Challenges of Taxing Financial Wealth

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This talk: three points

1. The financial wealth held in offshore tax havens is large, rising, and seems largely undeclared

$\rightarrow$ See "The Missing Wealth of Nations: Are Europe and the US net Debtors or net Creditors?", QJE 2013, book 2013-2015

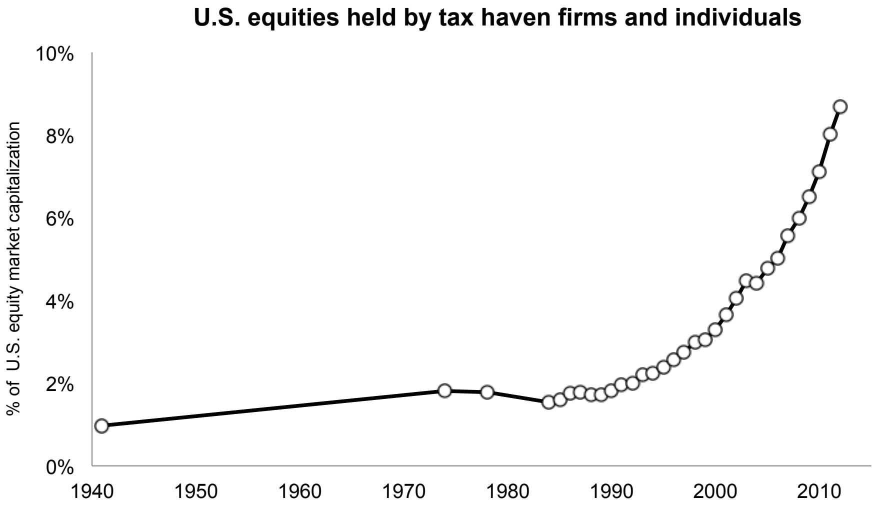
2. Tax avoidance by multinational companies is severely eroding the corporate tax base

$\rightarrow$ See "Taxing Across Borders: Tracking Personal Wealth and Corporate Profits", JEP 2014

3. There exist concrete solutions to both issues:
Well-defined sanctions for non-compliance and a financial registry

I- Offshore private wealth

A growing fraction of wealth is being managed by offshore financial institutions



In 2012, 9% of the U.S. listed equity market capitalization was held by tax haven investors (hedge funds in the Cayman Islands, banks in Switzerland, mutual funds in Luxembourg, individuals in Monaco, etc.). Source: author's computations using US TIC data

There is a lot of activity in offshore centers, usually legal and legitimate

What offshore centers do:

- Investment funds (Luxembourg, Ireland...)
- Shadow banking (Caymans...)
- Treasury management (U.S.-Cayman...)
- Personal wealth management (Switzerland, Singapore...)

But some offshore centers, institutions and instruments also facilitate tax evasion by wealthy individuals

Some tax haven activities and institutions facilitate tax evasion

How offshore tax evasion works:

- Shell companies
- Fake invoices
- Offshore accounts
- Disconnecting legal and beneficial ownership

What do we know about the magnitude of offshore tax evasion?

Monthly statistics by the Swiss National Bank

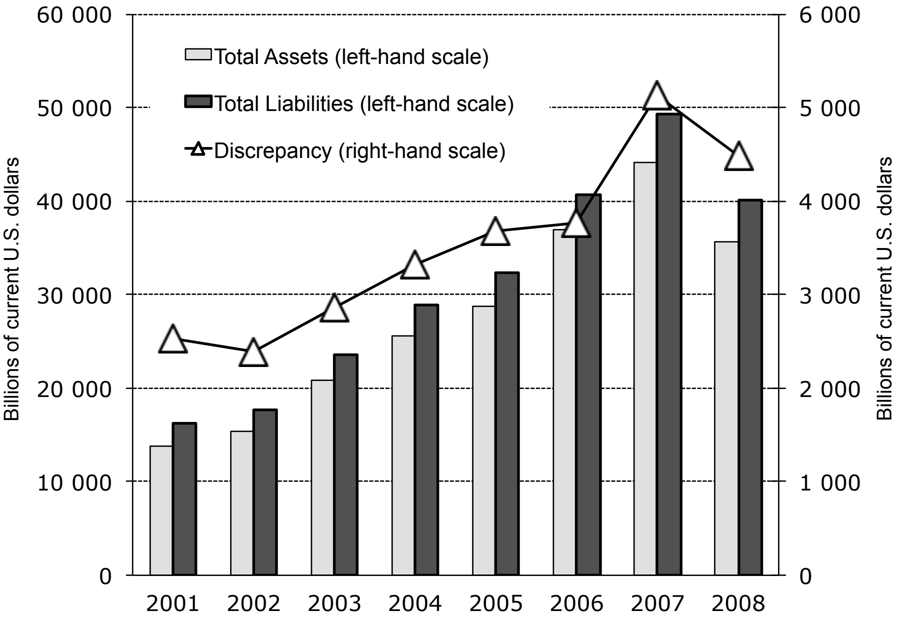
Systematic anomalies in the international investment positions of countries caused by offshore portfolio wealth

