jurisdictions. This is especially worrisome because the US is the largest financial center in the world. It has both an incentive and the possibility to develop tax haven operations in the future. Banks in states such as Delaware, Nevada and South Dakota already allow foreign investors to establish shell corporations that do not require identity verification. Thus, the Boston Consulting Group (2016) expects that only Hong Kong and Singapore will outpace offshore wealth growth in the US. This endangers the success in the fight against tax evasion (Hakelberg and Schaub 2018).

The EU should pressure the US into participating in reciprocal AEoI in the future. The US is the most important financial center of the world, but the European market is certainly important for its banks. Above all, the EU must speak with one voice to make their sanction threats credible. This requires abolishing internal dissent. The EU's market power can only be leveraged if countries in the EU act in concert. Abandoning the unanimity principle in tax policy in favor of simple or qualified majority voting would be a step in the right direction.

Recommendation 4: Expand effective cooperation to tackle tax avoidance

Finally, a return to a truly progressive tax system hinges on effective cooperation in the area of business taxation. However, to date no comparable breakthrough to AEoI has been achieved. Political pressure to move forward on this front should be upheld.
References


INCLUSIVENESS OR COHERENCE IN INTERNATIONAL TAX POLICY-MAKING?

COFFERS D7.5 POLICY BRIEF WP4
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Executive summary: At a time when media scandals concerning the taxation of multinational corporations abound and public and political attention are at unprecedented levels, the governance of the international corporate tax system requires serious scrutiny. This policy brief highlights the historical lack of inclusiveness in international tax policy-making. This lack has helped ensure coherence in basic governance principles, but has also contributed to a resistance towards change, potentially threatening the long-term legitimacy of the international tax system. Policy-makers must now weigh the (lack of) inclusiveness of international tax policy-making against the ability to achieve change and the overall coherence and sustainability of the system.

Policy recommendations:

- Policy-makers in the OECD, the EU and beyond should formalize ambitions for the stakeholder diversity in international tax policy-making.
- These ambitions should be realized after careful consideration of the trade-offs between diversity and inclusiveness, political progress and responsiveness, and coherence.
- These ambitions should be realized via actionable initiatives to support stated objectives for the overall design of international tax policy-making processes.

Introduction

Who makes the international rules governing the taxation of multinational companies, how, and with what effects? At a time when media scandals concerning the taxation of multinational companies abound and public and political attention are at unprecedented levels, these questions require serious scrutiny. The overall coherence, legitimacy and sustainability of the international corporate tax system is at stake. This policy brief analyses the policy-making process. The brief draws on research conducted under the European Union’s Horizon 2020 framework programme ‘Combating Fiscal Fraud and Empowering Regulators’ (#727145).

Specifically, the brief highlights the historical lack of inclusiveness in international tax policy-making. This lack of inclusiveness has two dimensions. First, geopolitically, the system of rules governing the taxation of multinational corporations has historically been dominated by a small group of states from the Global North. This is supported by an organizational property: for 60 years the Organisation for Economic Development and Co-operation (OECD), derogatorily named the ‘rich countries club’, has remained the focal point for international tax policy-making. Second, in terms of expertise, the diversity of voices deemed relevant and credible in international tax policy-making has traditionally been largely restricted to specific government and business perspectives. While the first dimension has been explored at length in previous research, the second dimension has received less scrutiny. This is particularly relevant because international tax policy-making is under significant pressure, as media exposés on the tax affairs of multinational companies, large-scale tax haven leaks and the context of a global financial crisis, have caused an explosion of public and political interest in what was historically a policy area with significant immunity to politicization. New actors have entered the stage and found a platform, including actors in and around the European Union, civil society activists, and traditionally marginalised countries from the Global South.

These developments have brought longstanding concerns about the legitimacy of the policy-making dynamics in international taxation to the surface. However, while critical questions about inclusiveness are pertinent, it is worthwhile noting that ‘closedness’ has also contributed to coherence in basic governance principles, due to strong normative homogeneity in the exclusive group of policy-makers. The current climate, calls for a careful examination of the properties of contemporary international tax policy-making, its impact on diversity/inclusiveness, its responsiveness, and the overall coherence of the system.

