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6 March 2019

Development (https://microeconomicinsights.org/category/development/), Public Finance (https://microeconomicinsights.org/category/public-finance/)

Authors: Annette Alstadsæter (Norwegian University of Life Sciences) (https://www.nmbu.no/ans/annette.alstadsater), Niels Johannesen (University of Copenhagen) (https://www.economics.ku.dk/staff/vip/?pure=en/persons/12366), Gabriel Zucman (University of California, Berkeley) (http://gabriel-zucman.eu/)

Tax evasion and inequality (https://microeconomicinsights.org/tax-evasion-and-inequality-evidence-from-scandinavia/)

Summary

How widespread is tax evasion – and what does that imply for the true extent of inequality? New research explores these questions by analyzing a unique dataset of leaked customer lists from offshore financial institutions (''Swiss Leaks' from HSBC Switzerland and the 'Panama Papers' of Mossack Fonseca) and tax amnesties conducted in the aftermath of the financial crisis of 2008-09. These are then matched to population-wide administrative income and wealth records in Denmark, Norway and Sweden.

The results show that offshore tax evasion is highly concentrated among the rich. The top 0.01% of households in Scandinavia by wealth evade about a quarter of the taxes they owe, largely by concealing assets and investment income abroad. Top wealth shares in the three countries increase substantially when adding back these unreported assets, highlighting the need to take account of tax evasion to measure inequality accurately.

As an example of the findings, the data show that the wealthier someone is, the more likely they were to hide assets at HSBC Switzerland: 1% of the richest Scandinavian households held an undeclared account in HSBC, which is only bank in one tax haven. Moreover, conditional on concealing assets in that bank, tax evaders hid on average the equivalent of 40% of their true wealth at HSBC Switzerland.

Indeed, across the datasets and in all three countries, the probability of using offshore intermediaries and of owning wealth in tax havens rises sharply with wealth. The researchers' estimates indicate that 50% of offshore assets belong to the wealthiest 0.01% households and around 80% belong to the wealthiest 0.1%.

It seems likely that such tax evasion is even higher in other developed economies, as Scandinavian countries rank among those with the strongest respect for the rule of law, the highest tax morale and the *lowest* amount of wealth held in tax havens.

Why do the rich evade so much? The straightforward answer is because they can. There is a whole industry – in Switzerland, Panama and other tax havens around the globe – that provides wealth concealment services to the world's wealthiest individuals. This industry typically only targets the very wealthy (people with more than $20 million or sometimes $50 million to invest), since serving too many would-be evaders would increase the risk of these banks and law firms being found in violation of the law.

Moderately wealthy individuals (those below the top 0.1%) do not have access to the services they sell and therefore don't evade much tax. Further down the ladder, the majority of the population only earns wages and pension income, which cannot be hidden from the tax authority.

The researchers conclude that to tackle top-end evasion effectively and to reduce inequality, it is vital to shrink the supply of wealth concealment services. This can be done by changing the incentives faced by the law and financial firms in tax havens – for example, by applying trade tariffs to non-cooperative tax havens and steep financial sanctions to the firms found abetting tax dodging.

Main article

How widespread is tax evasion – and what does that imply for the true extent of inequality? This research explores these questions by analyzing a unique dataset of leaked customer lists from offshore financial institutions matched to administrative wealth records in Scandinavia. The results show that offshore tax evasion is highly concentrated among the rich. The top 0.01% of households by wealth evade about a quarter of the taxes they owe, largely by concealing assets and investment income abroad. Top wealth shares in Denmark, Norway and Sweden increase substantially when adding back these unreported assets, highlighting the need to take account of tax evasion to measure inequality accurately.

Who evades taxes, and how much they evade, matters for both economists and policy-makers. One main source of information on the anatomy of tax evasion is randomized audits, which can uncover self-employment income, abuses of tax credits and, more broadly, all relatively simple forms of tax evasion (for example, Kleven et al, 2011).

