The G7's Tax Reform could entrench Global Inequality*

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The tax proposal decided at the G7 Finance Ministers' meeting last weekend has been hailed as 'historic' and 'transformative'. But in its present form, it is, unfortunately, neither. Major changes can and should be made — at least by the G20 where this will next be considered — if there is to be any serious global tax reform.

The proposal is based on the recognition that the international tax architecture, designed for an earlier and very different era, contains anomalies that enable multinational companies (MNCs) to avoid paying the same rate of taxes that local companies pay. They do this through accounting procedures described as 'base erosion and profit shifting' (BEPS), artificially moving profits to low-tax jurisdictions to avoid paying higher taxes in countries where they actually operate.

There is an obvious way to deal with this, and the Independent Commission for the Reform of International Corporate Taxation (of which I am a member) has been advocating a system of unitary taxation based on formulary apportionment. This means enabling every country to tax the global profits of MNCs, by apportioning the profits according to a formula based on sales, employment and capital, with a global minimum effective tax rate of 25 per cent. This would immediately remove any incentive for MNCs to shift profits around different jurisdictions, and lead to massive increases in tax revenues.

The US administration's tax push

Now that the Biden administration has woken up to the possibilities of significantly increased tax revenues, there has been renewed hope for a global tax reform. Janet Yellen's demand for 21 per cent minimum corporate tax, while still below the ICRICT demand, was nonetheless a very positive move. The idea of a minimum global rate is that countries can add top-up taxes on the profits of their MNCs who face lower tax rates abroad. This has to be done on a country-by-country basis, to prevent juggling of profits around different jurisdictions to avoid this.

The G7 compromise (in its 'second pillar' of the tax proposal) has led to a dramatically lower minimum rate of 'at least 15 per cent', close to the very low rates of tax havens like Ireland and Switzerland. It would lead to dramatically lower tax revenues as well: estimates by the EU Tax Observatory suggest that projected revenues for the European Union, for example, would decline from €167.8bn at 25 per cent, to €98bn at 21 per cent to only Euro €48.3 bn at 15 per cent. For the US, the projected decline in revenues is from €165.4bn at 25 per cent to €104.4 bn at 21 per cent to only €40.7 bn at 15 per cent.

It is remarkable that G7 governments are willing to give up so much potential tax revenue that could be usefully deployed for major social and physical investment, simply because of the lobbying power of large corporations. Clearly, the public in these countries is either unaware or unwilling to demand a more just outcome.

Developing countries lose out — again

What's even worse is that the G7 compromise does little for most developing countries, which are proportionately even greater losers from foregone tax revenues. For most developing countries, and for the world as a whole, the idea of unitary taxation of MNCs, with the taxes divided up according to a simple and fair formula, is much more relevant. It is a pity that in the negotiations, the proposal put forward by the Intergovernmental Group of 24 (G-24, a body coordinating the position of emerging economies) for fractional apportionment was not given due consideration.

Instead, the G7 proposal is embarrassingly inadequate and would likely lead to no real change. Since it has actively sought their removal, it is possible that the US government has only brought this forward to respond to the taxes being levelled against US-based digital MNCs in several other countries. Currently, other countries are saying they will agree to eliminate such taxes only after the US internally passes the relevant legislation, which is by no means certain.

In any case, the proposal is a far cry from the unitary taxation proposal of ICRICT. It suggests that governments should only get the right to tax at least 20 per cent of the profit earned in their country by an MNC that earn global profits over a 10 per cent margin (which they have defined as apparently 'excess profit').

Such a notion of 'excess profit' is bizarre – it is not used in any corporate taxation system in any country. Since profits are already defined as the excess over all costs (including costs of capital), they are clearly net income that should be taxed in the usual way, and indeed taxation should be progressive to capture rents. The effect of this restriction, and the further restriction to apply this new rule only to the largest multinationals, would be to dramatically reduce the number of eligible companies (less than 200 companies). This would mean that developing countries would gain little to nothing in additional tax revenues.

Just a triumph of marketing

Some details are yet to be worked out. For instance, how to define the tax base is still a vexed question. Ronen Palen argued that since this policy is based on accounting profits, it would still be easy for even very large MNCs to avoid it and fall below the 10 per cent threshold, including by dividing themselves up into separate firms that operate in alliance.

It's worth noting that Amazon, for example, may be exempt because its global profits are below the 10 per cent margin, unless the new system includes segmentation to bring into scope very profitable segments only (like Amazon's AWS). No wonder, many digital giants like Apple and Facebook have already welcomed this proposal. In addition, there are also already demands for carve-outs for certain sectors, like mining and finance.

Given the very limited changes in the G7 proposal, its wider reception as a huge step forward is really a triumph of marketing. And once again, sadly, the G7 has shown that they are not really leaders of the world, but leaders of a self-interested group of powerful countries.

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