Banks and tax havens*

Vincent Bouvatier*
University of Paris-Est Créteil, ERUDITE
Gunther Capelle-Blancard
University Paris 1 Panthéon-Sorbonne (Sorbonne Centre of Economics), Labex Refi (European Laboratory on Financial Regulation)
Anne-Laure Delatte
CEPII, CNRS

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Abstract:
Since the 2008 financial crisis, a string of scandals – UBS in 2008, Offshore Leaks in 2013, Lux Leaks in 2014, Swiss Leaks in 2015, Panama Papers and Football Leaks in 2016, Paradise Papers in 2017 – have brought to light the role played by banks in tax avoidance, money laundering, setting up shell companies, and circumventing international regulations. Yet reporting on these activities in a comprehensive manner is still challenging. Since 2016, the European Union mandates EU banks to publicly disclose their key financial data in all countries, including tax havens, through a tax transparency tool known as CBCR (Country-By-Country Reporting). Analysis of CBCR data shows that tax havens account for 18% of the turnover and 29% of the profits of European banks abroad, while they employ only 9% of their workforce there.

Before the 2008 crisis, tax havens often conjured a vision of sun-blasted islands, the Bahamas, suitcases filled with cash... While morally reprehensible, their existence was seemingly anecdotal. As the financial crisis contributed to a surge in public spending and taxes in many countries, it became increasingly hard to accept that some areas still provided shelter from taxation. According to the Tax Justice Network NGO, private wealth sheltered in tax havens totalled $21,000 billion in 2010, as much as the combined GDP of the United States and Japan (Henry, 2012). Tax havens are used not only for tax avoidance but also to circumvent banking and financial regulations through sophisticated schemes (Chavagneux et al., 2009).

In the wake of the crisis, G20 leaders made fighting tax havens a priority. They provided strong support to BEPS, the Action Plan on Base Erosion and Profit Shifting, the OECD's 2013 initiative aimed at combating profit transfer schemes. Next, the European Union took the lead in mandating its banks to publicly disclose their key financial data in all countries, including tax havens. Since 2016, the availability of regulatory information sources has facilitated the monitoring of bank activity in tax havens and helped build a comprehensive reliable database. The trend towards increased transparency has also spurred a stream of academic literature on the topic. This article shares key findings from the research.

* The arguments presented here are developed in "Les paradis fiscaux, des paradis pas du tout artificiels" (Delatte, 2017), *L'Économie mondiale, 2018*, Repères, La Découverte, and in *Banks in Tax Havens: New Evidence Based on Country-by-Country Reporting*, Report for the European Commission, Brussels (Bouvatier, Capelle-Blancard, & Delatte, 2017).

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Economic activity in tax havens: what do we learn from the research?

Very little in fact. For a long time, economists considered tax havens as an afterthought. While objectionable, they were viewed as inevitable and with no major impact on the rest of the economy. There is thus very little academic work, theoretical or empirical, on the subject. A survey of the top 100 most prestigious journals yields about 30 articles at most, less than one percent of all articles dealing with taxation. The lack of transparency was clearly a deterrent.

Using fastidious and often ingenious methods to counter the lack of data, a few studies analysed the role of tax havens in international economic exchanges. Hines and Rice (1994) were among the first to report on the impact of tax havens. In the early 1990s, they estimated that U.S. multinationals sheltered nearly a third of their foreign profits in tax havens. When it comes to the impact of tax havens on the global financial system, Lane and Milesi-Ferretti (2011) collected data on small offshore financial centres (excluding, among others, New York and London). They concluded that more money was invested in these small offshore centres than in Germany, France or Japan. The same study reported that 40% of worldwide foreign direct investment transited through these small offshore financial centres. More recently, Zucman (2013) calculated that in 2008 8% of household financial wealth worldwide was held in tax havens, and that 75 percent of these assets would not be declared. Consequently, the assets sheltered in tax havens would add up to twice the net external position of the world's richest countries. Finally, Zucman (2014) assessed that major tax havens sheltered 20% of U.S. profits (tenfold the 1980s figure) and 10% of European household wealth in 2013. Zucman estimated that overall, 10% of global GDP was held in tax havens.

