

Good tax practices in the fight against tax avoidance

The signalling role of FDI data



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Abstract

This report examines the role of Foreign Direct Investment (FDI) in tax havens. About 40-45% of the global FDI stock is hosted in tax havens, while their share in the world economy is only around 4½%. These abnormal FDI patterns suggest that FDI and international corporate tax avoidance are closely related. Traditional tax havens are attractive because of zero tax rates and uncooperative behaviour. For European tax havens it is rather a mix of policies related to improving the investment climate and this mix differs by country.

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LIST OF ABBREVIATIONS

ATAD	Anti-Tax Avoidance Directive
BEFIT	Business in Europe: Framework for Income Taxation
BEPS	Base Erosion and Profit Shifting
CbC	Country-by-country
CFC	Controlled Foreign Company
CIT	Corporate Income Tax
DAC	Directive on Administrative Cooperation
EU	European Union
FDI	Foreign Direct Investment
G20	Group of Twenty
GDP	Gross Domestic Product
MNEs	Multinational Enterprises
OECD	Organisation for Economic Co-operation and Development
OFC	Offshore Financial Centres
SPE	Special Purpose Entity
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
TH	Traditional Tax Haven

EXECUTIVE SUMMARY

Key Findings

This report examines the role of Foreign Direct Investment (FDI) in tax havens. 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. Although investment flows and stocks are not taxed, the returns on these investments are. However, the data to examine these profit flows between countries are often not available at a global or European level. Therefore, FDI data are used in this study. These are available and correlate positively with the returns, which means that abnormal patterns of FDI also reflect abnormal patterns of the profit flows. 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 about 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.

1. INTRODUCTION

KEY FINDINGS

This report examines the role of FDI in tax havens. Because multinationals have an incentive to locate holdings in tax havens due to lower or even negligible taxes, FDI and international corporate tax avoidance are closely related. The statistics on FDI stocks could show whether countries and thus Member States have normal or abnormal FDI patterns. The anomalies could be a point of departure for further analysis to possible preferential or even harmful tax arrangements in these countries.

Tax avoidance and tax evasion have a strong impact on government revenues and fiscal fairness towards taxpayers. Estimates suggest substantial tax revenue losses from tax avoidance and evasion that could amount to a few hundred billion US\$ per year¹.

The BEPS (Base Erosion and Profit Shifting) actions of the OECD (2015) include among others effective rules on controlled foreign companies (CFC) rules to address the risk that multinationals with holdings in low-tax jurisdictions can avoid taxation. Recently, the OECD and the Inclusive Framework (IF) countries have agreed on Pillar 2 in BEPS 2.0 which should guarantee a minimum global tax on corporate profits of 15%. While the international progress against tax avoidance is considerable, IMF concludes that this has not yet significantly reduced phantom investments towards global investment hubs. This signals a continued risk of tax avoidance (Damgaard et al. (2019)). The EU Tax observatory (2023) also concludes the international tax avoidance does not seem to have been reduced, despite the continuous policy efforts².

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 proposed ATAD 3 to reduce the number of shell companies used for tax purposes in the EU. Another important initiative is the Code of Conduct Group on Business Taxation, whose aim is to promote fair tax competition and address harmful tax practices. Under the code of conduct, Member States have committed to apply reinforced screening rules when looking for and remedy tax measures that could be harmful to the tax bases of other Member States.

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 purpose of the study is to provide an objective empirical framework for tax practices. This report addresses the question which indications/facts signal that countries do well or do not well in the fight

¹ OECD (2015) estimates corporate tax avoidance costs anywhere from USD 100-240 billion annually, or from 4-10% of global corporate income tax revenues. A 2023 study by Tørsløv et al. (from now on TWZ) estimated tax revenue losses of USD 188 billion in 2015 which increased to USD 247 billion in 2019 according to Wier and Zucman (2022). The EU Tax observatory (2023) also concludes that 10% of the corporate tax revenues are missed due tax avoidance. U.S. multinationals are responsible for about 40%, and European countries appear to be the most affected by this behaviour.

² Note that this report focuses on international corporate tax avoidance and not on tax evasion by rich individuals. According to the EU Tax Observatory (2023), offshore tax evasion has declined by a factor of about three the last decade due to the international exchange of information.

against tax avoidance. As such, the purpose of the study would be 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 could 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 complete³. 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 we will use 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 and discuss the quality of national and international responses in the fight against tax avoidance.

Section 2 of this report will discuss the development of global FDI stocks and relate this to the size of the world economy, measured by GDP. It will distinguish the FDI stocks towards and from tax havens. Section 3 will focus in more detail on the development of FDI in tax havens, in particular European tax havens and will discuss various indicators based on FDI stock/GDP ratios. Section 4 links the abnormal ratios of EU tax havens to harmful tax practices as reported by the Code of Conduct Group on Business Taxation in their semi-annual reports, cooperative behaviour in international taxation, according to the OECD progress reports and typical tax policies for conduit countries. Section 5 concludes and draws some policy lessons.

³ See for more details on the country coverage of these royalty flows a recent study of Lejour and van 't Riet (2023).

2. THE DEVELOPMENT OF GLOBAL FDI STOCKS

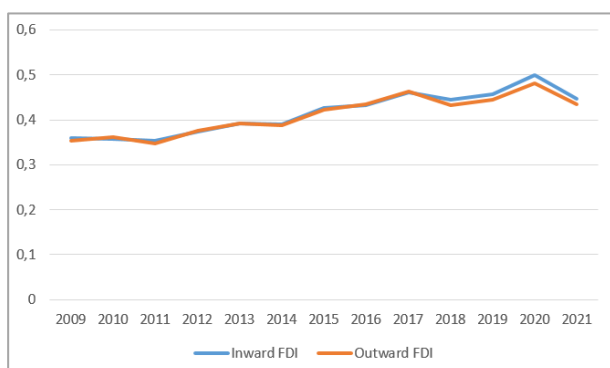
KEY FINDINGS

The global FDI stock GDP ratio increases between 2009 and 2021 from 36% to 45%, suggesting an increase in globalization, but it 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 of 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 45% in 2017 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 is only 4.4%. This implies that the share of tax havens in FDI is ten times as large as in GDP and could amount to 500%.

