Due to the Gloomy Economic Outlook EU Fight against Tax Havens Enters a New Phase

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Abstract

An important part of the massive loss of income registered by some states of the European Union is due to the tax havens. It is estimated that last year alone the impact at EU level was 75 billion Euros. Fiscal losses are equivalent to almost 52% of the combined public health budgets of poor countries and respectively 8% for rich countries. These data have generated increasing public pressure, which has led to a more pragmatic involvement of decision makers. Due to the Covid-19 crisis, the situation is becoming imperative, as the amounts needed to cover spending on health and social services have increased significantly. The EU created a list of tax havens in 2017 based on a definition of harmful tax practices in order to counter the practices of large companies that avoid paying their tax obligations by using the subterfuges offered by tax havens. The strategy was to put pressure on countries that allow this practice, encouraging blacklisted countries to change their tax rules.

Keywords: *tax havens, EU black list, profit shifting, Covid-19, Controlled foreign corporation*

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1. Introduction

The leaders of the European Union announced at the end of an unprecedented European Council this year that they agreed on an extremely ambitious recovery plan and a multiannual financial framework for 2021-2027, thus paving the way for a way out of the crisis and laying the foundations for a modern and resilient Europe.

But, in order to finance the necessary investments, a constant cash flow is needed at the level of the community institutions. Thus, the European Commission has decided to issue bonds on the financial markets on behalf of the EU.

To make loans possible, the Commission will amend the Own Resources Decision and create some leeway - the difference between the own resources ceiling of the long-term budget (the maximum amount of funds that the Union can ask from the Member States to fund its expenses) and expenditures.

Imposing taxes on digital giants is part of an older European plan. GAFA companies (Google, Apple, Facebook, and Amazon) are rightly considered to

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account for most of the tax evasion affecting the EU budget, by outsourcing profits, loans offered by parent companies at extremely high interest rates, or moving their headquarters to tax havens.

Such tactics have been identified as common practice for many multinationals, thus European decision-makers have tried to identify ways to keep as much money as possible within the Union. This means either tax paid directly to the EU budget, or contributions to national budgets and direct or indirect economic growth throughout the entire value chain.

2. Problem statement

The discussion on increasing the European budget's own resources is long and in direct correlation with the gap left by the United Kingdom's contribution to the Community budget. An extremely concise analysis shows that the amount contributed by the United Kingdom can be replaced by two sources: either by increasing the contribution of the Member States or by new taxes being imposed on European industries.

For a better understanding of the overall discussion regarding the political and budgetary burden, a look at the architecture of the Community budget is needed. The EU budget is financed almost entirely (99%) from its own resources. The decision on the own resources system is taken unanimously in the Council, taking into account the opinion of the European Parliament, and is ratified by the Member States.

Beyond well-known budgetary sources, Brussels has realized that against the background of the pandemic, the gap between expenditure and revenue will be extremely unbalanced. One of the areas of financing EU already had in mind was to counteract the tactics used by large transnational corporations in order to dramatically reduce their tax base. In the pandemic context, the expenses generated by the costs with the medical and social system in general, created an expectation in society that decision makers could not ignore. Thus began a much more dynamic process of implementing a set of measures by which the adoption of a registered office in one of the tax havens is no longer compatible with doing business in the European Union.

3. Research Methods

Deductive analysis tools were used to build this study, by corroborating the data provided by Eurostat and international institutions interested in the issue of tax havens to determine the financial impact at budgetary level. In this sense, we analyzed the main income lines and the way in which the evasion of fiscal obligations affects both the interests of the national states, but also at the European Union level.

