The Dutch Damage Done:

How the Dutch Tax Haven Activities Affect the World*

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Summary: This paper seek to answer the question of how the Dutch tax haven activities affect the world. In doing so, I investigate the size of Dutch tax haven activities, its impact on global corporate tax revenue and the impact on economic efficiency. Main conclusions are:

- Recent estimates suggests that multinational firms shift more than $600Bn. of profits to tax havens each year – this corresponds to a tax loss of 10% of global corporate tax receipts.
- According to the same estimates, the Netherlands receives $57Bn. in artificial profits and is thereby responsible for 10% of the world's global tax haven activity.
- The Netherlands profits from these activities by collecting substantially higher tax receipts, but as global tax rates continue to plummet, this revenue model is under pressure.

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1. Purpose of this paper

As a key ingredient in the Double-Dutch-Irish Sandwich and by granting profits safe passage to exotic ex-colonies, the Netherlands is well-known for its role in innovative tax haven activities. As a result of this behavior, the European Parliament in March 2019 placed the country on their tax haven list.[2] But is the Netherlands a tax haven? And if so, how much tax revenue is lost because of the Netherlands' stance? Finally, what is the harm to society by multinational firms paying lower taxes? In this brief policy note I seek to answer these questions. Let me stress from the beginning that answering these questions is fraud with difficulty and uncertainty. The analysis, moreover, is based on 2015 data. Since that year, the Netherlands has been heavily involved with BEPS and ATAD and has taken measure to blunt the most egregious features of its international tax system. Nonetheless, given the importance of this topic, I will do my best.

First, I will discuss the efficiency and incidence of the corporate tax and (related to this discussion) the welfare consequences of profit shifting. Second, based on the findings by Tørsløv, Wier and Zucman (2018), I aim to determine and quantify the tax haven activities of the Netherlands.

2. Corporate Taxes – What Good Are They?

Before getting into the intricacies of profit shifting in the Dutch context, I will briefly open Pandora's box: how efficient is the corporate tax (compared to other taxes) and who pays it?

Let me begin with the efficiency question. This question essentially boils down to whether you believe that a substantial part of global profits are pure economic rents or merely a minimal required return as the result of perfect competition. If profits to a large extent are the result of pure economic rents then we can tax these without causing any harm to economic activity (no efficiency loss), which would place corporate taxation among the most efficient taxes (sharing the podium with an imputed rent tax and lump-sum taxes). Conversely, if profits are the result of perfect competition and some (exogenous) required return (determined by outside options or a patience discount factor), then the corporate tax will be enormously distortive and fall largely on workers and consumers.

The classical argument against the corporate tax follows a simple logic: An increase in the corporate tax lowers after-tax returns to capital and hence leads to a reduction in investment until the marginal return to capital equals the required rate of return to capital. Lower capital investment lowers the productivity of workers, which in turn lowers wages – implying that the corporate tax is ultimately paid by workers. The key question in determining the validity of this argument is to determine what the "required" rate of return is and whether

[2] https://www.icij.org/investigations/luxembourg-leaks/seven-eu-countries-labeled-tax-havens-in-parliament-report/

firms are currently earning more than this rate (i.w., earning pure economic rents). The "required" rate-of-return is often thought of as the global rate of return to capital – implying that global capital markets will ensure that capital flows to countries where it gets the highest return. If this is the case, then a harmonized increase in the corporate tax rate across all countries will have no impact on investments, as such a tax hike will affect the rate-of-return equally in all countries. The classical models of capital taxation did not concern themselves with the dynamics of international taxation, but instead perceived the "required" rate-of-return as the rate that individuals consider high enough for them to postpone consumption (the patience discount factor).

Where does that put us, is the corporate tax the most or the least efficient tax there is? Pure economic rents sure seem to exist – particularly amongst multinationals. Take the example of Apple, with a 40 percent gross profit margin (net profit margin of 20 percent), a near monopoly status among its loyalists and earnings safely set in the +$50 billions. Would Apple sell less computers or stop its R&D efforts if it were forced to pay 50 percent in corporate taxes? – seems unlikely. The textbook example of pure economic rents is of course resource extraction and indeed Norway (with the world's fourth largest oil production per capita) manages to tax the profits from oil extraction by an astounding 78 percent.

