Annex

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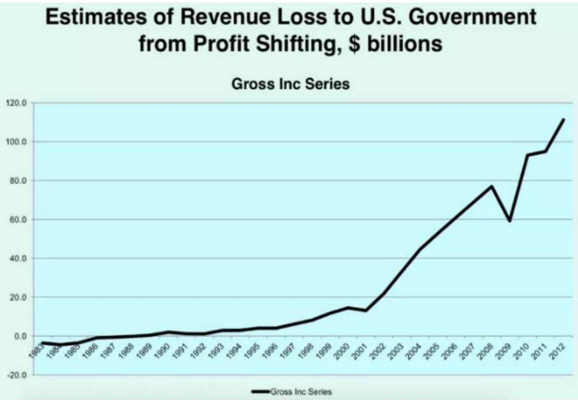
The first proper cracks appear in the foundations of international tax

The international tax system was designed by the League of Nations around a century ago and is now overseen by the OECD, a club of rich countries. The fundamental rules underpinning the system are no longer fit for the modern digital age, as they are allowing an orgy of multinational corporate tax avoidance, causing tax losses of the order of half a trillion dollars per year, worldwide – and rising.

The OECD rules treat each multinational, for tax purposes, as if it were simply a loose collection of **separate entities** trading with each other in a fair market on an "**arm's length**" basis (that is, at normal market prices.) But the economic rationale for multinationals to exist is precisely that they can outcompete such separate entities, for reasons including that the prices for intra-group transactions can vary from market prices. This system encourages multinationals to manipulate these transfer prices in order to shift profits into entities based in low-tax or zero-tax havens, where they pay little or no tax, and to shift their costs into high-tax countries to deduct against their tax bills there. Multinationals and their tax advisers lobby hard to keep the broken system going.



A better system, as we have long argued, would tax multinationals based on the genuine economic substance of where they do business. This should be done by treating a multinational as a single global unit, then dividing up its total global profits and apportioning the parts to each place where it does business, using a formula based on (for example) its sales and employment there.

The OECD for decades jealously guarded its "separate entities, arm's length" approach as the inviolable international standard. In 2013, it launched a project called BEPS (Base Erosion and Profit Shifting) a last-ditch attempt to patch up the gaping holes in the system. In 2019 it finally began to admit failure, and opened the door to new ideas.

In January, in a BEPS consultation on the digital economy, the OECD finally agreed to consider steps towards the more balanced, simplified and effective formula apportionment model, arguing that solutions "require comprehensive work that covers the overall allocation of taxing rights through revised profit allocation rules." In March, Christine Lagarde, head of the IMF, remarked that "we need a fundamental rethink on international taxation," noting that the current broken system harms all countries but is "especially harmful to low-income countries." It launched a comprehensive review of the rules. We are now at the cusp of one of the most important moments in world tax history.

Our background briefing on the opportunities of the reforms can be found here.

Britain Waives the Rules, and controls the rules

Until now, most narratives about corporate tax havens have identified a "Big Six" jurisdictions most responsible for corporate tax cheating: Ireland, Bermuda, Luxembourg, the Netherlands, Switzerland and Singapore. This mostly relies on work by Gabriel Zucman; Brad Setser, and Alex Cobham and Petr Janský, and generally involves investigating the jurisdictions into which US multinationals shift their profits into. Researchers for the US Joint Committee on Taxation (Tim Dowd, Paul Landefeld and Anne Moore) find that Cayman should also be included. Our dataset is different. It shifts the focus away from profit-shifting and towards flows of foreign direct investment (FDI), using IMF data. It also expands coverage beyond the US to cover all of the significant jurisdictions. This is the basis for our global scale weight.

Britain's predominant role can be shown in various ways. For one thing, the top three corporate tax havens according to the Corporate Tax Haven Index are all British. Second, the British territories are far more aggressive than the rest of the Big Six according to our constructed 'haven scores'. Of the 10 jurisdictions whose tax systems received the highest corporate tax haven scores for enabling corporate tax avoidance, 8 are part of the UK network: the British Virgin Islands, Bermuda, the Cayman Islands, the Isle of Man, Turks and Caicos, Anguilla, Jersey, and Guernsey. The UK and its network of satellite jurisdictions averaged a lowest available corporate tax rate of 1.73 per cent.

