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## OECD Launches New Effort to Undermine Tax Competition

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The Organization for Economic Cooperation and Development (OECD) is an international organization that collects statistics and publishes economic reports. In recent years, however, the Paris-based bureaucracy has also ventured into policy activism, with a strong bias toward expanding the burden of government.

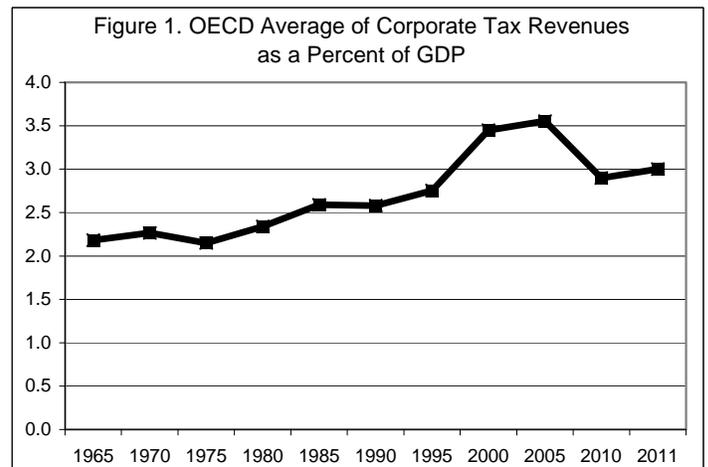
A new OECD study, “Addressing Base Erosion and Profit Shifting,” (BEPS), is very troubling in this regard as it proposes to expand the international taxing powers of governments.<sup>1</sup> Even though the BEPS report notes that corporate tax revenues have trended higher, it calls for dramatic changes in corporate tax policy based on the presumption that governments are not seizing enough revenue from multinational companies.

The OECD essentially argues that it is illegitimate for businesses to shift economic activity to jurisdictions that have more favorable tax laws. The report was produced in “response to calls by the German, UK and French finance ministers for coordinated action.”<sup>2</sup> However, such coordinated action to raise taxes would come at the expense of economic freedom and economic growth.

### Where’s the Problem?

The core accusation in the OECD report is that firms systematically—but legally—reduce their tax burdens by taking advantage of differences in national tax policies. Yet the report acknowledges that “... revenues from corporate income taxes as a share of gross domestic product have increased over time.”<sup>3</sup> Figure 1 shows the upward trend in average corporate tax revenues in the OECD. That increase has occurred despite dramatic cuts to statutory corporate tax rates since the 1980s in most countries.

Other than offering anecdotes, the OECD provides no evidence that a revenue problem exists. In this sense, the BEPS report is very similar to the OECD’s 1998 “Harmful Tax Competition” report, which asserted that so-called tax havens were causing damage but did not offer any hard evidence of any actual damage.<sup>4</sup>



Source: Organization for Economic Cooperation and Development.

The new OECD report calls for more tax rules on companies but does not acknowledge that governments already have immense powers to restrict corporate tax planning through “transfer pricing” rules and other regulations. Moreover, there is barely any mention of the huge number of tax treaties between nations that further regulate multinational taxation.

### Will the OECD Push for Formula Apportionment?

The OECD report does not propose any specific policies, but says that it will soon make recommendations to achieve “tax fairness” using a “holistic approach.”<sup>5</sup> The paper talks about a “comprehensive action plan” based on “collaboration and coordination” to “provide countries with tools, domestic and international.”<sup>6</sup>

That sounds like empty buzzwords, but the OECD hints at its intended outcome when it says that the effort “will require some ‘out of the box’ thinking” and that business activity could be “identified through elements such as sales, workforce, payroll, and fixed assets.”<sup>7</sup> That language suggests that the OECD intends to push global formula apportionment, which means that governments

would have the power to reallocate corporate income regardless of where it is actually earned.

Formula apportionment is attractive to governments that have punitive tax regimes, and it would be a blow to nations with more sensible low-tax systems. Under the type of system the OECD is likely developing, business income currently earned in tax-friendly countries, such as Ireland and the Netherlands, would be reclassified as French-source income or German-source income based on arbitrary calculations of company sales and other factors.