2.1. Global GDP and FDI

The global FDI stock to GDP ratio increased between 2009 and 2021 from 36% to 45%, see Figure 1⁴. Overall, FDI or at least its value / remuneration is increasing compared to GDP. Quite surprising are the dips in 2018 and 2021. For both years the dips are due to the large increases in global GDP, measured in US dollars, which inflates the denominator of this ratio, as can be seen in Figure 2. On the other hand, in 2015 and 2020, global GDP (expressed in US dollars) contracts, which induces an upward pressure to the FDI stock/GDP ratio. In 2016 and 2019, the global economy grew very modestly compared to other years, which also led to a higher FDI stock ratio. These deviations from the long-term trend suggest that the annual FDI stock/GDP ratio depends on the fluctuations of the world economy. This trend was for a long time an upward trend, but from the Figure noticeable drops can be spotted in 2018 and 2021. After 2018, the ratio increased again, but it is not clear whether this could happen again after 2021. A part of the dip is due to the catch-up growth of the global economy due to the COVID-19 recession in 2020, but another development is that FDI stocks seems to develop less progressively. The global stock hardly increased between 2020 and 2021, which is the smallest increase since 2009.

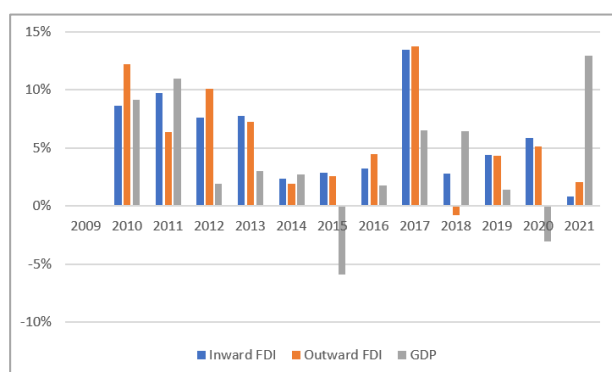
Figure 1: The development of the global FDI stock/GDP ratio between 2009 and 2021



Source: CDIS data from IMF for FDI stocks, GDP data from World Bank (WDI indicators) and own calculations. Inward (outward) FDI are the global inward (outward) FDI stock as share of global GDP in this figure.

⁴ These numbers are for inward FDI stocks. Using outward FDI stocks gives similar results, but not identical, as is also shown in Figure 1. 2021 is the year for which the latest data are provided. The data for 2022 will probably be added in December 2023. The data used are reported data by about 100 countries. Many small tax havens do not report, but in the succeeding chapters, the mirror data of the reporting countries will be added for the inward and outward FDI stocks of non-reporting countries. The use of these mirror data does not change the worldwide totals, so the results in this section will not change.

Figure 2: Annual growth rates of inward and outward FDI stocks and GDP, 2009-2021



Source: CDIS data from IMF for inward and outward FDI stocks, GDP data from World Bank (WDI indicators) and own calculations.

The long-term increase in FDI stocks is due to various causes. First, the globalization of the economy. It has become quite normal to produce various parts of products at different international locations. Production processes are split up due to specialization which can be produced at different locations within countries or in various countries. Lower transport costs have supported this process. Second, the world has become more digitalized, and this is also the case for products and services. Due to digitalization, the specific production location has become less important.

2.2. The role of tax havens in global FDI

FDI did probably not only develop because of 'real' factors such as globalization and digitalization, but also by more artificial factors. UNCTAD (2015) and Damgaard et al. (2019) show that a lot of FDI is not ultimate FDI in the sense that it is invested in the reporting host country, but FDI is often rerouted via other countries, which is also labelled as indirect FDI. A synonym for this behaviour is the 'term double counted FDI' because the inward FDI is reported in the host country and in the intermediate country and outward FDI is reported in the residence country of the investor and the intermediate country. While it makes sense that every country reports these flows in their balance of payment statistics, these numbers are double counted if you add them up at the global level. This can hardly be avoided as long as the purpose of the different FDI flows and stocks is not clear. Therefore, global FDI can also increase due to a more intense use of intermediate countries by MNEs, without an increase of FDI in the ultimate and residence countries, so without an increase in 'real' activity. We label this increase as an 'artificial' factor.

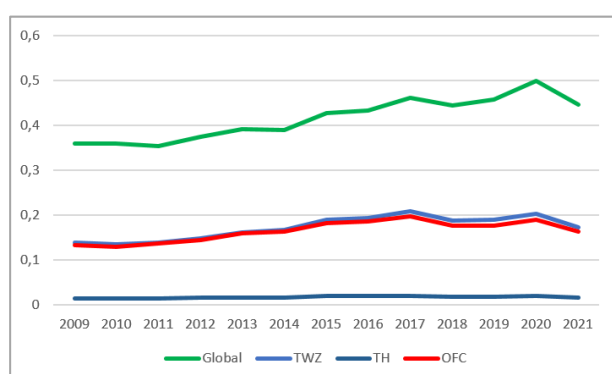
These intermediate countries are often called conduit countries. As traditional tax havens⁵, conduit countries have highly developed legal systems that facilitate the needs of multinational corporations (Mintz 2004, Garcia-Bernardo et al. 2017). Sometimes, these countries also have or had bank secrecy rules, like Switzerland. Different from traditional tax havens, conduits play a key role in the global corporate ownership network by allowing the transfer of capital without taxation (Garcia-Bernardo et al. 2017). According to Mintz (2004), these countries have equally large incoming and outgoing FDI flows. International FDI statistics show that is indeed the case (Lejour, 2023).

