

Tax Co-ordination in Europe: Assessing the First Years of the EU-Savings Taxation Directive

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Introduction

- **Objective of the paper**

To review the economic effects of the EU Savings Taxation Directive.

- **The EU Savings Taxation Directive**

An example of tax co-ordination at the international level that enables taxation of foreign interest income of domestic households according to domestic tax rules in order to increase tax compliance and reduce tax evasion.

- **Main results and limitations**

Based on relatively scarce and imperfect data (availability, coverage and definition problems, structural breaks), the authors conclude that the Directive hasn't led to any major shift in international savings.

They emphasize the necessity to interpret results with caution.

Outline

- 1 **The EU-Savings Taxation Directive**
- 2 **Literature review**
- 3 **The data and its limitations**
- 4 **Sectoral data results**
- 5 **BIS data results**
- 6 **Data from Member States and other jurisdictions' results**
- 7 **Regression analysis**
- 8 **Conclusion**

1 The EU-Savings Taxation Directive

Council Directive 2003/48/EC of June 3rd 2003 on taxation of savings income in the form of interest payments, applicable since July 1st 2005

Main characteristics of the Directive

■ Why?

To ensure the proper operation of the internal market and tackle the problem of **tax evasion**.

■ How?

Applying “**effective taxation**”, in accordance with the laws of the Member State of residence, to savings income in the form of interest payments made in one EU Member State to beneficial owners who are individuals resident in another Member State.

■ Who?

The Directive applies to **all EU Member States**.

The same measures are applied in **10 dependent or associated territories** of EU Member States: implementation of **bilateral agreements** signed by each of the 25 EU Member States with these jurisdictions. (Anguilla, Aruba, the British Virgin Islands, the Cayman Islands, Guernsey, the Isle of Man, Jersey, Montserrat, the Netherlands Antilles and the Turks & Caicos Islands)

Equivalent measures are applied in **5 European third countries**: Switzerland, Andorra, Liechtenstein, Monaco and San Marino.

1 The EU-Savings Taxation Directive

Council Directive 2003/48/EC of June 3rd 2003 on taxation of savings income in the form of interest payments, applicable since July 1st 2005

Under the terms of the Directive

■ An automated system of information reporting between States

All Member States are ultimately expected to automatically **exchange information** on interest payments by paying agents established in their territories to individuals whom reside in other Member States.

■ Transitional period for Belgium, Luxembourg and Austria: application of a withholding tax

Belgium, Luxembourg and Austria levy a withholding tax (at a rate of 15% for the first three years, 20% for the following three years, and 35% thereafter) for a transitional period.

75% of its revenue is transferred to the investor's state of residence.

■ What types of payments are concerned: definition of “interest”

Broader definition than the OECD international definition of interest payments.

It covers interest from **debt-claims** of every kind (cash deposits, corporate and government bonds and other similar negotiable debt securities), accrued and capitalised interest (zero-coupon bonds), interest income obtained as a result of indirect investment via collective investment undertakings.

Jiménez (2006), Gläser (2007), and Gläser and Halla (2008) identified problems in the Directive

Loopholes and legal shortcomings

■ **Paying agents and the geographical scope of the Directive**

The scope of the Directive limited to EU, 5 third countries and 10 dependent and associated territories and to the definition of “paying agents”. Tax evasion is possible by:

- (i) shifting funds to banks or other intermediaries located in tax havens or other financial centers (Hong Kong, Dubai, Panama, Singapore...);
- (ii) beneficial owners can use intermediate structures that aren't covered by the Directive.

■ **Beneficial owner**

Definition, Art. 2(1) of the Directive: *“any individual who receives an interest payment or any individual for whom an interest payment is secured”* i.e. it only applies to individuals but not to companies or other legal persons or arrangements (discretionary trusts).

Tax evasion is possible by using an interposed legal person or arrangement.

■ **Definition of interest income**

Even if the definition is broad, it doesn't cover income from other forms of savings (innovative financial products with capital protection, life insurance products).

Tax evasion is possible by changing savings instruments.