Expertise in international tax policy-making

The 2007-08 global financial crisis was followed by a raft of high-level reform initiatives aimed at ‘fixing’ the international tax system, politically identified as a key problem for states under sudden and striking fiscal pressure. Amongst these initiatives, the Base Erosion and Profit Shifting (BEPS) project, launched in 2013, was arguably leading. Combining strong political backing from the...
G20 with the OECD forum’s track record in the creation and diffusion of regulatory innovations, BEPS aimed at comprehensive change to tax treaties, tax law mismatches, corporate tax transparency and more. However, once the political momentum that had put ‘BEPS’ on the global agenda was channelled into the OECD policy-making process, the impetus for change was subdued, and the project resulted in a series of compromise agreements diverging substantially from the pre-BEPS political rhetoric. This was particularly so in the area of corporate tax transparency, which had a marked presence in public discussions and was targeted by civil society activists and critical politicians.

Central to this is expertise dynamics in international tax policy-making. The technical BEPS policy discussions was organised around the OECD’s ‘soft law’ mode of governance and shielded from the public and the political limelight. ‘Closedness’ around a narrow group of stakeholders manifests in competition between technical experts from national governments, international organisations, and the private sector over policy ideas. Within this group, hierarchies of prestige and influence are based on strategic combinations of expertise and network positioning. For instance, credibility may be enhanced by going through ‘revolving doors’, i.e. moving strategically between sectors and work roles. In particular, those rat the top of the expert hierarchy, and best positioned to promote their policy ideas, were either able to leverage a broad expertise base – drawing on knowledge resources from economics, accounting, and law, obtained through diverse careers – or able to leverage strong network positioning in prestigious global tax committees and clubs alongside a narrow, specialized expertise base.

These properties enabled certain professionals to speak authoritatively, mobilise credibility, set the standard for accepted arguments, and ultimately shape the policy process. Specifically, the highly political discussions were embedded in a specialised, expertise-intensive policy-making milieu. And this subdued the post-crisis political surge for change to the international tax system. This dynamic had several features. First, it was marked by policy insulation.. The access and influence of outsiders was restricted, as discussions were shielded from politicisation and public conflict, with emphasis on technical consensus and the ‘OECD way’ of conducting politics. To illustrate, the figure below show the participation of different stakeholder groups in one key public consultation during the BEPS project (Action 13). Second, key policy ideas that had been brought onto the pre-BEPS global political agenda were re-framed, from being radical proposals aimed at fundamentally changing the international tax system to technical tools ‘aiding’ professional insiders in everyday practice. Third, the appropriateness of policy proposals discussed as part the BEPS process were judged against established knowledge in the entrenched technical community, while claims based on appeals to more broadly framed societal values such as ‘morality’ and ‘fairness’ were largely discounted.

The process thus privileged technical experts in general, and specifically certain established professionals, who in large part favoured minimal change and opposed the radical overhauls promoted pre-BEPS by civil society activists and some politicians. In contrast, the broader ecology of stakeholders, including civil society organisations and stakeholders from non-OECD countries, particularly the Global South, gained little foothold in the policy processes. However, this ‘closedness’ importantly helped ensure the coherence of the system by enabling the diffusion and implementation of agreed policy recommendations to national governments around the world. Despite formal status as ‘soft law’, or policy recommendations, policy proposals agreed as part of the BEPS project, including those originating from critical outsiders, were effectively diffused amongst and beyond the policy-making community itself. Today more than 100 governments have committed to implementing the basic regulatory standards formulated in the BEPS6.

These expertise dynamics in policy-making at the OECD stand in sharp contrast to the tax policy processes of the European Union, a key present-day challenger to the OECD’s dominance over global tax policies. The European Union has, in the post-crisis years, become an arena for some of the highest profile global tax policy discussions. These are marked by a high diversity of voices and expertise, politicization and instability, and importantly produce hard law. Specifically, the contemporary EU international tax poli-
cy-making context is characterised by the active involvement and participation of a highly heterogeneous group of stakeholders, including civil society campaigners, a diverse range of business coalitions, politicians from the European Parliament, and an activist bureaucracy in the European Commission. However, historically dominant stakeholders, namely Member State governments, retain significant formal authority over EU tax policy-making, with each state holding formal veto powers over direct tax policy issues. In this setting, radical political reform initiatives and proposals on international tax issues have emerged. These have gone beyond and even directly against consensus positions agreed at the OECD, but have also exposed increasingly vocal internal controversies and hypocrisy among the Union’s Member States.

