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International tax reform and FDI*

by

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PMNEs are a key feature of today's globalized economy. In recent years, the issue of MNE tax avoidance, also known as Base Erosion and Profit-Shifting (BEPS), has been high on the international policy agenda. In 2015, the OECD estimated that BEPS cost countries US$100-240 billion annually, or about 4-10% of total global corporate income tax revenues.[1]

The digitalization of the economy has exacerbated BEPS risks by allowing MNEs to locate more easily some of their profits in jurisdictions where they have little or no real activity. In addition, digitalization has also enabled companies—and not only tech companies—to derive an increasing share of their profits from markets where they have no physical premises and no employees. There is now widespread agreement amongst countries and academics that the current international tax rules, developed in 1923, must be adapted to the current economy, ensuring that all businesses pay tax where they have activities and earn their profits, including where digital businesses participate in the economy of a country without physical presence.

International corporate taxation and BEPS activity are important drivers of FDI across countries. Both domestic corporate tax rates and international tax frameworks (e.g., tax treaties)[2] can substantially impact FDI. The literature also suggests that substantial FDI-shares is pass-through investment,[3] evidencing tax planning structures.

With the support of the G20, the OECD has brought together more than 135 jurisdictions within the G20/OECD Inclusive Framework on BEPS to work on overhauling the international tax rules facing MNEs. A 15-point Action Plan was developed and enacted between 2012 and 2015 to address BEPS, and global implementation has been underway ever since.[4] In light of increasing public pressure around profit-shifting, in 2017 the G20 mandated the OECD to renew multilateral discussions within the Inclusive Framework to address the tax challenges of digitalization. Countries are now actively negotiating a consensus-based solution to address these tax challenges by the end of 2020.

The ongoing work is built around a two-pillar approach and involves multiple public consultations with stakeholders, including businesses, academia and civil society. Pillar One aims at expanding the taxing rights of market jurisdictions (which, for some business models, is the jurisdiction where the user of a digital service is located) over certain defined business activities in exchange for improved tax certainty and removal of certain unilateral measure such as digital services taxes. Pillar Two (also referred as the Global Anti-Base Erosion or "GLoBE" proposal) focuses on the remaining BEPS risks and seeks to entitle jurisdictions to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

While many details remain the subject of ongoing negotiations, the OECD secretariat has presented a preliminary economic analysis illustrating—through some stylized scenarios—how the proposals could change tax revenues and investment levels. In October 2020, the Inclusive Framework released detailed Blueprint reports for Pillar One and Two.

Many caveats characterize this kind of economic analyses, which rely on assumptions concerning many parameters of the reforms that have yet to be decided at a political level. In addition, the modelling relies on assumptions about countries and firms' behavioral responses, which are subject to significant uncertainty. The results suggest that Pillar One is unlikely to have significant effects on global investment levels. Pillar Two may increase effective tax rates for some MNEs, especially those engaged in aggressive tax avoidance. Importantly, both Pillars would reduce the effective tax rates dispersion and reduce MNEs' profit-shifting incentives. This would be particularly beneficial for low and middle-income countries that often experience great losses from profit-shifting. An effective minimum level of corporate tax paid would also allow these countries to reconsider their domestic tax policies. Ineffective and inefficient tax incentives leading to effective tax rates below the minimum rate would become less appealing after the implementation of the reforms, as firms using incentives to lower their effective tax rate below the minimum tax rate would be subject to top-up tax. Also, the package should provide greater tax certainty—thus not adversely affecting the global investment environment overall—as opposed to the situation in which the absence of a consensus-based solution leads to uncoordinated and unilateral measures and risk of further tax and trade disputes.

The Blueprint reports and additional economic analysis will provide a solid foundation for a future agreement. If Inclusive Framework members will implement the two Pillars, international tax policies will significantly change. Implementing these policies is important, as it would modernize the international tax rules, improve tax certainty, reduce BEPS behaviors, and provide additional tax revenues.

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[1] OECD, "Measuring and monitoring BEPS, Action 11 – 2015 Final report," in *OECD/G20 Base Erosion and Profit Shifting Project* (Paris: OECD, 2015).
[2] Bruce A. Blonigen, Lindsay Oldenski and Nicholas Sly, "The differential effects of bilateral tax treaties," *American Economic Journal: Economic Policy*, vol. 6 (2014), pp. 1-18.
[3] Jannick Damgaard, Thomas Elkjaer and Niels Johannesen, "What is real and what is not in the global FDI network?," *IMF Working Paper* (2019) .
[4] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013).

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