⁵ In this report, countries are labelled as tax havens according to definitions and classifications in economic articles. This started with the Hines-Rice classification in 1994, which is later updated by Hines (2010) and Gravelle (2013). This report uses a recent classification of Tørsløv et al. (2023), labelled as TWZ-list. For the larger part, these tax haven lists overlap, but in recent decades, some (small) countries moved from the lists and others just developed as tax havens. Besides, the Netherlands Antilles is split up in various parts. The recent TWZ-list includes Belgium and the Netherlands as tax havens, which is also relevant for this report. The full list of tax havens, according to various classifications, can be found in annex 1.

Figure 3 shows that development of inward FDI stocks in relation to GDP for tax havens. Succeeding, we split the Tørsløv et al. (TWZ) list of tax havens in a list of 6 conduit countries and the rest. These 6 countries are Hong Kong, Ireland, Luxembourg, Netherlands, Singapore, and Switzerland, quite often called offshore financial centres (OFCs). The role of traditional tax havens (TH) is negligible. It also shows that the increase in the global FDI/GDP ratio until 2017 is primarily due to these six conduit countries. After 2017, this is different; the increase in the global ratio between 2019 and 2020 and decrease in 2021 is less pronounced for tax haven countries. A figure with outward FDI stocks shows a similar pattern (but is not presented).

The share of tax havens in the inward and outward FDI stock is about 40% of the global stocks in 2009. It increases to about 45% in 2017/2018 and decreases to about 40% again in 2021, see Figure 4⁶. The 6 conduit countries are responsible for about 90% of the FDI stocks of all tax havens included in the TWC list. The share of traditional tax havens is very low as we noticed before and decreases slightly the last two years, but this is hardly visible. For the OFC countries it decreases from the top in 2017 with 3%-points until 2021.

Figure 3: The role of tax havens in FDI relative to global GDP, 2009 – 2021



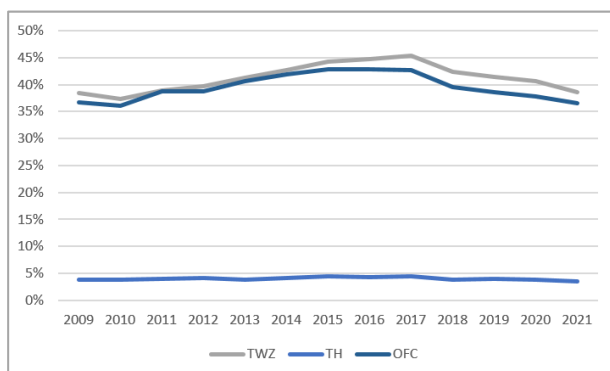
Source: CDIS data from IMF for inward FDI stock data, GDP data from World Bank (WDI indicators), tax haven indicators from Tørsløv et al. (2023, from now on TWZ), and own calculations. TWZ is according to the TWZ-list, OFC are six main conduit countries (Hong Kong, Ireland, Luxembourg, Netherlands, Singapore, Switzerland). TH are the other tax havens. Global reflects the global FDI stock. Notice that only the FDI stocks are different in the four indicators. The denominator is global GDP.

The share of tax havens in global FDI is large compared to their share in global GDP. The latter is only 4.4%, using the TWZ tax haven list, and remains constant of time. This implies the share of tax haven in FDI is ten times as large as in GDP. The global FDI stock/GDP ratio is 42% in 2021, suggesting that it is for all tax havens together about 400 to 500%.

About 3.4%-points of GDP in global GDP reflects the size of the economies of the six OFC countries, and the other 1.0%-points the other tax havens. This suggests that the FDI stock/ GDP ratio of the six OFC countries is even somewhat higher than for the other tax havens as we will discuss in more detail in section 3.

⁶ Due to reporting issues the annual global totals for outward and inward FDI stocks differ, and so is also the development over time. Therefore, the numbers presented here, are not very precise, but reflect to global development of both stocks.

Figure 4: Tax haven's share in Global FDI



Source: CDIS data from IMF for inward and outward FDI stock data, tax haven indicators from TWZ (2023), and own calculations. The shares are the inward (outward) FDI stock relative to the global FDI stock. OFC are six main conduit countries (Hong Kong, Ireland, Luxembourg, Netherlands, Singapore, Switzerland). TH are the other tax havens.

3. FDI IN INDIVIDUAL TAX HAVEN COUNTRIES

KEY FINDINGS

The list of the 25 country countries with the largest inward and outward FDI stocks includes 12 tax havens, and 7 of them are European in 2021. These countries have also the largest FDI stock/GDP ratios in the world. The Caribbean islands have the largest ratios but also many European tax havens rank high on this list. Nearly all have FDI/GDP ratios above 150% and are called investment hubs by the OECD, because of this characteristic. Since 2017, the role of the Netherlands and Luxembourg in global FDI is somewhat decreasing but these countries still qualify as investment hub. A statistical analysis shows that tax havens have indeed a significantly larger share of the global FDI stock in their jurisdictions than non-haven countries. This also confirms that high relative FDI positions compared to the global FDI stock and high FDI stock/GDP ratios could indicate that countries are tax havens.

3.1. Top rankings in FDI stocks in 2021

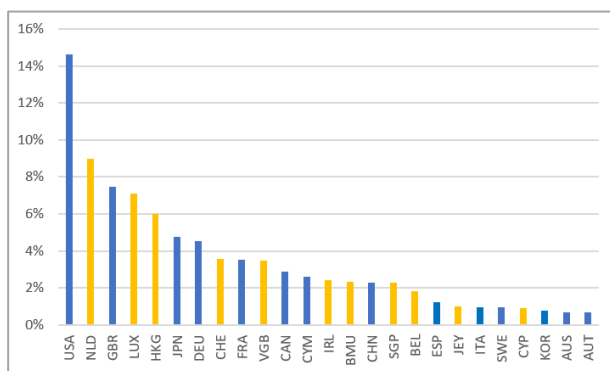
In 2021, multinational enterprises (MNE's) have invested 40 thousand billion US\$ abroad⁷. This is the global stock of FDI. 14.6% of this value is invested in the United States, which is at par with the share of the US economy in the world. For most other countries this is different. Figure 5 shows the countries with the largest share in global FDI stocks in 2021. 12 of these countries are defined as tax havens, that is about half of the top 25, while worldwide only 15% of the countries are labelled as a tax haven. This concentration of FDI is one of the characteristics of tax havens.