While the United Kingdom itself has a somewhat lower ranking in the Corporate Tax Haven Index, and relatively benign haven scores, this is because it has effectively outsourced the corporate tax haven game to a "spiderweb" of Overseas Territories and Crown Dependencies, which opted to stay politically and institutionally connected to Britain after the collapse of the British Empire in the 1950s and 1960s, which continue to operate via British courts and the British legal system, and which are umbilically connected to and supported by the City of London and the British political establishment: they represent "an extension of the City of London" financial centre, as one put it. These jurisdictions, which include Cayman, Bermuda, Jersey and the British Virgin Islands, enjoy partial autonomy from Britain in certain areas. This half-in, half-out arrangement with

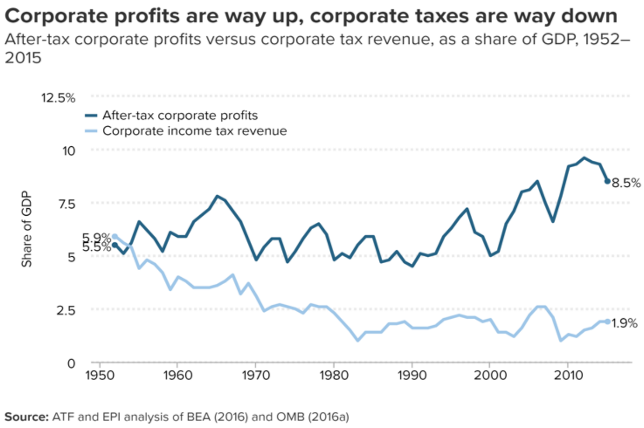
Britain allows the City to benefit handsomely from often nefarious activities run out of these tax havens, as the Corporate Tax Haven Index evidences, while allowing the British government to claim that 'there is little we can do' when scandal hits. In reality, Britain has full powers to impose or to veto lawmaking in these places.

During the years of Empire, Britain "Ruled the Waves." Today, for global multinational enterprises, Britain waives the rules. Indeed, several commentators have even called the international network of British tax havens scattered around the world constitute a "Second British Empire" that continues to loot other countries, providing benefits to the City of London.

- For our historical report on the UK and its relationship with the British tax havens, click here.
- For the seminal film about this, click here.
- For the seminal book about this, click here.

The race to the bottom

As one jurisdiction introduces a new tax loophole or tax cut or secrecy facility to attract mobile capital, others respond by offer even bigger or more devious mechanisms. This triggers others to try and get in on the act. The result sometimes gets called "tax competition" but a more appropriate term is **tax wars.** These result in an unseemly race to the bottom, which is **always** harmful.



This race steadily lowers the rate of taxes paid by multinationals, shifting the tax burden away from their mostly wealthy shareholders and onto the shoulders of small businesses and lower-income groups. This tax-cutting race doesn't stop at zero: it turns negative, as tax cuts are joined with outright subsidies.

The Corporate Tax Haven Index contains several indicators that demonstrate how a corporate tax haven's tax system can place pressure on others to degrade theirs in response, and the overall ranking itself is a measure of each jurisdiction's contribution to this toxic race.

Countries engage in 'tax wars' to attract mobile capital, steadily introducing new tax loopholes, tax cuts and secrecy and other facilities, prompting other countries to follow suit. The result is a race to the bottom, which steadily shifts the tax charge away from mobile capital, and onto the shoulders of less mobile factors such as small businesses and ordinary taxpayers.

The Corporate Tax Haven Index's Haven Indicators show how this happens. For instance, let's say a German multinational invests in Argentina, and makes €30 million in profits. Which country gets to tax that? Well, there are two basic approaches: the exemption system, and the credit system.

If the German tax rate on profits was 30 percent, it would normally levy €9 million on those profits. However, let's say Argentina has first levied €4m in taxes. Under a tax **credit system,** Germany would give credit for those €4m, and levy €5m to make the total up to €9m. The multinational doesn't much care which country levies the tax: it ends up paying €9m anyway, and doesn't feel a need to lobby Argentina to cut its tax rate.

However, if Germany operated an **exemption** (or "territorial") system, perhaps in order to attract multinationals' holding companies to Germany, Germany simply exempts all of the multinational's foreign income from tax. Now the multinational cares a lot about Argentina's tax rate, and will lobby hard for it to cut its rates.

For more on the dynamics of tax wars, **click here**.

Finance Curse: Corporate tax havens usually don't even benefit themselves

It is quite clear that corporate tax havens damage other countries, by undermining their corporate tax systems and in other ways. But they usually damage themselves too. It is an article of faith in Ireland, for instance, that its corporate tax haven policies are a 'cornerstone' of the Irish growth miracle from the 1990s. But this is a myth.

Countries with oversized financial sectors – something that generally applies to corporate tax havens - tend to suffer a "finance curse" involving a range of harms to themselves such as slower economic growth, steeper inequality, more political corruption, greater rigging of markets, more monopolisation (see the Annex, Part E) and a 'brain drain' out of wealth-*creating* sectors into wealth-*extracting* parts of the financial sector.

This is a rich and complex area, explored in detail here.

Corporate tax havens help build monopolies

When multinational enterprises engage in monopolistic behaviour, they are seeking to rig markets in their favour, so that they can kill their smaller competitors and boost their own profits. Exactly the same basic market-corrupting formula explains why multinationals use corporate tax havens. Both activities are forms of unproductive wealth extraction from other parts of the economy, which boost inequality, damage democracy, and contribute to widespread public anger.