Example: France-Switzerland-US

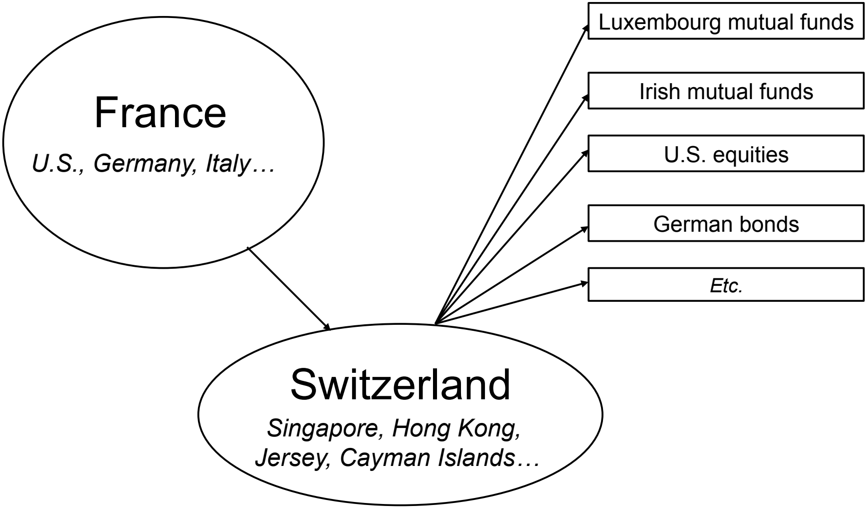
8% of the world's financial wealth offshore; if anything lower bound

Limited evidence on what fraction evades taxes (maybe 90-95% prior to 2008, down to 80% today?)

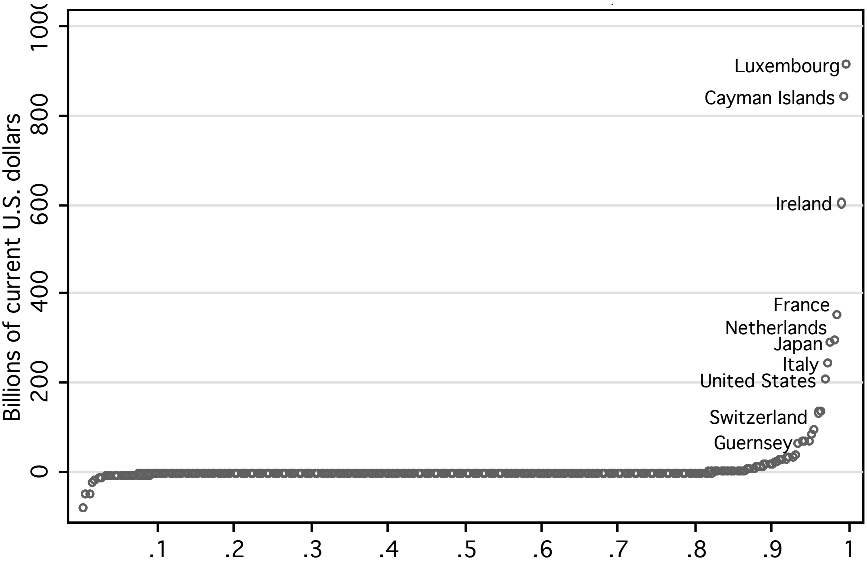
Less securities are recorded on asset than liability side of the world's balance sheet



In Switzerland, owners of offshore accounts mostly invest in Luxemb. funds



The missing global wealth is mostly invested in Luxembourg funds as well



8% of the world's financial wealth is held offshore, costing at least $200bn

	Offshore wealth ($ bn)	Share of financial wealth held offshore	Tax revenue loss ($ bn)
Europe	2,600	10%	75
USA	1,200	4%	36
Asia	1,300	4%	35
Latin America	700	22%	21
Africa	500	30%	15
Canada	300	9%	6
Russia	200	50%	1
Gulf countries	800	57%	0
Total	**7,600**	**8.0%**	**190**