The structure of own resources is as follows: *"Traditional"* own resources - consist of customs duties, agricultural duties, and taxes on sugar and isoglucose;

VAT-based own resources - consist of a percentage of the estimated VAT collected by the Member States, which is transferred to the Union; *Gross National Income-based own resources* - consist of amounts drawn from Member States' GNI in the form of a uniform percentage determined each year by the budgetary procedure; Other income sources and the balance carried forward from the previous financial year, as well as *Correction mechanisms* - designed to correct budgetary imbalances between Member States' contributions. Equally important is that own resources are imposed directly on European capitals and have a national surcharge regime, i.e. they are added to the EU budget and cannot be directed later to a certain fiscal or budgetary purpose. Member States in turn decide the budgetary source of the taxes imposed as own resources.

4. Findings

For the future Multiannual Financial Framework, the Commission and the Council have considered increasing the allocation of the Union's own resources by increasing national contributions to the EU Budget to 1.4% of Gross National Income (GNI) and, depending on the size of additional own resources, may be further increased to a maximum of 1.46% of GNI.

Furthermore, it was decided to impose a tax on non-recycled plastic amounting to EUR 0.8 / kg and to identify the opportunity to impose new environmental or digital sector taxes.

The European Parliament has acted as an extremely tough negotiator when the European budget was adopted. MEPs believe that the agreement on the EU budget 2021-2027 needs to be improved to enable the EU to honor its political commitments and meet the important challenges of the future.

The European Parliament also wanted to introduce new own resources for the EU budget, such as those from the new Common Consolidated Corporate Tax Base (CCTB), including the taxation of large digital companies; revenues from the Emissions Trading System (ETS), or a tax on plastic products.

EU member states, led by Germany, have accused the European Parliament of jeopardizing the € 750 billion recovery plan and the multi-annual European budget, which have been approved with great difficulty, as MEPs insisted on making European funds conditioned by the rule of law and receiving guarantees for the creation of new revenue sources for the European budget.

4.1 The fight against tax havens

The European Union has committed to being much more active in promoting an international system based on rules and much more concreteness in international trade. The dull and complicated community jargon simply translates to the need for money.

Tax havens deprive many states that have not enacted billions of dollars' worth of assertive fiscal control through appropriate legislation, generating and fueling social inequities and high poverty.

By directing money through tax havens to limit the payment of taxes and fees, multinationals deprive national governments of large sums of money that could be directed to education or health programs.

