



Tax evasion and Swiss bank deposits [☆]

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ABSTRACT

Bank deposits in offshore financial centers may be used to evade taxes on interest income. A recent EU reform limits the scope for this type of tax evasion by introducing a withholding tax on interest income earned by EU households in Switzerland and several other offshore centers. This paper estimates the impact of the withholding tax on Swiss bank deposits held by EU residents while using non-EU residents who were not subject to the tax as a comparison group. We present evidence that Swiss bank deposits owned by EU residents declined by 30–40% relative to other Swiss bank deposits in two quarters immediately before and after the tax was introduced. We also present evidence suggesting that the drop in Swiss bank deposits was driven by behavioral responses aiming to escape the tax - such as the transfer of funds to bank accounts in other offshore centers and the transfer of formal ownership of Swiss bank accounts to offshore holding companies - rather than repatriation of funds.

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1. Introduction

Offshore tax evasion has recently attracted much attention from policy makers as well as academic researchers. A recent paper estimates that the offshore financial wealth owned by households amounts to USD 6000 billion (Zucman, 2013). It is widely believed that most of this wealth is owned by the very richest households and that it largely escapes taxation. Hence, better enforcement of taxes on offshore wealth can potentially generate significant gains in terms of both equity and efficiency. It is therefore not surprising that the past decade has seen a number of notable policy initiatives against offshore tax evasion including information exchange agreements with offshore financial centers, amnesties for tax evaders disclosing offshore assets, criminal prosecution of bankers assisting with offshore tax evasion and the use of client information acquired from former bank employees to identify owners of undeclared offshore wealth. Little is known about the success of these measures because most economic activity in offshore financial centers is shrouded in secrecy.

This paper studies another important policy initiative known as the European Savings Directive. Since 2005, cooperating offshore centers such as Switzerland, Luxembourg and Jersey have applied a tax to the interest income of EU households and transferred the bulk of the tax

revenue to the households' home countries. Since the tax is withheld by the offshore banks and tax authorities are not informed about the identity of the tax payers, the Savings Directive enforces taxation of offshore wealth without compromising the bank secrecy of the cooperating offshore centers. Importantly, households that allow the offshore bank to report their interest income are exempt from the withholding tax. This implies that the tax only affects households unwilling to report their offshore interest income - tax evaders - while leaving compliant households unaffected.

The aim of the paper is to estimate how households with undeclared offshore deposits responded to the Savings Directive. This question is key to a normative evaluation of the policy. If the Savings Directive triggered no behavioral responses, it would appear as a highly attractive policy on both equity and efficiency grounds since it would amount to a transfer from rich and untaxed households to the government with no offsetting efficiency losses. Behavioral responses may, however, affect the normative properties of the policy in different ways. Specifically, increases in compliance, for instance through repatriation or self-reporting of offshore wealth, creates efficiency gains, whereas substitution toward untaxed alternatives, for instance through transfers from Swiss bank accounts to offshore centers outside the Savings Directive, creates efficiency losses.¹

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¹ To see this point clearly, let t^H denote the home country tax rate and t^W denote the withholding tax rate. Applying a standard argument, the marginal efficiency loss associated with a small increase in the withholding tax is captured by the revenue effect of behavioral responses to the tax change, hence increases in compliance cause an efficiency gain proportional to $t^H - t^W$ whereas substitution toward untaxed alternatives causes an efficiency loss proportional to t^W . Note that Chetty (2009) questions the validity of this argument in a tax evasion context. Also note that substitution effects are not captured by standard models of tax evasion in the tradition of Allingham and Sandmo (1972) where agents have access to a single evasion strategy, under-reporting of income.

To study how households responded to the Savings Directive, we use a unique dataset on cross-border bank deposits from the Bank for International Settlements (the “BIS”). More than 40 countries including the world’s largest offshore financial centers report deposit data to the BIS on the basis of bank balance sheets. The quarterly reports contain information about cross-border bank deposits at the bilateral level. We observe, for instance, the value of deposits in Swiss banks owned by German residents, deposits in Luxembourg banks owned by French residents and deposits in Jersey banks owned by UK residents.

The main analysis focuses on bank deposits in Switzerland. Both academic studies and industry surveys find that around one third of the global stock of household offshore wealth is managed by Swiss banks (Zucman, 2013; Boston Consulting Group, 2009) and certain features of the Swiss legal environment make it likely that a large fraction of this wealth escapes home country taxation. While Switzerland at least partly broke with its tradition for strict bank secrecy by agreeing to exchange tax relevant information with selected partner countries in 2009, it maintained a legal environment highly attractive for foreign tax evaders throughout the period of our analysis. Specifically, the legal principle of dual criminality implied that bank information may only be released by Swiss banks in cases where the alleged offense would constitute a criminal act under Swiss law. Since the simple non-declaration of income is not considered a criminal act in Switzerland, foreign tax evaders with Swiss bank deposits essentially had legal certainty that bank information would not be transmitted to their home country. According to Sullivan (2007), assets entrusted to Swiss banks by foreign households in ways that easily lend themselves to tax evasion amount to around \$1000 billion.²