Implications and policy recommendations

What do these findings mean for international tax policy-making? It is clear that historically, and to a notable extent still in recent years, the dominant forum for setting rules governing the taxation of multinational corporations has been characterised by a significant lack of inclusiveness, yet has achieved an impressive consensus around basic policy principles. In recent years, in the context of exploding issue salience and public attention, this ‘closedness’ has come under scrutiny and pressure. The EU has emerged as a key challenger to the OECD, with policy-making marked by a radically different mode of policy-making, which is more open, heterogeneous and conflictual. However, while the diversity of voices and inclusiveness of policy-making in the EU has fostered a responsiveness to public calls for change that the OECD was not well-suited for, it potentially comes at a significant cost. The EU’s rise and conflict with the established ‘OECD consensus’ threatens the overall coherence of the international tax system.

In other words, there appears to be a trade-off between inclusiveness and coherence in international tax policy-making, at least in terms of the two key institutions shaping international corporate tax rules. Inclusiveness and coherence both speak to the overall legitimacy of the system. Simply modelled, we might think of inclusiveness as representing what is conventionally called the ‘input’ aspect of legitimacy, or the responsiveness of the policy-making system to citizen concerns, and coherence as representing ‘output’ legitimacy, or the effectiveness of policy outcomes. Historically, international tax policy-making has prioritized output legitimacy, ensuring the internationally consistent adoption of technically sophisticated policies based on expert consensus, over input legitimacy, broad stakeholder participation and receptiveness to public concerns. However, at this juncture this trade-off is strained, not only due to the rise of the EU, but also due to conflicts between historical allies inside the OECD, as well as between the OECD and the G77. This raises the prospect of the further fracturing of international tax collaboration.

This, more than ever, calls for a careful re-examination of these trade-offs within and the properties of contemporary international tax policy-making. In particular, policy-makers must weigh the promotion of inclusiveness and/or coherence, and evaluate the contextual factors that condition this trade-off. Initiatives to increase inclusiveness might, for instance, entail opening up public consultation processes at the OECD in a way that more proactively included a greater breadth of stakeholders, moving away from an exclusively technically-based discourse and institutionalising deeper collaboration with historical ‘outsiders’. Of note, the OECD has already done a significant amount of work in this direction in the post-BEPS era. Its ‘Inclusive Framework’ now encompasses more than 100 countries as members on equal footing, involved in policy discussions, mutual peer review and more. Ongoing proposals to move the focal point of international tax policy collaboration to a United Nations forum might prompt greater diversity of voices. At the same, initiatives to increase coherence might, for instance, entail a closer alignment of OECD and EU policy processes through institutionalised collaboration. This would, for instance, mitigate against current risks of individual countries pursuing unilateral actions to ‘fix’ multinational corporate taxation, rather than relying on collaborative solutions. Or perhaps more controversially, it might entail the return of an OECD-dominated mode of policy-making.

However, it is important to note that these are not necessarily mutually exclusive pathways to addressing legitimacy concerns around international tax policy-making. Further, the utility of such initiatives is crucially dependent on what is trying to be achieved and the feasibility of each initiative in a broader context of international politics. For instance, a geopolitical balance, in which the Global North, OECD, EU members, and specific countries within these blocs, possess disproportionate economic and political in-

fluence and capacity is potentially the most significant barrier to greater inclusiveness. Equally, the large differential in professional-technical capabilities amongst stakeholder groups is notable. At the same time, the increasing geopolitical might of emerging markets, who may have fundamentally different views on the governance of international corporate taxation, must be a central consideration in the pursuit of system coherence. These are unescapable factors in evaluating the trade-offs in designing international tax policy-making processes.

What is perhaps of greatest importance, then, is that policy-makers make clear and strategically pursue their ambitions for international tax policy-making. Policy-makers are highly active in promoting various ambitions for the content of international tax policy, yet the structure of the process to bring those substantive ideas about are all too often left implicit, bar scattered calls from outsiders for radical institutional reform. Initially, policy-makers in the OECD, the European Union and beyond should explicate their goals for the involvement and diversity of stakeholders and types of expertise in international tax policy-making. Second, these ambitions should be accompanied by careful and transparent considerations of the trade-offs between diversity and inclusiveness, political progress and responsiveness, and coherence, in the broader context of international politics. Third, these ambitions should be accompanied by actionable initiatives to support the stated objectives for the overall design of international tax policy-making processes.
THE CRIMINALISATION OF TAX EVASION
AND THE SCALE OF PROFIT SHIFTING

