



European  
University  
Institute

ROBERT SCHUMAN CENTRE FOR ADVANCED STUDIES

# EUI Working Papers

RSCAS 2012/25  
ROBERT SCHUMAN CENTRE FOR ADVANCED STUDIES  
Global Governance Programme-20

TAXING HIDDEN WEALTH –  
LESSONS FOR POLICY MAKING

Niels Johannesen



**EUROPEAN UNIVERSITY INSTITUTE, FLORENCE**  
**ROBERT SCHUMAN CENTRE FOR ADVANCED STUDIES**  
**GLOBAL GOVERNANCE PROGRAMME**

*Taxing hidden wealth – lessons for policy making*

**NIELS JOHANNESSEN**

EUI Working Paper **RSCAS** 2012/25

This text may be downloaded only for personal research purposes. Additional reproduction for other purposes, whether in hard copies or electronically, requires the consent of the author(s), editor(s). If cited or quoted, reference should be made to the full name of the author(s), editor(s), the title, the working paper, or other series, the year and the publisher.

ISSN 1028-3625

© 2012 Niels Johannesen  
Printed in Italy, June 2012  
European University Institute  
Badia Fiesolana  
I – 50014 San Domenico di Fiesole (FI)  
Italy  
[www.eui.eu/RSCAS/Publications/](http://www.eui.eu/RSCAS/Publications/)  
[www.eui.eu](http://www.eui.eu)  
[cadmus.eui.eu](http://cadmus.eui.eu)

## **Robert Schuman Centre for Advanced Studies**

The Robert Schuman Centre for Advanced Studies (RSCAS), created in 1992 and directed by Stefano Bartolini since September 2006, aims to develop inter-disciplinary and comparative research and to promote work on the major issues facing the process of integration and European society.

The Centre is home to a large post-doctoral programme and hosts major research programmes and projects, and a range of working groups and *ad hoc* initiatives. The research agenda is organised around a set of core themes and is continuously evolving, reflecting the changing agenda of European integration and the expanding membership of the European Union.

Details of the research of the Centre can be found on:

<http://www.eui.eu/RSCAS/Research/>

Research publications take the form of Working Papers, Policy Papers, Distinguished Lectures and books. Most of these are also available on the RSCAS website:

<http://www.eui.eu/RSCAS/Publications/>

The EUI and the RSCAS are not responsible for the opinion expressed by the author(s).

## **The Global Governance Programme at the EUI**

The Global Governance Programme (GGP) aims to share knowledge, and develop new ideas on issues of global governance, serve as a bridge between research and policy-making, and contribute the European perspective to the global governance debate.

The GGP comprises three core dimensions: training, research and policy. The Academy of Global Governance is a unique executive training programme which combines EUI's top-level academic environment with some of the world's leading experts in the field of global governance and is targeted to young executives and policy-makers, public sector officials, private sector professionals, junior academics, and diplomats. Diverse global governance issues are investigated in research strands and projects coordinated by senior scholars, both from the EUI and from internationally recognized top institutions. The policy dimension is developed throughout the programme, but is highlighted in the GGP High-Level Policy Seminars, which bring together policy-makers and academics at the highest level to discuss issues of current global importance.

For more information:

[www.globalgovernanceprogramme.eu](http://www.globalgovernanceprogramme.eu)



## **Abstract**

The past decade has seen several large-scale policy initiatives against offshore tax evasion and policy activity is still hectic. The present paper reviews available data sources on household wealth in offshore jurisdictions, provides an overview of recent empirical results pertaining to offshore tax evasion as well as a discussion of the implications they have for current policy discussions.

## **Keywords**

Tax evasion, offshore wealth, capital taxation, tax havens





## 1. Introduction

The past decade has seen several large-scale policy initiatives against offshore tax evasion. Notably, the Savings Directive of the European Union introducing withholding taxes in tax havens and the push for international information exchange by the OECD and the G20 have caused fundamental changes in the environment where tax evaders operate. Policy activity in the field is still hectic. The EU countries are currently negotiating an amendment to the Savings Directive with the aim of closing certain specific loopholes; the UK and Germany are concluding individual treaties with Switzerland, which broaden the scope of the withholding taxes; and both OECD and developing countries are still signing information exchange treaties with tax havens at high frequency.

The prolific policy activity, however, calls for thorough evaluation of the experiences with already implemented policy initiatives. While the study of offshore tax evasion is notoriously difficult due to the pervasive secrecy in offshore jurisdictions, recent empirical papers have made significant contributions to our understanding of the phenomenon. These contributions also offer important guidance to current policy process.