### Grabbing More Revenue

The OECD report claims that corporate tax planning is causing “massive revenue losses,” but there is no evidence of that, as Figure 1 illustrates. Nonetheless, some governments support the BEPS project as something that could lead to big revenue gains.

Switching to formula apportionment would increase tax revenues. One 2007 study found that “...such a change is likely to generate substantial additional U.S. government revenue. ... an increase of approximately \$50 billion.”<sup>8</sup> Another study estimated that “...an equal-weighted, three-factor formula would have increased their U.S. tax liabilities by 38 percent.”<sup>9</sup>

With a switch to formula apportionment, nations with high tax rates would likely gain revenue, while jurisdictions with pro-growth systems would be losers, including Ireland, Hong Kong, Switzerland, Estonia, Luxembourg, Singapore, and the Netherlands.

### Undermining Competition and Increasing Taxes

Formula apportionment would result in corporations paying higher taxes to some countries and perhaps lower taxes to other countries. However, formula apportionment would be worse than a zero-sum game because it would create a web of regulations that would undermine tax competition and become increasingly onerous over time.

Consider that tax competition has spurred OECD governments to cut their corporate tax rates from an average of 48 percent in the early 1980s to 24 percent today.<sup>10</sup> If a formula apportionment system had been in place, the world would have been left with much higher tax rates, and thus less investment and economic growth.

Another problem is that formula apportionment could lead to an overstatement of the tax base. If governments gain the power to define global taxable income, they will have incentives to rig the rules to unfairly gain more revenue. For example, governments could move toward less favorable, anti-investment depreciation schedules, which would harm global growth.

### Advantages of Reducing the Corporate Tax Rate

Nowhere in the BEPS report is there any discussion of the harmful effects of the corporate income tax. That is remarkable, given that, in a separate report on taxes and the economy, the OECD concluded that “corporate taxes are found to be most harmful for growth.”<sup>11</sup> As such, nations should not be hiking corporate taxes, but reducing them further to boost their struggling economies and improve standards of living.

The new OECD report does not acknowledge that the supposed BEPS problem is really a function of high tax rates in some nations. Nor does it discuss how tax compliance would automatically improve if nations moved to neutral tax regimes that ended tax system distortions, such as the double taxation of corporate earnings.

### Conclusion

The OECD complains that “... governments are often under pressure to offer a competitive tax environment,” and that “failure to collaborate ... could be damaging in terms of ... a race to the bottom with respect to corporate income taxes.”<sup>12</sup> In other words, the OECD is admitting that the BEPS project seeks higher tax burdens and the curtailment of tax competition. But that misguided pursuit flies in the face of the OECD’s own advocacy elsewhere of more efficient tax systems with lower corporate tax rates.

<sup>1</sup> Organization for Economic Cooperation and Development, “Addressing Base Erosion and Profit Shifting,” February 2013.

<sup>2</sup> Vanessa Houlder, “OECD Presents Plan to Close Tax Loopholes,” *Financial Times*, February 12, 2013.

<sup>3</sup> OECD, p. 16

<sup>4</sup> For a discussion of that report, see Chris Edwards and Daniel J. Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008).

<sup>5</sup> OECD, p. 50.

<sup>6</sup> OECD, p. 51.

<sup>7</sup> OECD, p. 20.

<sup>8</sup> Kimberly Clausing and Reuven Avi-Yonah, “Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment,” Brookings Institution, June 2007.

<sup>9</sup> Douglas Shackelford and Joel Slemrod, “The Revenue Consequences of Using Formula Apportionment to Calculate U.S. and Foreign-Source Income: A Firm-Level Analysis,” *International Tax and Public Finance* 5, no. 1 (1998): 41–59.

<sup>10</sup> Kevin Hassett and Aparna Mathur, “Report Card on Effective Corporate Tax Rates,” American Enterprise Institute, February 2011.

<sup>11</sup> Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia, “Taxation and Economic Growth,” Economics Department Working Paper, OECD, July 3, 2008.

<sup>12</sup> OECD, p. 48.