There is a saying in public economics that ‘*the poor evade, the rich avoid*’, with an underlying assumption that the rich use top advisers and legal measures to reduce their tax bill. But random audits do not capture tax evasion by the very wealthy satisfactorily, as they fail to detect sophisticated forms of evasion involving anonymous shell companies and secret offshore accounts.

Our research shows that offshore evasion is highly concentrated among the rich. Based on our results, the saying could be updated to: ‘*the poor evade, and the rich evade even more*’.

Knowing more about how tax evasion is distributed would help tax authorities – who face tight budget constraints – to target their enforcement effort more effectively. Tax evasion at the top is important to study because although wealthy taxpayers are few in number, they own a large share of total wealth and are liable for a large fraction of total taxes. Tax evasion also matters for analyzing the effects of government intervention in the economy as it redistributes the tax burden.

We show that the distribution of evasion has implications for measured inequality, which is underestimated when excluding tax evasion through tax havens.

Combining administrative data, audits and leaks to shed light on tax evasion in Scandinavia

To capture offshore tax evasion by the wealthy, we use new micro-data that make it possible to study tax evasion by very rich individuals. These data come from recent, massive leaks from offshore financial institutions – HSBC Switzerland (‘Swiss Leaks’) and Mossack Fonseca (the ‘Panama Papers’) – and tax amnesties conducted in the aftermath of the financial crisis of 2008-09.

Working in cooperation with Scandinavian tax administrations, we have been able to analyze the leaked and amnesty micro-data matched to population-wide administrative income and wealth records in Denmark, Norway and Sweden.

In 2007, an employee of HSBC Switzerland extracted the internal records of the bank and turned the data over to the French government. The leaked documents included the complete internal records of the more than 30,000 clients of the bank. At the time, HSBC Switzerland was a major player in offshore banking, managing assets of about $120 billion or about 5% of all the foreign wealth managed by Swiss banks.

This HSBC leak is a unique source of information for studying tax evasion because the leak is a random event and because it comes from a large and arguably representative offshore bank. The share held in HSBC Switzerland by Scandinavians corresponds to the share of wealth held by Scandinavians in total in Switzerland, according to statistics published by the Swiss central bank.

Further evidence that HSBC is a representative provider is that there is only a 2% overlap of the sample of HSBC evaders and Scandinavian voluntary disclosures, so it is not the case that HSBC was the go-to provider of tax haven services for Scandinavians.

It is not illegal to have an account with HSBC: it is only tax evasion if the account is not reported to the tax authorities. In this case, around 90% of accounts were undeclared, and these make up our sample of tax evaders.

The data show that the wealthier you are, the more likely you were to hide assets at HSBC Switzerland: 1% of the richest Scandinavian households held an undeclared account in HSBC, which is only bank in one tax haven. Moreover, conditional on concealing assets in that bank, tax evaders hid on average a lot of wealth at HSBC Switzerland, the equivalent of 40% of their true wealth.

Our other two sources of information on offshore tax evasion draw a similar picture.

In the spring of 2016, the International Consortium of Investigative Journalists published the names and addresses of the owners of shell companies created by the Panamanian law firm Mossack Fonseca. It is not illegal in itself to be associated with a shell company, but it is an indication of evasion-related behavior. Many of these cases are still under investigation by the tax authorities.