The first part of the empirical analysis estimates the size of the behavioral responses to the Savings Directive. We exploit that the Savings Directive changed the tax environment for tax evaders resident in the EU while leaving tax evaders resident outside the EU unaffected. This allows us to estimate the causal effect on Swiss bank deposits by comparing the change in deposits held by EU residents to the change in deposits held by a control group of non-EU residents. The estimated effect is large and very robust. In a variety of different specifications, we consistently find that the Savings Directive reduced EU-owned bank deposits in Switzerland by 30–40%. The reduction occurred during just two quarters immediately before and after implementation of the policy, which strongly supports a causal interpretation of the estimates. We find similar although somewhat smaller effects on bank deposits in the four other offshore centers covered by the Savings Directive for which bilateral deposit data are available, Luxembourg, Jersey, Guernsey and the Isle of Man.

These results have two important implications. First, the finding that the stock of offshore bank deposits responded strongly to a policy that only affected tax evaders is highly suggestive that a significant fraction of offshore wealth is undeclared. This is consistent with the view held by most tax specialists but while this view is largely based on anecdotal evidence, the present analysis is based on systematic information about bank deposits in some of world’s leading offshore banking centers. Second, the results suggest that tax evaders are highly responsive to changes in the international tax environment. Under conservative assumptions, the estimated response to the Savings Directive implies a tax elasticity of undeclared Swiss deposits in the range of 2–2.5.

The second part of the empirical analysis attempts to uncover the nature of the behavioral responses to the Savings Directive. In other words, if EU-owned bank deposits in Switzerland dropped by 30–40% as suggested by the results reported above, what happened to all that money? First, we show that the Savings Directive caused a large increase in EU-owned bank deposits in Macao and Panama, the only two offshore centers outside the Savings Directive for which we have

bilateral deposit data. This suggests that the reduction in Swiss deposits partly reflects deposit shifting to escape the withholding tax. Second, we show that the Savings Directive caused a large increase in Swiss deposits recorded in the BIS statistics as belonging to Panama, a leading offshore provider of incorporation services. This is consistent with EU households transferring formal ownership of Swiss assets to sham corporations in Panama allowing them to escape the withholding tax while keeping their assets in Switzerland. Finally, we investigate whether the estimated reduction in Swiss deposits could be driven by repatriation of funds. We exploit that the tax cost of repatriating undeclared Swiss deposits depends crucially on home country taxes. If repatriation was a quantitatively important response to the Savings Directive, we should expect the drop in Swiss deposits to be larger for EU countries with low taxes on interest income. We find no signs of such a pattern suggesting that the reduction in Swiss deposits was not to a significant extent driven by repatriation of funds.

The paper relates to several strands of literature. Two earlier papers estimate the effect of tax variables and institutional variables on cross-border deposits while paying no particular attention to offshore centers: Alworth and Andresen (1992) estimate a cross-sectional gravity model and report modestly sized effects of source taxes while Huizinga and Nicodème (2004) estimate a panel gravity equation and find no effects of source taxes in the preferred specifications. Two papers are directly concerned with the Savings Directive but employ empirical strategies quite different from ours: Hemmelgarn and Nicodème (2009) deploy national account data, deposit data and government revenue data to assess the impact of the Savings Directive and conclude that the Savings Directive had no measurable effects. Klautke and Weichenreider (2010) show that bonds, which are exempt from the withholding tax due to a grandfather clause, are not associated with lower pre-tax returns than comparable taxable bonds suggesting that there are other ways to effectively avoid the withholding tax. Another related paper is by Johannesen and Zucman (2014) who show that information exchange treaties between offshore centers and other countries induce shifting of deposits between offshore centers but no repatriation of funds. Related to the analysis of Panama sham corporations are the studies by Hanlon et al. (2011) on the use of offshore corporations by U.S. households as well as Zucman (2013) and Johannesen and Zucman (2014). Finally, Brown et al. (2011) study tax and political determinants of Swiss bank deposits and report that weak political governance in the home country is more strongly associated with large stocks of deposits in Swiss banks than high tax rates.

The paper is structured in the following way: Section 2 lays out institutional details of the international tax environment and places the Savings Directive in this context. Section 3 describes the deposit data. Section 4 presents the empirical strategy. Section 5 illustrates time trends in Swiss bank deposits around the implementation of the Savings Directive. Sections 6 and 7 present results on the size and the nature of the behavioral response to the Savings Directive respectively. Section 8 provides concluding remarks.

2. Background

The first part of this section describes some basic principles of international taxation while highlighting the institutional features that make Swiss banks attractive for tax evaders. Since we aim to describe the institutional background for the Savings Directive, we focus on the rules applicable around 2005. The next two parts provide details on the Savings Directive and subsequent institutional developments.

2.1. The tax environment

The interest income of households is generally taxable in the home country regardless of where it is earned. To the extent that households do not self-report interest income from foreign sources, enforcement of residence based capital taxes requires information exchange between

² This figure combines \$606 billion of on-balance-sheet assets and \$356 billion of off-balance-sheet assets typically in the form of fiduciary deposits as of 2006 (the precise meaning of fiduciary deposits is explained in the background section).

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