The other countries in the top 25 are the largest economies in the world. These are the G7 countries, Spain, Sweden, Korea, Australia, and Austria. The share of FDI in the UK is quite large. In some studies, the UK is also considered to be a conduit country (Garcia-Bernardo et al. (2017), van 't Riet and Lejour, 2018), due to its central role in incoming and outgoing FDI. The European tax havens are the Netherlands, Luxembourg, Switzerland, Ireland, Belgium, and Cyprus. Jersey also belongs to the top 25. The other tax havens are Hong Kong, British Virgin Islands, Cayman Islands, Singapore, and Bermuda. Another European tax haven is Malta which is somewhat lower on this list.

In 2021, the top5 countries under the tax havens hosted 44% of the global FDI stock, while this was 52% in 2009, see Figure 6. This reflects the globalisation trend. The European and US economies have become relatively less important while Asian economies have been on the rise. Moreover, tax havens have become more important between 2009 and 2021; these countries hosted 38% of the global FDI stock in 2009 and 45% in 2017, but this reduced to 39% in 2021. The share of the European tax havens decreased from 27% in 2009 to 24% in 2021, due to the smaller shares of Belgium, the Netherlands and Luxembourg. The role of the Asian tax havens, Hong Kong, and Singapore, increased in this period. To some extent the increase could reflect the growing importance of Asia in the world economy, but it could also be the result of more stringent anti-tax avoidance and evasion legislation in Europe.

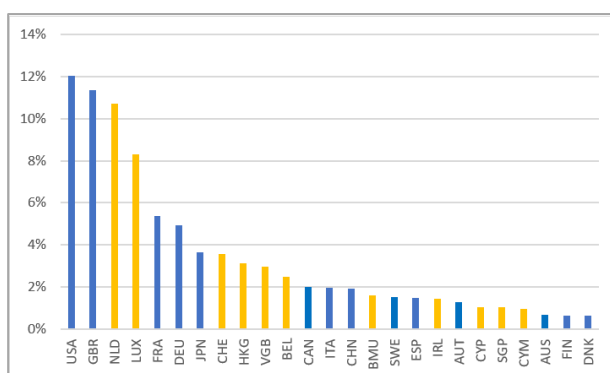
⁷ The numbers are based on inward FD stocks. Based on outward FDI stocks, the numbers are similar. Therefore, we do not present them here, but are available upon request.

Figure 5: The top25 countries with the largest FDI stocks in 2021 (% of global FDI stock)



Source: CDIS data from IMF for inward and outward FDI stock mirror data, tax haven indicators from TWZ (2023), and own calculations.

Figure 6: The top25 countries with the largest FDI stocks in 2009 (% of global FDI stock)



Source: CDIS data from IMF for inward and outward FDI stock mirror data, tax haven indicators from TWZ (2023), and own calculations.

3.2. Top rankings in FDI / GDP ratios

The large role of tax havens in redirecting global FDI stocks is reflected in the largest FDI stock/GDP shares. Table 1 presents the largest shares for all countries with a GDP more than 0.5% of the world economy in 2021⁸. Some traditional tax havens have very large inward and outward FDI stocks given their GDP. Examples are the British Virgin Islands, Cayman Islands, Bermuda, Jersey, and Mauritius. Luxembourg and Cyprus are the EU countries with the largest FDI stocks/GDP ratios, and also Malta, the Netherlands, and Ireland have ratios above 200%. We notice that Belgium has the lowest ratio of the European tax havens.

Table 1: FDI stock / GDP shares, global FDI and GDP stocks in 2021

Tax Haven	Global FDI-stock (share)	FDI stock/GDP (ratio)	Global GDP (share)
British Virgin is	3.50%	26,754%	0.01%
Cayman Islands	2.61%	18,440%	0.01%

⁸ This implies that we exclude tax havens as Samoa, Guernsey, Marshall Islands, Barbados, Curacao, Seychelles, Bahamas, Liechtenstein, Isle of Man.

Tax Haven	Global FDI-stock (share)	FDI stock/GDP (ratio)	Global GDP (share)
Bermuda	2.34%	13,072%	0.01%
Jersey	1.01%	8,005%	0.01%
Luxembourg	7.09%	3,241%	0.09%
Mauritius	0.60%	2,137%	0.01%
Cyprus	0.89%	1,271%	0.03%
Hong Kong	6.00%	646%	0.38%
Netherlands	8.98%	350%	1.06%
Singapore	2.27%	227%	0.41%
Ireland	2.42%	192%	0.52%
Switzerland	3.57%	174%	0.85%
Belgium	1.83%	121%	0.63%
United Kingdom	7.45%	93%	3.33%

Source: CDIS data from IMF for inward FDI stock data (mirror data), GDP data from World Bank (WDI indicators), tax haven indicators from TWZ (2023), and own calculations. Table 1 presents all countries with a FDI stock /GDP ratio of 100% or higher, and the size of the jurisdictions should be at least 0.5% of the world economy in 2021.

These ratios are much higher than the global ratio of 42% in 2021. For many jurisdictions, the large inward and outward shares reflect their role in redirecting FDI stocks, instead of ultimate investment in these countries. UNCTAD (2015), Damgaard et al. (2019), Lejour et al. (2022) show that these countries also have a large share of double counted FDI and host many SPEs which report large FDI stocks on their financial balances, respectively.

3.3. Differences between havens and non-havens

In 2021, the global average FDI inward stock/ GDP ratio is 41.4% and for the EU it is 81.1%. This includes extra and intra-EU FDI. The EU average is much higher because these countries are developed economies which attract FDI and because of the relative concentration of large tax havens, according to the TWZ definition. The average ratio of the non-haven Member States is 36.1%, while it is 379% for the EU tax havens⁹.