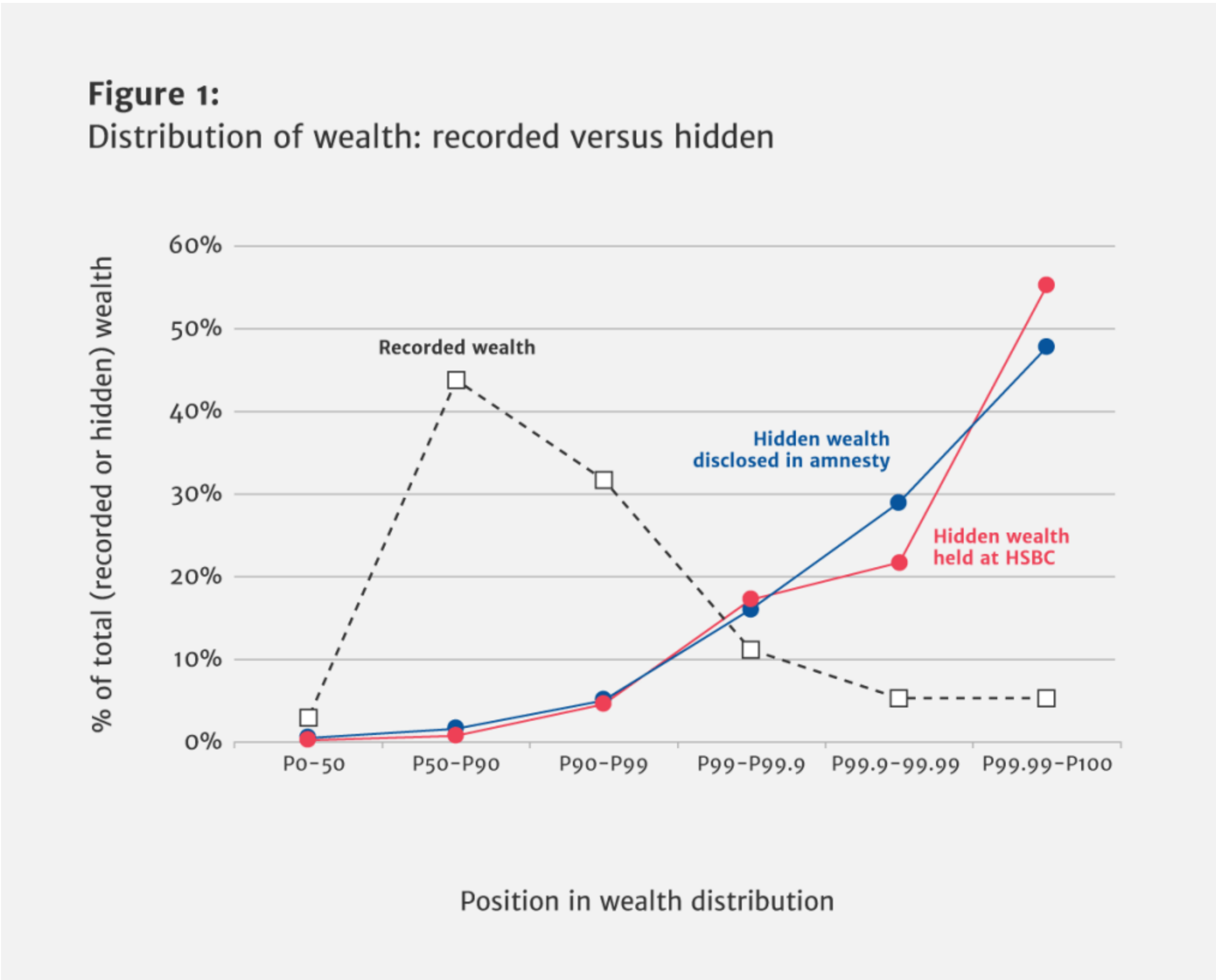
Again, the use of these services is highly concentrated among the rich. More than 1% of the richest Scandinavian households held a shell company through Mossack Fonseca, one provider of secrecy services in one out of many jurisdictions serving as tax havens.

Norway and Sweden have longstanding voluntary disclosure amnesties enabling tax evaders to come clean. As long as disclosure is voluntary, no penalty taxes apply, and the taxpayer has to pay taxes due up to ten years back in time when bringing the money home. Data show that 14% of the top 0.01% richest Norwegian and Swedish households in 2006 later admitted having evaded taxes. The super-rich own half of the total amount of disclosed offshore wealth.

Putting it all together

We find similar patterns in our three datasets (HSBC, the Panama Papers and amnesties) and in three countries (Denmark, Norway and Sweden). In all cases, the probability of using offshore intermediaries and of owning wealth in tax havens rises sharply with wealth. By our estimates, 50% of offshore assets belong to the wealthiest 0.01% households and around 80% belong to the wealthiest 0.1%.