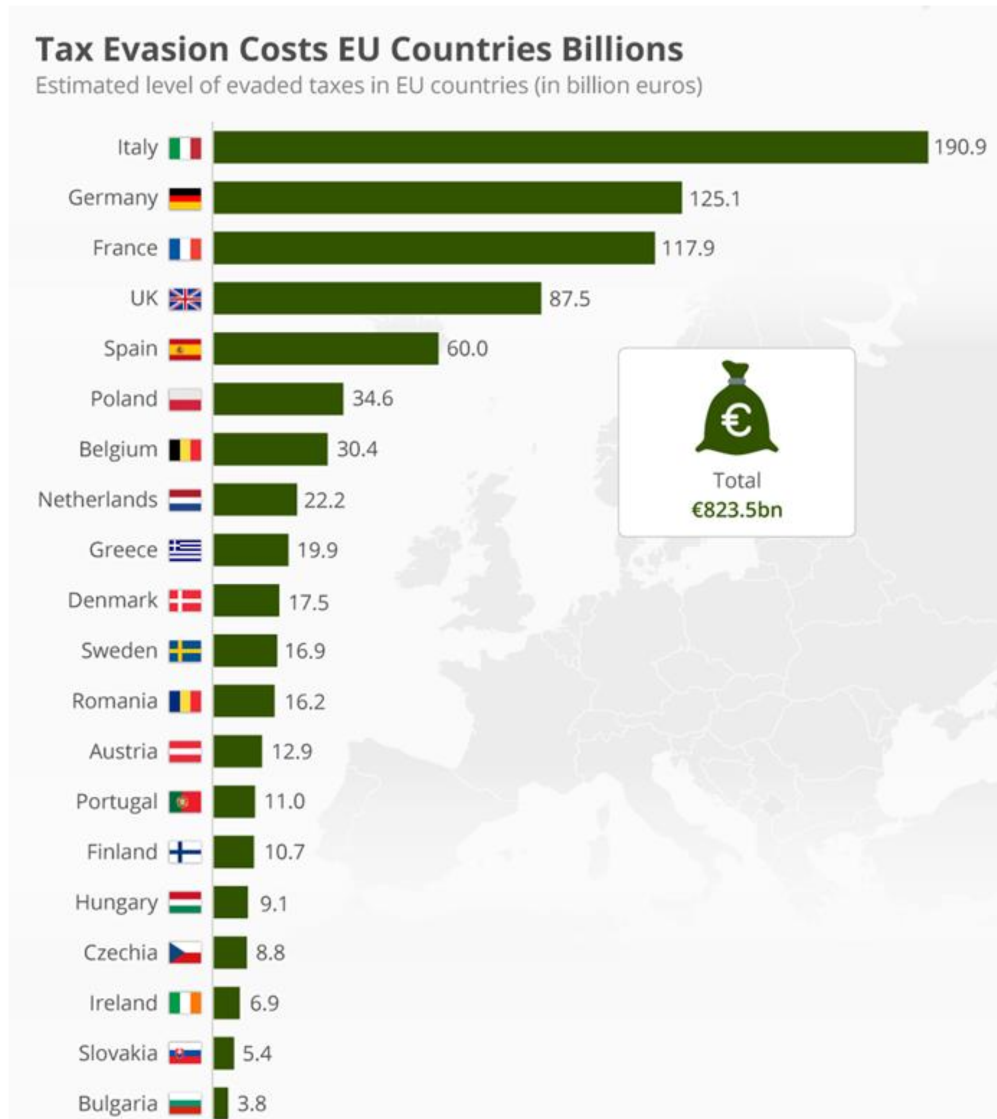

Figure 1. Tax Evasion impact in EU countries (2019)
Source: European Union Commission statistics

The Union needs more and more money to circulate in European markets and financial flows in order to compete with the US economy, whose administration is engaged in trade wars, including with China, a country that does not play by the rules.

Without necessarily waiting for the reform of the World Trade Organization, the Union aims to be much more active in regulating the global trade in favor of rules and principles that are in line with European values.

The first step was the adoption of EU Directive 1164/2016 – "AntiTax Avoidance Directive" (ATAD), to combat cross-border tax avoidance practices and provide a common framework at the EU level for the implementation of the results of the OECD/G20 against the erosion of the tax base and the transfer of profits (BEPS).

The main measures proposed by ATAD are: Limiting interest deductibility; Exit tax in case of transfers of assets, transfer of fiscal residence, or transfer of activity of a permanent headquarter; General anti-abuse rule; Rules on controlled foreign corporations (CFCs); Rules for combating the non-uniform treatment of hybrid financial instruments or entities.

One year later, the Union proposed Directive 2017/952 known as ATAD II, which provides for additional measures to combat the non-uniform treatment of hybrid financial instruments or entities.

4.2 The blacklist

In the meanwhile, the European Union has been working on a blacklist of tax havens operating outside the EU, even considering sanctions against these states. The list contains 17 jurisdictions and a gray list of 47 supervised territories that have agreed to make changes to national tax regulations.

The first 17 states included on the list are: American Samoa, Bahrain, Barbados, Grenada, Guam, North Korea, Macao, Marshall Islands, Mongolia, Namibia, Palau, Panama, Saint Lucia, Samoa, Trinidad Tobago, Tunisia, and United Arab Emirates.

The main purpose was to harmonize the tax legislation of the so-called tax havens with the relevant legislation at the Community level. However, it is extremely likely that European decision-makers have skipped some names that should have been on the list.

