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TRADE, INVESTMENT AND TAX COOPERATION

Tax Competition

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Abstract

The world is facing a new round of international tax competition that may result in a ruinous race to the bottom, undermining the fiscal capacity of states to respond to global challenges and to implement the Agenda 2030. G20 leaders must take action to strengthen multilateral and cooperative approaches to taxation, curtail harmful tax competition and protect their own tax base as well as that of developing countries.

Challenge

Tax competition may be an important tool to attract investment, but more often than not it undermines the capacity of governments to mobilize sufficient resources to finance public services - including those services that are essential for sustainable development and economic growth. Particularly harmful are tax competition practices that a) erode the tax bases of other countries, thereby diminishing global welfare, b) deny other countries the opportunity to adapt their tax regimes in response to unwanted spillovers, due to a lack of transparency of the measures, or c) introduce market distortions in favor of specific groups or actors by shifting the tax burden to the disadvantage of other groups or actors, thereby undermining the fairness and social acceptance of tax systems.

The US tax reform of December 2017 threatens to trigger another round of worldwide tax competition, as other G20 governments may feel urged to adjust their corporate tax regimes as well. We see the risk of a downward spiral driven by three mechanisms:

- First, race-to-the-bottom corporate tax competition may involve lowering statutory tax rates as well as providing additional tax breaks for specific types of economic activity. In particular the latter tend to be harmful because they distort markets.

- Second, preferential tax regimes, distorting investment incentives and so-called anti-abuse rules as in the case of the US tax reform affect the level playing field significantly. If other countries react with similar measures, the resulting global tax structure could be even more complex and mutually harmful.

- Third, while tax cuts might boost economic growth in the short run, growing budgetary deficits could be a hindrance to growth in the medium term, as higher budget deficits would push up interest rates, which would discourage investment. For instance, the US tax reform is expected to cause an additional deficit of between USD 0.5 and 1.5 trillion over the coming decade, depending on the source of the estimation. This limits the space for public policies in the future and

puts a strain on coming generations, especially against the background of already high public debt rates in the US. If other governments would follow suit, fiscal space would shrink globally and limit resource availability for promoting balanced, sustainable and inclusive growth.

The consequences are likely to differ across countries:

- First, industrialized countries could see their tax base affected by a new round of corporate tax competition. By contrast, many developing countries might be less directly affected by this type of tax competition - either because they seek investments in sectors where market barriers exist (for instance, extractive industries) or because they already offer generous tax breaks in highly competitive sectors. However, they are likely to suffer from indirect effects, as their revenues from direct taxes are often heavily dependent on corporate taxation, the lion's share of which is typically borne by a small number of multinational corporations (MNCs). Developing countries could be under pressure to raise indirect taxes, shifting the tax burden further from corporations to consumers, particularly middle- and low-income sectors.

- Second, in addition, many measures already undertaken or foreseen by G20 member countries (such as for instance certain tax incentives for research and development) create additional competitive advantages for large MNCs which might lead to new distortions in the economic structure of countries worldwide, thereby affecting the capabilities of national economies to innovate, create jobs and adapt to the transformation of global production patterns, in particular to the growing digitalization of the world economy.

Proposal

Abolishing and preventing economic distortions of the kind outlined above should be a main goal of international tax policy. We ask G20 leaders to take urgent and decisive action in two distinctive though interrelated topics: (a) reverse the current tendency to engage in harmful tax competition and (b) provide a level playing field for taxation and investment.

1. Reverse the current tendency to engage in harmful tax competition

G20 leaders should deepen cooperation with regard to the exchange of tax-related information and the fight against Base Erosion and Profit Shifting (BEPS)

Unilateral action by individual countries, as powerful as they may be, is not an adequate response to the requirements of taxing a globalised economy. Any gains arising from such action will be short-lived, as other countries are

likely to introduce compensatory measures and economic actors should be expected to quickly adapt to the changing conditions.

A change of investment behaviour due to tax reforms is not necessarily negative, but cooperation should take account of differences in capacities of developed and developing countries to undertake appropriate action. Research shows that countries are taking different approaches to the implementation of BEPS Actions (IBFD 2018, Mosquera Valderrama 2018), leading to peculiar and undesired forms of tax competition. We observe that countries implementing BEPS are sometimes in disadvantage with respect to countries that are not implementing BEPS. For instance, BEPS minimum standard Action 6, which aims at "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" foresees the inclusion of principal purpose tests (PPT) in tax treaties. These tests create an extra requirement for taxpayers who are investing in that country. Discretionary application of the principal purpose test by tax administrations can introduce additional distortions in the global competition for investments. In this sense, balancing competition and BEPS implementation is needed to achieve a global model of tax governance in which developed and developing countries compete on a level playing field.

