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Tax unfairness in the European Union

Towards greater solidarity in fighting tax evasion

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From Polish to European Solidarity

2020 brings one of the most important commemoration dates in the Polish history – the 40th anniversary of establishing the Solidarity movement. The wave of August 1980 strikes led to the creation of NSZZ 'Solidarność' – the first legal trade union organisation in communist countries. In 1980, the union had almost 10 million members, i.e. 80 per cent of state employees. The formation of Solidarity marked the beginning of the 1989 changes – the overthrow of communism and the end of the Yalta system. Solidarity championed freedom and more sustainable development.

Today, the fight against unfair practices of many businesses across the world resembles the principles that were in the hearts of the Polish workers who fought for their freedom and reforms of the communist state.

The billions attracted by tax havens do harm to many people all over the world, decreasing the funding for public services and forcing many countries to raise taxes on consumption and work. Forty years ago, Polish workers demanded that everybody should pay their fair share and claimed social justice.

Before the 2008 financial crisis, tax havens were generally seen as exotic sideshows to the global economy, the Caribbean islands or Alpine financial fortresses frequented by celebrities, gangsters and wealthy aristocrats. Since then, the world has woken up to two sobering facts: firstly, the phenomenon is far bigger and more central to the global economy than nearly anyone had imagined; and secondly, the largest havens are not where we thought they were.

Tax havens collectively cost governments between USD 500 billion and USD 600 billion a year in lost corporate tax revenue, depending on the estimate, through legal and not-so-legal means.

Corporations are not the only beneficiaries. Individuals have stashed USD 8.7 trillion in tax havens, estimates Gabriel Zucman. James S. Henry's more comprehensive estimates yield an astonishing total of up to USD 36 trillion. Both, assuming very different rates of return, put global individual income tax losses at around USD 200 billion a year, which must be added to the corporate total.

VAT fraud is another leaking element of the system. EU Member States lose around EUR 60 bn annually. The creation of a single market of 28 countries brought with it VAT fraud which became the new white-collar crime exported to Central and Eastern Europe. The main reason behind Poland's crackdown on crime is that VAT revenue makes up around 40% of its budget. Warsaw did not try to reinvent the wheel; rather, it was inspired by other countries, mainly in Europe, sometimes taking measures to a new level. Currently, the level of fraud in VAT is among the lowest levels in the EU and Poland is one of the countries wishing to tighten VAT cooperation between tax authorities in the Union.

Overall estimates of tax evasion in the world vary widely due to financial secrecy and patchy official data and because there is no generally accepted definition of a tax haven. They provide an escape route from financial regulations, disclosure, criminal liability, and more. Since the main corporate users of tax havens are large financial institutions and other multinationals, the system tilts the playing field against small and medium-sized enterprises, boosting monopolisation.

Political damage, while unquantifiable, must be added to the charge sheet: most centrally, tax havens provide hiding places for the illicit activities of elites who use them, at the expense of the less powerful majority. Tax havens defend themselves as ‘tax neutral’ conduits helping international finance and investment flow smoothly. But while the benefits for the private players involved are evident, the same may not be true for the world as a whole; it is now widely accepted that, in addition to tax losses, allowing capital to flow freely across borders carries risks, including the danger of financial instability in emerging market economies.

Countries must step up work to ensure that tax administrations and anti-corruption authorities can effectively cooperate in the fight against tax evasion, bribery and other forms of corruption. With annual revenue losses from tax evasion and corruption estimated in billions, it is critical that government agencies should join forces to deter, detect and prosecute such crimes. Improving cooperation between tax authorities is at the heart of the fight. The OECD, the IMF and the European Commission and the European Parliament are the institutions currently doing most of the work.

Financial flows seeking secrecy or fleeing corporate taxes seem to be worsening inequality, increasing vulnerability to crises and dealing unquantifiable political damage as secrecy-shrouded capital infiltrates Western political systems. This is a lose-lose situation.

I wish for us politicians to change. We need to work on solutions that will curb this problem. From Polish to European Solidarity, we need a European Tax Deal that would heal tax systems in the EU. According to this report, we lose as much as the yearly expenditures from the European Multiannual Financial Framework – EUR 170 bn in total – so a lot is at stake. We need a coalition of the willing, those eager to fight and win.

Mateusz Morawiecki

Prime Minister of the Republic of Poland

Contents

Key figures

EUR 170 billion	The value of tax revenue lost by EU Member States due to cross-border tax evasion, of which: EUR 60 bn due to artificial profit shifting by multinational companies, EUR 46 bn due to moving wealth by rich individuals, EUR 64 bn due to cross-border VAT frauds.
13%	On average, such part of CIT revenue in EU Member States is lost due to artificial profit shifting. Almost ⅘ of this is lost due to transfers within the EU.
6 beneficiaries	The number of EU Member States which benefit from the artificial profit shifting process. These are: Belgium, Cyprus, Ireland, Luxembourg, Malta and the Netherlands.
TOP 3 sufferers	France, Germany and the United Kingdom – these are the EU Member States with the highest loss resulting from artificial profit shifting (in nominal terms).
8 percentage points	The fall in average effective corporate income taxation in the EU in the last two decades – from 24% in 2000 to 16% in 2017.
40%	Such part of the world's foreign direct investment (FDI) is phantom. Luxembourg and the Netherlands are the two main phantom FDI destinations in the world, whereas Ireland ranks among the top 10 countries of this type.
10% of GDP	The value of EU citizens' wealth held in offshore financial centres. At least 75% of this is not reported to tax authorities.
12%	The average VAT gap in EU Member States in 2017. It is an equivalent of EUR 137 bn loss in public revenue. Over 40% of this amount may result from cross-border VAT frauds.

Key findings

→ **The evolution of the tax systems in the European Union Member States in recent decades is an example of the 'race to the bottom' phenomenon. The taxation of both corporations and rich individuals has significantly declined.** It means that a growing part of public goods must be financed by other parts of the tax base, with probably increasing share of less powerful members of the society in total tax payments. This could be one of the reasons for rising inequalities and a sense of injustice within European societies.

→ **Tax avoidance and evasion practices are among the main reasons for the decline in effective taxation of corporations and rich individuals.** In a globalised economy, such practices become a more and more international rather than national challenge. Three dimensions of cross-border tax avoidance and evasion are the most common: artificial profit shifting by multinational companies, moving wealth by rich individuals between jurisdictions and VAT frauds that use intra-Community transactions.

