TAX OPTIMIZATION AND ROUND TRIPPING OF CAPITAL: AN EXPLORATORY STUDY

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Abstract: *In order to reduce their tax liabilities, large companies around the world can develop tax-planning strategies by using creative accounting techniques. This is generally done by shifting profits from high-tax countries to tax havens or offshore financial centers. The purpose of this paper is to analyse the role of offshore jurisdictions in international tax planning using the statistics on direct investment inflows and outflows globally. The findings show that two of the top 3 countries with the largest size of direct investments are the Netherlands and Luxembourg. Also, eight of the first 25 countries or territories are offshore jurisdictions. Many of these tax jurisdictions have a higher level of direct investments than some G8 countries. Analysing foreign investment per capita, the results showed that almost all countries or territories in the top 10 reporting economies are tax havens or offshore financial centers. Given that the results are similar in both inflows and outflows of direct investments, they suggest that there is a round tripping of capital.*
Keywords: *tax optimization, tax avoidance, tax havens, foreign direct investments, offshore companies*

1. INTRODUCTION

In the context of tax competition, multinational firms can shift their profit through transfer pricing from countries with high taxation to low tax jurisdictions (Fuest *et al.*, 2011). These tax jurisdictions are often called tax havens or offshore financial centers and have low corporate tax rates or even zero for certain categories of income, in order to attract foreign companies. The main areas of application of offshore transactions in order to reduce the tax debts worldwide are international trading, real estate, intangible assets (trademarks, copyrights, licenses), investment activities, insurance activities, offshore banking or ship-ownership (Ginevičius *et al.*, 2004). A very simple case is the one in which companies over-invoice or under-invoice their imports and exports, depending on how it is more convenient from a fiscal point of view (Sikka & Willmott, 2010; De Boyrie *et al.*, 2005).

The subject of tax havens and offshore financial centers is extremely complex, considering that the offshore business world is constantly changing. These jurisdictions can be analyzed from several perspectives, as they have economic, political, social, ethical, but also environmental implications. Most of the papers have highlighted the role of tax havens in developing tax avoidance strategies and in cross-border tax evasion (Sikka & Willmott, 2010; Otusanya, 2011; Fuest & Riedel, 2012; Johannesen, 2014). However, the levels of tax evasion and global revenue losses are difficult to analyze because of the lack of accurate data, and for this reason the studies carried out on this subject over time are based on estimates (Vellutini *et al.*, 2019; Tax Justice Network, 2017; Cobham & Janský, 2018; Crivelli *et al.*, 2015). Other papers focused on the relationship between tax avoidance by exploiting legislative loopholes (in a legal way) and corporate social responsibility (Dowling, 2014; Fisher, 2014; Preuss, 2012; Lenssen *et al.*, 2010; Christensen & Murphy, 2004; Sikka, 2010). Practically, the legitimate question that arises is whether a company that uses tax optimization strategies could be considered socially responsible, as long as it moves its profits from the country in which they were obtained. Continuing this idea, the question arises whether accounting firms, law firms or tax consultants involved in developing tax optimization strategies respect the ethical and moral principles of their professions (Shafer & Simmons, 2008), even if the profit-shifting operations to low tax jurisdictions are made in compliance with the law. Some authors have addressed the link between offshore jurisdictions and corruption (Brown *et al.*, 2011; Hebous & Lipatov, 2014; DeBacker *et al.*, 2015), considering that the profit can be exported more easily in countries with a higher level of corruption. Hebous & Lipatov (2014) have statistically demonstrated through an empirical study that there is a high probability that firms investing in high-corruption countries have affiliates in tax havens. In addition, the same authors indicate that offshore jurisdictions support investments made in corrupt countries, but at the same time provide shelter for corrupt officials to hide their incomes. It could also be considered that tax havens and offshore financial centers lead to inequality between taxpayers, whether they are individuals or companies (Alstadsæter *et al.*, 2019). Picciotto (2007) identifies that multinational companies pay low taxes on profit or even avoid paying taxes on profit, while low-income individuals pay higher taxes (as a proportion of income) than wealthy individuals. However, some authors suggest that tax havens play a valuable role in the global economy as they facilitate the efficient allocation of capital (Mitchell, 2006). A less approached perspective regarding tax havens is the connection between these jurisdictions and the environment, but without being ignored (Galaz *et al.*, 2018).