Review and amendments

■ Main idea

On the 13th of November 2008, the European Commission adopted an amending proposal to the Savings Taxation Directive with a view to **closing existing loopholes** and better **preventing tax evasion**.

■ Amendments

- (i) Identify and cover interest payments which are channeled through intermediate tax-exempted structures;
- (ii) Change in the definition of the “paying agent” (or financial intermediary) in order to cover interest payments channeled through intermediate tax-exempted structures;
- (iii) Extend the scope of the Directive to income obtained from investments in innovative financial products and life insurance products.

Literature on the Savings Taxation Directive: 3 strands

Empirical Contributions

Currently: almost no literature.

(i) **Klautke and Weichenrieder (2008)** analyze a specific loophole of the Directive due to grandfathering.

(ii) **Johannesen (2009)**: the Directive has a negative significant effect on the depositing of EU residents in some external countries (Switzerland) but no evidence of increased depositing in countries outside the scope of the Directive.

(iii) **Huizinga and Nicodème (2004)** on the determinants of international deposits. Foreign deposits react to taxation and also to information sharing (i.e. the Directive should have led to changes in international depositing).

(iv) **Litgthart and Voget (2008)** on the determinants driving government's decision to share information bilaterally. They show that information sharing is shown to be reciprocal in most cases.

Theoretical strand

What determines the choice of countries for information exchange vs withholding tax scheme.

Countries' incentives to share information voluntarily.

The role of revenue sharing to make information sharing attractive.

Legal strand

Functioning of the Directive and identifications of loopholes.

Data characteristics

Sectoral accounts

Data from **Eurostat's sectoral accounts**.

Analysis of:

- (i) Interest payments vs other types of savings income;
- (ii) HH recipients vs financial and non-financial corporate recipients.

BIS data

Bilateral data from the Bank for International Settlements (BIS) on deposits from foreign bank and foreign non-bank depositors.

Data for BIS reporting countries referring to **payments made cross-border to depositors in a EU Member State** has been selected, and separated in 3 groups:

- (a) EU member States and third countries that apply a withholding tax;
- (b) EU member States that exchange information;
- (c) Other jurisdictions that do not apply the directive.

Data from Member States and other jurisdictions

Data on the **information shared** and on the **tax revenue** received from or paid to other countries, delivered by Member States and other jurisdictions.

Data available for the second half of 2005 and 2006:

- (i) Amount of withholding tax (by country);
- (ii) Amount of interest payments and sales proceeds;
- (iii) Amount of interest payments and sales proceeds by type;
- (iv) Number of beneficial owners, paying agents.

Data caveats

Sectoral accounts

Missing data before 2000 and for 7 Member States.

The data includes interest payments that **do not fall in the scope of the Directive** (domestic interest payments).

BIS data

Two **statistical breaks** in reporting with impact on totals.

Data expressed in **USD**: volatility of the USD exchange rate.

No information on the **exact split** between individual depositors (subject to the Directive) and corporate depositors.

Incomplete coverage: not all EU members report to the BIS.

Data from Member States and other jurisdictions

Data delivery and quality is imperfect (countries can choose to report different sorts of data).

Available data: amount of information exchanged or withholding tax collected.

Difficulty to **estimate amounts** of income shifted to tax havens or shifted back to the domestic country.

Mismatches between amounts (ex: for information exchange countries, amount of interest vs amount of interest by type)

These caveats highlight the limits of the descriptive analysis.

4 Sectoral data results

The Directive doesn't seem to have led to major changes in the composition of savings incomes in the European households.