→ **Taxing profits in the jurisdiction where the profits are actually produced – this should be the fundamental principle for organising tax systems worldwide. However, not all countries, including some of the EU Member States, abide by this rule.** Artificial profit shifting by multinational enterprises between different jurisdictions is a widespread practice that deteriorates the CIT revenue in the EU Member States. On average, EU Member States lose 13% of their CIT revenue due to artificial profit shifting. That translates into EUR 60 bn loss in tax revenue across EU each year.

→ **Some EU Member States benefit from the artificial profit shifting process and should be called EU tax havens. These are: the Netherlands, Ireland, Belgium, Luxemburg, Malta and Cyprus.** Multinational companies derive benefits from favourable legal regulations in these countries. This happens to the detriment of the other EU Member States. Some of the EU tax havens – the Netherlands, Luxembourg and Ireland – are the global leaders in holding foreign investments that are phantom in nature – aimed at reducing tax liabilities rather than resulting from real economic activities.

→ **The rich citizens of the EU hold almost EUR 1.5 trillion wealth in international financial centres, and at least 3/4 of this value is not reported to tax authorities.** This translates into EUR 46 bn loss in EU Member States' public revenue each year. The VAT gap is still a severe EU problem as well. It amounted to almost EUR 140 bn in 2017, with over 40% of this amount probably resulting from cross-border VAT frauds. Organised criminal groups extort tax by using weaknesses of the system for collecting VAT from intra-Community transactions.

→ **Several actions to tighten tax systems have been proposed recently, but their impact is questionable, particularly for corporate taxation.** The recommendations issued by international organisations have insufficient power to force countries to introduce them in the shape desired (or to introduce them at all). In addition, national regulations often cannot keep up with the increasingly sophisticated tax avoidance schemes. Therefore, international solutions reforming the tax base are needed and, surely, greater determination and solidarity in fighting the problems described at the EU level is fundamental. **We submit the following proposals for the public debate:**

- Including the EU Member States in the screening process for the grey- and blacklist of tax havens. The classification criteria for those lists should be fully precise and publicly available.
- Giving the European Commission the power to impose sanctions on countries (including the EU Member States) that have been classified as tax havens.
- Introducing compensatory taxation at the EU level – a minimum tax paid by multinational enterprises in each EU Member State they operate in, calculated on a tax base that disallows the deduction of certain payments to related parties (interests, royalties, etc.).
- Establishing an obligation for multinational companies to regularly disclose information on their tax strategies in a standardised format, applicable for all EU Member States.
- Introducing solidarity in fighting tax evasion to the mainstream political agenda in the EU, including political marginalisation of the countries failing to comply with the common rules.

Introduction

In a globalised economy, establishing fair tax systems within countries is a more and more international rather than national challenge. As companies and individuals increasingly operate across borders, tax systems need to adjust to the situation and go beyond national regulations as well. However, the actions taken are not sufficient and lag behind economic reality. As a result, the loopholes that arise between different jurisdictions – sometimes intentionally created by some governments – are used by economic actors to significantly lower their tax burden.

The tax evasion[1] practices, increasingly crossing the national borders, undermine social cohesion within the countries and the sense of solidarity between them. Such practices are particularly used by large multinational companies which have both a significant motivation (interest) and sufficient resources (human and financial) to invest in aggressive tax planning. As a consequence, their contribution to financing state activities is on the decline and the loss must be compensated by other taxpayers. This may be a driver of rising inequalities and a sense of injustice among citizens. Moreover, some countries' practices facilitating tax evasion erode integrity in international relations.

The study aims to identify the mechanisms behind the process of international tax evasion as well as calculating the total loss suffered by EU Member States due to this phenomenon. We divide our analysis into three parts – tax evasion concerning corporate income tax (CIT), personal income and wealth tax and value-added tax (VAT). We draw on the existing literature to describe how multinational enterprises, rich individuals and organised criminal groups extort taxes, acting beyond the national borders. We also sum up the numbers to show that the practice of international tax evasion significantly undermines tax revenue in EU Member States.

According to our findings, tax evasion that crosses national borders accounts for about EUR 170 bn loss in EU Member States' tax revenue each year. Moreover, some EU Member States – specifically the Netherlands, Ireland, Belgium, Luxembourg, Malta and Cyprus – use unfair practices to enhance the artificial shifting of profits of multinational companies. They derive some benefits from the process, but this happens to the detriment of other Member States and the sense of solidarity within the EU community.

The article is organised as follows. The first chapter describes the evolution of tax revenue in the EU Member States in recent decades. The second chapter explains the process of artificial profit shifting by multinational enterprises, which undermines CIT revenue in most EU Member States. In the third chapter, we show how rich individuals move their income and wealth to avoid paying taxes. The fourth chapter concerns the VAT gap, still a severe EU problem. Finally, in the last part of the study, we draw conclusions and discuss policy implications.

[1] The literature uses two separate terms to describe the processes of escaping taxation: tax avoidance and tax evasion. Technically, the former term means the legal use of tax laws to reduce tax burden, whereas the latter means illegal practices used to avoid paying taxes. In practice, it is often hard to precisely classify taxpayers' behaviour into these two groups. In this paper, to simplify the message, we use the term 'tax evasion' for both – legal and illegal practices for lowering tax liabilities.

The evolution of taxes in the EU – decreasing for the rich and powerful, to the detriment of the others

The evolution of tax systems in the European Union Member States in recent decades is an example of the 'race to the bottom' phenomenon. This term is used to describe the gradual decline in the tax rates imposed on capital (especially on corporate profits), as a result of international tax competition. When one government decides to cut tax rates or give special privileges to some taxpayers, another introduces similar actions to maintain tax competitiveness in the global economy. This creates a vicious circle, which negatively affects non-privileged taxpayers who have to take a growing part of the costs of providing public goods on their shoulders.

Since the 1990s, the average standard CIT rate in the EU Member States has significantly decreased. In the 1995–1999 period, it amounted to 34–35%, while in the following ten years it dropped by 10 percentage points – to 24% in 2009 (chart 1). This trend has slowed down, but not stopped, since the global financial crises. The average top CIT rate in the EU reached 22% in 2019, ranging from below 15% in Bulgaria, Cyprus, Hungary and Ireland, to over 30% in France, Malta and Portugal.