Not all companies earn large economic rents. Multinational companies operating in fierce competition with razor thin profit margins also exist (Walmart comes to mind). The neoclassical economic argument in these cases is that investors would not accept a lower after-tax return on their investment, but instead consume more of their savings. This lowers the capital stock, which in turn raises after-tax returns (to their required level), raises consumer prices and lowers wages. In the end workers and consumers lose and all would be better off if the government had taxed consumption or labor directly instead.

Those are the theoretical arguments – but (as the familiar phrase goes) what does the data show? The short answer is that we do not know. We do observe that before-tax profits fall drastically whenever governments increase tax rates, but this is largely because of artificial profit shifting (as shown in Tørsløv, Wier & Zucman 2018) and therefore not very informative on the consequences of a truly well enforced corporate tax. An important example of the difficulties in making solid conclusions on the burden of the corporate tax is seen in Fuest, Peichl & Siegloch (2017). They find that 51 percent of the burden of corporate taxation falls on workers, but when zooming in on multinationals there is no burden on workers, which they argue is the result of profit shifting.

Adding to the complexity is of course the interaction between the enforcement of the corporate tax and other taxes on e.g. labor. In tax enforcement a general rule is that the broader is the base the less room there is for tax avoidance by relabeling income (Piketty et al. 2014). Efficiency aside –to the extent that some of the tax

incidence lies on shareholders, the corporate tax allows countries to tax *foreign* shareholders operating in their country, hence lowering the tax burden of *domestic* residents[3]

3. Profit Shifting – Is That A Problem?

A separate question from whether or not a corporate tax is a good idea is whether *profit shifting* (i.e. the avoidance of corporate tax by multinational enterprises) is a good idea. In general, from a competition standpoint, it is poor idea to have differing corporate tax rates based on firm ownership. A tax rebate targeting multinationals will over time grant an unfair competitive advantage and hence put otherwise efficient domestic business out of business. That is, if multinational firms pay lower taxes than domestic firms do, then multinational firms can deliver a higher return to investors without being more productive than domestic firms are. This allows multinational firms to attract more funds without necessarily having a strong real performance (Johannesen, 2012). Not only is profit shifting a tax rebate confined to multinationals but recent evidence from Wier & Reynolds (2018) also suggests that it is only the very largest multinationals that benefit. Indeed, it is not for reasons of tax collection but on the basis of competition concerns that power-Dane and EU Commissioner of Competition Margrethe Vestager goes after the innovative profit shifting of major multinationals such as Apple, Starbucks, Fiat and IKEA.[4]

Some economists argue that a targeted tax rebate for multinationals might in fact be a good idea, as multinationals respond more to taxation than domestic firms do (Hong & Smart, 2010). This argument, however, is only pertinent to local tax responses to profit shifting – globally, multinationals are no more mobile than domestic firms (interplanet shifting is not a thing, yet).

Where does all of this leave us? Should we curb profit shifting or not? Governments across the world, the general public and international organizations all seem to think that we should. The corporate tax currently constitutes roughly 10% of total tax receipts in developed countries and 20% in developing countries (UNCTAD 2015) - to abandon this tax instrument does seem risky. Meanwhile global profits constitute an increasing share of global income and multinational profits are further becoming an increasing share of global profits (Tørsløv et al. 2018)

4. The Dutch Case – What the Data Show

Recent advances in the collection of balance of payment statistics (following the BPM6) and foreign affiliate statistics (FATS) allows for a detailed analysis of global profits shifting. Together with my colleagues Gabriel

[3] See Auerbach (1997), Bradford (2003), Avi-Yonah and Clausing (2008), Grubert and Newlon (1997) and Huizinga and Nielsen (1997)
[4] https://www.theguardian.com/business/2017/dec/18/eu-probes-ikea-after-dutch-deals-reduce-tax-bill-by-1bn)