The bulk of the literature has focused on financial trading or on multinationals.[1] So far, no study had ever provided detailed insight into the presence of banks in tax havens.

Bank activity in tax havens: what do we know?

A string of scandals

Since the financial crisis, the banking system's involvement in tax havens has been a matter of special attention. In 2008, an FBI investigation uncovered the practices of Swiss Bank UBS, accused of providing technical assistance to help its American clients shelter $20 billion abroad. Subsequently, similar investigations were launched in Germany and France. In 2013, the International Consortium of Investigative Journalists (ICIJ) published Offshore Leaks, a report highlighting the key role that most international banks play by offering services that facilitate tax avoidance. In 2014, ICIJ published Lux Leaks, a report that leveraged confidential information to expose tax avoidance schemes in Luxembourg, and underscored the occurrence of the practice within the EU itself. In 2015, revelations were aimed directly at banking group HSBC, suspected of tax avoidance and money laundering. In 2016, the Panama Papers exposed the activities of international banks in tax havens. Banks are involved in the development of shell companies, foundations, and trusts that facilitate tax avoidance, tax evasion, and money laundering on behalf

[1] Tax planning is not limited to tax havens. Through the practice known as "transfer pricing", invoicing goods or services between companies belonging to the same multinational organisation at advantageous prices, corporations are free to allocate their costs between the countries in which they operate. This in turn provides opportunities to shift profits where taxation is most advantageous (Nayman, 2017).

of their clients. Besides, tax havens are likely used to circumvent international regulations (Palan, Murphy & Chavagneux, 2013). Then in 2017, the Paradise Papers exposed the tax avoidance practices of the wealthiest.

Country by country reporting obligation

At the Mexico Summit in December 2012, G20 leaders, pressured by public opinion in the aftermath of the financial crisis, publicly expressed support for the OECD's BEPS Action Plan, which addresses tax base erosion and profit shifting by multinationals. The programme consists in a series of fifteen "actions" and relies on multilateral cooperation between governments, so that the tax is collected where the economic activity of multinationals actually takes place. This initiative has made tangible progress by focusing on tax transparency and data sharing, both instrumental in the fight against tax avoidance.

Since 2015, a European directive has also made it mandatory for European banks to include, in their annual reports, country by country reporting on turnover, profit, number of employees, taxes, and subsidies. Thanks to this requirement we — in partnership with NGO Oxfam and the Fair Finance network (see Bouvatier et al., 2017) — have been able to analyse the activities of large EU banks abroad.

European banks: a massive footprint in tax havens

Using documents published by the thirty-six largest European banks or, to use banking regulation jargon, the "Systemically Important Financial Institutions", we built a database of the activities of banking subsidiaries in tax havens. The list of tax havens was based on the list compiled by Hines and Rice (1994), who initially identified 41 tax havens among 200 countries or so.

According to our data (Bouvatier et al., 2017), European banks operate in 25 tax havens (18 "small" tax havens with a population under 2 million, and 7 "large" tax havens), and in 112 other countries (see summary results in table 1). Tax havens are tiny wealthy countries whose GDP per capita is threefold that of other countries. In these countries, the corporate tax rate, at 5% vs. 17% on average, is unsurprisingly much lower, and financial infrastructure is more developed. However, if the regulatory indices available are to be believed, the level of financial regulation seems comparable to that of other countries.

The remaining data in table 1 speaks for itself: banks in our sample declare 18% of their turnover and 29% of their profits in tax havens, while only 9% of their workforce is employed there. Unless we assume that employees in tax havens are especially productive, these figures suggest that portions of the turnover and profits are artificially transferred. In Bouvatier et al. (2017), we estimate that tax havens can accommodate on average two-and-a-half times more banking activity than other countries. This figure is an average, as Luxembourg for instance actually attracts nine times more banking activity. We also estimate that by shifting profits to tax havens, the 36 EU banks in our sample contribute to a tax shortfall of 5 to 20 percent of total tax revenues. By and large, multinationals can turn to the subsidiaries of international banks and use their services to leverage differences in taxation worldwide. Tax havens are by no means the only participants in tax avoidance schemes, but they are no doubt key stakeholders.