Figure 1 shows the distribution of wealth in Scandinavia (Denmark, Norway and Sweden) excluding offshore wealth, and the distribution of wealth held at HSBC and disclosed by amnesty participants. The latter is highly concentrated among the rich.



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The distributional tax gap

In a companion study (Alstadsæter et al, 2018), we show that even though on aggregate, private financial wealth corresponding to 10% of global GDP is held in tax havens, this is highly heterogeneous across countries.

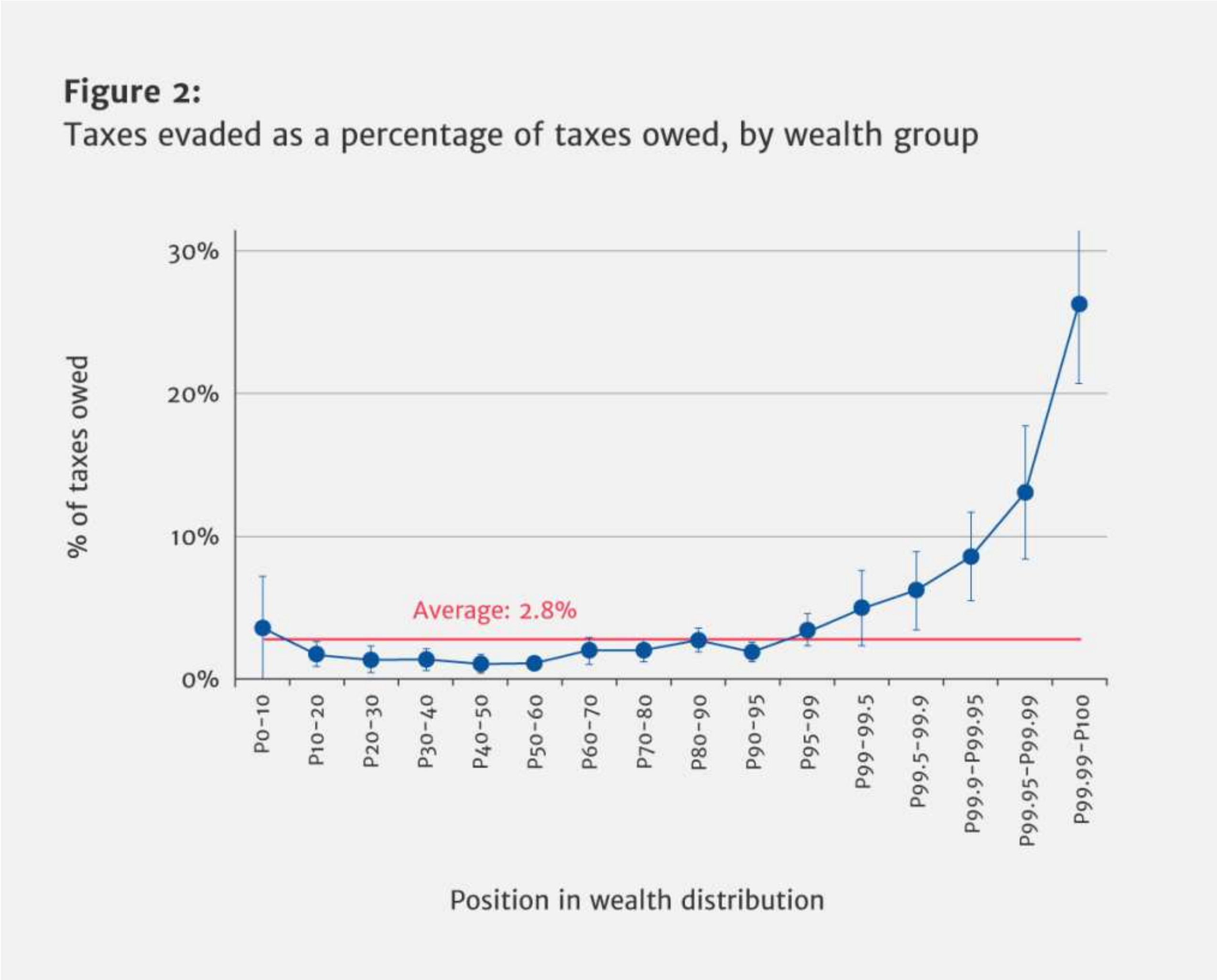
Scandinavian countries are at the lower end of this evasion distribution, with their households holding equivalent of a few percent of GDP in offshore wealth. This figure rises to about 15% in continental Europe, and to as much as 60% in Russia, Gulf countries and a number of Latin American countries.