Effective corporate taxation measures also show a fall in the tax burden imposed on the profits of corporations. The implicit tax rate on corporate income[2] has declined in almost all EU Member States since 2000. On average, the difference between its 2000 and 2017 levels amounts to 8 percentage points (a decrease from 24% to 16%). The effective average tax rate[3] is also on the decline in most countries. On average, it amounted to 20% in 2018, in comparison to over 22% in 2007. Effective taxation measures take into account not only the standard CIT rate but also exclusions from the tax base and preferential CIT rates. It is important, as some EU Member States use preferential taxation rules for specific situations, often to enhance profit transfers from other countries (described in more detail in the next chapter).

Reducing the tax burden imposed on corporations results in a fall in their contribution to financing public goods from which they benefit. Since 2007 (the pre-crisis era), the share of CIT revenue in total taxation has decreased in 24 out of the 28 EU Member States (chart 2). On average, the revenue from CIT accounted for almost 10% of total tax revenue in EU Member States in 2007, whereas the share dropped to 8% by 2018. Such a decline could only be justified if the scale of reaping the benefits of public goods (e.g. public infrastructure or the effects of public education) should dramatically change at the same time; however, it seems unlikely.

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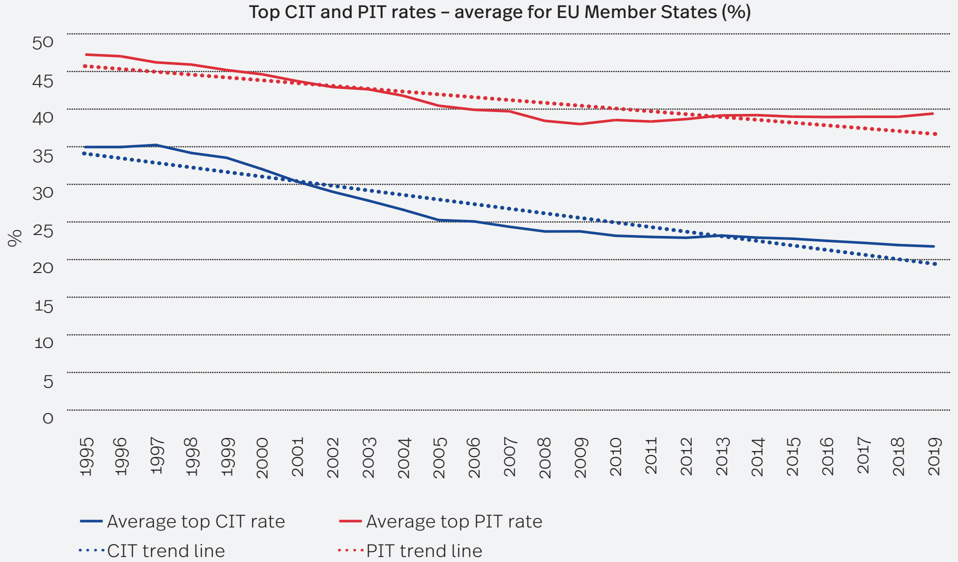
2 The ratio between revenue from taxes on corporate income and all taxable capital and business income of corporations.

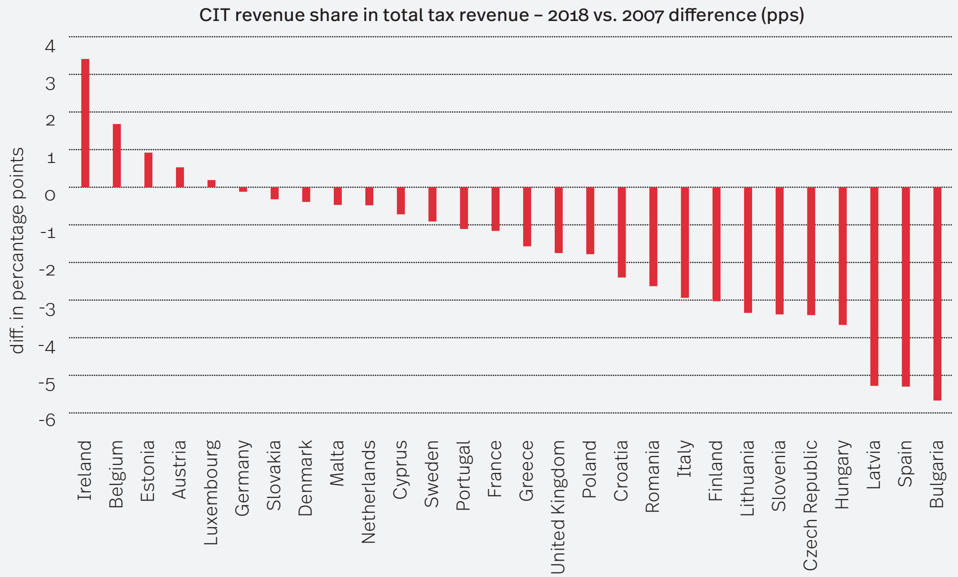
3 A forward-looking micro-based indicator computed by applying some of the basic tax rules to a hypothetical investment (as opposed to the implicit tax rate, based on real aggregated revenue and tax base).

↘ Chart 1. Both the average top CIT and PIT rates have significantly decreased in the EU Member States since the 1990s



Source: own elaboration based on DG TAXUD data.

↘ Chart 2. In most of the EU Member States, the share of CIT in public sector revenue is clearly below the pre-crisis level



Source: own elaboration based on Eurostat data.

The tax burden on the richest individuals is on the decline as well. The average top PIT rate in EU Member States decreased in particular before the global financial crises – from 47% in 1995 to 38% in 2008 (chart 1). Since 2008, it has remained slightly below the 40% threshold, amounting to 39% in 2019. There are only four EU Member States having increased the top statutory PIT rate between 1995 and 2019 (Greece, Latvia, Portugal and the United Kingdom), whereas another four countries maintained the rates unchanged (Austria, Ireland, Malta and Slovenia). All the other 22 EU Member States reduced the top PIT rate, some of them significantly.

A gradual decline in tax burden imposed on corporations and rich individuals means that a growing part of public goods must be financed by other parts of the tax base, with probably increasing share of less powerful members of the society in total tax payments. This may be a driver of rising inequalities and a sense of injustice among the European citizens. The average tax revenue as a percentage of GDP in EU Member States is at a record high now – in 2018 it amounted to 37.1%, almost 2 percentage points above the 2010 level (such a high share was last observed in 1999). If the total tax burden is high and growing and, at the same time, the contribution of corporations and rich individuals is on the decline, greater responsibility for the financing of state activities must be passed on to other taxpayers, especially those earning medium and low wages.