COFFERS D7.5 POLICY BRIEF WP6
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Summary

In this policy brief Working Package 6 addresses two sets of policy issues: How strongly should one criminalize not paying taxes? How can one measure profit shifting of multinational enterprises? First, tax evasion was recently put under the umbrella of anti money laundering regulation. While originally Money Laundering was meant for combatting drugs, its scope broadened over time from drugs to corruption, terrorism financing and lately also to taxes. This means that tax evasion will become more seriously criminalized than before. Second, profit shifting of multinational enterprises to tax havens have been receiving increasing attention. Yet, its scale remains uncertain due to data gaps. Recent research uses the best available foreign direct investment data to provide illustrative estimates of profit shifting and finds that, on average, developing countries lose more corporate tax revenue relative to their GDP than OECD countries.

Policy recommendations

1. In particular medium and big tax crimes should be investigated and prosecuted under the umbrella of anti money laundering regulation.
2. More harmonisation of terms and practices within Europe is urgently needed to link medium to big tax crimes to money laundering.
3. Initiatives such as the OECD’s Base Erosion and Profit Shifting framework needs to be more inclusive towards developing countries.
4. Country-by-country reporting data of multinational enterprises should be used to estimate the scale of profit shifting and the data should be made public in full.

The criminalisation of tax evasion and the scale of profit shifting

In this policy brief Working Package 6 addresses two sets of policy issues: How strongly should one criminalize not paying taxes? How can one measure profit shifting of multinational enterprises?

1. How strongly should one criminalize not paying taxes?

Lately, tax evasion was put under the umbrella of anti money laundering regulation. While originally Money Laundering was meant for combatting drugs, its scope broadened over time from drugs to corruption, terrorism financing and lately also to taxes. This means that tax evasion will become more seriously criminalized than before.

Background

Many leaks, like the Panama Papers in April 2015, followed by Lux leaks, Bermuda Leaks revealed that the global unregulated tax system was seriously going wrong. The most recent ‘Paradise Papers’ of November 2017 show 13.4 million confidential documents relating to offshore investments of 120,000 people and companies in 19 jurisdictions involving around 10 trillion of USD (Boston Consulting Group 2017). They include mainly tax avoidance constructions of big companies like Facebook, Apple, Uber, Nike, Siemens who all own offshore companies. They also revealed illegal loans of 45 million USD from Glencore, the largest multinational commodity trading and mining company, in order to get rights at a copper mine in Congo. Directors of companies listed in the Paradise papers include leaders of African states, the British Queen and last but by no means least Lord Sassoon, the president of the Financial Action Task Force on Money Laundering (ICIJ 2017).

The revelation of the diverse leaks showed that a large volume of unpaid taxes was missing which meant a tremendous inequality which could fill the public coffers and be used for public needs. To link tax evasion to money laundering can be seen as a political effort to prevent and reduce tax evasion by criminalizing it more heavily.

Problems

While drugs and organized crime are clearly defined as crimes in the member states, tax evasion is not. It is therefore doubtable whether the directive really adds to the combat.

Will the Fourth EU Anti Money Laundering Directive help to criminalize people and companies that evade taxes? If one looks at the reactions of countries to the Panama Papers (almost no investigations having been taken up against persons or companies revealed in the EU Member States) or to the case of former football star Uli Hoeness (a mild prison sentence spent in the department of FC Bavaria youngsters during the days and then halved) one has the feeling that not paying taxes is still a minor delict, hence far away from qualifying itself as heavy crime for money laundering conviction purposes.

Possible Solutions

Should tax evaders be put into the same crime box as drug dealers and terrorism financiers? If the purpose of the new International Standards transposed into EU Member States’ national laws is to intensify the prosecution of tax evasion and tax fraud, to put it under the umbrella of money laundering is certainly a way of emphasizing the seriousness of stealing public money. It can also help law enforcement, since prosecuting money laundering offers more possibilities than prosecuting tax evasion in most countries.

However, the other extreme would be to apply the new rules to all types of tax evasion, tax fraud and tax crime. This might backfire, as a large part of the population is involved in some kind of shadow economy activity and tax evasion.