In order not to be included on the list, countries must meet three criteria or promise to reform their systems to comply. Nations must have fair tax rules, without preferential measures or agreements that allow companies to shift their profits to avoid paying tax. It must have transparent standards and implement profit reduction measures set by the Organization for Economic Co-operation and Development. There is also the fortunate case where some states have complied with stricter rules when trading with the Community bloc and have thus been removed from this list. It must be said that this list is constantly being updated and European states find it quite difficult to agree on it.

In a press release in March 2019, the European Commission announced that it assessed 92 countries based on three criteria: fiscal transparency, good

governance and real economic activity, and also based on an indicator, the presence of zero income tax.

According to the situation presented by the Commission, 60 states have taken action in response to the concerns expressed by the Commission, and more than 100 harmful tax regimes have been eliminated, and the list has helped standardize international tax practices. Two years after the list was introduced, the Union added 6 more countries to the list (Aruba, Belize, Bermuda, Fiji, Oman, Vanuatu, and Dominica) and announced that three G20 countries (Russia, Mexico, and Argentina) would be subject to verifications, due to a more in-depth examination and the introduction of more mandatory transparency criteria.

The Union considers that the EU list has led to changes in global tax practices that would have been unimaginable just a few years ago, being primarily a common tool to reduce the risks of tax abuse and unfair fiscal competition worldwide. At the same time, the EU blacklisting process has created a framework for dialogue and cooperation with the EU's international partners, to address concerns about their fiscal systems and to discuss tax issues of common interest.

4.3 The blacklist is not so black

A closer look at the list and the Union's approach in this regard shows that beyond the political statements, the list has enough shortcomings, things that need improvement and in some places, it seems to have some loopholes intentionally placed there by European decision-makers.

Among the positive aspects, it should be noted that the list contributed to a change of paradigm and managed to stop what seemed "business as usual" in many countries. The Union's list and approach have managed to pressure 40 states and to determine them to reform more than 100 "harmful practices."

We are talking here about tax regimes such as special economic zones or export processing zones where only foreign companies are exempted from paying taxes. They jeopardize tax revenue collection and have a negative impact on tax collection in other states, providing substantial tax cuts to large companies.

On the downside, we need to acknowledge that the margin for examining states is quite lax, thus allowing some jurisdictions to reform inefficiently or not at all, and to continue harmful practices. We are talking here about two major issues of analysis, which must also be taken into account by European decision-makers.

Firstly, the EU looks only at tax practices that offer preferential or selective treatment to specific sectors, foreign profits, or simply foreign corporations. The perverse effect of this approach is that, for example, if Hong Kong applies harmful tax practices to all profits, which it can easily do, this is counted as a good thing by the EU, although the effect is obviously more than harmful.

Then, the criteria imposed by low or zero tax regimes against the use of front/shell companies by multinational corporations could be too weak, in fact representing an escape clause that could "clean" the activities of tax havens such as Bermuda.

Several economists say that if some objective criteria were applied properly, at least 35 states would be blacklisted. Important names for the EU would

be Albania, Northern Macedonia, Montenegro, Switzerland, or Serbia. The same analysts say that given a rigorous analysis, the Netherlands, Luxembourg, Ireland, and Cyprus should also be included in this list, having some of the worst corporate tax regimes.

In fact, the scandals about companies such as Apple or Amazon avoiding taxes by moving their headquarters to Ireland or Luxembourg are further proof that there are tax havens among EU member states. These scandals also hint at a rift between national governments, which want multinationals to have headquarters in their countries as they provide employment and generate a multiplier effect in the economy, turning a blind eye to the outsourcing of profits, and European decision-makers who want to make large corporations pay more tax to the Union budget.

Beyond the technical nuances on which the list is based, the political rhetoric behind-closed-doors will always be the one that decides. Some countries such as the United States or Switzerland, which given a more precise analysis could be included on the list, are very likely to never be blacklisted. The Union focused abroad, completely ignoring a serious analysis of Cyprus, a well-known tax haven.

