Tax Justice Network Briefing

tax justice network

The greatest opportunity for reallocating taxing rights in a generation: now or never for the OECD

The OECD is consulting on the biggest reshaping of international tax rules for ninety years, addressing the allocation of taxing rights between countries and a possible minimum tax rate. But the organisation has a history of bending to lobbying by its own member states and their multinational companies.

If the OECD is unable this time to deliver an effective response to systemic tax avoidance, its reign as a global rule-setter may soon be up. But in any event, there is no going back now: the discussions are finally asking the right questions. Should the OECD process fail to deliver a truly global answer, the search for solutions – for effective global governance of tax – will move to the UN.

Three great shifts towards tax justice

The OECD consultation reflects three great shifts in the debate, each of which has been central to the advocacy of the tax justice movement over the last two decades.

First, there is finally a recognition that the arm's length principle is not fit for purpose. Multinationals do not conduct intra-group transactions in this way, by definition and by economic logic, and the pretence not only gives international tax rules a bad name but more importantly has led inevitably to the systemic tax abuse that characterises the operations of multinationals all around the world today.

The IMF has estimated that profit shifting results in revenue losses globally of $600 billion; our reworking puts the total nearer $500 billion. Our analysis of US-headquartered multinationals shows that while in the 1990s they shifted 5%-10% of their profits away from the location of the underlying real economic activity, this had exploded two decades later to 25%-30%.

The second important shift in the debate is one of the fundamental framing. For decades, international tax rules have been set in the context of concerns over the risks of double taxation and of double non-taxation. The former has been heavily emphasised by multinationals and their advisers and lobbyists, while the latter was only raised consistently by tax justice advocates who were outside the decision-making processes. The explosion of both profit shifting itself and also of growing high-quality research on the associated revenue losses, has put greater emphasis on double non-taxation.

That analysis has also repeatedly confirmed that countries with lower per capita incomes are subject to

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the greatest losses, as a share of existing tax revenues. And this has led now both the OECD in its consultation, and other influential actors such as the IMF in their responses, to present as the key determinant of the success of any reforms, their impact on the global distribution of taxing rights – with particular attention to lower-income countries.

The distribution of taxing rights between states has direct consequences for the realisation of human rights within states. Effective taxation delivers the 4 Rs: revenues to support key public services, infrastructure, public administration and the rule of law; redistribution to curb inequalities; repricing to manage socially damaging production and consumption of e.g. carbon emissions and tobacco; and political representation.

This last R, often overlooked, reflects the important role of tax in establishing the social contract, and the accountability of states that rely on tax for their expenditures. For that reason, for example, a higher share of tax revenue in total expenditure is associated with more spending on public health systems; and over and above the level of spending, also with better and more inclusive health outcomes. Separate to the level of money available, it is more likely over time to be spent well when it is more heavily tax-financed.

The stylised facts explain why the human rights impact of taxing rights is especially powerful in lower-income countries. These have consistently lower tax revenue overall (as a share of GDP), and fewer options to raise revenues, so corporate income tax makes up a higher share of tax revenues.

At the same time, weaker tax administration and weaker political power mean that lower-income countries can be more easily exploited by multinationals and their tax advisers, with the result that estimated losses due to tax avoidance are disproportionate. The relatively weak level of public services and in some cases of political representation and governance also, mean that recovering the losses would be likely to deliver disproportionate benefits in terms of the progressive realisation of human rights.

The scenario described has an added dimension of injustice. The current distribution of taxing rights escalates and amplifies social inequalities, especially gender inequalities, and in doing so engineers a range of discriminatory outcomes for women.

The undermining of progressive direct taxation including corporate tax not only leaves higher inequalities in place on the revenue-raising side, but also reduces the funds available for redistribution through public expenditures. As the ideological commitment to 'austerity' measures has made painfully clear, the burden of lower pubic spending falls disproportionately on women in countries at higher as well as lower levels of per capita income.