The aim of the present paper is to provide an overview of the recent empirical results pertaining to offshore tax evasion as well as a discussion of the implications they have for current policy discussions. The paper proceeds in the following way. Section 2 reviews available data sources on household wealth in offshore jurisdictions in order to establish the plausible magnitude of this “hidden wealth”. Section 3 describes the Savings Directive and presents existing studies of its effects, notably Johannesen (2011). Section 4 accounts for the recent wave of information exchange treaties with tax havens and presents the available empirical evidence, notably Johannesen and Zucman (2012). Section 5 draws up lessons from the studies of offshore tax evasion and discusses implications for policy design. Section 6 concludes.

## 2. Quantifying offshore wealth

A natural first step in analyzing the fight against offshore tax evasion is to establish a notion of the size of the problem. The obvious challenge is that tax evasion is generally not directly observable – in the nature of things tax evaders might actually do their best to make it unobservable. Nevertheless, there are sources of information and techniques that have been used to back out plausible estimates of household wealth in tax havens. We will briefly review these sources in turn. It is useful to consider the two components of financial wealth, bank deposits and securities, separately.

The *Locational Banking Statistics* of the Bank for International Settlements (the “BIS”) is a direct source of information on bank deposits in offshore jurisdictions. Notably, for 43 major international banking centers - including 19 tax havens - the BIS provides information on the total value of bank deposits owned by foreigners and a decomposition on the residence countries of the foreign owners. The 19 tax havens are Austria, Bahamas, Bahrain, Belgium, Bermuda, Cayman Islands, Chile, Cyprus, Guernsey, Hong-Kong, Isle of Man, Jersey, Luxembourg, Macao, Malaysia, Netherlands Antilles (now Curacao), Panama, Singapore and Switzerland. Hence, the BIS Locational Banking Statistics contain information on the value of bank deposits in Switzerland owned by UK residents, in Luxembourg owned by French residents, in Cayman Islands owned by US residents and so on.

Table 1 displays the total value of banks deposits owned by foreigners in the 10 most important international banking centers (excluding bank deposits owned by other banks, which are unlikely to play a role in tax evasion). In 2011, foreign deposits in UK banks amounted to around USD 1,600 billion, which made UK the largest international banking center in the world. Cayman Islands and Switzerland are the most important tax havens ranking third and fourth respectively, but also Singapore, Belgium and Hong Kong are among the 10 largest international banking centers. Across all

43 jurisdictions reporting to the BIS Locational Banking Statistics, foreign bank deposits amount to roughly USD 7,000 billion of which around USD 2,700 billion are placed in banks in the 19 tax havens listed above.

**Table 1: Foreign deposits in top-10 banking centers in 2011 (USD billion)**

United Kingdom	1,609
United States	935
Cayman Islands	635
Switzerland	463
Japan	404
Netherlands	329
Singapore	296
Germany	290
Belgium	217
Hong Kong	204

Source: Bank for International Settlements, Locational Banking Statistics

There is no comparable source of information on securities held through banks in tax havens. The *Coordinated Portfolio Investment Survey* collected by the IMF includes some bilateral information about cross-border holdings of securities but, crucially, excludes the most important tax havens.

Recently, however, Zucman (2011) has developed an ingenious method for estimating household portfolios of securities held through tax havens. The method essentially relies on inconsistencies in international portfolio statistics, which derive from the fact that assets are hidden from the tax authorities of the country of residence. Applying this method, it is found that households own portfolios of shares and bonds of around USD 4,500 billion in tax havens.

In sum, the BIS Locational Banking Statistics provides *direct* evidence that the global value of bank deposits owned by households and firms in tax havens amounts to around USD 2,700 billion. There is no information on the split between households and firms, but drawing on more detailed Swiss data, Zucman (2011) conservatively estimates that roughly half, that is around USD 1,400 billion, belong to households. Moreover, Zucman (2011) provides *indirect* evidence that the global value of shares and bonds owned by households through banks in tax havens amounts to around USD 4,500 billion in 2011. Hence, a plausible estimate of global household offshore financial wealth is around USD 6,000 billion.

### 3. The EU Savings Directive

The Savings Directive aims to enable the member states of the European Union to tax the foreign interest income earned by households. It took effect on 1 July 2005 and initially covered the 25 EU member states as well as 15 non-EU jurisdictions including Switzerland, the Cayman Islands, Jersey, Guernsey and the Isle of Man. The EU enlargement on 1 January 2007 brought the number of participating jurisdictions to 42.