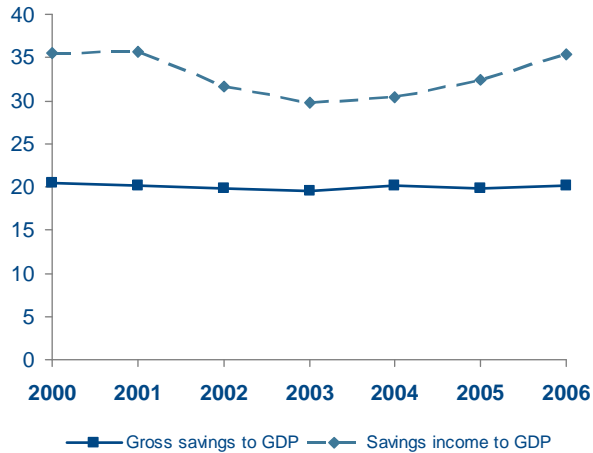


Figure 1

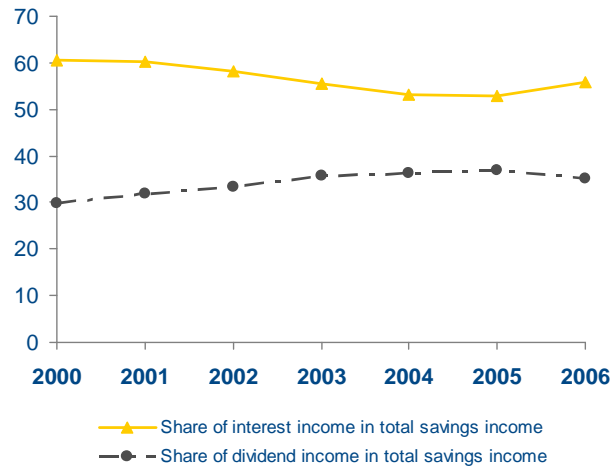


Figure 2

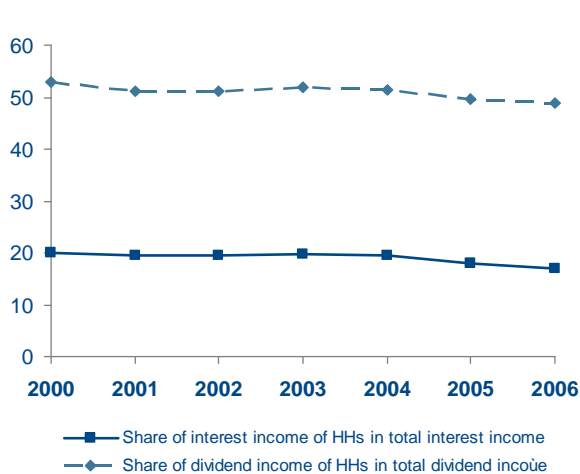


Figure 3

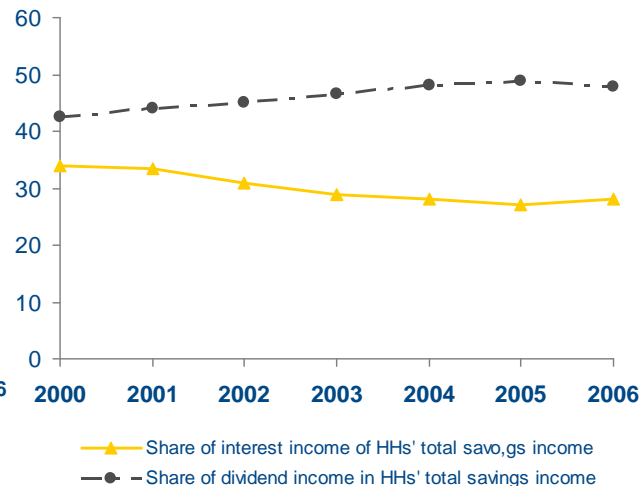


Figure 4

- The amount of gross savings (from HHs and corporations) in % of GDP has been stable while the amount of income from savings (property income) in % of GDP has followed a U-curve (figure 1).