Some EU Member States use unfair methods to attract tax revenue from other Member States

Taxing profits in the jurisdiction where the profits are actually generated[4] – this should be the fundamental principle for organising tax systems in the global economy. The more globalised the economic relations are and the larger portion of global GDP is represented by multinational enterprises, the more important this rule is for maintaining the integrity of tax systems. However, not all countries, including some of the EU Member States, abide by this rule. Multinational companies take advantage of this by artificially shifting their profits to low-tax jurisdictions and thus reduce their tax liabilities.

Artificial profit shifting by multinational enterprises has a significant negative impact on public revenue in most EU Member States. In total, EU Member States lose over EUR 60 bn of tax revenue each year due to artificial profit shifting (at 2016 prices). The highest losses are suffered by Germany (EUR 18 bn), France (EUR 11 bn) and the United Kingdom (EUR 14 bn). In relation to CIT revenue, EU Member States lose, on average, 13% of their current revenue (chart 3). This share ranges from 20–30% in Germany, Hungary, France and the United Kingdom to around 10% in some Central and Eastern European countries (characterised by a relatively low tax burden on corporations) – Bulgaria, Czechia, Slovakia, Slovenia and Romania.

Most of the artificial profit shifting process in the EU takes place among the EU Member States. Almost 80% of the CIT revenue lost due to artificial profit shifting by EU Member States is a loss in favour of other EU Member States (see again – chart 3). That means that the rule of taxing profits in the country where the profits are actually generated – described in the first paragraph of this chapter – is largely disrupted within the EU. It significantly undermines solidarity in building fair tax systems in the EU as a whole.

Belgium, Cyprus, Ireland, Luxembourg, Malta and the Netherlands benefit from the artificial profit shifting process. These countries should be called EU tax havens. Their total balance resulting from profit shifting amounts to EUR 16 bn. The share of the benefits from artificially attracting profits in total CIT revenue varies from 16% in Belgium and 30% in the Netherlands to 54% in Luxembourg and 65% in Ireland, to as much as 88% in Malta. That means that an important part of public revenue in the countries in question is generated to the disadvantage of public revenue in other EU Member States.

Favourable legal regulations in the EU tax havens allow multinational enterprises to build complex structures of parents and subsidiaries, aimed at reducing their tax liabilities. The main element of international tax evasion is locating affiliates of multinational corporations in countries that do not apply severe tax consequences to capital flows and do not impose strict controls thereon. Multinational

4 More precisely: in jurisdictions where the profit-producing activities are carried out.

companies take advantage of the loopholes in the above-mentioned EU jurisdictions and use advanced tax engineering to achieve lower tax rates or even to avoid paying taxes at all. The regulations concerning 'special purpose entities' (SPEs) are especially important in this context as this form is often used to channel investments through selected countries (see box 1 for a detailed description of the methods used to shift profits between countries and box 2 for a detailed discussion of the role played by SPEs in this process).

Due to artificial profit shifting, the EU tax havens are global leaders in holding phantom foreign direct investments (FDI). In all of the above-mentioned EU tax havens except Belgium, both inward and outward FDI stocks are several times higher than GDP. It largely results from creating artificial structures by multinational companies to reduce tax liabilities (Loretz et al. 2017). According to Damgaard et al. (2019), almost 40% of global FDI is phantom. Luxembourg and the Netherlands host nearly half of the world's phantom FDI. In addition, Ireland ranks among the top 10 countries of this type, next to several commonly known global tax havens such as the British Virgin Islands, Bermuda or the Cayman Islands.

Box 1. The schemes of artificial profit shifting by multinational enterprises

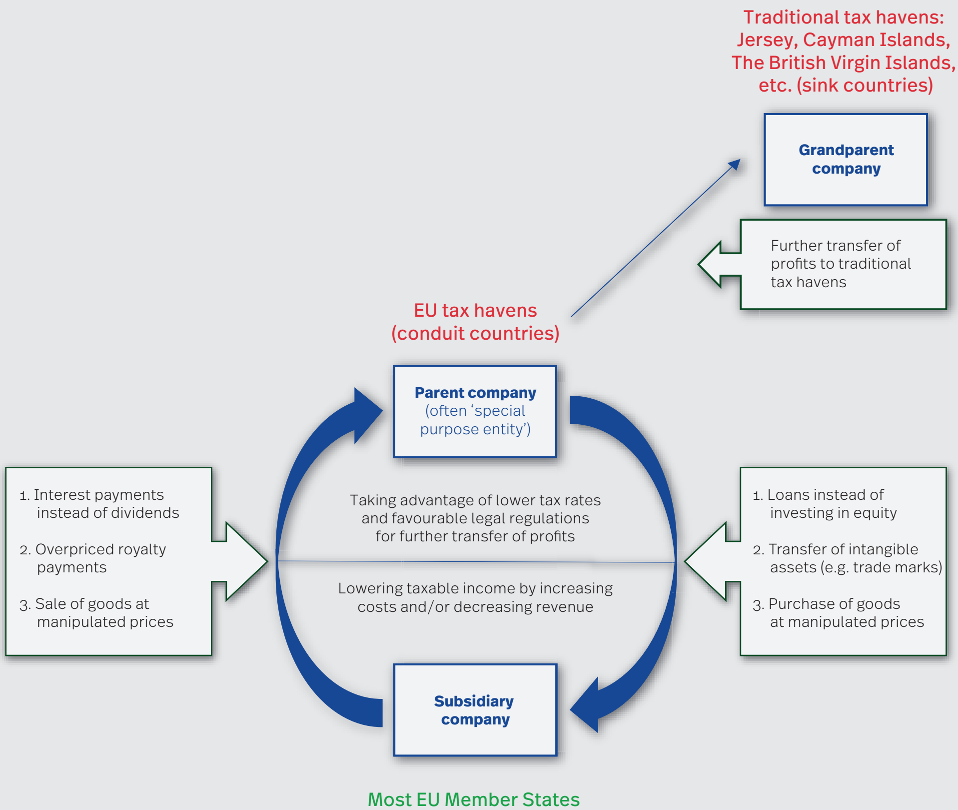
Multinational companies use differences in taxation rules between various jurisdictions to reduce their tax burden. In general, countries claim the right to tax not only the profits of their tax residents, regardless of where they are generated, but also non-residents' profits obtained in the country. This can lead to double taxation of the same profits – in the country of income and in the taxpayer's country of residence. To avoid the problem, countries sign bilateral or multilateral tax agreements on the elimination of double taxation, defining the rules for distributing taxation rights between states.