But how many people can be criminalized in a society? If a large majority of people participate in some kind of illegal activity, the legal norm cannot be executed. Take the extreme example where every civil servant accepts a gift as a compensation for his public service. In this case, no corruption combat would be possible. Society would be a ‘gift exchanging’ society rather than one that fights corruption. Similarly, if more than a certain percentage of people would not obey traffic rules (for example stop at a red light)
traffic rules would not work. If a very small delict gets prosecuted in the same way as a big one, the investigators, prosecutors and courts would be inundated. For educational purposes it may be wishful to criminalize even small delicts. Rules can change behaviour and also tax morale if applied to many people.

However, for practical reasons especially medium to big tax crimes should be investigated and prosecuted. The Anti Money Laundering Directive can be a helpful tool for some countries, but not for others. Already the Third Directive offered very different possibilities. Sweden, for example, found it much easier to prosecute criminals due to the reversal of the burden of proof which is possible under money laundering. Other countries, like Germany, found the Directive an additional burden, since double punishment for one crime is not possible and the underlying predicate crime would have to be proven (see Unger et al 2014).

In order to link medium to big tax crimes to money laundering more harmonisation of terms and practices within Europe is urgently needed.

2. How can one measure profit shifting of multinational enterprises?1

The topic of profit shifting of multinational enterprises (MNEs) to tax havens has been receiving increasing attention from researchers, policymakers and the media alike. One of the reasons is that it has become rather easy for MNEs to avoid paying corporate tax, but also, thanks to recent leaks of confidential documents and thorough investigative case studies, it has become relatively easy for the public to learn about this trend and for researchers to provide evidence of it.

The scale of tax revenue losses due to profit shifting

Yet, the scale of tax revenue losses incurred by individual governments remains uncertain due to the inherent difficulties of estimating tax avoidance and due to gaps in the availability of relevant data. Some of these limitations are being addressed by recent proposals of the EU or the OECD, while some other are being overcome by innovative researchers using, for example, confidential corporate tax returns to learn how aggressively foreign MNEs reduce their corporate tax liability. While similar studies do provide rigorous evidence, they are limited in their scope and provide revenue loss estimates for only one or a handful of countries. In contrast, in a recent COFFERS research paper by Janský and Palanský (2018), we aim to provide estimates of the scale of profit shifting and the consequent tax implications for as many countries as possible, which naturally requires us to sacrifice rigour to some extent for the sake of improved scope.

We ask which countries’ tax revenues are affected most by this tax avoidance and how much. To estimate the scale of profit shifting, we start by observing that the higher is the share of foreign direct investment from tax havens, the lower is the reported rate of return on this investment. Similarly to the 2015 World Investment Report of the United Nations Conference on Trade and Development, we argue that the reported rate of return is lower due to profit shifting. Unlike the report, however, we provide illustrative country-level estimates of profit shifting which enable us to study the distributional effects of international corporate tax avoidance.

Results

We find that, on average, while OECD countries lose least, low and lower middle income countries are among those that lose most corporate tax revenue relative to their GDP. On the basis of these estimates, we conclude that profit shifting deepens the existing income inequalities and the differences in government revenues between countries. Furthermore, we compare our results with four other recent studies that use different methodologies to derive country-level estimates of tax revenue losses due to profit shifting. In a first such comparison made, we find that every study identifies differences across income groups, but the nature of these differences varies across the studies.

Policy implications

While we find, using our new estimates, that low and lower middle income countries lose significantly more revenue in relative terms than OECD countries, these countries are more likely to be among those that are relatively less able to implement effective tools to reduce the amount of profit shifted out of their countries. In terms of policy recommendations, our work thus further corroborates the importance of the wider inclusiveness of initiatives such as the OECD’s Base Erosion and Profit Shifting framework for the tax revenues that developing countries need. With our estimates we might also aid policy makers in developing countries for which no country-specific estimates of profit shifting scale existed so far. In this paper we provide the first, albeit illustrative, estimates for many developing countries worldwide based on FDI data, for which in some cases there are no more detailed data available or collected. More generally, we find that there are differences across countries by income and by region in how much they are vulnerable to profit shifting and policy makers should pay close attention to their specific situation.

The existing research provides a clear argument for policymakers to pay attention to profit shifting of MNEs, while future research should further develop the empirical approach to improve on the existing estimates and enable learning about which havens are responsible for the estimated revenue losses. One new promising data source is the MNE’s country-by-country reporting data to be published by OECD in aggregate and anonymised form in 2019. However, only when this data is made public in full and detailed form (for which there are no plans yet), researchers and policymakers can await a comprehensive answer on what the true scale of profit shifting is.