Germany is also criticized for tolerating the so-called Cum-Ex business for years, which involves the reimbursement of unpaid value-added tax. The Netherlands is one of the European states that have publicly opposed the creation of the list. And it did the same using all diplomatic channels.

5. Conclusions

The European Commission has identified fair taxation as one of the top priorities on its political agenda. Beyond the progress made in the last five years, the subject will certainly advance on the agenda, especially in the context of post-pandemic economic recovery efforts.

But we must also say that some of the new harmful tax practices are being “manufactured” inside the Union, with many countries not delivering on their commitments. One example in this regard is the implementation of the Controlled Foreign Corporation (CFC) rules in several Member States, as well as the lack of a serious analysis of practices of EU countries according to the criteria promoted by the European institutions.

The CFC rules were adopted by a Directive in 2016, with a transposition deadline of December 2018. Based on the 2015 OECD recommendations on combating tax base erosion and profit shifting (BEPS), the Directive applies to all taxpayers subject to income tax in one or more Member States, including headquarters of companies whose tax residence is outside the EU.

The directive sets rules in 5 areas of taxation: limitation of interest deductibility, exit taxation, general anti-abuse rules, taxation of foreign controlled companies, and taxation of hybrid arrangements.

CFC rules have been a rather controversial area of fiscal policy at the EU level for many years, with some cases even reaching the Court of Justice of the European Union - case C-196/04 Cadbury Schweppes - where that particular implementation of these rules by the Member States has been found to be incompatible with EU law.

Beyond the partial implementation of European Directives or Regulations, Member States, often under domestic industry pressure, develop, at the very least, questionable tax schemes. Competition in regards to taxation at the Union level has not only intensified in recent years but also the nature of taxation has changed considerably.

In 1997, the average legal rate for corporate income tax in the Union was 35.2%. In 2018, it decreased to 21.9%. Moreover, competition regarding taxation has intensified in other areas too. One of the most important in recent years is the taxation of intangible assets such as patents, trademarks, and software.

Most Member States of the Union have decided to support innovation through fiscal policies, but if we look at the last decade we see that many incentives for research and development, or intellectual property have led to a race to reduce taxes.

Tax exemptions for the digital sector are a topic that will certainly be hotly debated in the coming years. In fact, in Romania, this is a topic that is constantly re-emerging on the public agenda. The removal of the exemption of the IT sector from the payment of income tax would bring an income of approximately 1 billion lei to the state budget. To put this in perspective, the general consolidated budget had an income amounting to 321 billion lei in 2019.

Romania, like the entire European Union, is facing the same dilemma. Taxing the digital sector could bring additional revenue to some pandemic-stricken national budgets. At the same time, a second possible effect may be the exodus of labor to other countries or companies may find ways to obtain lower taxation.

Member States may draw some red lines when it comes to these incentives for different industries. First, the incentives enjoyed by researchers, small companies, or other entities must not be harmful as a whole. Care must be taken to prevent super-deductions or tax credits offered for research and development from becoming harmful. And last but not least, tax exemptions for intellectual property or patents must not turn into harmful incentives.

The COVID-19 pandemic and the strong economic contraction, followed by the money and fiscal incentives offered by the Commission to the Member States represent a zero moment for all European capitals. Union governments need to show more political determination to counter tax avoidance practices and to identify and combat the financial engineering that large corporations practice.

For this to happen, the "trialogue" between the European institutions must first work. Too often, legislative initiatives with a lot of substance have been proposed by the Commission and rejected by the Council. Member States must also no longer point the finger, and instead honestly assess their economies and behavior in terms of tax practices.

The subject must become common on the political agenda so that the highly technical and specific aspects are combined with the political component. Political arguments must be backed up by technical criteria if legislative negotiations are to be successful. The European Union must also continue to play its role as a gendarme in identifying and countering unfair taxation practices, both within the Community and in third countries.

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