The third shift is that the 'race to the bottom' has lost all intellectual credibility. This shift too reflects the long overdue realisation that the lobbying positions of major multinationals and their advisers have been better grounded in self-interest than in economic realities. For decades, these groups have promoted the extreme views that low or zero tax and regulation is most conducive to economic growth; and that maximising economic growth also leads to the best human development outcomes. Neither position is backed by evidence.

One measure of malign corporate influence on policy debates is the extent to which these views have been reflected in, and amplified by, the positions of international institutions. One particularly egregious example is the World Bank's flagship Doing Business Indicators. This highly influential tool exerts policy pressure on governments to demonstrate their attractiveness to foreign investors by 'streamlining', 'simplifying', 'improving' their regulatory approaches. None of these, or the range of other language used, is a euphemism for making regulatory systems more robust and regulation more effective.

Within the Doing Business Indicators, and apparently without shame, the Paying Tax Indicators are the creation of professional services firm PwC – which makes a substantial share of its income from the sale of tax avoidance schemes and tax advice to multinationals. It is not surprising that the indicators reward governments that decide to tax companies less, or not at all. But it is shocking that the World Bank would allow its great power over lower-income countries to be put to this use.

Various 'free market' corporate outfits still promote a 'competitiveness' agenda claiming that jurisdictions and their people can benefit from low- or no tax, and low- or no regulation approaches. But despite the deep pockets of its promoters, this view is increasingly widely understood for the socially costly special pleading that it is. Within the OECD consultation, this is reflected in the unprecedented discussion of minimum tax rates to be applied globally.

Overall, there is a powerful consensus on the original tax justice positions: that taxing rights should be aligned with the location of real economic activity; that jurisdictions should not (be able to) 'compete' to procure profit shifting from elsewhere by offering near-zero tax rates; and that the resulting redistribution of taxing rights will benefit lower-income countries in particular, and provide the basis to deliver on rights obligations in all countries. What remains is to see whether this time, the consensus position can be translated into effective reform.

Opportunities and risks in the coming reform

The G20 finance ministers at their June 2019 meeting are likely to sign off a plan for reforms to be developed over the following 18 months. On the basis of current discussions, that plan will reflect the three shifts towards tax justice outlined above. And the political context for discussions provides great opportunity for progress, compared to the disappointing earlier reform.

During 2011-2012, there was a growing sense that radical reform of international tax rules had become feasible – not least, because so many OECD member states were struggling with the lingering financial crisis that began in 2008. The single goal of the OECD Base Erosion and Profit Shifting initiative (BEPS) was to reduce the misalignment of profits with real economic activity.

But while that seemed to many to require considering of approaches that would indeed allocate tax base on the basis of real economic activity, early references to the possibility were completely excised by the time the action plan was agreed in July 2013. Instead, BEPS became the last great defence of the arm's length principle.

The world is now in the equivalent window, for the next reform. The initial documents speak of radical reform, but negotiations now underway between major powers may see a much narrower range of possibilities left in the plan to be signed off. There are, however, two major differences this time around. First, the major OECD countries themselves are of quite different views on how to proceed. The US, EU, Germany, France, the UK and others have each proposed or unilaterally moved forward with elements of new approaches that go beyond the arm's length principle, to greater or lesser extents. Second, at least in theory, many lower-income countries have a voice in the process through their membership not of the OECD itself but of its 'Inclusive Framework'.

The Inclusive Framework was established, in effect, to obtain commitments to conform to the BEPS outcomes from these lower-income countries which were largely absent from the process of agreeing them. But with the almost immediate return to discussions, due to the evident necessity for 'beyond BEPS' reforms, lower-income countries will have a much clearer opportunity to influence the outcome – should they choose to use it. If the major OECD countries continue to lack consensus, there will be some space for lower-income countries to exert influence.

But there are substantial risks too, within each of the two pillars of the OECD consultation that are likely to form the basis of the reform plan. At a basic level, pillar one addresses the question of how the tax base will be determined, and pillar two the question of a minimum tax rate to be applied.