Unfortunately, the opposite effect of the attempts to establish multinational tax rules is often achieved, i.e. double non-taxation or lower taxation. Although most double-taxation agreements are based on model conventions, they differ in details and contain provisions that are more or less favourable for taxpayers in the contracting states. The ease of creating new legal entities, capital mobility, differences in countries' tax legislation and the variety of bilateral tax avoidance agreements create a favourable environment for multinational companies to avoid taxation – usually by tax-neutral dividend payments or the avoidance of withholding tax on interest.

Specifically, there are three most common schemes for artificial profit shifting to reduce tax liabilities:

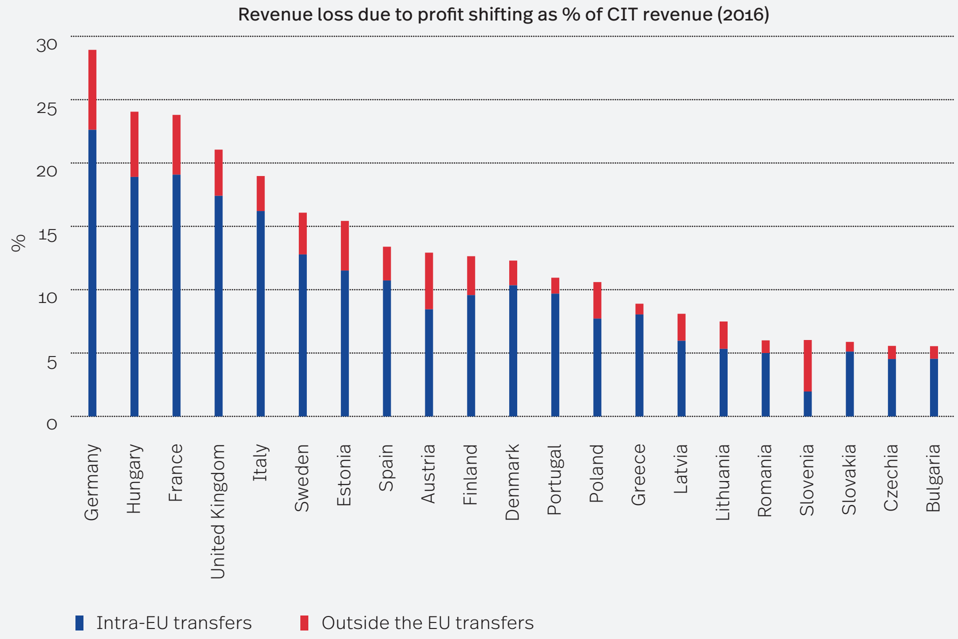
- **Interest payments** – unlike equity financing, which is not treated as tax cost in most tax jurisdictions (although some countries allow notional interest deductions on equity), debt financing is essentially a tax cost for the debtor. With the use of interest payments, it is easy to transfer profits earned in a country with higher taxation to countries where the tax burden is lower. Multinational companies use specific financing structures for capital groups as vehicles for shifting profits to low-tax countries or obtaining double deductions or no inclusions.

- **Royalty payments** – intangible rights are highly individualised, which makes it difficult to estimate their value precisely. As a result, they are susceptible to manipulation for tax purposes. Profit shifting usually involves the transfer of intangible assets or intellectual property to a country with a relatively low tax burden and then charging taxpayers in a country with higher taxation for using these rights. The examples of intangible rights used in this context are: copyright, utility models, patents, trade marks, know-how, etc.
- **Favourable transfer pricing** – multinational enterprises may distort the prices of intra-company transactions to increase profits in lower-tax countries at the expense of higher-tax countries. It is possible, in particular, in the case of goods and services that are unique as their value is difficult to be determined. However, also for common goods, there is always a certain margin in price setting that groups of undertakings may use to shift profits to the desired destination.

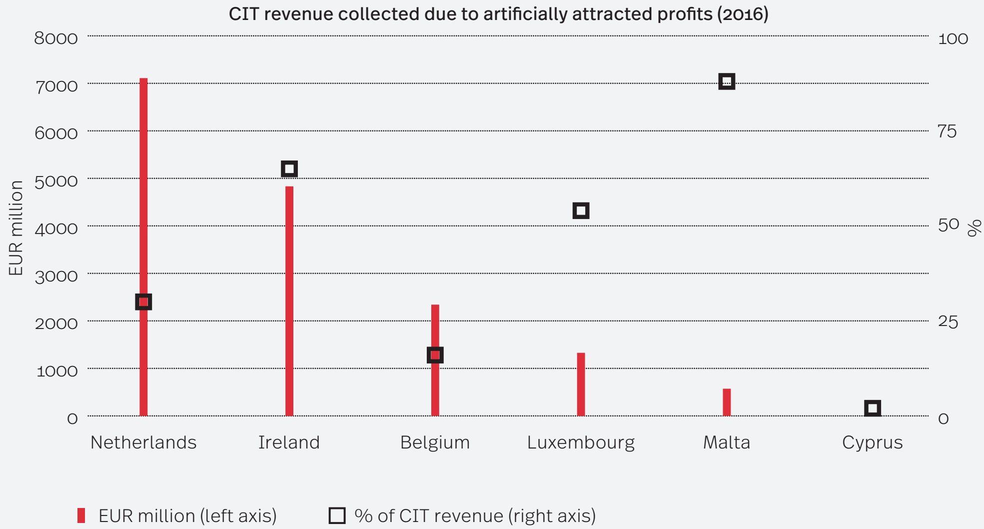


For further reading, see: Schwartz (2009), Meldgaard et al. (2015), Loretz et al. (2017), Beer et al. (2018).

↘ Chart 3. Most of the EU Member States lose a huge part of CIT revenue due to artificial profit shifting...



↘ Chart 4. ...but some of the EU Member States benefit a lot from this process



Source for both charts: own elaboration based on: Tørsløv, T., Wier, L., Zucman, G. (2019). The Missing Profits of Nations. Available at: https://missingprofits.world/.

Multinational corporations often treat EU tax havens as intermediate destinations, used to transfer profits to further tax havens. The literature distinguishes the tax havens on sink jurisdictions, attracting and retaining foreign capital, and conduit jurisdictions, serving as intermediaries in the routing of international investments and enabling the transfers of capital with minimum taxation. A comprehensive study of the global corporate ownership network has been prepared by Garcia-Bernardo et al. (2017). It shows that the Netherlands and Ireland belong to the top five conduit jurisdictions worldwide. In particular, those countries facilitate the transfer of value from and to sink jurisdictions and are used for this purpose by companies from a variety of countries (including EU Member States)[5].