Assuming that the total hidden wealth is distributed as in our micro samples, we apply this distribution to available estimates of the macroeconomic amount of wealth hidden in tax havens to estimate how much tax is evaded offshore by each group of the wealth distribution.

Based on the observed composition of offshore wealth and the returns on global securities markets and deposits in 2006, we apply a 4.5% taxable rate of return to the wealth hidden. Some of the wealth held offshore is probably accumulated out of untaxed earnings, but we are not able to quantify that form of evasion with the data at our disposal. Using a tax simulator for the tax year 2006, we estimate the amount of evaded tax on hidden wealth and the imputed return to this wealth in each bin of the wealth distribution.

By combining estimated offshore evasion rates with evasion rates from random audits, we find that on average 2.8% of total personal taxes go unpaid and that tax evasion appears to rise sharply with wealth. But as Figure 2 shows, this varies greatly across the wealth distribution.

We find that the top 0.01% richest households evade about 25% of the taxes they owe, mainly by concealing assets and investment income abroad.



(https://i0.wp.com/microeconomicinsights.org/wp-content/uploads/2019/03/MI-TEaI-CHARTS-MARCH19-02.png?ssl=1)

Over the last 15 years, a number of studies have used tax data to construct top income and wealth shares for many countries. This body of research discusses the problem raised by tax evasion (for example, Atkinson et al, 2011), but until recently there have been few data that would allow it to be quantified systematically. Our contribution here is to study micro-data that provide the first direct evidence on how hidden wealth is distributed.

At the very top of the pyramid, the wealth concentration is much greater than previously estimated. In Norway, where the available wealth data are particularly detailed, the super-wealthy appear to be 30% wealthier than previously thought, when wealth hidden in tax havens is taken into account. The share of wealth owned by the top 0.1% increases from 8% to 10%.

Do our findings apply to other countries?

We do not claim that our estimates of evasion by wealth group in Scandinavia hold everywhere as a universal law. We note, however, that there is nothing unique to Scandinavia that could explain the high evasion rates that we find at the top.

Residents of all developed countries are typically taxable on their worldwide income, as in Scandinavia. And although Scandinavian countries are high-tax in an international perspective, this owes more to their high value-added and payroll taxes than to high rates on personal capital incomes, which are taxed at flat, relatively low rates in Norway and Sweden.

If anything, tax evasion among the rich might actually be even higher in other developed economies, as Scandinavian countries rank among those with the strongest respect for the rule of law, the highest tax morale and the *lowest* amount of wealth held in tax havens.

Why do the rich evade a lot? Because they can

There is an industry – in Switzerland, Panama and other tax havens around the globe – that provides wealth concealment services to the world's wealthiest individuals. This industry typically only targets the very wealthy (people with more than $20 million or sometimes $50 million to invest), as serving too many would-be evaders would increase the risk of these banks and law firms being found in violation of the law.

Moderately wealthy individuals (those below the top 0.1%) do not have access to the services they sell and therefore don't evade much tax. Further down the ladder, the majority of the population only earns wages and pension income, which cannot be hidden from the tax authority.

To reduce top-end evasion significantly, it is vital to shrink the supply of wealth concealment services. This can be done by changing the incentives faced by the law and financial firms in tax havens – for example, by applying trade tariffs to non-cooperative tax havens and steep financial sanctions to the firms found abetting tax dodging (Zucman, 2015).