In each case, the mere fact that the questions are being considered represents radical progress from when the Tax Justice Network was formally launched in 2003, and our policy proposals written off at the OECD and elsewhere as utopian. But in each case also, there remains a high risk that major OECD members, at the behest of their multinationals and related lobbyists, will seek to collapse progress back towards the status quo – just as happened in the BEPS process.

Pillar one

In pillar one, despite acceptance in principle that the arm's length approach is no longer fit for purpose, there are a set of decisions to be taken that may still protect its operation in large degree. First, it must be determined how widely any reforms will apply. The consultation originally applied only to the 'digital economy', understood to indicate a relatively small group of major technology and social media multinationals whose tax behaviour was widely seen as most extreme. But over time, it has come to be recognised that the same problems – in particular, of potential separation of taxable profit from real activity – exists across all industries to some, growing, degree. Universal application therefore seems likely – but is not guaranteed.

Second is the question of how far any non-arm's length approach would apply. This relates most obviously to proposals to identify 'residual profits', and to treat these on a separate basis from 'routine' profits. At the opposite end of this spectrum are proposals that would aim to allocate *all* profits on the basis of the location of real activity.

Third is the question of the approach that would be applied, to the agreed element of profits from the agreed set of industries or multinationals. Possibilities here extend to the longstanding tax justice proposal, for unitary taxation with formulary apportionment: that is, assessing profits at the unit of the multinational group (rather than separate entities within the group), and then directly apportioning these as tax base between jurisdictions on the basis of the respective shares of real economic activity (e.g. sales and employment).

Analysis from the IMF confirms earlier findings from academic researchers, that a sales basis would be somewhat better for lower-income countries on average than the status quo; while an employment basis would support a much more dramatic improvement. In each case, most high-income OECD members would also stand to benefit significantly. The 'losers' would be those jurisdictions that at present benefit most from deliberately procuring profit shifting from other states. Chief among these are the Netherlands, Ireland, Luxembourg, Switzerland, Singapore, Bermuda and Cayman.

The opportunity for a broadly beneficial, global reallocation of taxing rights is clear. It would be maximised by ensuring that the reform process takes the broader view on each of the three questions identified here: that is, that the reforms apply to all industries, and allocate the total profit of multinationals on the basis of the location of their real economic activity including employment.

In each of these areas, the risks are political more than technical. The core failing of the arm's length principle is that it creates a series of manipulable boundaries. Every intragroup transaction presents an opportunity to set a price, justifiable on the basis of one or more of the OECD's range of acceptable approaches. Inevitably, the overall tax position becomes a driver for some or all of those decisions.

Partial approaches to the first and second of the three questions identified within pillar one of the OECD reform risk replacing the arm's length principle with equally manipulable boundaries at other points in the overall tax evaluation.

First, a distinction between digital and other industries, where the latter remain taxed on an arm's length basis, would create an incentive for a given multinational and/or entities within a group not to be labelled 'digital'. Second, a distinction between 'routine' and 'residual' profit where the latter cannot be artificially shifted would see the effort currently focused on manipulating intragroup prices redirected to define as much profit as possible as 'routine'.

The political decisions on whether to take such partial approaches will have serious implications for the effectiveness of the emerging system. The third question in pillar one, meanwhile, is fundamentally political also. The decision over the basis for taxation will determine the extent to which the reform addresses the current global inequalities in the distribution of taxing rights. If a unitary approach and formulary apportionment were to be agreed, the relative weight on employment and sales will have a powerful impact.

To be clear: there are important technical aspects to the issues under consideration, but the key choices will be fundamentally political and have major redistributive implications worldwide.

As such, it is of grave concern that the decision will be taken in the OECD club of rich countries. The ability of lower-income countries to exert influence through the Inclusive Framework will be crucial to whether the final outcome provides any significant improvement in their taxing rights, or seeks only to protect those of major OECD member states. The perceived fairness of the outcome will also, in turn, determine the future legitimacy of the OECD as the forum for international tax rule-making.