Box 2. Special Purpose Entities – vehicles for artificial profit shifting

Special Purpose Entities (SPEs) are among the main structures used by multinational companies for shifting profits between different jurisdictions. SPEs are entities that tend to have little employment and little (or no) productive capacity or physical presence in the host country, and are ultimately controlled by a non-resident company. Their core business consists of holding/financing non-resident companies on behalf of their enterprise group, as well as channelling funds between affiliates. Examples of SPEs include brass plate companies, financing subsidiaries, conduits, holding companies, shelf companies and shell companies (OECD 2015; Eurostat 2019).

SPEs are organisational structures that do not directly generate tax savings but act as vehicles to facilitate tax savings. Firstly, they allow multinational enterprises to increase the number of tax-advantaged activities. Secondly, they enhance relative tax savings from existing tax-advantaged activities, for example, to shift profits to lower-tax jurisdictions. Demeré et al. (2019) show that, indeed, firms using SPEs have cash effective tax rates significantly lower than non-SPEs users, proving that SPEs facilitate economically significant tax savings.

The scale of using SPEs by multinational enterprises is growing rapidly, and they are commonly accused of a significant contribution to the continuing decline in global corporate tax revenue. In addition, some of the EU Member States – especially the Netherlands and Luxembourg – are indicated as the world's leaders in the establishment of this type of corporate structure. SPEs account for about 80% and over 90% of the total value of FDI in these countries, respectively (United Nations 2015; European Commission 2016; Volckaert 2016; Demeré et al. 2019).

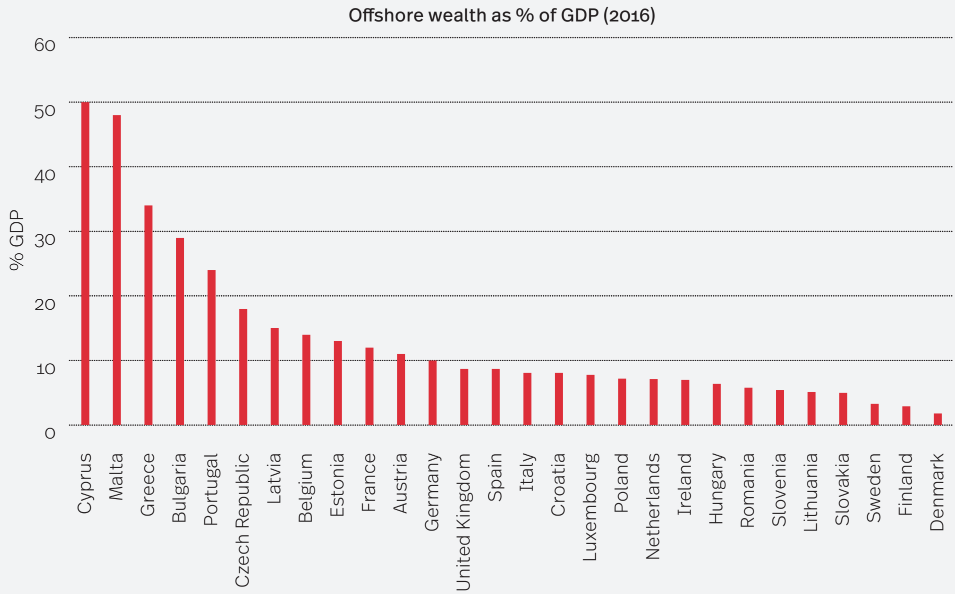
[5] Garcia-Bernardo et al. (2017) also identify some specific relationships between countries. For example, Ireland is a route for Japanese and American companies to Luxembourg, Cyprus for Russian companies owned from the British Virgin Islands, while Belgium is used as a conduit basically for one company – Euroclear.

Rich individuals in the EU massively move their wealth and avoid taxation

European countries face an ongoing problem of their citizens' wealth being transferred to international financial centres. Due to increasing financial globalisation, it is much easier for individual taxpayers to make and hold investments outside of their countries of residence, either in their names (as deposits or portfolio assets) or through shell companies and screening entities. The estimated value of offshore wealth held by EU Member States' citizens is EUR 1.5 trillion, accounting for almost 10% of EU GDP (2016 data).

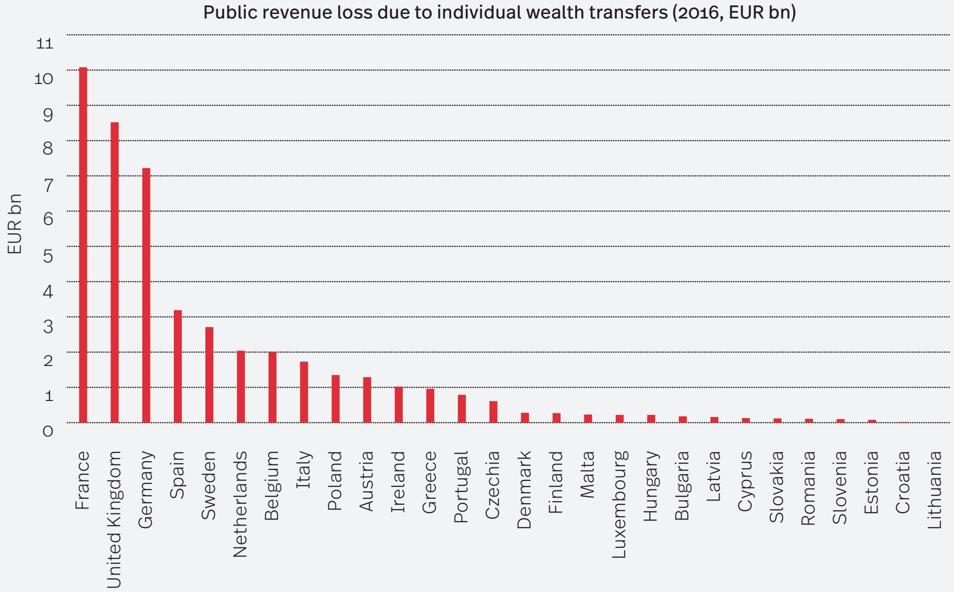
Germany, France, the United Kingdom and Italy are the countries with the largest offshore wealth. The value of transferred wealth ranges from EUR 142 bn in Italy to EUR 331 bn in Germany. In terms of share of GDP, it is Cyprus, Malta, Bulgaria and Greece whose citizens transfer the largest amounts of wealth, ranging from 29% of GDP in Bulgaria to nearly 50% of GDP in Cyprus and Malta (chart 5).