A recent study estimates that about 10% of the world's gross domestic product is held in tax havens (Alstadsæter *et al.*, 2018). However, it is relatively difficult to perform a very accurate analysis of the impact that offshore jurisdictions have on national economies or global economy for several reasons. First, the offshore business world is very mobile and investments can be moved very easily. Capital mobility also causes a change in national fiscal policies, as the governments of many countries tend to reduce corporate tax rates in order to attract foreign direct investments to support economic growth (FitzGerald, 2002). For these reasons, it started a competition between countries to attract direct investments from other countries (FDI) and the OECD has called it “harmful tax competition”. Bucovetsky (1991) showed that differences between states in terms of population determine differences in terms of taxation, and smaller jurisdictions in this regard tend to impose lower tax rates. In addition, in the context of financial globalization, the tax rates practiced in certain states can influence the tax rates of another state or territory (Altshuler & Goodspeed, 2015). Hong & Smart (2010) argued, "an increase in international tax avoidance can lead to an increase in both statutory and effective tax rates on capital". Tax havens can make countries with high taxation to cut or reduce their taxes in order not to face the export of profits and, implicitly, not to lose budget revenues (Fuest & Riedel, 2009). From another point of view, Mitchell (2006) considers that tax competition between states determined by low tax jurisdictions is beneficial because it encourages better tax law in the rest of the world. Therefore, in the world of offshore business, things can change very quickly.

A second reason that creates difficulties in researching tax havens is the confidentiality of transactions in these jurisdictions and, in this regard, researchers face a lack of data. Thirdly, in order to carry out a research, the question that arises is which of the countries are tax havens or offshore financial centers. In this regard, there is no consensus among researchers, organizations and tax authorities on the definition of a tax haven, so there is no generally accepted list of these jurisdictions. Over time, several lists have been developed, and among the most representative, we can mention those prepared by Hines & Rice (1994), International Monetary Fund (2000), OECD (2000) or Tax Justice Network (2005). In addition, Tax Justice Network (2020) began in 2009 to develop a financial secrecy index every two years that "ranks jurisdictions according to their secrecy and the scale of their offshore financial activities". In our paper is used the same list of tax havens as in the studies undertaken by ActionAid (2011) and Afrăsinei *et al. (2016a; 2016b).*

The high values of both foreign direct investment inflows and outflows can be an element that demonstrates the presence of round tripping of capital (Repousis *et al., 2019).* This paper is an exploratory study that analyzes the global direct investments in order to identify the role of offshore jurisdictions in international tax planning. For this purpose, we will use the statistics on direct investments provided by the International Monetary Fund for a period of 5 years.

2. THE ROLE OF OFFSHORE JURISDICTIONS IN INWARD AND OUTWARD DIRECT INVESTMENTS

The impact of tax havens on the world economy can be analyzed using the statistics of direct investment inflows and outflows. In the following, we will analyze the data regarding the global inflows and outflows of direct investments from the last 5 years. Thus, through table no. 1 we highlighted the statistics provided by the IMF in terms of direct investment inflows and outflows for the top 25 reporting economies in the world for the period 2014 - 2018.

Table 1. Inward Direct Investment between 2014 and 2018 - Top 25 Reporting Economies in the World