The Savings Directive provides for two alternative types of international cooperation. The first type of cooperation is based on *automatic information exchange*: Banks report interest income earned by (foreign) EU resident households to their local tax authorities who, in turn, provide this information to the tax authorities of residence countries. The second type of cooperation is based on *withholding taxes*: Banks levy a tax on the interest income of (foreign) EU resident households and remit the revenue to their local tax authorities who, in turn, transfer 75% of the tax revenue to the tax authorities of the residence country without disclosing the identity of the tax payer. The withholding tax rate was initially 15% in 2005 but gradually increased to 20% in 2008 and 35% in 2011. While the majority of the EU member states opted for automatic information exchange, Austria, Belgium and Luxembourg

as well as most of the participating jurisdictions outside the European Union adopted the withholding tax.

It should be noted that the Savings Directive may be circumvented with relative ease in several ways (European Commission, 2008). First, since only 18 of the more than 50 tax havens in the world participate in the Savings Directive, moving assets to a non-participating jurisdiction is a simple and effective strategy to circumvent the withholding tax. Second, the Savings Directive operates on an immediate ownership rather than a ultimate ownership basis, hence transferring the formal ownership of assets to a trust or a corporation in a non-participating jurisdiction allows tax evaders to fall outside its scope. Third, the Savings Directive applies only to interest income narrowly defined, which implies that letting structured finance products with returns linked to leading interest rates replace bank deposits effectively allow tax evaders to circumvent the withholding tax.

Johannesen (2011) studies the impact of the Savings Directive on bank deposits in Switzerland, which is traditionally considered a primary destination for hidden wealth due to its strict banking secrecy rules and lack of commitments to international information exchange. The data are from the BIS Locational Banking Statistics described above.

Methodologically, the paper exploits that the Savings Directive effectively taxes the Swiss source interest income of EU residents while leaving the Swiss source interest income of non-EU residents untaxed. The Swiss bank deposits of non-EU residents thus establishes a counterfactual for Swiss bank deposits of EU residents absent the Savings Directive, which allows for an estimate of the causal impact of Savings Directive on Swiss bank deposits.

The paper finds that the Savings Directive reduced bank deposits in Switzerland owned by EU residents by more than 40%. To the extent that a significant share of Swiss bank deposits belong to firms, which are outside the scope of the Savings Directive and therefore presumably did not respond to it, the percentage reduction in Swiss deposits held by households is likely to have been even larger.

Several patterns support the causal interpretation of this estimate. First, bank deposits owned by EU residents and non-EU resident followed strikingly similar time trends prior to 1 July 2005. This lends support to the notion that deposits owned by EU residents and non-EU resident would have followed similar time trends after to 1 July 2005 in the absence of the Savings Directive and, hence, that the observed divergence in time trends around 1 July 2005 is the causal effect of the Savings Directive. Second, most of the estimated reduction in Swiss bank deposits owned by EU residents occurred during just two quarters between 1 April 2005 and 30 September 2005. The close temporal association between the introduction of the tax and the drop in bank deposits clearly strengthens the case for a causal interpretation. Third, the result is robust to comparing the behavior of EU residents to a narrow group of comparable countries such as the remaining OECD countries. The direct comparison of highly similar countries makes it implausible that the sudden divergence in trends around 1 July 2005 is due to other shocks than the Savings Directive with a strongly differential impact in EU countries and non-EU countries.

The paper conducts a similar analysis for Luxembourg and Jersey, which are both tax havens applying a withholding tax under the Savings Directive. The effects are slightly smaller and less precisely estimated but the overall picture is the same. The Savings Directive caused a very significant drop in bank deposits owned by EU residents in these countries.

While Johannesen (2011) provides strong evidence that Savings Directive caused a very significant drop in bank deposits owned by EU residents in Switzerland and other tax havens applying the 15% withholding tax, it does not provide a definitive answer to the equally interesting question: What happened to the funds that were removed from bank accounts in these countries?

It seems implausible, however, that the drop in bank deposits in Switzerland reflects repatriation to the residence countries to any significant extent. First, all EU member states had considerably higher tax rates on interest income than the 15% withholding tax rate initially applied under the Savings

Directive. Hence, leaving wealth in tax havens was considerably more tax efficient than repatriation and implied no significant risk of detection. Second, participating tax havens generally allowed households to avoid the withholding tax by accepting that information on interest income be automatically transmitted to their country of residence. It follows that repatriation was not necessary for tax evaders who desired to come clean while avoiding to pay the withholding tax.