↘ Chart 5. Offshore wealth held by individuals exceeds 20% of GDP in some EU Member States



Source: own elaboration based on: Vellutini, C., Casamatta, G., Bousquet, L., Poniatowski, G. (2019). Estimating International Tax Evasion by Individuals. European Commission, Taxation Papers, No. 76.

↘ Chart 6. Germany, France and the United Kingdom are the countries to suffer the most due to individual wealth transfers (in nominal terms)



Source: own elaboration based on: Vellutini, C., Casamatta, G., Bousquet, L., Poniatowski, G. (2019). Estimating International Tax Evasion by Individuals. European Commission, Taxation Papers, No. 76.

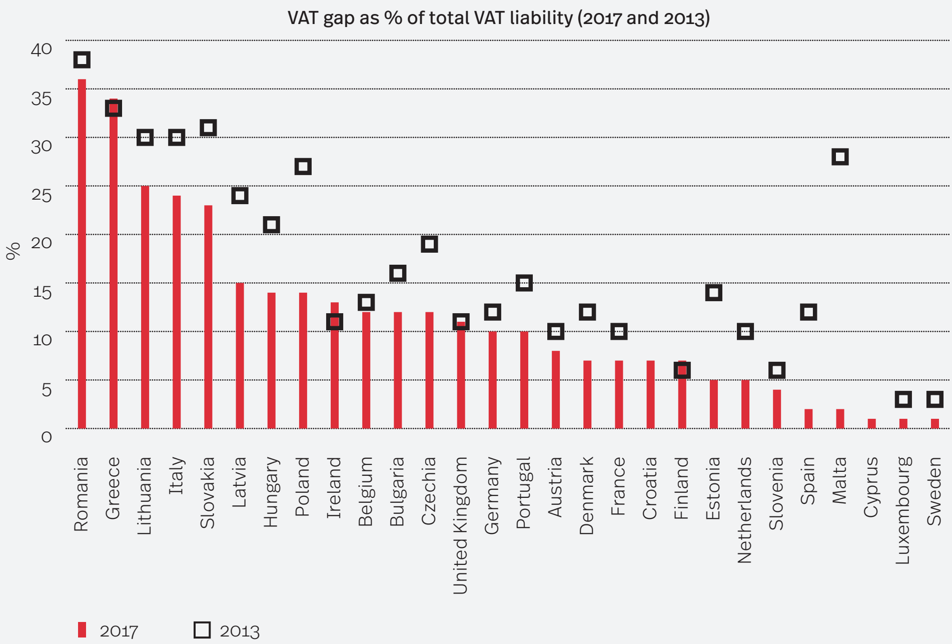
Most of the wealth transferred abroad goes untaxed, thus contributing to a significant loss in public revenue in EU Member States. At least 75% of the wealth held offshore by EU citizens is not reported to tax authorities. As a result, as much as EUR 1.1 trillion is not subject to taxation. This results in a loss of revenue of EUR 46 bn in EU Member States. This amount constituted 0.32% of the EU's total GDP in 2016. When taking into account the whole 2004–2016 period, the average annual revenue loss of the EU states was EUR 46 bn, accounting for 0.46% of EU GDP annually.

The extent to which EU governments are hurt by tax evasion by individuals is diverse, with some countries losing a significant part of their public revenue. The largest EU economies – France, the UK and Germany – are those to lose the greatest amounts in nominal values – ranging from EUR 10 bn for France to EUR 7 bn for Germany (chart 6). The countries suffering the most in relation to the amount of direct taxes collected are Bulgaria, Cyprus, Latvia and Malta – losing between 7% and 17% of direct tax revenue. On average, the EU Member States lose 4% of direct tax revenue due to individual wealth being transferred offshore.

The VAT gap – a decreasing but still severe EU problem

The EU Member States continue to lose a significant part of public revenue due to VAT frauds and inadequate VAT collection systems. This loss is expressed by the VAT gap – the difference between the VAT paid and the theoretical value of VAT revenue should all taxpayers declare their actions and transactions correctly. On average, the VAT gap amounted to 12% of the theoretical VAT revenue in EU Member States in 2017. This translated into a loss of EUR 137 bn in public revenue.

↘ Chart 7. The VAT gap still exceeds 10% of VAT revenue in half of the EU Member States



Note: no data for the VAT gap value in 2013 in Croatia and Cyprus.

Source: own elaboration based on: Poniatowski, G., Bonch-Osmolovskiy, M., Durán-Cabré, J., Esteller-Moré, A., Śmietanka, A. (2019), Study and Reports on the VAT Gap in the EU-28 Member States: 2019 Final Report, TAXUD/2015/CC/131.

In recent years, the VAT gap has declined in most of the EU Member States, but its value remains alarmingly high in several countries. The VAT gap ranges from over 20% in Romania, Greece, Lithuania, Italy and Slovakia, to barely noticeable values in Sweden, Luxembourg and Cyprus (chart 7). Especially Greece and Romania have failed to reduce the VAT gap, still losing around one-third of VAT revenue. On the other hand, there are countries like Poland and Malta, having significantly reduced the VAT gap in the past few years (for a detailed description of the Polish case – see box 3).

Box 3. Reducing the VAT gap – Lessons from Poland

Poland managed to significantly reduce the VAT gap in 2013–2017– from 27% to 14% of potential VAT revenue. That was the second-largest VAT gap decline in the EU (after Malta). Moreover, Poland continues to further decrease the gap – according to preliminary calculations, it amounted to barely 9% in 2018 (Poniatowski et al. 2019). This means that Poland has moved from the group of countries with the highest VAT gaps in the EU to the group of countries with VAT gaps below the EU average in just a few years (mainly the 2015–2018 period).

This spectacular success results from a coordinated effort to adopt modern legislation, consolidate the tax administration agencies and initiate their cooperation with the IT and banking sectors. The main actions taken include:

- Implementation of a fully electronic reporting system for VAT registers in the form of the Standard Audit File for Tax. Its format contributed to much more effective processing and analysing of corporate turnover and VAT register data.
- Adoption of the split payment mechanism, which enables buyers to transfer only the net value of the transaction to the seller's bank account, while the VAT part goes directly to the taxable person's VAT sub-account.
- The National Revenue Administration was established by consolidating the tax administration system, the Customs Service and the fiscal control system, previously operating separately. That facilitated control activities and contributed to fewer checks needed to detect VAT fraudulent practices.
- Cooperation between the consolidated tax authorities and the IT and banking sectors was launched, resulting in designing automated analytical tools that enabled spotting fictitious turnover and suspicious bank transactions.