We ask the G20 leaders to promote regional cooperation in the implementation of international standards, including BEPS. The G20 should facilitate the creation of regional (or sub-regional) peer review and consultancy mechanisms that would allow countries to set and revise their own goals and targets for implementation, getting regular feedback from neighbouring countries. The G20 should actively promote regional learning processes: To give an example, the exchange of information (for instance, on trade flows and taxation) between neighbouring countries could be used to jointly implement technical platforms and standards and to build administrative capacity. This would make countries fit for the exchange of information on a broader international scale and allow them to better use that information locally.

G20 leaders should agree on a minimum corporate tax rate

Tax competition has harmful consequences for the global provision of public goods when effective tax rates of all countries end up below the level that countries would have chosen if no measure to attract foreign tax bases was introduced or if no reaction to other countries' measures was required. This has distributional effects to the disadvantage of immobile factors and impedes a fair sharing of the burden of financing sustainable development between all economic actors. Currently, average statutory corporate tax rates around the world are converging at around 25 per cent. Many tax havens apply much lower rates. While the BEPS project tackles some of the most pressing issues regarding corporate tax evasion and avoidance, it only marginally addresses the problem of tax competition. Initiatives on tax coordination between countries only exist at a regional level within the EU

and the West African Economic and Monetary Union (WAEMU). A practical approach towards establishing a minimum level of tax coordination about particularly harmful practices of corporate taxation would be to agree on a minimum corporate tax rate.

G20 leaders should explore the possibility of introducing a minimum corporate tax rate to be applied to the worldwide profits of private companies. Such a common minimum corporate tax rate would stop rewarding tax havens and prevent a race to the bottom, while keeping G20-based multinational companies, as well as other companies and permanent establishments operating in G20 countries, on a level-playing field with competitors. Such a minimum tax rate should help limit both tax avoidance and harmful tax competition. The determination of corporate tax rates above the minimum level would remain subject to the national tax rules.

2. Provide a level playing field for taxation and investment

G20 leaders should Improve the transparency of tax instruments for the attraction of investments

We ask G20 leaders to ensure that tax instruments used for the attraction of investments are employed with a view on creating, rather than undermining the level-playing field for investors. Clarity, simplicity and reliability are relevant criteria in this context. Measures to improve the design and transparency of tax incentives are presented in the T20 Policy Brief on "Tax Expenditure and the Treatment of Tax Incentives for Investment".

G20 leaders should work towards a common corporate tax base and explore ways to treat multinationals as single entities

Some progress has been made in addressing tax avoidance by multinational corporations in recent years. Much remains to be done, however. We ask G20 leaders to engage in a strategic debate on a reform of tax systems to make these fit for purpose in a globalised economy in which many companies operate across borders, but are managed as one single entity. A first step in this direction would be to broaden existing initiatives under the BEPS project, especially regarding the digital economy, as the delay in the introduction of tax measures to address the challenges of digitalization implies, in practice, an underlying preferential tax regime.

A second step would be to agree on a common corporate tax base (CCTB), applying harmonized nexus and profit allocation concepts in line with the exigencies of digitalization. As a third, longer-term measure, introducing a common consolidated corporate tax base (CCCTB) with broad international applicability would be an adequate approach to taxing the globalized and digitalized world economy. This approach would take into account assets invested, human resources employed and sales generated/destined.

Consolidation in this context means that, rather than individual jurisdictions, the overall distribution of the above-mentioned factors (capital, labour, sales) would be taken into account to allocate the tax base. We see important benefits of this approach with regard to the simplicity and certainty of taxation, the lowering of compliance costs, the internalization of unwanted spillover effects and a further facilitation of cross-border trade and investment. As the European Union is moving in the direction of implementing a CCTB and, subsequently, a CCCTB, we urge G20 leaders to explore opportunities for the scaling-up of this initiative.

That the G20 promotes and facilitates: a) the organization of a Special Group of countries (composed by Argentina, Australia, Brazil, Canada, New Zealand, Thailand and USA, as net exporters; China, Korea, Japan, Russia and Saudi Arabia as main net importers; and India as a top trader, b) that, within the institutional space in WTO, a permanent Secretariat is established to convene the Group for the purpose of dialogue, exchange of information and progress in special trading arrangements to facilitate a freer global trade in food among them and a greater market stability worldwide.

G20 leaders should promote the use of new technologies to fight trade mispricing and misinvoicing

We ask G20 leaders to jointly promote the use of digital technologies, such as blockchain technology, as an instrument to improve the transparency and security of trade flows. This includes making tax and customs administrations fit for such purpose and enabling them to exchange the necessary information by means of public infrastructure investments and capacity development. We further ask G20 leaders to provide the necessary means to support low- and lower-middle-income countries in their own digitalization agenda, in order to enable them to take part in the exchange of such information and to benefit from a better control of trade flows.

Additional measures to tackle current challenges in the taxation of the digital economy are presented in the T20 Policy Brief on "Digital Trade and Digital Taxation".

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