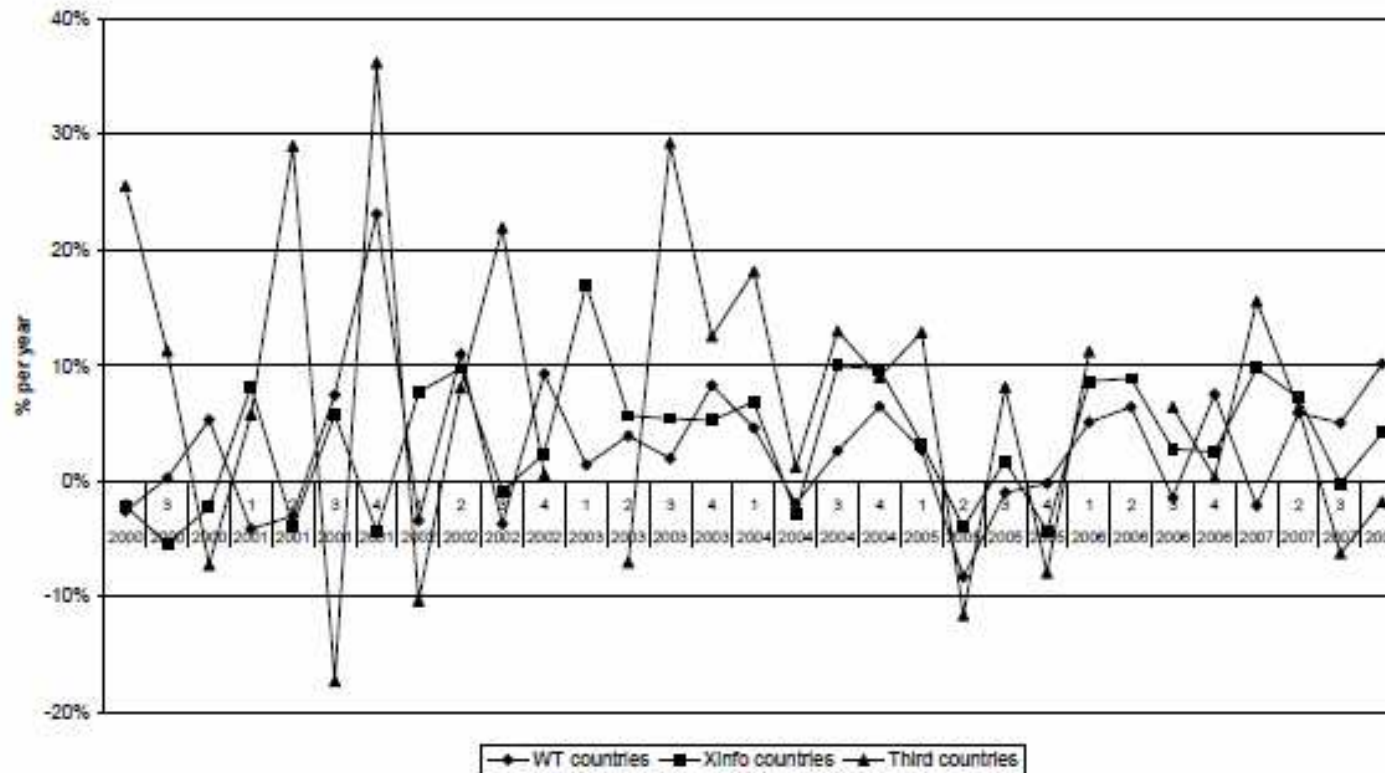
- Steady decrease of the share of interest income in total income savings and increase in the share of dividends (figure 2). Can be explained by low interest rates.

- Share of HH recipients has been stable but drops in 2005 and 2006, due to an increase in payments received by financial corporations.

- Gradual shift from interest toward dividend revenue between 2000 and 2004 but a significant share of savings income is still made of interest income.