The two forms of market-rigging are often directly linked. For one thing, corporate bosses who are more aggressive in using tax havens also tend to be more aggressive on using monopolistic power to extract monopoly profits from consumers, workers, pensioners, suppliers, taxpayers and other stakeholders. What is more, tax cheating boosts soaring multinational corporate profits — and those profits are very often channelled into wasteful mergers and acquisitions.

One way for a multinational to cut its tax bill is to merge with another company located in a low-tax jurisdiction, and move its tax residency there. This has been the case with large numbers of "tax-driven mergers and acquisitions (M & A)" to create a larger merged multinational firm, with both lower tax payments for schools and hospitals, and also greater monopolistic power in markets. The tax avoidance and the monopolisation are part of the same package. Mergers go in great global waves. According to one report (p16), close to 80 percent of FDI in the late 1990s involved cross-border M & A activity: in recent years this ratio has likely remained over 50 percent (p16), running at around $500 billion - $1.5 trillion a year (p97), contributing to the political anger that is fuelling fast-rising extremism in many countries.

Solutions

There are many technical solutions to the global scourge of corporate tax havens that rig markets in favour of large multinationals against smaller businesses and individuals. All solutions require deep-rooted political change.

At a technical level, there are two classes of solutions: **first,** multiple fixes to improve the current system, and **second,** a big overarching solution to aim for.

Multiple fixes

There are myriad ways to fix the current system: this press release isn't the place to lay these out in detail. However, the Corporate Tax Haven Index provides an excellent and unique way of addressing the problems. The key is to sanction those jurisdictions on the basis of high overall haven scores (or high scores on particular indicators or sets of indicators.) These sanctions must include the following:

Disallow multinationals from operating from or through the worst offenders. So the European Union could, for instance, rule that multinationals headquartered in *any* EU member state be forbidden from having any affiliates in the worst-offending jurisdictions with the highest haven scores. (A stronger version would apply the same rule to any multinational operating in any EU member state.)

Overarching solution

We have for years advocated one overarching solution to corporate tax havens.

The current international system is rests on the fiction that multinational enterprises are merely loose collections of **separate entities** (or affiliates) trading with each other at **arm's length** prices. Under this system, countries get to tax each separate entity registered in their jurisdiction. Predictably, this has led to multinationals shifting large amounts of their global profits into tax havens, where the effective tax rate is very low or zero.

The radical alternative, which sometimes gets called 'Unitary Tax' (or unitary tax with formula apportionment), would, especially if combined with an agreed minimum tax rate, essentially cut corporate tax havens out of the international tax system.

The unitary system treats each multinational as a single global entity - which is what it is. Its total global profits would then be allocated out to the countries where it does business, in proportion to the amount of genuine economic activity carried out in each place. That country can then tax its share of global profits at whatever rate it likes. Those profits would be allocated according to a formula, which may be based (for example) on that corporation's sales and employees in each place. A globally agreed minimum tax rate would help cement the system.

This way, it wouldn't matter if a corporation runs a one-person booking office in Luxembourg with almost no local sales in its tiny domestic market: under this formula, only a miniscule portion of its global profits would be allocated to Luxembourg, so it wouldn't matter if its tax rate was zero.

Partial versions of this system are already in operation in some places - many individual U.S. states use a version of this for calculating state taxes, for instance.

It is also quite feasible for there to be a staged, steady transition from the current system to the unitary system. And the Corporate Tax Haven Index, through its haven indicator system, provides a clear map how to proceed, as the box explains.

A route to unitary tax

Each step towards improving a country's Haven Score would tend to push its tax system in a unitary direction. For instance, Indicator 2 assesses whether a country implements a tax credit system, where countries give tax credits for taxes paid elsewhere. Imagine a multinational active in five countries, each of which taxes the locally-generated portion of a multinational's income. Under a tax credit system, the remainder would be taxed in the multinational's home country. Such a system would be generally equivalent to the unitary approach of allocating the multinational's global profits to each country according to economic substance, and letting them tax their portion at their preferred rate.

Or, for example, the anti-avoidance Indicators 15-18 limit a multinational's ability to get local tax deductions for outwards payments of interest, royalties, services payments and dividends, which are standard tools for shifting profits into tax havens. If these particular activities were disallowed, it would be a partial step towards unitary tax, which eliminates such profit-shifting. Likewise, public country-by-country reporting would produce a global-level view of a company's tax and financial affairs, as required by any unitary tax system with formula apportionment.

A unitary tax system contains many pitfalls and complexities too, of course — and many political obstacles to implementation, given the vested interests that benefit from the current unworkable system. But it is the system we need to work towards.

Utopian demands?

The Tax Justice Network has made a number of "impossible" demands since it was set up in 2003, many of which were considered laughable at the time by OECD and other international policymakers. Many of these demands, such as Country by County Reporting, and Automatic Information Exchange, are now accepted international standards, or on the way to becoming so.

We are confident that the world will now start moving steadily towards unitary tax. The main actors have now publicly accepted that the current system is broken, and this is the only viable alternative. However, we are aware that powerful private actors will wish to push international tax rules in different directions. So there is everything to fight for.