This article summarizes 'Tax Evasion and Inequality' by Annette Alstadsæter, Niels Johannesen and Gabriel Zucman, which is forthcoming in the *American Economic Review*.

Annette Alstadsæter is at the Norwegian University of Life Sciences. Niels Johannesen is at the University of Copenhagen. Gabriel Zucman is at the University of California, Berkeley.

Further reading

Alstadsæter, Annette, Niels Johannesen and Gabriel Zucman (2018) 'Who Owns the Wealth in Tax Havens? Macro Evidence and Implications for Global Inequality', *Journal of Public Economics* 162: 89-100.

Atkinson, Anthony, Thomas Piketty and Emmanuel Saez (2011) 'Top Incomes in the Long-Run of History', *Journal of Economic Literature* 49(1): 3-71.

Johannesen, Niels, and Gabriel Zucman (2014) 'The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown', *American Economic Journal: Economic Policy* 6(1): 65-91.

Kleven, Henrik Jacobsen, Martin B Knudsen, Claus Thustrup Kreiner, Søren Pedersen and Emmanuel Saez (2011) 'Unwilling or Unable to Cheat? Evidence from a Tax Audit Experiment in Denmark', *Econometrica* 79(3): 651-92.

Zucman, Gabriel (2013) 'The Missing Wealth of Nations, Are Europe and the U.S. Net Debtors or Net Creditors? (http://gabriel-zucman.eu/files/Zucman2013QJE.pdf)', *Quarterly Journal of Economics* 128(3): 1321-64.

Zucman, Gabriel (2015) *The Hidden Wealth of Nations: The Scourge of Tax Havens*, University of Chicago Press.

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20 September 2018
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Authors: Charles I Jones (Stanford University) (https://www.gsb.stanford.edu/faculty-research/faculty/chad-jones), Peter J Klenow (Stanford University) (http://www.klenow.com/)

Growth and well-being: policy should not be based on GDP alone (https://microeconomicinsights.org/growth-well-policy-not-based-gdp-alone/)

Economists are often accused of focusing excessively on GDP, with the result that government policies make GDP a priority to the detriment of other contributors to well-being. This research proposes a broader summary statistic that incorporates consumption, leisure, mortality and inequality. While the new statistic is highly correlated with GDP per capita, cross-national deviations are often large: Western Europe looks considerably closer to the United States; emerging Asia has not caught up as much; and many developing countries are further behind. Each component of the statistic plays a significant role in explaining these differences, with mortality being the most important. While still imperfect, the statistic arguably provides better guidance for determining public priorities and evaluating policies than does GDP alone.