Quarterly growth of non-bank deposits

Growth rate of external non-bank deposits vis-à-vis directive countries in USD



Source: BIS and own calculations

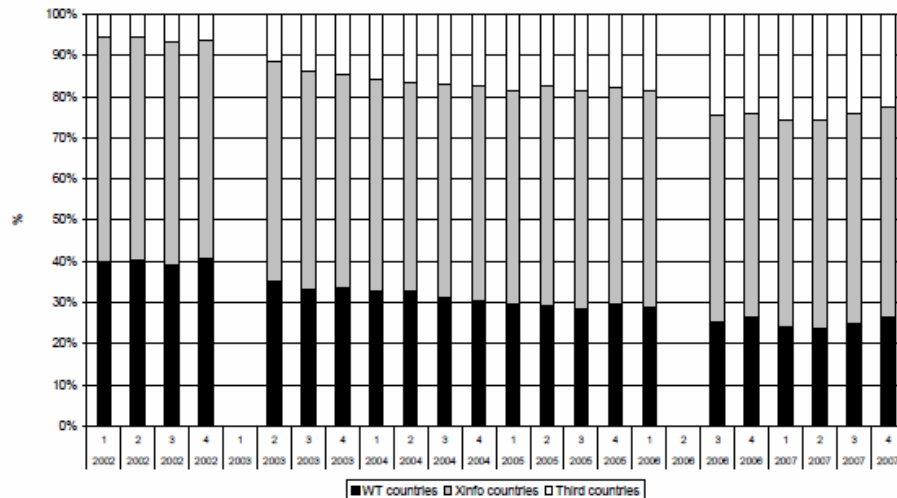
No common pattern for the growth of non-bank deposits in the countries covered by the directive (categories a and b) compared to the third countries (category c).

Only difference: **higher volatility** rate for countries under the scope of the Directive (a and b) vs third countries (c) until 2004.

5 BIS data results

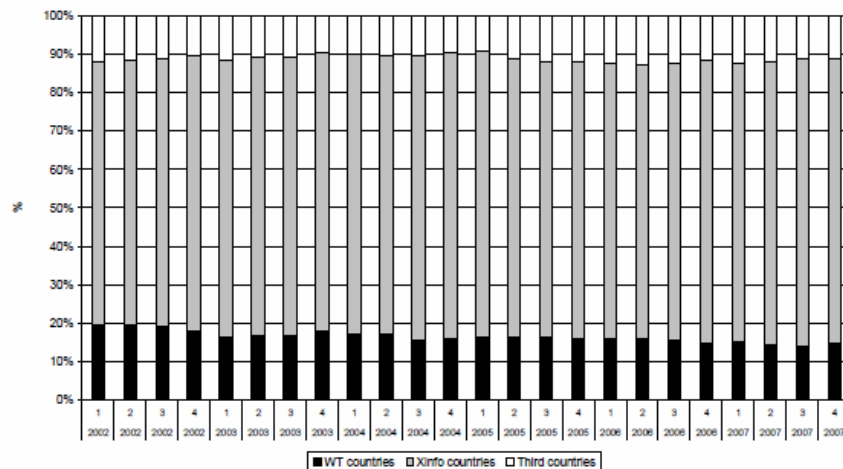
Share of BIS reporting countries by category in non-bank deposits and in bank deposits

Share of bank countries in non-bank deposits



Source: BIS and own calculations

Share of bank countries in bank deposits



Source: BIS and own calculations

2 structural breaks (category c): Q1-2003 and Q2-2006.

(i) Non-bank deposits:

Constant shares since 2005.

Decrease of share of deposits for countries of category a (from 35% to 29.3%) from mid-2003 to mid-2005 to the benefit of third countries, but stability after 2005.

(ii) Bank deposits:

Stable shares. About 70% of bank deposits are in countries that apply information sharing (category b).

(iii) Comparison of non-banks and banks deposits:

a and b = 35% of total external deposits and c=20%.

Share of total deposits made by external banks has not changed while the share of non-bank deposits in countries exchanging information has decreased => preference for countries with bank secrecy?

Conclusion: shift of non-bank deposits to third countries, but before the Directive.

Possible explanation: anticipation of the Directive.