No.	Country	Year 2014	Country	Year 2015	Country	Year 2016	Country	Year 2017	Country	Year 2018
1	*Netherlands**	4.334.701	*Netherlands**	4.216.479	*Netherlands**	4.397.631	*Netherlands**	5.128.495	*Netherlands**	4.715.201
2	*Luxembourg**	3.258.954	*Luxembourg**	3.705.595	*Luxembourg**	3.813.020	*Luxembourg**	4.289.797	United States	4.344.610
3	United States	2.945.795	United States	3.354.907	United States	3.765.114	United States	4.025.492	*Luxembourg**	3.759.144
4	China, P.R.: Mainland	2.331.755	China, P.R.: Mainland	2.579.564	China, P.R.: Mainland	2.534.532	China, P.R.: Mainland	2.688.470	China, P.R.: Mainland	2.814.067
5	United Kingdom	1.744.718	United Kingdom	1.530.094	United Kingdom	1.475.549	United Kingdom	1.607.987	United Kingdom	1.864.384
6	*Hong Kong**	1.330.332	*Hong Kong**	1.395.343	*Hong Kong**	1.418.689	*Hong Kong**	1.588.198	*Hong Kong**	1.706.788
7	*Singapore**	914.521	*Singapore**	954.341	*Switzerland**	1.121.919	*Switzerland**	1.352.536	*Switzerland**	1.354.535
8	Germany	859.564	*Switzerland**	890.484	*Singapore**	984.298	*Singapore**	1.184.373	*Singapore**	1.269.518
9	*Switzerland**	812.826	*Ireland**	888.195	*Ireland**	840.667	*Ireland**	1.057.988	*Ireland**	1.000.435
10	France	700.065	Germany	781.720	Germany	794.530	Germany	957.444	Germany	939.189
11	Canada	641.902	France	687.374	France	694.898	France	818.525	France	825.023
12	Brazil	599.347	Australia	565.788	Australia	606.140	Spain	702.002	Spain	721.909
13	Spain	596.701	Canada	565.688	Canada	603.602	Australia	689.395	Australia	682.865
14	Australia	582.533	Spain	561.573	Spain	591.499	Canada	665.160	Canada	642.572
15	Belgium	556.048	Belgium	549.344	Brazil	563.291	Brazil	635.124	Brazil	568.741
16	Mexico	491.707	Mexico	501.999	Belgium	534.041	Belgium	602.286	Belgium	537.832
17	*Ireland**	416.072	Brazil	429.842	Mexico	473.424	Mexico	490.574	Mexico	511.275
18	*Cyprus**	385.233	*Cyprus**	387.753	Russian Federation	393.910	India	458.778	India	488.127
19	Italy	352.501	Italy	340.467	*Cyprus**	388.595	Russian Federation	441.123	*Cyprus**	428.427
20	Sweden	315.752	India	320.292	India	352.757	*Cyprus**	436.657	Italy	426.429

21	India	312.852	Sweden	315.175	Italy	352.635	Italy	424.733	Russian Federation	409.720
22	*Mauritius**	298.631	*Mauritius**	279.104	Sweden	310.045	Sweden	354.398	Sweden	352.413
23	Russian Federation	290.039	Russian Federation	262.748	*Mauritius**	283.327	*Mauritius**	331.423	*Mauritius**	332.504
24	Austria	273.232	Austria	244.346	Indonesia	249.859	Chile	255.600	Chile	251.867
25	Hungary	224.508	Indonesia	222.410	Chile	249.080	Hungary	249.944	Austria	246.083

*Note: *tax haven countries or territories*

(Source: own processing according to data provided by the IMF)

Analyzing the data from table no. 1, it can be observed that in the period 2014-2018 the highest level of direct investments was registered in the Netherlands and in Luxembourg (except for 2018). The United States, China and the United Kingdom generally ranked after these two countries. Given the size of the domestic economy and the number of inhabitants, the high level of direct investment inflows confirms that Luxembourg and the Netherlands are offshore financial centers. These two countries correspond to the characterization made by Zorome (2007) who states “an offshore financial center is a country or jurisdiction that provides financial services to nonresidents on a scale that is incommensurate with the size and the financing of its domestic economy”.

Hong Kong, Switzerland, Singapore, Ireland, Germany and France are ranked next in the top according to the size of direct investments. If in the case of the last two countries (France and Germany) the position in the ranking could be justified from an economic point of view, the other countries are considered tax havens or offshore financial centers (Alstadsæter *et al.*, 2018), which without intense financial activity would not have such a high level of direct investment.

Among the top 25 reporting economies in the world, we notice the fact that there are also other tax havens, such as Cyprus or Mauritius. For example, Cyprus is ranked in the top for most years ahead of countries such as Italy, India, Russia, Sweden or Austria. This fact highlights the existence of financial vehicles in these countries (Cooley, & Sharman, 2015) used by multinational companies.

Making an analysis of the entire period, it can be seen that six of the top 10 countries are tax havens (60%), and in the top 25 reporting economies in the world are eight offshore jurisdictions (32%). However, direct investment inflows into tax havens have a higher cumulative value than in other countries. For example, the eight tax havens have a cumulative value of direct investments of 47% of the total direct investment inflows of the top 25 countries in 2018.