Table 1: Characteristics of tax havens

	Non tax havens (112)	Small tax havens (18)	Large tax havens (7)
Population and living standard			
Average GDP (PPP, € bn)	963	16	268
Average population (thousand)	58,100	304	6,316
GDP/capita (€)	16,615	51,104	42,534
Taxation, regulation and financial infrastructure			
Effective tax rate (%)	17	5	5
Banking regulation index (0-100)	24	23	25
Infrastructure development index (0-100)	54	67	68
Foreign operations of the 36 largest European banks			
Turnover (€ bn)	229,216	13,639	34,959
Turnover (% of total)	82	5	13
Employees	1,108,140	22,649	83,460
Employees (% of total)	91	2	7
Profit (€ bn)	53,983	7,656	14,492
Profit (% of total)	71	10	19

Source: Bouvatier et al. (2017), using CBCR bank data from 2015 annual reports.

Current reforms to combat tax havens

Achieving greater transparency is ostensibly the first measure in the fight against tax havens. Unfortunately, transparency requirements do not yet apply to non-financial multinationals, which are aggressively fighting regulation. On December 8, 2016, France's Constitutional Council, rejected the European Directive requiring French multinationals to disclose their financial results, on the basis that it represented a disproportionate infringement of free enterprise.

The BEPS Action Plan has also enabled the implementation of automated data transfers between tax authorities. As of now, tax authorities have no insight into the activity of foreign subsidiaries of multinational groups headquartered in their country. They are thus unable to identify potentially abusive transfer pricing practices. The OECD's objective is to require each entity of a multinational company to file an activity report in its tax jurisdiction of residence. Then, thanks to bilateral agreements between States, each jurisdiction in which the group operates would automatically exchange reports. As of May 2017, 60 countries had signed bilateral agreements, with data sharing scheduled to begin in September 2017. Nevertheless, as was observed by Johannesen and Zucman (2014), bilateral bank data sharing agreements may prove ineffective as deposits are not repatriated but eventually transferred to other tax havens beyond the scope of these bilateral agreements.

Initiated in 2000 and updated annually, a black list identifies the jurisdictions that refuse to cooperate in the fight against money laundering and the financing of terrorism. It is supplemented with a grey list that includes countries that have committed to the fight but have yet to implement "substantial" measures. One hopes that naming and shaming corporations and banks will eventually drive them to change their practices. Both lists are regularly criticized by NGOs, the black list for being too short (it contained only four countries in 2009), and the grey list for being too complacent with countries that have not acted upon their commitments. Nonetheless, several studies point to the ineffectiveness of such measures. In fact, as demonstrated by Ferwerda and Unger (2009), they may prove counter-productive, as named and shamed organisations might actually derive more business from being featured on these lists!

The Common Consolidated Corporate Tax Base (CCCTB), initiated by the European Commission in 2011 and relaunched in 2016, may eventually prove the most effective measure to date, in full alignment with the BEPS Action Plan. According to this device, multinational companies with cross-border activities in the EU and whose turnover exceeds €750 million a year would file a single consolidated tax statement for all EU activities. Then, taxable profits would be distributed by country according to the activity of the group in each location. In practice, the apportionment could be based on turnover, number of employees, or assets held by country. The EU's objective is clearly aligned with the OECD's plan: taxing profits where they occur and not where taxation is the most favourable. As is often the case whenever the Commission proposes to overhaul the corporate income tax system, however, a few Member States are showing strong opposition to the proposal. Countries that enjoy strong tax attractiveness, such as Ireland and Luxembourg, have nothing to gain – in fact much to lose – if such consolidation of profits is implemented.

Conclusion

Public opinion was instrumental in changing attitudes towards tax havens. Access to new data, driven by greater transparency requirements, contributes to increased public awareness. Much remains to be done, however. To date, only the European banking sector is mandated to disclose its financial data. But if banks play a key role in tax havens, it is essentially because they act as intermediaries of multinational companies. The transparency mandate must therefore also apply to non-financial sectors, but the current lack of political will remains a major hurdle.

Europe, which has some of the most dynamic tax havens with Luxembourg, Jersey, or Monaco, is a strong advocate of curtailing tax avoidance. But as is often the case, its ability to push a public-interest agenda forward is often hindered by national interests. Only the relentless pressure of public opinion will eventually tip the balance in the right direction.

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