The fact that tax havens have larger FDI stock/GDP ratio's than other countries is a global phenomenon. It can also be shown by a simple regression in which a country share in global (inward) FDI is regressed on a constant term, its share in global GDP and a tax haven indicator. The indicator is 1 if the country is

⁹ We have also compared the EU tax havens with a group of smaller EU economies, including the Scandinavian countries, because the inclusion of large economies could cause a downward bias on the FDI stock/GDP ratio. However, the differences are limited, and therefore we do not present the results. Because the havens are 13% of the EU economy, the high FDI/GDP ratio doubles the overall EU ratio.

a tax haven according to the TWZ list, and 0 for other countries. If we use the data for 219 countries in 2021, the constant term is not significant, but the coefficients for relative GDP and for the tax haven indicator are statistically significant. The results can be interpreted as follows¹⁰: if a country's share in global GDP is 1% (which is quite large for a tax haven), then its share in global FDI is 0.48% 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. If the average FDI stock /GDP ratio is about 40%, it is for a tax haven with a 1%-share in the world economy about 120%.

The United Nations Conference on Trade and Development (UNCTAD) has estimated that around 30% of all international corporate investments have been routed through hubs before reaching the ultimate destination country. Conduit jurisdictions that attract an above-average share of global investments are referred to as 'investment hubs'. OECD (2020) operates this term by defining investment hubs as jurisdictions with inward FDI stocks exceeding 150% of GDP. Given the calculation in section 3.2, this ratio seems somewhat high for large economies and somewhat low for small economies, but it is in the range with the estimates presented before. According to the OECD definition, Luxembourg, Cyprus, Malta, the Netherlands, Switzerland, Ireland are European investment hubs, but Belgium not. This also reflects the discussion of TWZ (2023) that Belgium is a border case.

Table 2: Statistical relation between relative FDI stocks and tax haven status

	Coefficient	standard error	t-value
Relative GDP	.475	.141	3.37
TWZ tax haven	.010	.003	3.22
Constant term	.0003	.0005	0.64

Note: The dependent variable is relative FDI (Inward FDI stock). There are 219 observations/ countries, using data for 2021. We use CDIS data from IMF for inward FDI stock data (mirror data), GDP data from World Bank (WDI indicators), tax haven indicators from TWZ (2023), and own calculations. The estimator is an OLS regression with robust standard errors, R^2 is 0.485. The standard error measures statistical accuracy of the estimated coefficient in the previous column. The t value is defined as the value of the coefficient divided by the standard error and measures the statistical significance of the coefficient. If the t-value is larger than 2, the estimated coefficient is interpreted to be significant in at least 95% of the cases.

The analyses in this section and from international organizations suggest that the FDI stock/GDP ratio is a good indicator for identifying tax havens. The OECD operationalizes this with a ratio of 150%. Nearly all tax havens identified in other academic studies will meet that operationalization. In the European Union, Luxembourg, Cyprus, Malta, the Netherlands, and Ireland will be defined as investment hubs, and Belgium is a borderline case. Switzerland, Liechtenstein, the Channel Islands, and the Island of Man are other European countries that fit into this definition. In the next section, we will check whether it is possible to link these large FDI positions in these countries to national tax policies.

¹⁰ The average country share in global GDP is 0.46% (with 219 countries). This is somewhat in the mid-range of EU tax havens GDP. Then the relative FDI share is 0.21% for a non-haven country and 1.21% for a tax haven country.

4. LINKING ANOMALIES TO HARMFUL TAX PRACTICES

KEY FINDINGS

European tax havens differ from traditional tax havens because corporate and personal income is taxed, quite often against substantial tax rates. Moreover, the former are also cooperative in international tax matters as other Member States are. 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 somewhat more harmful tax practices are identified by tax havens than by non-havens. 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 to be the combination of various tax and other business friendly policies that distinguish tax havens from non-havens.

4.1. European and traditional tax havens differ

The European tax havens have high FDI stock/GDP ratios as nearly all tax havens, but they differ considerably from traditional small island economies (which are usually labelled as traditional tax havens). The European countries facilitate the passthrough of financial flows composed of FDI in one direction and the taxable returns on these investments in the other direction. Multinationals often motivate this passthrough by the tax savings they can obtain. These countries are often called conduit countries. Using firm-level data, Garcia-Bernardo et al. (2017) classify Ireland, the Netherlands, Singapore, Switzerland, and the UK as conduit OFCs. Using a less strict definition, Cyprus, Hong Kong, and Luxembourg also fall into this category. Van 't Riet and Lejour (2018) classify the UK, Luxembourg, and the Netherlands as the most important conduit countries in a network analysis of international corporate taxation.

Like traditional tax havens, conduit countries have highly developed legal systems that facilitate the needs of multinational corporations (Mintz 2004, Garcia-Bernardo et al. 2017). Sometimes these countries also have bank secrecy rules, like Switzerland. Conduit countries have higher corporate income tax rates than typical low-tax jurisdictions, but lower rates than large economies. Therefore, other countries treat conduit countries and traditional tax havens differently; countries apply CFC-rules only to traditional tax havens and many countries have double tax treaties, including lower withholding tax rates, with conduit countries but not with traditional tax havens (Lejour, 2023).

The motives for being a tax haven are also different. While countries could deliberately have acted to become a 'traditional' tax haven for diversifying their economies (Dharmapala and Hines, 2009), this is less clear for becoming a conduit country¹¹. Countries often choose to foster their international investment climate, which could also stimulate a conduit role (but not necessarily). Mintz (2004) argues that this role results from various efficiency and tax revenue arguments, depending on international tax competition. Slemrod and Wilson (2009) argue that the costs of being a tax haven are higher or even too high for larger economies because the tax haven benefits do not increase with economic size. This could explain that conduit countries do not choose to be a traditional tax haven with zero tax

¹¹ An exception is Luxembourg. It has a small and prospering economy, partly by creating a tax arbitrage functions for multinational firms (Marian, 2017).

rates¹². They suggest that these countries have a dual motivation for setting low tax rates: the investment climate and profit shifting.