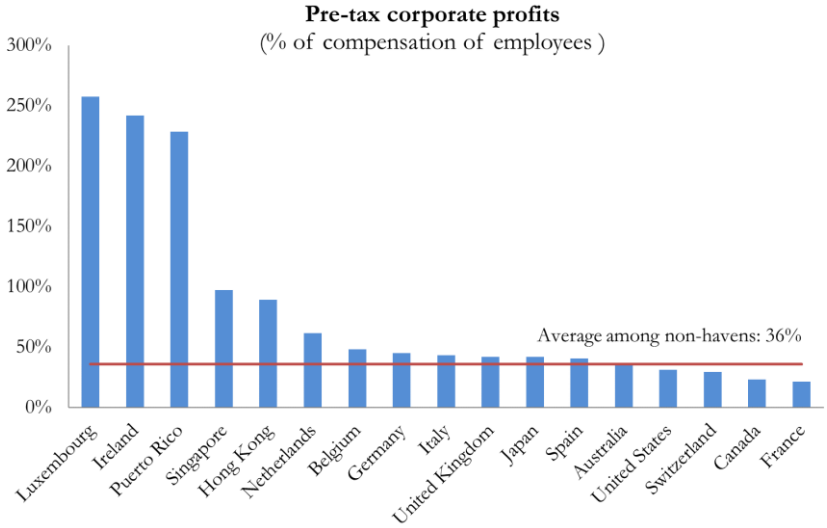
Zucman and Thomas Tørsløv we examine these data in our paper "The Missing Profits of Nations". Our approach is five-fold:

1. Using national accounts, we map out global profits on a country basis. This yields the first global map of where profits are booked.[5]
2. Using foreign affiliate statistics (FATS) we are then further able to separate the profits accruing to *local* and *foreign*-owned firms. Additionally, by separating the production inputs used by *local* and *foreign*-owned firms we can calculate the profitability gap between *foreign* and *local* firms. What we observe is that foreign firms operating in tax havens are enormously more profitable than local firms, while foreign firms operating in high-tax countries are less profitable than local firms.
3. By using newly published bilateral balance of payment statistics we are able to identify excessive "high-risk" payments to tax havens. These "high-risk" payments are known vehicles of profit shifting including royalty payments, management fees and internal interest payments.
4. We estimate the amount of profits shifted to tax havens by a) estimating the excess profitability of foreign-owned firms in tax havens, and b) estimating the excess high-risk payments going to tax havens. We find, reassuringly that a≈b.
5. We distribute the tax base lost based on the excess high-risk payments made by each country.

To start from the top. Figure 1 shows how corporate profitability differs among countries. In general, a business pay €1 in wages will see that translate into 36 cents of profits. However, in prominent tax haven Luxembourg this ratio is eight times as high. The Netherlands also stands out with a ratio of 61 percent.

Figure 1

[5] Concretely we calculate this as Corporate Value Added less Indirect Taxes and Subsidies less Compensation of Employees less Net Interest Paid less Depreciation.