Table 2. Outward Direct Investment between 2014 and 2018 - Top 25 Reporting Economies in the World

No.	Country	Year 2014	Country	Year 2015	Country	Year 2016	Country	Year 2017	Country	Year 2018
1	*Netherlands**	5.336.237	United States	5.289.071	United States	5.586.030	*Netherlands**	6.208.205	United States	5.950.991
2	United States	5.108.835	*Netherlands**	5.208.068	*Netherlands**	5.381.568	United States	6.013.335	*Netherlands**	5.755.618
3	*Luxembourg**	3.975.421	*Luxembourg**	4.516.623	*Luxembourg**	4.603.721	*Luxembourg**	5.140.401	*Luxembourg**	4.603.138
4	United Kingdom	1.513.125	United Kingdom	1.606.347	United Kingdom	1.491.990	Germany	1.645.130	China	1.982.270
5	Germany	1.398.632	*Hong Kong**	1.369.311	*Hong Kong**	1.375.923	United Kingdom	1.625.169	United Kingdom	1.749.177
6	*Hong Kong**	1.308.366	Germany	1.369.170	Germany	1.367.664	*Hong Kong**	1.532.742	Germany	1.643.698

7	France	1.294.221	France	1.268.191	Japan	1.315.221	Japan	1.497.525	*Hong Kong**	1.636.445
8	Japan	1.152.006	Japan	1.228.766	*Switzerland**	1.309.832	France	1.451.663	Japan	1.567.161
9	*Switzerland**	1.077.130	*Switzerland**	1.131.402	France	1.279.663	*Switzerland**	1.438.451	France	1.507.926
10	Canada	728.561	*Ireland**	909.642	*Ireland**	856.603	*Ireland**	986.822	*Switzerland**	1.494.721
11	*Ireland**	619.407	Canada	754.206	Canada	814.686	Canada	920.831	*Ireland**	942.909
12	Spain	523.854	Belgium	603.554	Belgium	615.388	Belgium	721.930	Canada	936.122
13	Belgium	500.068	Spain	512.955	Spain	536.727	Spain	604.711	Belgium	594.141
14	Italy	477.482	Italy	456.606	Italy	456.392	Italy	547.565	Spain	578.294
15	Australia	467.167	Australia	415.401	Australia	432.022	Australia	495.971	Italy	554.303
16	*Cyprus**	392.074	*Cyprus**	408.498	*Cyprus**	406.133	*Cyprus**	452.309	Australia	490.986
17	Sweden	383.551	Sweden	359.256	Sweden	358.317	Sweden	388.880	*Cyprus**	436.852
18	Russian Federation	329.818	Austria	290.934	Russian Federation	334.275	Russian Federation	380.047	Sweden	374.569
19	Austria	325.197	Russian Federation	282.651	Korea, Rep. of	296.690	Korea, Rep. of	343.129	Korea, Rep. of	368.884
20	Korea, Rep. of	251.765	Korea, Rep. of	276.047	Austria	248.828	Austria	287.871	Russian Federation	344.318
21	*Mauritius**	229.965	*Mauritius**	222.815	*Mauritius**	234.419	South Africa	272.985	*Mauritius**	283.106
22	Brazil	207.851	Denmark	189.334	Denmark	203.292	*Mauritius**	266.956	Austria	280.254
23	Denmark	194.806	Brazil	184.909	Brazil	201.765	Brazil	254.236	South Africa	246.439
24	Norway	167.995	Norway	174.388	Norway	194.517	Denmark	235.381	Denmark	222.159
25	Hungary	166.029	South Africa	154.683	Hungary	193.383	Norway	204.568	Brazil	208.431

*Note: *tax haven countries or territories*

(Source: own processing according to data provided by the IMF)

Table no. 2 highlights the top 25 reporting economies in the world in terms of direct investment outflows, according to statistics provided by the IMF. From the analysis of these data, it can be seen that the first three countries are the same as in the case of direct investment inflows. For example, G8 countries (which became the group of seven after the exclusion of Russia), with the exception of the United States, are ranked after offshore jurisdictions such as the Netherlands or Luxembourg. A report by the Centre for Research on Multinational Corporations (Van Dijk *et al.*, 2006) concluded, “all the empirical evidence indicates that the Netherlands is a tax haven”. These evidences are because the Netherlands offers foreign companies’ facilities “to reduce their tax charges on interest, royalties, dividends and capital gains income from subsidiary companies” (Van Dijk *et al.*, 2006). In addition, Dörry (2015) characterizes Luxembourg as “the world’s largest cross-border investment fund center”. A recent study (Hardeck & Wittenstein, 2018) examines how multinational companies manage to avoid taxes through "hybrid arrangements" in Luxembourg. Through financial instruments, companies can reduce their tax liabilities. Converting the character of income (for example, dividends can be “false” characterized as interest or capital gains), companies are able to repatriate their profits to jurisdictions where offshore entities are not subject to withholding taxes (Hardeck & Wittenstein, 2018).