In the Netherlands, the larger part of inward and outward FDI stocks is registered as SPEs¹³. These are firm holdings, without much real activities, but with large income flows from other countries and outward income flows to other countries. In 2021, the Dutch government asked an advisory committee to focus on these SPEs. The report of the committee¹⁴ identified three reasons why multinationals use SPEs in the Netherlands so extensively. These are tax avoidance, use of investment treaties and the flexible company law. Moreover, the favourable business climate, including the supply of high-quality service providers does also contribute to the establishment of these SPEs. These reasons align to the motives for being a conduit country. The attractive business climate for foreign firms and the rest is a byproduct, see Mintz. (2004). Although this suggests that there are not very specific features that characterize the European tax havens in terms of policies, we look at several various tax policies that could potentially be underlying causes for the conduit function in this chapter. One conclusion is that countries have different attractive features for multinationals.

4.2. Harmful tax practices by European tax havens

Because the European tax havens have less identifying tax characteristics than traditional tax havens, it is much harder to explain that these countries have abnormal FDI stock/GDP ratios. It is not a matter to only comparing tax rates. It is probably the whole tax system together with other investment policies that triggers the conduit role, besides real or ultimate investment, in these countries. Despite these difficulties, we try to link these policies with the frequency to perceived and reported harmful tax practices and the alignment with anti-BEPS policies according to the OECD progress reports.

First, we investigate the preferential tax regimes examined by the code of business taxation working group¹⁵. This group has identified many tax practices that could be potentially harmful in the Member States and subsequently concluded whether these are harmful or not in recent decades. In the former case, these are often abolished or grandfathered. These conclusions are based on case-by-case investigations. In total, 380 cases have been examined, of which 95 were classified as harmful and 46 of them are abolished or phased out, as presented in Table 3. Then, there are still 49 harmful regimes.

The 6 EU countries identified as tax havens (by TWZ) had relatively more harmful tax practices in the past than other EU countries, but they also have abolished or phased out more harmful regimes. Currently, these countries are responsible for nearly 30% of the existing harmful practices. So, on average European tax havens seemed to have more harmful practices (at least in the past) than non-havens.

The OECD (2023) does also assess preferential tax regimes of the members of the Inclusive Framework (IF) since 2015. Out of the 27 tax regimes of the EU Member States that have been reviewed, 10 are from tax haven countries. Four of these ten regimes have been abolished and six are assessed as not harmful. Of the other 17 tax regimes, 16 are considered not to be harmful and 1 is abolished. Also, this suggests that tax regimes of tax havens are more often reviewed than those of non-havens and that a larger share is being abolished.

¹² Slemrod and Wilson (2009) do not use the phrase conduit countries but brick and mortar economies with low tax rates, which seems to be comparable with the former phrase.

¹³ See Lejour et al. (2022).

¹⁴ Dutch committee on conduit companies, 2021, The road to acceptable conduit activities, October 2021.

¹⁵ Code of Conduct Group (Business Taxation): Overview of EU Member States' preferential tax regimes examined since the creation of the COCG in March 1998. Every half year, the group provides a new list. This is the (most recent) list of 16 June 2023,

Table 3: Preferential and harmful tax regimes in EU Member States

	Countries	Tax regimes	Harmful regimes	Abolished/ phased out regimes	Amended regimes	Still harmful regimes
EU Member States	27	380	95	46	2	49
EU tax havens	6	105	46	32	1	14
Tax haven share	22.2%	27.6%	48.4%	69.6%	50.0%	28.6%

Source: Own calculations based on Council of the European Union (2023).

The differences in the frequency of the harmful tax practices cannot explain the high FDI ratios in these countries. First, the differences between European tax havens and non-havens are not that large. Second many of the harmful tax practices are quite specific and do not apply to the whole economy. However, we could interpret a relative high share of harmful tax practices as an expression of the desire of countries to develop very business-friendly investment policies, which could even be harmful to other countries. This interpretation aligns to the motivation of countries of becoming a conduit country. The consequence of this interpretation is that the assessment of individual preferential tax regimes will probably not affect the overall attractiveness of various Member States for passthrough and ultimate investment.

4.3. Other tax and investment policies

Regarding bilateral investment treaties, Belgium, Luxembourg, and the Netherlands have ratified a lot of these treaties, while Cyprus and Malta have less treaties and Ireland none¹⁶. In general, larger economies have more treaties, because these have also more foreign relations with other countries. Besides, history matters such as a colonial past and donor relations with developing countries matter. On average the 6 EU tax havens have concluded 46 treaties of which 37 are in force, while the 21 non-haven Member States have on average 49 treaties of which 45 are in force. Although there is a difference in the number of treaties in force, this does not reveal a clear pattern, in particular not given the variety in treaties of tax havens.

Table 4: Number of bilateral investment and tax treaties by EU Member States

Bilateral treaties	Total on investment	In force on investment	Total on taxation
Belgium	83	61	70
Cyprus	18	17	35
Ireland	0	0	53
Luxembourg	83	60	57

¹⁶ Source: <https://investmentpolicy.unctad.org/international-investment-agreements/by-economy>. Besides all countries have investment provisions in other treaties, often trade agreements. These are similar for all EU countries because that is an EU competence.

Bilateral treaties	Total on investment	In force on investment	Total on taxation
Malta	10	9	38
Netherlands	80	75	74
EU havens; average	46	37	55
EU non-havens; average	49	45	56

Source: UNCTAD, International Investment Agreements Navigator and own calculations, accessed November 24, 2023. Notice that besides Bilateral investment treaties, the EU also made investment agreements in 71 trade and investment treaties of which 61 are in force (for all Member States). Data on tax treaties come from van 't Riet and Lejour (2018). The totals are the number of treaties within a set of 108 (partner) countries, mainly high and upper middle-income countries. So, these numbers are somewhat lower than the totals.

A brief analysis of the number of concluded tax treaties leads to a similar result. According to van 't Riet and Lejour (2018), EU tax havens have on average a similar amount of tax treaties as EU non havens. Different from investment treaties this is not based on the total amount of bilateral tax treaties, but on a sample of 108 countries (see also Table 4)¹⁷.