For further reading, see: Sarnowski and Selera (2019).

A significant part of the VAT gap results from cross-border VAT frauds. The EU runs a trade surplus with itself – exporters report greater exports than the amounts reported by importers as imports. This is a logical impossibility, which is largely a consequence of fraudulent misreporting. According to Braml and Felbermayr (2019), the self-surplus of the EU amounted to EUR 307 bn in 2018. The authors argue that the discrepancy is associated with massive cross-border VAT frauds, up to EUR 64 bn. This means that potentially more than 40% of the total VAT gap in the EU Member States may result from cross-border transactions[6].

Organised criminal groups use weaknesses of the system for collecting VAT from intra-Community transactions to extort tax. VAT carousel fraud is one of their favourite instruments. It consists in creating a fictional supply chain of goods which crosses the borders within the EU. Companies engaged in the carousel buy goods and immediately sell them to another company, carrying out up to several hundred transactions a month. Payments are purely artificial – the transactions are intended solely to extort tax (for a detailed description of the mechanism see Sarnowski and Selera 2019). The carousel fraud is possible due to a specific system for collecting VAT on intra-Community transactions based on taxation in the state of destination and tax exemptions in the states of origin (zero rate of VAT).

[6] Previous calculations assigned about one-third of the total VAT gap to cross-border VAT frauds (Lamensch and Ceci 2018).

Conclusions and policy implications

Building a fair tax system is now not only a challenge to individual EU Member States, but also an increasing challenge to the EU as a whole. In this paper, we have shown that EU Member States lose an important part of their tax revenue due to tax avoidance and evasion across national borders. Artificially shifting the profits of multinational corporations between different jurisdictions, moving wealth by rich individuals to international financial centres, cross-border VAT frauds – these practices altogether account for about EUR 170 bn loss in public revenue in the EU Member States. That loss needs to be compensated by other taxpayers, which ultimately leads to rising inequalities and a sense of injustice among European citizens.

There are tax havens within the EU that deepen the problem of tax evasion through their specific legislation. They are: the Netherlands, Ireland, Belgium, Luxembourg, Malta and Cyprus. Those countries, in particular, benefit from the process of artificial profit shifting within the EU; in addition, they are often used by multinational enterprises as conduits in further transfers of profits to traditional tax havens. Such a practice of several countries deteriorates the sense of solidarity within the whole EU.

In recent years, several actions to enforce tax systems have been proposed, but their impact is questionable. This is particularly true for corporate income tax. Despite many resolutions and recommendations issued by the EU institutions and other international organisations (e.g. the OECD), or a number of anti-abuse regulations introduced (both general and specific), tax evasion remains a problem. There are two reasons for the situation. **Firstly, at present, recommendations have insufficient power to force countries to introduce them in the shape desired (or to introduce them at all).** As a consequence, some countries introduce regulations in such a way that their actual legal effect is practically irrelevant. **Secondly, national regulations often cannot keep up with the increasingly sophisticated tax avoidance schemes; therefore, solutions reforming the tax base internationally are needed.** Taxpayers strive to imitate economic justification for transactions that aim to avoid taxation and it is increasingly difficult for the tax administration to prove bad intentions. It does not mean that *ad hoc* policies against tax avoidance make no sense – certain patterns of international tax avoidance have already been eliminated completely, while others have been limited. Nevertheless, reforming the tax base internationally may combat the causes rather than the symptoms of the problem.

To answer these issues, we submit five tightly defined actions for public debate:

1. **Including the EU Member States in the screening process for the grey- and blacklisted tax havens. The classification criteria for the lists should be fully precise and publicly available.** As shown in this paper, cross-border tax evasion is, in the first place, an intra-EU problem. Therefore, there is no reason for excluding the EU Member States from the tax haven assessment. The criteria for the assessment should include e.g. the legal facilities for suspicious capital flows. Alternatively, the grey- and blacklisting process may involve specific national solutions that are the most harmful to the cohesion of the EU's tax system rather than entire tax regimes.

2. **Giving the European Commission the power to impose sanctions on countries (including the EU Member States) that have been classified as tax havens.** This should give the Commissions' recommendations the power needed to have a real impact. One of the main instruments may be the exclusion of companies registered in grey- and blacklisted countries from participation in public tenders in the EU area. Currently, tax haven-based companies win roughly 5% of value of public contracts in the EU Member States (Skuhrovec 2019). Public procurement is the perfect ground where governments can start pushing against tax haven abuse. Not only do they have additional motivation (the risk of conflict of interest), but they also enjoy a very strong leverage as the contracting authorities. Another measure is the introduction of anti-abuse regulations to the EU directives concerning the flows of passive income. If the recipient Member State's ratio of passive income flow (dividends, interest, royalty payments) exceeds certain thresholds based on objective criteria, the benefits would not be granted to the taxpayers and the withholding tax would be applied.
3. **Introducing compensatory taxation at the EU level – a minimum tax paid by multinational enterprises in each EU country they operate in, calculated on a tax base that disallows the deduction of certain payments to related parties (interests, royalties, etc.).** The solution is based on Base Erosion and Anti-Abuse Tax (BEAT), recently introduced in the United States. According to BEAT regulations, every large corporation calculates its tax liability at a standard tax rate and compares it to the liability at the lower BEAT rate, calculated after adding back to the tax base deductible payments such as interest, royalties and certain service payments. The corporation must pay the higher liability of these two (TPC 2018, PEI 2019).
4. **Establishing an obligation for multinational enterprises to regularly disclose information on their tax strategies in a standardised format, applicable for all EU Member States.** Corporations should present not only their tax results, but also how they manage tax risk, their attitude to tax planning, how the business works and any other relevant information relating to taxation. Multinational companies may also be rated by the tax authorities with respect to the information they provide. The challenge is also to boost cross-border cooperation in terms of access to and exchange of standardised data concerning tax information.
5. **Introducing solidarity in fighting tax evasion to the mainstream political agenda in the EU, including political marginalisation of the countries failing to comply with the common rules.** This is the softest of the listed recommendations, but increasing political pressure seems to be essential to eliminating tax haven practices within the EU. It is important to note that such pressure is already in use in the EU in other issues, e.g. the migrant crisis or violations of the rule of law.

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