A lot of progress has been done recently, but a lot remains to be done

Automatic exchange of bank information will probably become global standard by end of 2010s: **great!** Three obstacles at this stage:

- Securing compliance from offshore bankers
- Making sure offshore banking does not move to uncovered jurisdictions

$\rightarrow$ **Need well-defined, proportional sanctions to secure global, actual compliance**

- Addressing the opacity of international financial record-keeping

$$\Downarrow$$

A world financial registry would make it possible to measure wealth and fill in the giant gaps in international data

II- Multinational corporations tax avoidance

The taxation of multinationals is based on 3 principles adopted in the 1920s

Source-based taxation

Taxes are to be paid to countries where profits have been made

Not to countries where shareholders live (= residence taxation)

But how to determine where the profits have been made?

Arm's length pricing

Subsidiaries of a same group must compute their profits as if unrelated

I.e., trade goods and services internally at market prices

Bilateral agreements

No multilateral agreement like GATT

Instead, thousands of bilateral tax treaties

Each of the 3 core principles for international taxation raises its own issues

Bilateral agreements

Treaty shopping to generate stateless income

Example: Google ▸ google

Arm's length pricing

Easy to manipulate transfer prices

Reference prices often do not exist

Source-based taxation

Artificial profit shifting

Tax competition for real investments

$\Downarrow$

The way we tax corporations is not adapted anymore to today's globalized world

What is the cost of multinational corporate tax avoidance?

Hard to quantify: double-counting issues, tax laws vary substantially across countries, etc.

My approach: use national accounts and balance of payments data

Focus on US firms: what is happening to the profits of US-owned companies?

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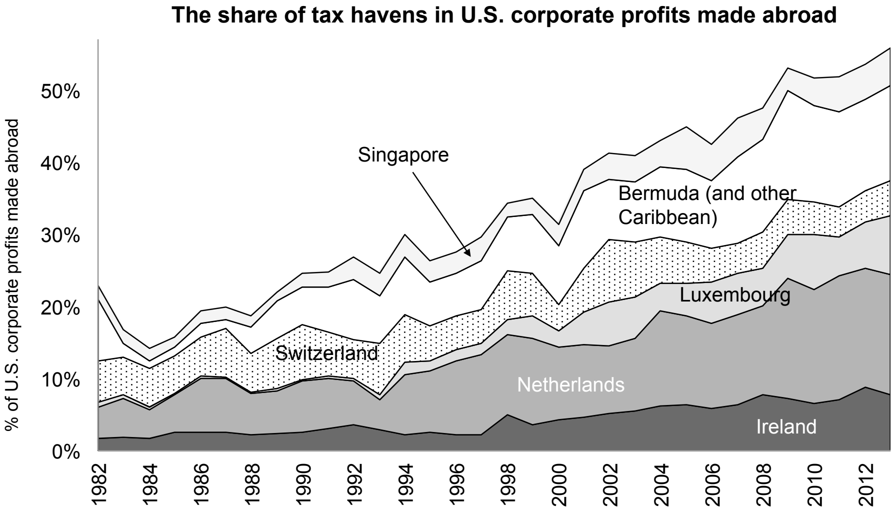
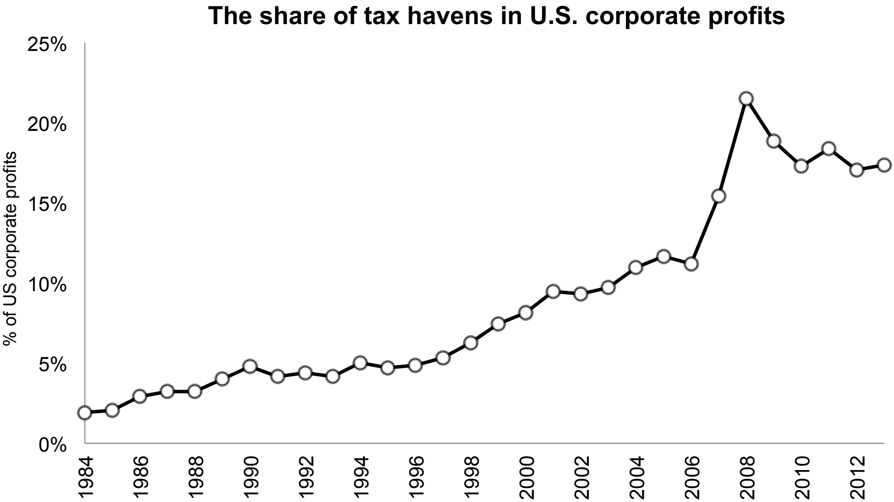
Latest data show offshore tax avoidance is sizable and growing fast