Regarding withholding taxes, Malta does not have withholding taxes on outgoing dividends, interest and royalty payments, Cyprus not on dividend and interest, and Luxembourg not on royalties and interest, see Table 5. In the past, Ireland and the Netherlands also did not have a withholding tax on outgoing interest and royalties. Ireland has a standard rate of 20% and the Netherlands levies a tax of 25.8% on royalties and interest payments to low-tax jurisdictions. Low or negligible withholding tax rates could be a reason for being a conduit country. However, there are also various other Member States with low withholding tax rates. The unweighted averages of these tax rates hardly differ between EU havens and non-havens, except for royalties. Only if we would ignore the withholding tax rates of Belgium the averages of the tax havens are substantially lower.

Cyprus and Ireland have a low statutory and effective corporate income tax rate, but the other EU tax havens not. However, Tørsløv et al. (2023) find, among other things, that the effective tax on foreign profits in tax havens is low. For Ireland, Luxembourg, Malta, and the Netherlands this effective tax rate is much lower than the effective tax rate on all profits according to EC (2023). For Belgium and Cyprus, the differences are much smaller (compare the last column in Table 5 to the third column).

Table 5: Relevant tax rates for profits by EU Member States

Tax rates	Statutory CIT	Effective CIT	Withholding tax dividend	Withholding tax interest	Withholding tax royalties	Effective tax foreign profit
Belgium	25	23.1	30	30	30	19

¹⁷ There is not an accessible global list for bilateral tax treaties as there is for bilateral investment treaties. Therefore, I used data on bilateral tax treaties from earlier work. Given the negligible differences between haven and non-haven countries, it is not worthwhile to update the numbers to all countries and in time. In general countries agree on bilateral tax treaties with countries which they have more intense economic relations. These are in general the high and upper middle-income countries. Because these countries are in the sample, the numbers reflect most all bilateral tax treaties.

Tax rates	Statutory CIT	Effective CIT	Withholding tax dividend	Withholding tax interest	Withholding tax royalties	Effective tax foreign profit
Cyprus	12.5	13.3	0	0	10	12.5
Ireland	12.5	14.1	25	20	20	4.8
Luxembourg	24.9	21.8	15	0	0	2.8
Malta	35	23.3	0	0	0	4.4
Netherlands	25.8	23.2	15	0*	0*	10.5
EU havens; average	22.6	19.8	14.2	8.3	10.0	9.0
EU non-havens; average	20.4	18.3	13.8	10.1	15.3	

Source: EU Taxation Trends, https://taxation-customs.ec.europa.eu/taxation-1/economic-analysis-taxation/data-taxation-trends_en. For the statutory tax rates for 2023 and the effective tax rates for 2021. The rates of the withholding taxes are from PWC, <https://taxsummaries.pwc.com/quick-charts/withholding-tax-wht-rates>. The effective rates on foreign profits are from Tørsløv et al. (2023). * Since 2021, the Netherlands levies a tax on income flows to low-tax jurisdictions.

Foreign profits are mainly generated in other countries and redirected through the conduit countries to the residence country of the headquarter. According to the exemption provision to avoid double taxation of profits, it follows that these profits are not taxed in conduit countries, which could explain the low effective tax rates. However, not only EU tax havens have exemption as standard rule for double tax relief of corporate income. At least all Member States must apply the exemption rule to inter-company profits generated in another Member State if the company owns at least 25% of the shares of the subsidiary, according to the Parent-Subsidiary directive. Moreover, most Member states also apply some form of exemption with various conditions to profits originated in other countries¹⁸.

A common characteristic is that all EU tax havens receive relative to GDP many tax revenues from corporate income and that these countries host missing profits. Table 6 shows that on average EU tax havens receive much more revenues from corporate income taxes than non-havens do. EC (2023) also shows that the six tax havens are all in the top 7 of Member States with the highest Corporate Income tax (CIT) revenues (% of GDP). One reason is that these countries attract a lot of activity and multinationals. Another reason is that these countries attract profits generated abroad. This amount to 239 billion euro in 2015 according to Tørsløv et al. (2023). These numbers reflect the conduit role of these countries but do not indicate its causes.

¹⁸ See e.g. the country comparison on the corporate income tax of PWC, 2020, Comparative Analysis on Taxation of Multinationals. This comparison includes Austria, Belgium, France, Germany, Ireland, Japan, Luxembourg, Netherlands, Korea, Singapore, Spain, Sweden, Switzerland, United Kingdom, and the United States and it also gives an overview on the exemption rules.

Table 6: Corporate income tax revenues and the size of missing profits in EU tax havens

Profits	Corporate income tax revenues (to GDP)	Missing profits (billion euro)
Belgium	3.8	13
Cyprus	6.5	4
Ireland	3.6	106
Luxembourg	4.5	47
Malta	5.1	12
Netherlands	3.9	57
EU havens; average	4.6	239
EU non-havens; average	2.8	-142

Source: EU Taxation Trends, https://taxation-customs.ec.europa.eu/taxation-1/economic-analysis-taxation/data-taxation-trends_en for tax revenues in 2021 (% GDP). The size of missing profits come from Tørsløv et al. (2023). A positive number refer to 'hosted' missing profits and a negative number to lost profits. Numbers are for the year 2015.

Another attractive feature for multinationals is the possibility for having tax rulings with the tax authorities. These rulings establish clear rules on the tax positions beforehand. Belgium, Luxembourg, and the Netherlands conclude many rulings, amongst others on transfer pricing.

European tax havens are as cooperative in international tax matters as other Member States. The OECD progress reports reveal that all EU countries are Inclusive Framework members, accept the Two-pillar plan to address the tax challenges arising from the digitalisation of the economy (October 2021) and comply to BEPS actions 6, 13, 14 and 15 on preventing treaty abuse, country by country reporting, effective dispute resolution and the multilateral instrument¹⁹. Some Member States have received some recommendations from the OECD secretariat on the information exchange on tax rulings. Moreover, all Member States agree to the automatic exchange of information. We notice large differences in cooperation between European countries and traditional tax havens, but not between EU tax havens and non-havens.