6 Data from Member States and other jurisdictions' results

(1) Countries operating information exchange system

Table 2: Interest payments and sales proceeds reported by countries using information exchange*

EU Member States	2005 (2nd half)	2006	2007
Austria	n.a.	n.a.	n.a.
Belgium	n.a.	n.a.	n.a.
Bulgaria**	-	-	n.a.
Cyprus	5.28	15.05	25.41
Czech Republic	2.92	17.81	28.75
Germany	880.73	1392.08	942.00
Denmark	n.a.	1.18	893.10
Estonia	n.a.	4.40	n.a.
Spain	488.11	423.42	258.52
Finland	28.02	60.83	n.a.
France	588.14	2020.04	2485.40
Greece	8.85	23.11	1.00
Hungary	n.a.	n.a.	n.a.
Ireland	258.88	771.00	1901.24
Italy	280.53	1815.92	1210.35
Lithuania	n.a.	0.00	n.a.
Latvia	0.18	0.85	n.a.
Luxembourg	1119.79	4188.88	8344.34
Malta	1.02	2.10	n.a.
Netherlands	107.83	800.14	n.a.
Poland	0.00	0.71	10.00
Portugal	n.a.	0.58	5.18
Romania**	-	-	7.34
Sweden	n.a.	n.a.	n.a.
Slovenia	0.59	1.35	n.a.
Slovakia	1.87	4.78	n.a.
United Kingdom	8132.48	n.a.	n.a.
Third Countries			
Switzerland	70.50	549.12	500.89
Dependent and Associated Territories			
Anguilla	n.a.	n.a.	n.a.
Aruba	0.01	0.09	n.a.
Cayman Islands	8.81	18.02	n.a.
Netherlands Antilles	n.a.	0.05	n.a.
Morocco	n.a.	n.a.	n.a.

in m Euro

*Amount of interest payments and sales proceeds under Art. 9 subject to exchange of information/ voluntary disclosure, (Beneficial owners and residual entities) reported according to Art. 8(2) last paragraph.

**Bulgaria and Romania joined the EU in 2007 therefore no data is available for 2005 and 2006

Two reporting possibilities:

(i) Total amount of interest or income + total amount of sales proceeds

(ii) Same amounts but by type of interests

=> mismatches of values

Observing the total amounts of interest and sales proceeds:

The largest economies and financial centers report the highest values of interest payments and sales proceeds: UK, France, Germany, Luxembourg.

Ex: UK in 2005 reported 9.1bn Euro

6 Data from Member States and other jurisdictions' results

(2) Countries levying a withholding tax

Table 4: Tax revenue shared by countries with withholding tax regime

EU Member States	2005 (2nd half)	2006	2007
Austria	9.48	44.32	59.53
Belgium	7.51	19.61	25.92
Luxembourg	35.90	124.59	153.00
Third Countries			
Andorra	3.50	12.77	16.34
Liechtenstein	1.94	7.08	9.06
Monaco	3.75	11.70	n.a.
San Marino	1.13	7.47	10.75
Switzerland	77.23	255.92	298.23
Dependent and Associated Territories			
British Virgin Islands	0.00	n.a.	n.a.
Turks and Caicos	0.01	0.02	n.a.
Guernsey	4.93	16.83	n.a.
Jersey	13.26	32.15	38.34
Isle of Man	13.26	20.35	23.39
Netherlands Antilles	n.a.	0.05	n.a.

in m Euro

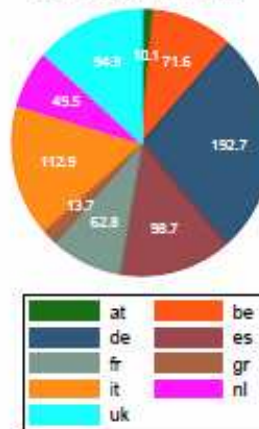
Most of the revenue from the withholding tax went to **Switzerland** (46%) and **Luxembourg** (23%), i.e. almost **70%** of the total revenue.

Nb: these figures are obtained according to available data (some countries didn't report).

Largest countries in the EU received the largest shares: Germany (192.7m Euro).

Exception: Belgium (71.6m Euro), 74% of the revenue comes from Luxembourg.

Received Withholding Tax Revenue
2005 - 2007 in m Euro



Source: European Commission

Conclusion:

Reported interest payments increased between 2005 and 2006 but not especially in 2007.

Increased reported volumes in Luxembourg and Ireland, decreased volumes in Germany, Spain, Italy and Switzerland.