More than half of the foreign profits of US-owned firms are booked in tax havens



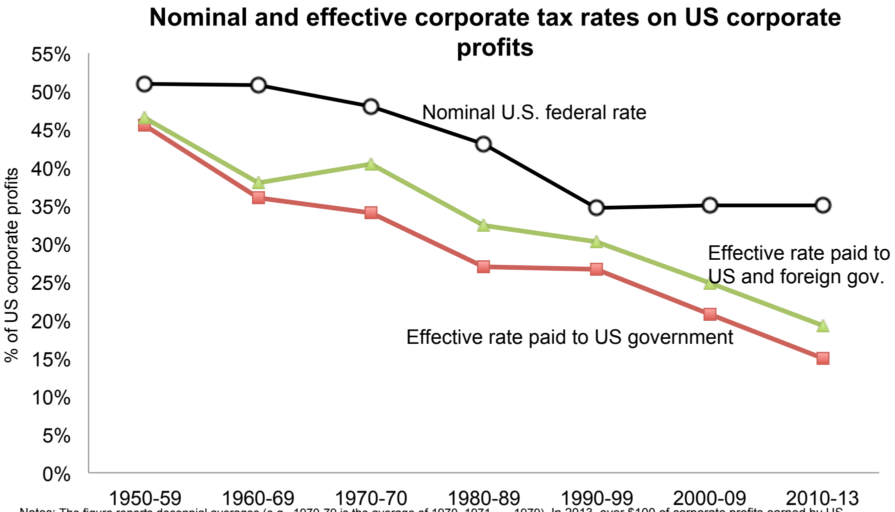
Notes: This figure charts the share of income on U.S. direct investment abroad made in the main tax havens. In 2013, total income on U.S.DI abroad was about $500bn. 17% came from the Netherlands, 8% from Luxembourg, etc. Source: author's computations using balance of payments data, see Online Appendix.

20% of all US corporate profits are booked in tax havens



Notes: This figure charts the ratio of profits made in the main tax havens (Netherlands, Ireland, Switzerland, Singapore, Luxembourg, Bermuda and other Caribbean havens) to total US corporate profits (domestic plus foreign). Source: author's computations using NIPA and balance of payments data, see Online

The effective rate paid by US corporations has been reduced by 1/3 since late 1990s



Notes: The figure reports decennial averages (e.g., 1970-79 is the average of 1970, 1971, ..., 1979). In 2013, over $100 of corporate profits earned by US residents, on average $16 is paid in corporate taxes to the U.S. government (federal and States) and $4 to foreign governments. Source: author's computations using NIPA data, see Online Appendix.

The way to go: formula apportionment

Abandon arm's length pricing, tax corporations' consolidated profits, and apportion those profits to each country according to some formula (with a high weight on sales)

This works well in the United States for the State corporate taxes

Common Consolidated Corporate Tax Base project in Europe; needs to be extended to global profits of non-EU firms

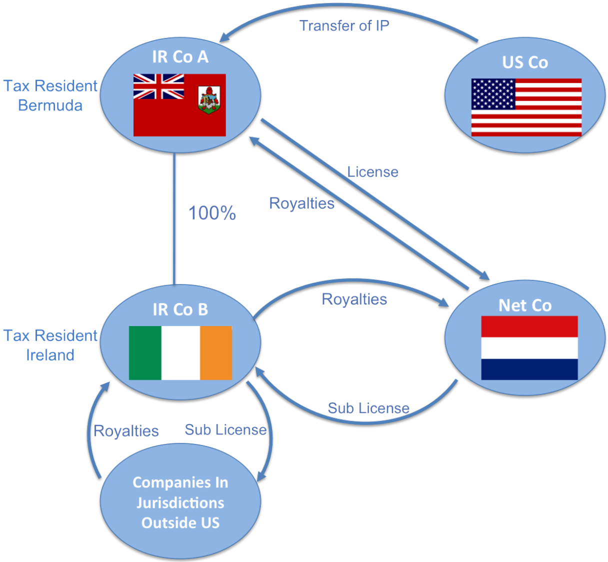
The EU could move unilaterally; best would be to move jointly with the US in the context of trans-atlantic free trade talks

$$\Downarrow$$

Formula apportionment is doable, and would render corporate tax planning obsolete

Supplementary Slides

How Google avoids taxes: the double Irish Dutch sandwich



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