A much more likely explanation than repatriation is that tax evaders moved wealth to untaxed alternatives in response to the Savings Directive. As noted above, the Savings Directive in its current form contains several loopholes that allow tax evaders with assets in Switzerland to avoid the withholding tax with relative ease, e.g. moving assets to a non-participating jurisdiction, holding assets through a trust or a corporation in a non-participating jurisdiction or replacing bank deposits with exempt structured finance products with very similar characteristics.

This conclusion is consistent with other complementary evidence on the effects of the Savings Directive. For instance, Klautke and Weichenreider (2010) study bonds market effects while exploiting that bonds issued prior to 2001 are outside the scope of the Savings Directive. The main finding is that exempt bonds are not associated with a lower pre-tax return than otherwise comparable taxable bonds suggesting that techniques allowing investors to avoid the provisions of the Savings Directive are readily available.

#### **4. Information Exchange Treaties**

For more than a decade, the OECD has promoted transparency in tax havens in the form of bilateral treaties providing for exchange of tax relevant information. Like the Savings Directive, the aim is to establish effective taxation of income earned in tax havens, but the approach is clearly distinct. Whereas the Savings Directive provides for anonymous taxation in tax havens and subsequent transfer of tax revenue to residence countries, the idea underlying the OECD transparency principle is that tax havens provide information that allow countries to enforce their own residence based capital taxes.

The bilateral treaties promoted by the OECD build on a specific standard of information exchange known as *information exchange upon request* under which countries can solicit information about specific tax payers from the partner country. The practical use of this type of information exchange, however, is much contested. In order to place a request for information, countries need to document a suspicion against the specific tax payer about which information is requested. Obviously, this type of information is very difficult to come about, which suggests that from the perspective of tax evaders, the risk of detection is relatively small even when information exchange upon request is implemented and adequately enforced.

For several years, the OECD efforts to promote information exchange treaties were largely fruitless. Some tax havens officially endorsed the transparency principle, but generally concluded very few treaties. Most major tax havens such as Switzerland, Luxembourg and Singapore objected strongly to the transparency principle itself and declined to engage in effective exchange of information.

The turning point occurred at the G20 summit in London in April 2009. Against the backdrop of the financial crisis, a political determination emerged among the G20 countries to address the problem of offshore tax evasion. Tax havens were threatened with economic sanctions unless they implemented the OECD transparency standard – specified by the OECD to be at least 12 bilateral treaties providing for effective information exchange. In the rest of 2009, more than 300 information exchange agreements were concluded and the treaty signing activity remained high throughout 2010 and well into 2011.

Johannesen and Zucman (2012) use deposit data from the BIS Locational Banking Statistics to evaluate the *G20 Tax Haven Crackdown* and report two main findings. First, the wave of information

exchange treaties since the G20 summit have not reduced the total value of bank deposits in tax havens. Second, the information exchange treaties have provoked a relatively small but statistically significant transfer of deposits from more compliant tax havens to less compliant tax havens. These findings make a rather dismal picture: To the extent that countries are concerned mainly with the overall scale of offshore tax evasion and not with the specific tax havens used by evaders, the G20 Tax Haven Crackdown is a failure.

## **5. Lessons for policy making**

The Savings Directive amounts to a simple and easily interpretable natural experiment whereby the net return of a particular evasion strategy is reduced by 15% (i.e. deposits in Swiss banks held directly) whereas the net return of a number of alternative evasion strategies is unchanged (i.e. deposits in Singapore banks held directly; deposits in Swiss banks held *indirectly* through sham entities in third countries; and structured financial products held in Swiss banks).

The analysis in Johannesen (2011) shows that the modest tax of 15% caused a large reduction in Swiss bank deposits of at least 40%. We previously argued that the behavioral response largely reflected substitution towards alternative evasion strategies. The more general lesson to draw from this finding seems to be the following:

*Lesson 1: Offshore tax evasion strategies are highly substitutable and evaders respond strongly to incentives*

The implication of this lesson is clearly that any partial policy measure against offshore tax evasion is very vulnerable to circumvention. For instance, the Savings Directive only targets tax evasion in certain tax havens and in the form of certain types of income (interest income defined narrowly). If tax evasion strategies are indeed highly substitutable, tax evaders respond to such a partial policy initiative by substituting towards tax havens and types of income, which are not targeted. This suggests that broadening the scope of the Savings Directive in terms of, for instance, the number of tax havens and the types of income covered, are crucial to make it effectively counter offshore tax evasion. The current proposal from the European Commission to amend the Savings Directive would address some but not all of these concerns.