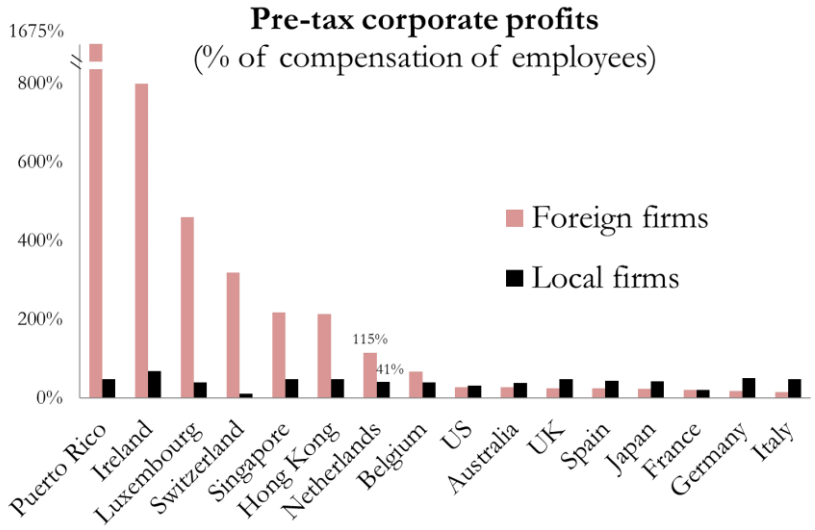
Source: Tørsløv, Wier & Zucman 2018

What is interesting of course is to further disentangle the profitability of firms into that of the locally owned and the foreign owned. What we in this case see is that the entire profitability premium in tax havens is driven by foreign-owned (and hence multinational) firms. E.g., in the Netherlands, domestically owned firms will earn 41 cents in profits per €1 spend on salaries, which is very close to the overall profitability in non-havens. By contrast, Dutch foreign-owned firms earn 115 cents per €1 spend on wages (triple the profitability of foreign-owned firms in the Netherlands). Standard economic theory would suggest that local businesses in the Netherlands would be put out of business and workers would migrate from the local firms to the foreign-owned firms. Additionally, we would anticipate that these enormously productive workers in the foreign-owned firms would be better at wage bargaining. Maybe, some might argue, the foreign-owned firms just have more machines, yielding large returns to worker salaries. As we show in the paper, this does not seem to be the case. So what is going on? The most likely answer is that workers in foreign-owned firms in the Netherlands are not overly productive, but instead that the high profits of these firms are an artefact of artificial profit shifting (i.e. paper profits moving to the Netherlands).

Strikingly, we see the exact opposite pattern in high-tax countries. Systematically, local firms in high-tax countries are more profitable than foreign firms. E.g., local firms in Germany earn 51 cents per €1 paid in wages, while foreign firms make only 18 cents. Again, the most likely explanation is of course that the low profitability of foreign-owned firms in Germany is the result of artificial profit shifting.

It is important to keep in mind that locally owned firms can be multinational too (head-quartered firms). E.g., Apple, Amazon, Google and Facebook are local American firms. It seems likely that the pattern in figure 2 would be even more pronounced if we were able to truly separate multinational from purely domestic firms.

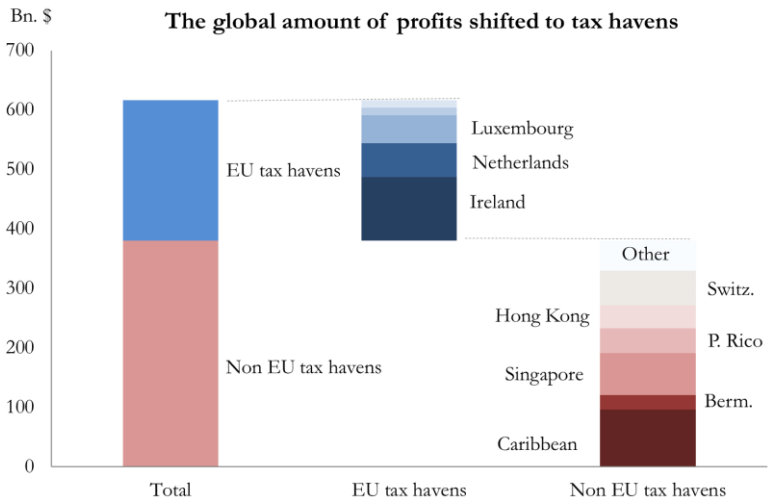
Figure 2



Source: Tørsløv, Wier & Zucman 2018

We have so far established that the foreign firms are excessively profitable in tax havens, but at the same time under-profitable in high-tax countries. The most natural estimate of the amount of profits shifted to tax havens is simply to assume that profitability in the local and foreign sector should be identical. In the case of the Netherlands, we assume that the profitability of foreign-owned firms (115 percent) should equal the profitability of local firms (41 percent). Making this computation in the case of the Netherlands implies that we estimate $57 Billion are shifted to the Netherlands. This places the Netherlands firmly amongst the fourth largest tax havens in the world and the second largest tax haven in the EU (see figure 3). Globally, we estimate that more than $600 Billion are shifted to tax havens.