Pillar two

Conceptually, the emergence of a minimum tax rate in international policy debates is most welcome. As discussed, this reflects an important narrative shift against the well-funded siren call of the race to the bottom. It is not, however, without political risks.

Simple operation of a minimum tax would empower the individual states where multinationals' real economic activity takes place. It would allow those states to impose withholding taxes on intragroup payments made to low-tax jurisdictions, removing the incentive for those payments (and indeed the respective entities, if the low-tax location is their only reason to form part of the multinational structure).

One risk is that multinational lobbying may push towards global, rather than jurisdiction-level, application of this approach. It remains uncertain how this would play out, but it is conceivable that the effect would be to limit any benefits for smaller, lower-income countries.

If, for example, Malawi was losing out to intragroup payments being made to a Cayman entity paying near zero tax, empowering Malawi to impose a withholding tax to meet some minimum rate *at jurisdiction level* could be a powerful remedy. But consider a multinational with the majority of its operations in high-income countries, paying something near statutory rates in each (of say 30%-35%). With the existing structures and tax rates elsewhere, it's entirely possible that an overall *global* minimum rate of say 25% could be achieved while at the same time most lower-income countries continued to lose out to profit shifting. That is, with a global rather than jurisdiction-level minimum tax, Malawi could be unable to reduce its losses to Cayman because – in effect – the multinational in question is paying a fair level of tax in the OECD. The risk that major OECD countries pursue reforms in their own interest, with little concern for ensuring others share in the benefits, remains as clear as ever.

The second risk with pillar two is more deeply political. Recall Ha-Joon Chang's memorable description of major OECD countries as 'kicking away the ladder'. This reflects the use of IMF, World Bank and other conditionality to prevent lower-income countries, including many former colonies of OECD members, from pursuing the type of policies that saw the latter achieve their own economic success. The argument hits home in relation to a broad group of policies, but among them the restricting of trade policy measures to support particular industries is especially salient.

The minimum tax proposals also have the potential to cut across lower-income countries' industrial policy. There is broad agreement that tax incentives are very often without merit, since companies choose their investment location according to more substantive criteria including infrastructure and skilled labour, and only then look to achieve a lower tax rate.

Best practice requires tax incentives to be scrutinised by parliament (not, e.g., signed off privately by a single minister), and the costs and benefits to be fully transparent. That would in practice lead to a large-scale reduction in the level of tax expenditures, as well as to dramatic improvements in the benefit-cost ratio of any remaining instruments. Our research has shown, for example, that profit-based tax incentives may well be effectively useless in fulfilling any industrial policy aim. But this stops well short of the IMF position, for example, of calling for a complete end to any and all incentives.

If the pillar one reforms are done fully, so that all profits are apportioned as tax base according to the location of real economic activity, then a minimum tax puts a floor beneath the extent of tax 'competition' to attract that real activity. But if pillar one ends up in a much more partial approach, however, and the OECD fails effectively to distinguish between jurisdictions competing for real activity and jurisdictions seeking to procure profit shifting, then a minimum tax will treat both the same.

Identifying the likes of the Netherlands, Bermuda and Luxembourg as profit shifting hubs that undermine others' revenues would allow a minimum tax to curtail this behaviour – i.e. it would kick in when payments do not reflect that real activity. Failing to do so risks a minimum tax becoming a blunt tool that limits lower-income countries' industrial policy approaches just as much as it disciplines the abuses of profit shifting jurisdictions.

Ultimately, if pillar one does not determine the tax base, it is unclear how a minimum rate could even be assessed. Would, for example, billions of dollars of US tax subsidies to Amazon be counted as reducing the relevant effective tax rate? Or would the focus of pillar two fall squarely on the more open practices of zero-tax jurisdictions?

It is not fanciful to imagine a rerun of the hypocritical dynamics that marred the OECD's late-1990s 'harmful tax practices' project, with pressure for reform applied to a set of small island economies while major OECD member states carried on unhindered. (Those at the World Bank and IMF charged with hard or soft conditionality in relation to tax should also learn this lesson well.)