Switzerland and Luxembourg are the main sources of withholding tax revenue while Germany, Italy and UK are the most important receivers.

■ Objective

Estimate the possible effects of the introduction of the Directive on variables such as the **level of interest received by HHs** and the **share of interest in the total property income of HHs**.

■ Caveats

- (i) The data doesn't only cover interests covered by the Directive;
- (ii) Changes in explanatory variables will influence different types of interest payments in different ways;
- (iii) Data available for 1995-2006 i.e. effects can only be seen for the last year or two;
- (iv) Binary variable for the Directive's effects: may act as a fixed effect for a group of countries during the last year of observation by picking up unobserved effects common to EU Member States during these years.

■ Main Results

The econometric analysis **doesn't detect any major effect of the Directive** on the dependent variables:

- (i) Level of interest received by HHs: has decreased but this is due to increase in financial corporations' receipts. Regression results are negative but not statistically robust;
- (ii) Share of interest in total property income received by HHs has declined in favor of dividends but it already started in 2000.

The estimated effects of the introduction of Directive is heavily dependent on the specification of the model.

7 Regression analysis

Regression results

Table 6: Effect of the Directive on Interest received by Households

Variables	(1) Log Interest	(2) Log Interest	(3) Log Interest	(4) Share Interest	(5) Share Interest	(6) Share Interest
Directive	.347** (2.67)	-.160 (.99)	-.095 (.45)	-.253** (3.98)	-.220** (3.96)	-.113 (1.33)
Log population	-13.459** (5.96)			1.104 (1.10)		
Inflation	-.005 (0.85)	-.009 (1.52)	-.015 (1.82)	-.003 (1.59)	-.002 (1.18)	-.003 (0.84)
Deposit interest rate	.046** (4.97)	.048** (5.60)	.040** (4.19)	-.002 (1.29)	-.002 (1.07)	.008** (2.61)
Real GDP growth	-.023 (0.85)	-.030 (1.43)	-.020 (0.84)	-.014* (2.21)	-.015* (2.30)	-.014 (1.68)
Log nominal GDP		2.019** (7.37)	1.323** (37.25)		-.033 (0.30)	-.003 (0.23)
Constant	194.249** (6.07)	-18.804** (4.62)	-8.025** (15.33)	-19.689 (1.08)	.920 (0.94)	.550* (2.61)
Time dummies	Y	Y	Y	Y	Y	Y
Country dummies	Y	Y	N	Y	Y	N
Observations	188	188	188	177	177	177
R-squared	0.99	0.99	0.95	0.90	0.89	0.20

Source: Eurostat, Sectoral Accounts. Robust t-statistics in parentheses. * significant at 5%; ** significant at 1%. T-stat in parenthesis. Standards errors are White coefficients.

Regressions (1) to (3) on log interest.

Regressions (4) to (6) on share interest.

(i) **Size of the country** should have a positive effect on the amount of interest received by its HHs.

(ii) **Inflation** should have an ambiguous effect

(iii) **GDP growth** is expected to have a negative effect

(iv) **Interest rate** on deposits is expected to have a positive effect on the level of interest and an ambiguous effect the share of interest.

Year dummies (unobserved year-specific effects) for all regressions.

Country dummies for some regressions (unobserved country-specific effects).

No statistically significant and robust effect of the Savings Taxation Directive.

Conclusion

■ No effects of the Taxation Directive?

Despite poor data availability and its caveats, the analysis suggests that the Directive has no significant effects on the development of the investment vehicles that fall under its scope.

Insignificant effects can be explained by:

- (i) Data caveats and limitations due to the regression model used: future analysis will benefit from improved data availability and therefore stronger results and more knowledge on the model specification effects;
- (ii) The existing loopholes in the Directive (partly amended in 2008): analysis after 2008 might show stronger results once the Directive is improved; there will however be a discontinuity before and after 2008;

Interpretation of these results must therefore be conducted with caution.

Further analysis remains to be done, especially regarding quantification of tax evasion, but this will require stronger reporting capacities in one hand, and reduction of the loopholes in the other hand.