Why a Minimum Effective Tax Rate is Urgently Needed

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Francis Weyzig (Senior Policy Advisor at Oxfam Novib)

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The proposal for upholding a minimum effective tax rate on corporate profits, on which the OECD Inclusive Framework recently invited comments, has received a lot of criticism. A minimum tax would deny developing countries the possibility to compensate for a poor investment climate by offering tax breaks, harming their development. Worse, it would undermine the sovereignty of countries to choose a sound tax mix and cause a shift towards distortionary subsidies. And what does a minimum tax have to do with digitalization of the economy in the first place?
In this blog, I'll argue why a minimum tax is a good thing, drawing some parallels with trade policy. If you are a fan of trade wars, sorry for bothering you. If you are not and in for some fresh thinking, read on.

Let's start with the reason why this proposal if on the table in the first place. The Inclusive Framework found that the tax challenges of the digitalization of the economy are not limited to specific business sectors. However, some existing problems are exacerbated by digitalization or manifest themselves prominently in highly digitalized businesses. Addressing these challenges means addressing the underlying problems. One of those problems is that the success of BEPS Actions, especially Action 5 against harmful tax practices, has increased tax competition for real economic activities. A minimum tax puts a floor in such competition.

For some readers, this will ring alarm bells. Competition is good, and corporate tax is the most harmful tax of all – why on earth would someone advocate for a floor? Corporate tax raises prices for consumers, it reduces employment and private investment, and on top of that it comes with huge administrative costs. If anything, the race to the bottom should be welcomed!

Well, not so fast. Let's look at the broader picture. Corporate tax does produce all of these negative effects, but so do other types of taxes. VAT also raises prices, reduces employment and private investment, and comes with compliance costs. Personal income tax is partly passed on to shareholders and consumers through higher wage costs, etcetera. Furthermore, governments do need to get their revenues from somewhere. Competition hardly affects this. Voters and bond markets, not multinationals, are the primary brakes on public profligacy.

There's no reason, then, to assume that less corporate tax is always good. It depends on the alternative. A combination of moderate corporate taxes and VAT probably causes a smaller drag on economic activity than a revenue-equivalent combination of no corporate taxes and a high VAT, for example. Moreover, different types of taxes have different effects on the behaviour of economic agents and on the distribution of income and wealth. For instance, reducing corporate tax relative to wage taxes will lead to more capital-intensive production methods and hence less employment at a given level of economic activity. A good tax mix is a balancing act.

Countries do compete to attract internationally mobile businesses, though. Therefore the corporate tax policy of one country affects the policy choices of other countries. That's where the trade policy parallel comes in.

Many governments have used import tariffs to provide domestic companies with a competitive advantage. However, when other governments respond by doing the same, the outcome can be rather ugly. With high tariffs everywhere, competition between firms is highly distorted, international trade is strangled, and countries don't specialize in producing what they are relatively good at. The classical solution is to limit tariffs through trade agreements, preventing mutually damaging trade wars.

Corporate tax cuts trigger similar interactions. Countries like Indonesia and Viet Nam, or Kenya and Ethiopia, have been trying to compete for large foreign investment projects by granting large tax holidays. Other countries, like the Netherlands and Belgium, or Singapore and Hong Kong, have used special tax regimes to lure corporate headquarters. Countries mainly compete within their own league; tax breaks cannot make up for poor governance, weak infrastructure, or low productivity. However, the trend of replacing discriminatory tax advantages with lower rates for all companies that meet certain substance requirements, induced by the success of BEPS Actions, is global.

This produces an ugly outcome too. Tax competition hardly increases the total number of large investment projects or corporate headquarters, while it dramatically reduces the corporate tax revenues of all countries combined. The corresponding solution is to limit tax competition through an agreement on minimum taxes. Paradoxically, by reducing international pressure, this would give many countries greater sovereign control over their domestic tax mix than they have at present.

Of course, trade theory doesn't say that all tariffs are bad. Redistributive effects matter too: trade measures may have opposite effects on producers and consumers, or capital owners and workers. In addition, protective trade measures can be part of sensible broader policies to stimulate development over time. Also, tariffs are not the full story. Governments may resort to subsidies or other means to provide certain companies with a competitive advantage.

Such nuances apply to tax policy as well. If corporate tax holidays or low effective tax rates are disabled, some governments may indeed boost other incentives, such as capital expending, or subsidies. Still, this may be an improvement. The tax benefits of capital expending are limited by the size of tangible investments, for example, and subsidies are more likely than tax exemptions to receive the same amount of scrutiny as other public expenditures. Therefore preventing excessive tax rate competition should be a key goal of international tax policy.

But what about capital import neutrality? In small or oil-rich countries with zero profit taxes, foreign investors subject to a minimum tax rule will face an unfair disadvantage compared to domestic competitors. That has no equivalent in trade policy.

True, but this point should not be exaggerated. Arguably, the special circumstances of some twenty countries with zero rates or without corporate taxes, representing less than 2% of the world economy, should not stand in the way of a solution for the other 98%. Larger Arab states might prefer being subject to minimum tax rules over ending up on a blacklist. For small island economies, a country-level *de minimis* threshold for foreign profits covered by minimum tax rules could do the job.

Other design issues are more challenging. What is the best way to assess effective tax rates, striking a balance between simplicity and accuracy? What flexibility is needed to make the rules work for different countries, including developing countries with limited administrative capacity? And how to coordinate different elements of minimum tax rules, including backup measures?

Let's move the debate to such design questions. As a result of progress against BEPS, the need for a minimum effective tax rate has become urgent. We have the choice between working towards a robust global solution now, or waiting for countries to implement uncoordinated measures, like the US and Germany have already done. In fact, we have no time to lose.