Inspecting all these different elements that could contribute to the conduit function, it appears that some EU tax havens stand out with a tax treaty network, others with their investment treaty network, other havens with zero rate withholding taxes or low effective corporate income tax rates, others with tax rulings and some with more harmful tax practices. These are only differences related to international taxation. Differences in company law or other attractive investment climate policies could also play a role.

¹⁹ <https://www.compareyourcountry.org/tax-cooperation/en/2/631/default>.

5. CONCLUSIONS

Tax havens have far above average FDI stock/GDP ratios. These positions are statistically significantly higher than of non-haven countries. Despite their limited role in the global economy, tax havens register about 40% of all inward and outward FDI stocks in 2021. The OECD classifies investment hubs as countries in which the inward FDI stocks is at least 150% of GDP and this fits well to the academic lists of tax havens.

Therefore, it would make sense to consider ratios above 150% as anomalies. Because the magnitude of foreign direct investment is closely related to the corresponding size of profit, dividend, interest, and royalty flows (in the other direction), large FDI stocks could also signal corporate tax avoidance structures. These would require closer inspection as part of anti-BEPS policies.

We did not find specific tax policies that cause these large investment flows. European tax havens are typically conduit countries which are used by multinationals to redirect their investment flows and corresponding returns. The economic literature concludes that this conduit function is a by-product from business-friendly policies. It seems to be a complex combination of various tax and other policies that contribute to the tax haven status. Moreover, that mix seems also to differ by conduit country. However, the specific mixes of business-friendly policies in conduit countries are not necessary for a blossoming economy because also the economies of many other countries prosper.

From this conclusion, it is 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 did in 2006 and the Netherlands did recently, but these policies will probably not have a big impact on the conduit role.

New European policies could affect the conduit function of specific Member States. The first is the drafted ATAD-3 directive, or unshell directive, which tries to impede the establishments of SPEs for tax motives. This could hamper the establishment of SPEs which are mainly used to retouring dividends, interest payments and royalties to other countries. The second is the recent BEFIT proposal. With a common or harmonized corporate tax base for large multinationals (with an annual turnover of more than 750 million euro) and an agreement on the national taxing rights of this tax base, profit shifting becomes less attractive. According to the Global Tax Evasion Report of the EU Tax Observatory (2023), the EU tax havens account from more than 40% of the shifted corporate profits through corporate structures in tax haven countries. If this amount of shifted profits could be reduced via a BEFIT agreement, the FDI/GDP ratio will probably decrease in many tax havens. Because national withholding tax and corporate tax rates still vary between Member States, profit shifting will not disappear, but the BEFIT proposal would limit it.

In the past, there has been also several proposals to limit differences in withholding taxes between the Member States and other countries to avoid the exploitation of the differences in tax rates through tax treaty shopping strategies by multinationals. The European Parliament already 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 borders of the EU. These are also proposals that de-incentivise multinational firms to use tax avoidance strategies because the gains of these strategies will shrink.

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ANNEX 1: LIST OF TAX HAVENS, ACCORDING, TO VARIOUS DEFINITIONS

Country	Gravelle	TWZ_2020	Hines_Rice_94	Hines_2010
Andorra	1	1	1	1
Anguilla	1	1	1	1
Antigua and Barbuda	1	1	1	1
Aruba	1	1		1
Bahamas	1	1	1	1
Bahrain	1	1	1	1
Barbados	1	1	1	1
Belgium		1		
Belize	1	1	1	1
Bermuda	1	1	1	1
Bonaire, St. Eustatius, Saba		1		
British Virgin Islands	1	1	1	1
Cayman Islands	1	1	1	1
Cook Islands	1		1	1
Costa Rica	1			1
Curacao		1		
Cyprus	1	1	1	1
Djibouti				1
Dominica	1		1	1
Gibraltar	1	1	1	1
Grenada	1	1	1	1
Guernsey	1	1	1	1

Country	Gravelle	TWZ_2020	Hines_Rice_94	Hines_2010
Hong Kong	1	*1	1	1
Ireland	1	*1	1	1
Isle of Man	1	1	1	1
Jersey	1	1	1	1
Jordan	1		1	1
Lebanon	1	1	1	1
Liberia	1		1	1
Liechtenstein	1	1	1	1
Luxembourg	1	*1	1	1
Macao	1	1	1	1
Maldives	1		1	1
Malta	1	1	1	1
Marshall Islands	1	1	1	1
Mauritius	1	1		1
Micronesia				1
Monaco	1	1	1	1
Montserrat	1		1	1
Nauru	1			1
Netherlands		*1		1
Netherlands Antilles	1		1	1
Niue	1			1
Panama	1	1	1	1
Puerto Rico		1		

Country	Gravelle	TWZ_2020	Hines_Rice_94	Hines_2010
Saint Kitts and Nevis	1	1	1	1
Saint Lucia	1	1	1	1
Samoa	1	1		1
San Marino	1			1
Seychelles	1	1		1
Singapore	1	*1	1	1
Saint Maarten		1	1	1
St Vincent & the Grenadines	1	1	1	1
Switzerland	1	*1	1	1
Tonga	1			1
Turks and Caicos Islands	1	1	1	1
Vanuatu	1	1	1	1
Virgin Islands US	1			
Total	49	42	40	52

Source: Gravelle (2013), Hines and Rice (1994), Hines (2010), TWZ (2020). 1 indicates a tax haven classification according to the list in the column. The asterisks in the column TWZ refer to OFC countries.

This report examines the role of Foreign Direct Investment (FDI) in tax havens. About 40-45% of the global FDI stock is hosted in tax havens, while their share in the world economy is only around 4½%. These abnormal FDI patterns suggest that FDI and international corporate tax avoidance are closely related. Traditional tax havens are attractive because of zero tax rates and uncooperative behaviour. For European tax havens it is rather a mix of policies related to improving the investment climate and this mix differs by country.

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