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31 May 2018
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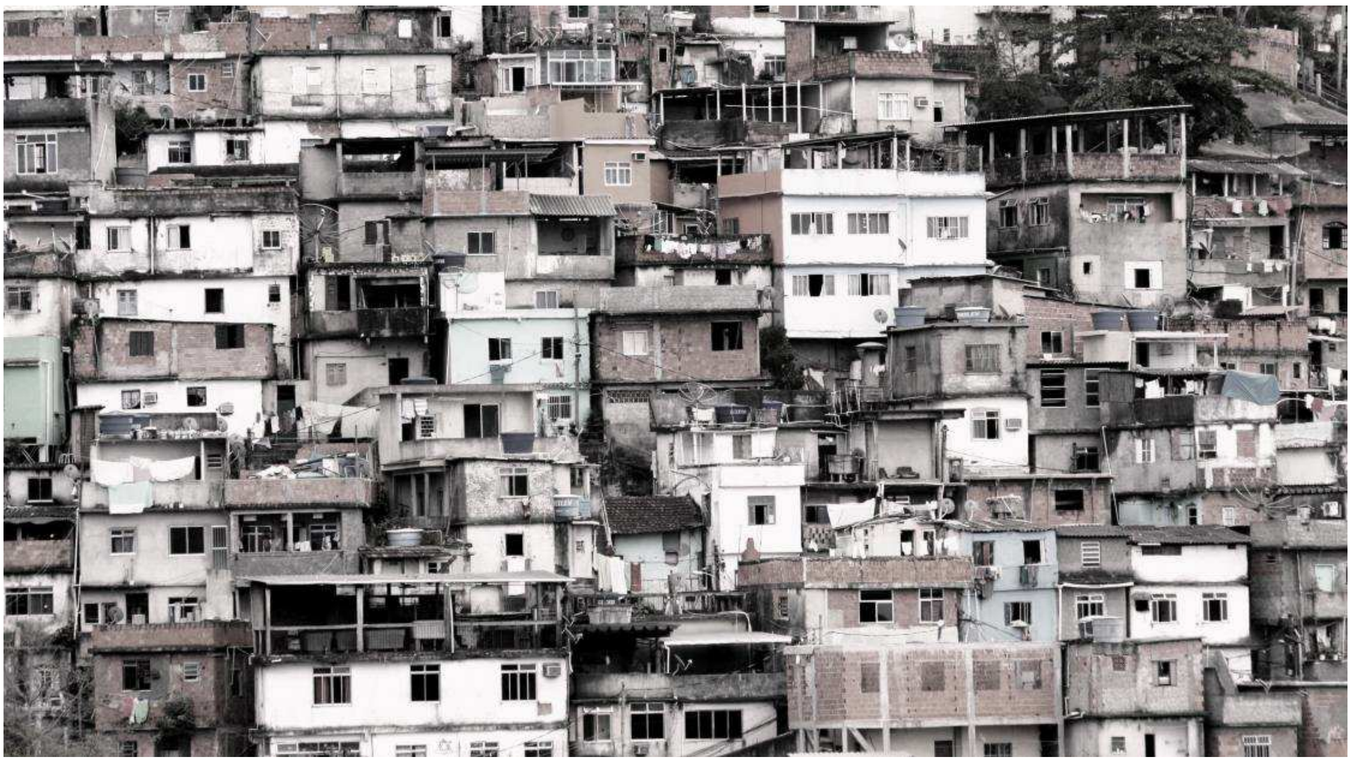
Authors: Raymond Fisman (Boston University) (http://sites.bu.edu/fisman/), Daniel Paravisini (London School of Economics) (http://www.lse.ac.uk/Finance/People/Faculty/Paravisini), Vikrant Vig (London Business School) (https://www.london.edu/faculty-and-research/faculty/profiles/v/vig-v)

Cultural proximity and loans (https://microeconomicinsights.org/cultural-proximity-loans/)

In many, many cases, people have a preference for working and doing business with those who share the same religious beliefs, come from the same geographic region, or have something else in common. If this preference arises from discrimination against other groups – if there is economically inefficient favoritism – the economy will not reach its full potential. But could there also be efficiency gains from transacting with people who are culturally proximate? If so, is it possible for the gains to be large enough to more than offset the losses from discrimination? Surprisingly, the answer to both questions is yes. However, that does not mean the barriers between groups should be reinforced. Policies that break down informational barriers between groups could produce further gains.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20 February 2018

Development (https://microeconomicinsights.org/category/development/)

Authors: Robert Allen (New York University, Abu Dhabi) (https://nyuad.nyu.edu/en/academics/divisions/social-science/faculty/robert-allen.html)

Absolute poverty: when necessity displaces desire

(https://microeconomicinsights.org/absolute-poverty-necessity-displaces-desire/)

The number of people living in poverty in countries around the world is commonly measured using the World Bank's poverty line – the '$1 per day' that many people have heard of, though it has risen over time and now stands at $1.90 per day. However this measure assumes that the needs of the poor are the same in every country, an assumption at odds with the evidence and common sense. This paper develops a Basic Needs Poverty Line that overcomes this problem giving us new and in some cases surprising insight into the severity of the poverty problem in both rich and poor countries around the world.

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