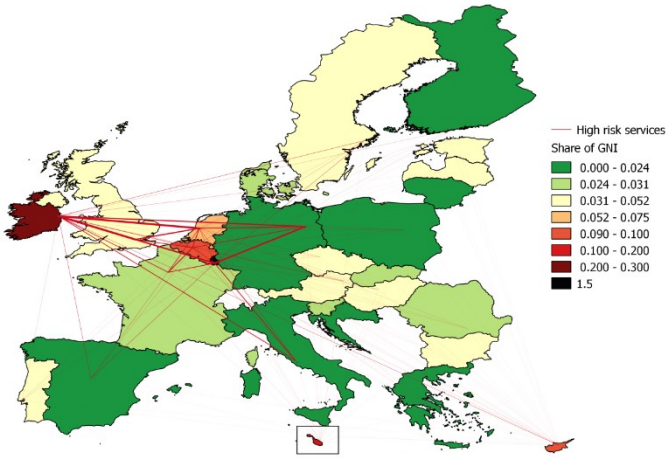
Figure 3



Source: Tørsløv, Wier & Zucman 2018

With a clear estimate of how much is shifted to tax havens, the following question becomes: who paid for this? Here recent statistical advances in the balance of payment statistics can go a long way in informing us. Concretely, we now have data on well-known vehicles of profit shifting: royalty payments, management fees, financial services, insurance services, ICT payments and internal interest payments. Figure 4 shows the European flow of these services. Unsurprisingly, we see the EU tax havens receiving excessive amounts of these high-risk payments. What is astounding is that when we add together the high-risk payments going to tax havens we get $646 Billion, almost exactly the same amount as we estimated the excess profitability to be in tax havens. The two methods are hence completely consistent.

Figure 4
High risk payments in the EU



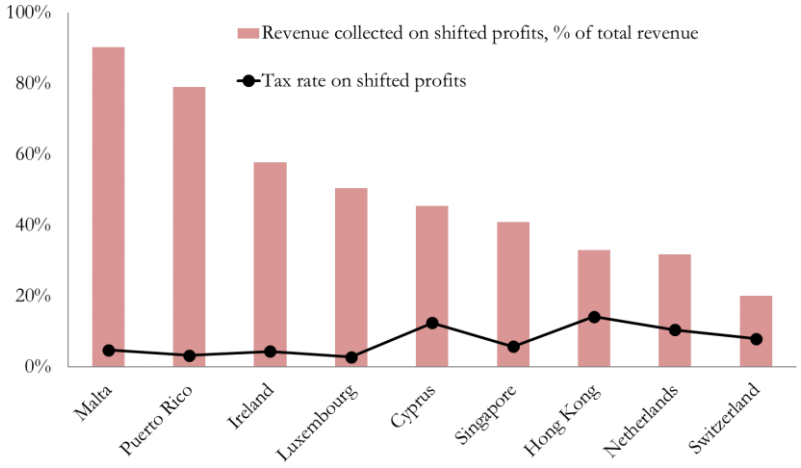
Source: Tørsløv, Wier & Zucman 2018

In the case of the Netherlands, what we find is thatit receives $81 billion in high-risk payments from non-havens plus an additional $31 billion from tax havens – they then transfers back €59 billion to other tax havens, leaving it with $50 billion net of conduit activities. Remember that the excess profitability of foreign firms in the Netherlands was $57 billion. That is, through using two very different estimation strategies we in fact converge to a very similar magnitude of the profits shifted to the Netherlands.

What does the Netherlands win by allowing these activities? First, it of course lais the ground for an enormous tax planning industry. According to LinkedIn 34.000 individuals are employed with transfer pricing skills in the Netherlands – that is a remarkable number of individuals. Second, and more importantly, the Netherlands earns a great deal of tax revenue. That is, by attracting large artificial amounts of paper profits, and taxing a small fraction of these (while letting most fall outside the tax base), Netherlands manages to collect a lot of corporate tax. According to our estimates, a third of Dutch corporate tax receipts are the result of artificial profit shifting (Figure 5). This tax gain of course comes at great cost – for each €1 the Netherlands win, high-tax countries lose €3.