The potential is clear for partial or flawed reforms under pillar one to make inevitable a pillar two reform that embeds political inequalities, at the expense of smaller jurisdictions and those with lower per capita incomes. Given the already increasingly controversial nature of a high-income country members' club effectively setting international tax rules for the world, this will require careful handling and the curation of broad support for the eventual policy decisions.

This should not be read as a concern about pursuing pillar two, however. Some senior voices from 'big four' accounting firms have attempted to present pillar two as a threat to lower-income countries' sovereignty. The basis for this claim – that these countries need tax incentives to make up for a poor investment climate – runs counter to the evidence on investment location. It is also self-serving and hypocritical, coming from firms whose tax advice and lobbying is so central to the revenue losses that lower-income countries suffer. If the big four had any genuine concerns about fiscal sovereignty, they would look to their own practices. This, instead, looks like a disingenuous attempt to find support for blocking measures which could actually reduce the big four's international harm.

A global minimum tax rate can be a powerful progressive tool, curtailing the race to the bottom – but to achieve this, it must be combined with a comprehensive tax base reform under pillar one.

Conclusions

The working basis for the OECD reforms of 2019-2020 reflects three powerful shifts in the narrative, towards tax justice. First, that the arm's length principle which has been the basis for the international tax rules for nearly a century, is not fit for purpose. Second, that tax avoidance by multinational companies causes massive revenue losses worldwide, with especially damaging effects on lower-income countries and the fulfilment of their citizens' human rights. And third, that the race to the bottom on tax rates must be curbed, for the common good.

The two pillars of the reform throw up a range of issues that are political, more than technical. Pillar one has the potential to deliver comprehensive reform of the tax base, moving to a unitary approach that apportions multinationals' global profits as tax base in proportion to the share of economic activity in each country of operation.

Reflecting the location of employment as well as sales, i.e. production as well as consumption, is crucial to delivering a fairer distribution of taxing rights. But there are a set of much more partial proposals that would recreate the weaknesses of the current system, in terms of its openness in key dimensions to manipulation by multinational companies and their advisers – and of competition among certain jurisdictions to procure profit shifting at the expense of all other countries.

The second pillar of the reform proposals would introduce a highly welcome minimum tax rate, which together with a comprehensive reform of the base would mark an important step forward against the race to the bottom.

Here too, however, there are risks that major OECD countries might pursue their own interests to the detriment of lower-income countries, or to the detriment of insignificant small island tax havens with low statutory rates, while ignoring more sophisticated tax games played by OECD members, and potentially introducing policy restrictions that bind on the latter rather than on profit shifting havens.

The reforms also represent what will likely prove to be the OECD's last chance to show itself capable of delivering international tax rules that go beyond the arm's length principle to address avoidance and the resulting global inequalities in taxing rights. That will be politically difficult, given the imbalance between major economies that are OECD members, and the great majority of lower-income countries that only have a voice – currently of indeterminate influence – through the Inclusive Framework. The proof of this concern will only be revealed over time.

A clear OECD failure to deliver for lower-income countries is likely to see momentum move rapidly to a globally representative UN forum instead, which will ultimately be necessary in any case but could be long delayed by successful progress over the next two years.

For now, the reforms provide an unprecedented opportunity to achieve major revenue gains for many countries. The G24 group of countries and others can provide important leadership within the discussions, insisting on the more comprehensive reforms that would deliver broadly shared benefits of significant scale. The tax justice movement will continue to engage and provide both technical and political support.

We are an independent international network launched in 2003. We conduct high-level research, analysis and advocacy on international tax; on the international aspects of financial regulation; on the role of tax in society; and on the impacts of tax evasion, tax avoidance, tax 'competition' and tax havens. We seek to create understanding and debate, and to promote reform, especially in poorer countries. We are not aligned to any political parties.

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