By comparison, information exchange treaties constitute a relatively broad policy measure against offshore tax evasion in the sense that they address all types of income (e.g. interest income, dividend income and capital gains) and look through holding structures involving sham entities in third countries. To the extent that treaty networks are incomplete, however, the G20 Tax Haven Crackdown suffers from the same deficiency as the Savings Directive, namely that only evasion in certain tax havens are targeted thus creating a scope for circumvention by substituting to non-targeted tax havens. The implication of Lesson 1 is that countries should endeavor to complete treaty networks in order to eliminate this scope for substitution.

As reported above, the findings of Johannesen and Zucman (2012) suggest that the information exchange treaties caused relatively small transfers of funds from cooperative havens to less cooperative havens. The average response to the signing of an information exchange treaty in terms of transfers of funds to havens not covered by a treaty is considerably smaller than the average response to the 15% withholding tax under the Savings Directive. There are, in principle, two possible explanations for this pattern. First, due to the comparably broad scope of information exchange treaties, the set of available alternative evasion strategies is smaller than under the withholding tax, hence substitution to alternative evasion strategies is effectively limited on the supply side. Second, the increase in the probability of detection of tax evasion implied by the signing of a treaty is relatively small, hence substitution to alternative evasion strategies is limited on the supply side. The latter explanation appears much more plausible than the former. Offshore wealth is concentrated on relatively few, wealthy individuals and it therefore seems highly unlikely that the transactions costs

associated with a transfer of funds from one tax haven to another would be prohibitive. More likely, treaties are not perceived to involve a serious risk of detection, which is consistent with the fact that countries generally request information under their treaties quite infrequently. This discussion is summarized in Lesson 2.

*Lesson 2: Information exchange upon request implies a relatively small increase in the probability of detection.*

The policy implication of Lesson 2 is that treaties should be made more demanding. Ideally, treaties would provide for automatic information exchange whereby treaty partners would systematically and periodically exchange information about the income of residents of the partner country. This type of information exchange is currently practiced between most member states of the European Union.

An interesting policy debate concerns the question whether withholding taxes (as implemented under the Savings Directive) or information exchange (as implemented under the G20 Tax Haven Crackdown) is a preferable instrument to combat offshore tax evasion. The empirical findings presented in this paper do not provide an unequivocal answer to this question. Rather, it seems that both withholding taxes and information exchange, in their current form, suffer from serious weaknesses that allow for large-sale evasion, but that both could, potentially, take a form that would effectively end offshore tax evasion. Specifically, a withholding tax applied in all of the world's tax havens to all types of income seems, for most practical purposes, to achieve the same ends as a comprehensive, multilateral agreement on automatic information exchange.

## 6. Conclusion

This paper has discussed available empirical evidence on the behavioral responses to recent large-scale policy initiatives against offshore tax evasion and has drawn conclusions for future policy making. Most importantly, the empirical evidence shows that offshore tax evasion strategies are highly substitutable, which makes partial policy initiatives addressing only a subset of the alternative evasion strategies particularly vulnerable to circumvention. Moreover, the current form of information exchange does not seem to imply a large increase in the probability of detecting offshore tax evasion. A withholding tax on all types of income applied in all tax havens and a multilateral agreement on automatic information exchange offer themselves as alternative solutions that would effectively put an end to offshore tax evasion.

## References

- European Commission, 2008. Report from the Commission to the Council, COM(2008) 552 final
- Johannesen, N., 2011. Tax Evasion and Swiss Bank Deposits. Unpublished manuscript
- Johannesen, N. and Zucman, G., 2012. The end of bank secrecy? An Evaluation of the G20 tax haven crackdown. Paris School of Economics working paper 2012-04.
- Klautke, T., and Weichenreider, A., 2010. Interest Income Tax Evasion, the EU Savings Directive and Capital Market Effects. Fiscal Studies 31(1), p. 151-170.
- Zucman, G., 2011. The Missing Wealth of Nations: Are Europe and the U.S. net Debtors or net Creditors? Paris School of Economics working paper 2011-07.

**Author contacts:**

**Niels Johannesen**

Department of Economics

University of Copenhagen

Øster Farimagsgade 5

Building 26

1353 København K

Denmark

Email: Niels.Johannesen@econ.ku.dk

