BRIEFING

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European Parliament

Good tax practices in the fight against tax avoidance

The signalling role of FDI data

Background

Tax avoidance and tax evasion have a strong impact on government revenues and fiscal fairness towards taxpayers. Estimates suggest substantial tax revenue losses that could amount to a few hundred billion US$ per year.

While the international progress against tax avoidance is considerable, the IMF concludes that this has not yet significantly reduced phantom investments towards global investment hubs. This signals a continued risk of tax avoidance. International tax avoidance does not seem to have been reduced, despite the continuous policy efforts.

The EU took several actions against corporate tax avoidance, such as the Anti-Tax Avoidance Directives (ATAD) 1 and 2, and the Directives on Administrative Cooperation (DACs), which introduced country-by-country reporting between tax authorities on tax-related information on multinationals among others. Moreover, the European Commission introduced ATAD 3 to reduce the number of shell companies used for tax purposes in the EU. Another important initiative is the Council code of conduct for business taxation, whose aim is to promote fair tax competition and address harmful tax practices.

However, the number of tax measures that could be harmful or contribute directly or indirectly to tax avoidance are numerous and vary a lot between Member States. Moreover, many of the measures are not specifically designed to avoid corporate taxes, but can be used by MNEs in this way, often indirectly via complex structures. This makes it hardly possible to analyse such structures one-by-one and to assess the role of the different Member States in corporate tax avoidance.

The present document is the executive summary of the study on International tax avoidance identified by FDI positions and some solutions. The full study, which is available in English can be downloaded at: https://www.europarl.europa.eu/RegData/etudes/IDAN/2023/754198/IPOL_IDA(2023)754198_EN.pdf

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Aim

This study addresses the question which indications/facts signal that countries do well or do not well in the fight against tax avoidance. A purpose of the study is to look at macroeconomic indicators related to international income flows. Such flows may show anomalies that could signal possible tax avoidance. Of course, not all these anomalies are related to tax avoidance, but the indicators can be a starting point for a fruitful discussion on these anomalies and their causes.

International transactions of corporate income are often in the form of dividends, interest, or royalty income. These forms of income are normally taxed in the country where these transactions are received. That is at least the case for interest and royalties. Dividends could be exempted if the profit is already taxed in the source country. The data for these transactions between different jurisdictions are not easily available at the aggregate level. There are bilateral data on royalty income, provided by the OECD, but these are far from complete. Bilateral data on aggregated dividend or interest income is even less available. However, dividend is the return on investment and interest is the return on a loan. The mirror of these profit income flows between country B and A is foreign direct investment (FDI) from country A to B. These data are available, and the study uses these as a signal for international profit income transactions. Normally, these transactions are motivated by business reasons, but anomalies, could be due by other reasons, such as international tax avoidance. These signals could be used to evaluate the quality of national and international responses in the fight against tax avoidance.

Key Findings

Because FDI and foreign affiliates of multinational firms in low-tax jurisdictions could provide these firms opportunities to lower their tax burden, FDI and international corporate tax avoidance are closely related. The statistics on FDI stocks reveal whether Member States have normal or abnormal FDI patterns. The anomalies are a starting point for further analysis to possible preferential or even harmful tax arrangements in these countries. The abnormal patterns could reflect situations in which the policy initiatives against international tax avoidance and evasion are still not effective.

The global FDI stock to GDP ratio increased from 36% to 45% between 2009 and 2017, suggesting an increase in globalization, but could also provide more opportunities for international tax avoidance. The financial centres Hong Kong, Ireland, Luxembourg, Netherlands, Singapore, and Switzerland are responsible for about 90% of the FDI stocks in all tax havens. The share of tax havens in the inward and outward FDI stock was about 40% of the global stocks in 2009. It increased to about 45% in 2017/2018 and decreased to about 40% again in 2021, mainly due to the developments of the FDI stocks in the financial centres. The share of tax havens in global FDI is large compared to their share in global GDP. The latter share is only 4.4%. This implies that the share of tax havens in FDI is ten times as large as in GDP, indicating that FDI stock/GDP ratios in tax havens could amount to 500%.

The Caribbean havens have the highest ratios but also many European tax havens rank high. Nearly all havens have FDI/GDP ratios above 150%. Because of this characteristic, the OECD secretariat labels them as investment hubs. Since 2017, the role of the Netherlands and Luxembourg in global FDI is somewhat decreasing but these countries still qualify as investment hub. The list of the 25 countries with the largest inward and outward FDI stocks include 12 tax havens in 2021, and 7 of them are in Europe.

A statistical analysis shows that tax havens have a significantly larger share of inward FDI stocks registered in their jurisdictions compared to non-haven countries. These countries also own a relatively larger share of outward FDI stocks. If a country's share in global GDP is 1% (which is quite large for a tax haven), then its share in global FDI, inward and outward, is about 0.5% if it is no tax haven. If it is a tax haven, the share is 1%-point higher, and thus is 1.48%. This is about three times as large. For smaller economies, the relative differences are even larger. If the average FDI inward stock/GDP ratio is about 40%, it is for a tax haven with

a 1%-share in the world economy about 120%. This comes close to the FDI/GDP ratios of various European tax havens as the Netherlands, Ireland and Belgium.

These analyses confirm that high relative FDI stocks compared to the global stock and high FDI stock/GDP ratios could indicate that countries are tax havens. Moreover, the 150% criterion of this ratio for an investment hub seems to be a good benchmark of identifying tax havens and this is in line with recent academic lists of tax haven countries.

Different from traditional tax havens with negligible corporate and personal income tax rates, EU tax havens normally levy reasonable tax rates. Moreover, these countries are also cooperative in international tax matters and are implementing anti-BEPS policies as other Member States do, according to the OECD progress reports. In the past, the EU tax havens had on average more harmful tax practices than other Member States, but most of them are abolished or phased out. On average, still more harmful tax practices are identified in tax haven countries than in non-havens, but the differences are not very large.

Tax havens have different tax characteristics that could favour their conduit function such as a tax treaty and investment treaty network, low withholding taxes and the possibility of tax rulings. These characteristics differ by EU tax haven and are often also not distinguishable from other Member States. It seems that the combination of various tax and other business climate policies contributes to the conduit function. In this way, tax havens are different from non-havens, but the policy mix differs by country. This makes it hard to recommend policies for reducing this conduit function. Some specific national policies could limit this conduit function such as the introduction of withholding taxes as Ireland and the Netherlands did, but these policies will not end their conduit role.

New European policies could reduce the conduit function of European tax havens. One example is the proposed ATAD-3 directive, which would make it harder to establish special purpose entities (SPEs) purely for tax motives. Another example is the BEFIT proposal. With a common harmonized tax base in the EU, it makes less sense for multinationals firms to shift tax bases between Member States, if also the taxing rights are defined.

In the past, there have been several proposals to limit differences in withholding taxes between the Member States and other countries. The European Parliament discussed the possibilities to limit the functioning of the Interest and Royalty directive in the past and Lejour and van't Riet (2020) discussed the possibility of minimum withholding tax rates for dividend, interest, and royalty flows at the external border of the EU. Such a proposal would reduce the use of tax treaty shopping strategies by multinationals and curb the conduit function of EU tax havens.

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