In the top 10 reporting economies, there are also other tax havens, such as Hong Kong, Switzerland or Ireland. These are ranked ahead of some G8 countries (Canada, France, Germany, Italy, Japan, and Russia). Constantly present every year in the top 25 reporting economies are Cyprus along with Mauritius.

Analyzing the entire period, it can be seen that five of the top ten countries are tax havens (50%), and in the top 25 reporting economies, there are seven offshore jurisdictions (28%). However, direct investment outflows from tax havens have a higher cumulative value than other countries. For example, in 2018 the seven tax havens have a cumulative value of direct investments of 44% of the total direct investments of the top 25 countries.

Given the fact that in the top 25 countries with the largest direct investments are ranked some jurisdictions such as Luxembourg, Hong Kong, Ireland, Cyprus or Mauritius before much stronger economies, such as France, Japan, Canada, Spain, Italy, Russia, Austria or Brazil, we found it relevant to analyze the direct investments per capita. Thus, table no. 3 highlights the top 10 countries or territories according to the level of direct investments per capita.

Table 3. Inward and Outward Direct Investment per capita in 2018 – Top 10 Reporting Economies in the World

No.	Investment in:	Investment per capita (US Dollars)	No.	Investment from:	Investment per capita (US Dollars)
1.	*Luxembourg**	6.185.550	1.	*Luxembourg**	7.574.315
2.	*Malta**	426.302	2.	*Cyprus**	367.328
3.	*Cyprus**	360.244	3.	*Netherlands**	334.027
4.	*Netherlands**	273.646	4.	*Mauritius**	223.746
5.	*Mauritius**	262.787	5.	*Hong Kong**	219.628
6.	*Hong Kong**	229.068	6.	*Ireland**	194.274
7.	*Singapore**	225.145	7.	*Switzerland**	175.508
8.	*Ireland**	206.126	8.	*Malta**	144.326
9.	*Switzerland**	159.048	9.	Belgium	52.017
10.	*Macao**	55.270	10.	Denmark	38.320

*Note: *tax haven countries or territories*

(Source: own processing according to data provided by the IMF)

Table no. 3 shows that all countries or territories in the top 10 at direct investment inflows (per capita) are tax havens. Luxembourg is ranked first; with a value, almost 15 times higher than the country that is ranked second (Malta). On the next positions in the top 10 are Cyprus, the Netherlands and Mauritius. In addition, the top eight tax jurisdictions in the ranking of direct investment outflows (per capita) are tax havens. The ranking is approximately the same as for direct investment inflows per capita, except that Malta ranks 8th. We found it relevant to make this analysis to highlight the fact that the high values registered in these jurisdictions are because they are offshore financial centers.

Another indicator that can highlight the role that offshore jurisdictions play in the world economy is GDP. We consider that a relevant analysis of this topic involves reporting the GDP to the number of inhabitants. Thus, table no.4 highlights the top 10 countries or territories in the world by GDP per capita in the period 2014-2018.

Table 4. GDP per capita - Top 10 Reporting Economies in the World

No.	Country	Year 2014	Country	Year 2015	Country	Year 2016	Country	Year 2017	Country	Year 2018
1	Monaco*	189.171	Liechtenstein*	167.291	Monaco*	169.916	Monaco*	167.102	Monaco*	185.741
2	Liechtenstein*	178.846	Monaco*	165.938	Liechtenstein*	165.028	Luxembourg*	107.361	Luxembourg*	116.640
3	Luxembourg*	118.824	Luxembourg*	101.376	Luxembourg*	104.278	Macao*	81.517	Macao*	87.209
4	Norway	97.019	Switzerland*	82.082	Switzerland*	80.172	Cayman Islands*	81.125	Switzerland*	82.797