Figure 5

Corporate tax revenue collected & tax rate on shifted profits



Source: Tørsløv, Wier & Zucman 2018

5. Conduit or Tax Haven?

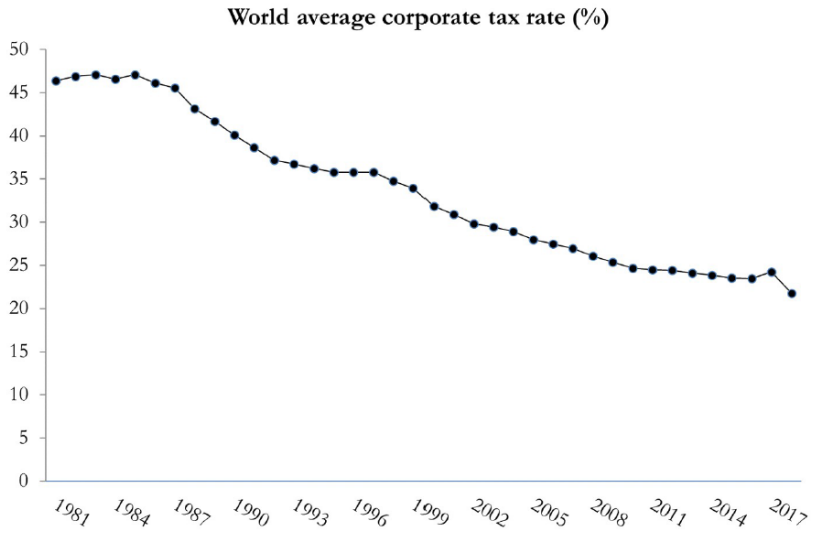
The Netherlands is often referred to as a "conduit" country (see e.g. Garcia-Bernardo et al. 2017). A conduit country is defined as a country enabling profit shifting to tax havens or simply put allows safe transfer of profits to tax havens. In our paper "The Missing Profits of Nations" we simply define tax havens as countries with excessive profitability in multinational firms and low effective corporate tax rates. The Netherlands meets the bar of being a tax haven according to this definition. That is, profits do not simply seem to pass through the Netherlands to exotic destinations, but according to official Foreign Affiliate Statistics, Country-by-Country reports and Balance-of-Payments data they appear to stay in the Netherlands. While staying in the Netherlands these profits are taxed at very low rates (8-12 percent).

As documented in Tørsløv et al. (2018) it appears that the Netherlands does not recognize all the profits being reported by foreign firms in the Netherlands. For example, US firms report an additional $32 Billion in profits in the Netherlands, which the Dutch authorities do not recognize. This of course raises the more difficult question of whether the profits are in the Netherlands or just lost in vacuum. We take the stance that internationally agreed Foreign Affiliate Statistics, Country-by-Country reports and Balance-of-Payments data point towards the profits being in the Netherlands and we therefore allocate these profits to the Netherlands.

7. The End of the Corporate Tax?

The Dutch days of collecting artificial profits may soon end. In the last 40 years the average global corporate tax rate has halved. In the last 30 years alone, it has fallen by 30 percent. In 2018, the US finally entered this race by cutting its top statutory tax rate from 40 to 27 percent. Each year new tax havens emerge – as the most recent example, Hungary slashed its corporate tax rate to 9 percent in 2017. As countries try to guard themselves from profit shifting they cut tax rates and some try to turn the table by becoming tax havens. These inclinations are likely to become stronger as multinationals achieve a greater and greater position in the world economy. It does not take an economist to make a prognosis based on figure 6, if a fundamental reform is not enacted, the corporate tax rate is likely to end, and with it, the Dutch fortune made upon it.

Figure 6



Source: Tørsløv, Wier & Zucman 2018

7. What Could High-Tax Countries Do?

Why do high-tax countries not intervene? Why do they allow profits to be shifted out of their economies? Take the case of Germany paying $13 Billion in excessive royalty and interest payments to Dutch affiliates. Could they question these payments more aggressively? Probably not. The current legal framework of setting "arm's-length" prices is so flawed that the scope for successful enforcement is very small (see e.g. Avi-Yonah, R. and K. Clausing, 2008). Could they impose withholding taxes on the interest and royalty payments? No. The interest and royalties directive erases the possibility of imposing withholding tax rates on these transactions between EU countries (as long as a minimum of activity is preserved in the Netherlands). This directive makes the Netherlands a supercharged tax haven for EU high-tax countries. Why don't the EU high-tax countries change the EU legislation? Because they need unanimity among all EU states to do that. So what is left?

Germany could abandon the arm's-length principle entirely and e.g. switch to using formula apportionment. In this system, Germany would look up the global profits and sales of a multinational company, which are public information. If a firm has 10 percent of its revenue in Germany, Germany could then apportion 10 percent of the global profits as tax base in Germany. This can be done unilaterally or, preferably, in coordination with a group of countries. Unilateral actions are likely to be messy, but the threat of these may in itself drive tax harmonization and coordination. The Netherlands should support these efforts if it wishes to see the corporate tax survive the next 30 years. There is a straightforward way for the Netherlands to contribute: increase the effective taxation of multinationals operating in the Netherlands.

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