5	Macao*	93.777	Isle of Man*	81.606	Isle of Man*	79.156	Isle of Man*	80.989	Norway	81.697
6	Isle of Man*	88.974	Cayman Islands*	76.280	Cayman Islands*	78.296	Switzerland*	80.450	Ireland*	78.806
7	Switzerland*	86.606	Macao*	75.341	Macao*	74.061	Norway	75.497	Iceland	73.191
8	Qatar	83.859	Norway	74.356	Norway	70.461	Iceland	71.315	Qatar	68.794
9	Cayman Islands*	74.990	Qatar	63.039	Ireland*	63.197	Ireland*	69.650	Singapore*	64.582
10	Denmark	62.549	Ireland*	61.995	Iceland	61.758	Qatar	61.264	United States	62.795

*Note: *tax haven countries or territories*

(Source: own processing according to data provided by The World Bank)

As can be seen from table no. 4, more than half of the jurisdictions with the highest GDP per capita in the world are tax havens or offshore financial centers. In 2014, there are seven offshore jurisdictions (70%), in 2015 and 2016 there are eight offshore jurisdictions (80%), in 2017, there are seven offshore jurisdictions (70%), and in 2018, there are six offshore jurisdictions (60%). However, we point out that the values for all jurisdictions in the world have not been available in the World Bank database. For example, jurisdictions such as Bermuda, Cayman Islands, Gibraltar, Isle of Man, Liechtenstein, San Marino, and British Virgin Islands do not have data available for all years or not at all.

Table no. 4 is very suggestive in terms of the role of financial capital mobility through foreign direct investment. The data suggests once again that in countries and territories with a small population such as Liechtenstein, Luxembourg, Macao, the Cayman Islands, Monaco, the Isle of Man or Singapore there is intense financial activity. Professional accountants and large accounting firms play an important role in supporting this financial activity, given their presence in these jurisdictions by a number of offices disproportionate to the number of inhabitants (Afrasinei & Georgescu, 2015).

Data on direct investment inflows and outflows, corroborated with data on gross domestic product per capita and direct investment per capita suggest that there is a round-tripping of capital. For example, Luxembourg, like other offshore jurisdictions, is used by multinational companies in tax optimization strategies for interposing an entity in a third country, between home and source country (Hardeck & Wittenstein, 2018).

3. CONCLUSIONS

As we emphasized in this paper, the subject of tax havens and offshore financial centers is extremely complex. It can be viewed from several perspectives, as it has economic, political, social, and even environmental implications. However, in general, the papers address the link between offshore jurisdictions and tax avoidance. The connections to tax havens of the companies allow them to elaborate tax optimization strategies in order to reduce their tax liabilities. Thus, the budget revenues of the countries where the profits were obtained may be affected.

The role of offshore jurisdictions in the global economy can be observed by analysing global direct investments. In this paper, we identified the fact that tax havens and offshore financial centers are among the top jurisdictions in terms of the size of both direct investment inflows and outflows. Countries such as Luxembourg and the Netherlands are ahead of the world's largest economy, the United States of America. In addition, Hong Kong, Singapore, Switzerland or Ireland have a higher size of direct investment inflows than large world powers such as Germany, France, Spain, Canada or Italy. Hong Kong has a larger size of direct investment outflows than countries such as Germany, France, Japan, and Switzerland and Ireland have a larger size of direct investment outflows than Canada, Spain or Italy.

The analysis of the inflows and outflows of direct investments per capita was the next step in our study. The results showed that all of the top 10 countries or territories in terms of direct investment inflows per capita are offshore jurisdictions. On the first position in the top is Luxembourg, which has a much larger size of direct investments than other countries (both inflows and outflows). In order to complete the previous findings, we subsequently analysed the gross domestic product per capita globally and found that the countries with the highest value are also offshore jurisdictions, namely Monaco, Liechtenstein, Luxembourg, Monaco and Switzerland. In addition, in the top 10 reporting economies there are countries or territories such as Macao, the Isle of Man, the Cayman Islands, Ireland or Singapore. It has once again been confirmed that financial globalization has created opportunities for these jurisdictions to attract foreign capital and flourish. The findings suggest that a very large proportion of the investments made in the world are made through tax havens and offshore financial centers.

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