Chapter 6

HOW TO STOP THE SPIRAL

In 2019, the International Monetary Fund asked a slate of experts for their views on the future of corporate taxation and tax competition. Most of the fund's interlocutors answered that tax competition was "likely to intensify" in the foreseeable future.[1] Since each nation has a sovereign right to choose its form of taxation, who could possibly force tax havens to stop their dumping? Some countries, the experts agreed, will always offer lower taxes than their neighbors if it's in their interest to do so. Mobile profits will seek the lowest tax burden. There may be ways to fix egregious forms of abuse. But taxing multinational companies at high rates? In a more and more tightly integrated global economy? Hopeless.

This view is wrong. There is nothing in globalization that requires that the corporate tax should disappear. The choice is ours. The race to the bottom that rages today is a decision we've collectively made—perhaps not fully consciously or explicitly, certainly not a choice that was debated transparently and democratically, but a choice nonetheless. We could have chosen to coordinate, and we've chosen not to. We could have chosen to prevent multinationals from booking profits in low-tax places, but we let them do it. We can make other choices, starting today.

WHY HAVE COUNTRIES FAILED SO FAR TO COORDINATE?

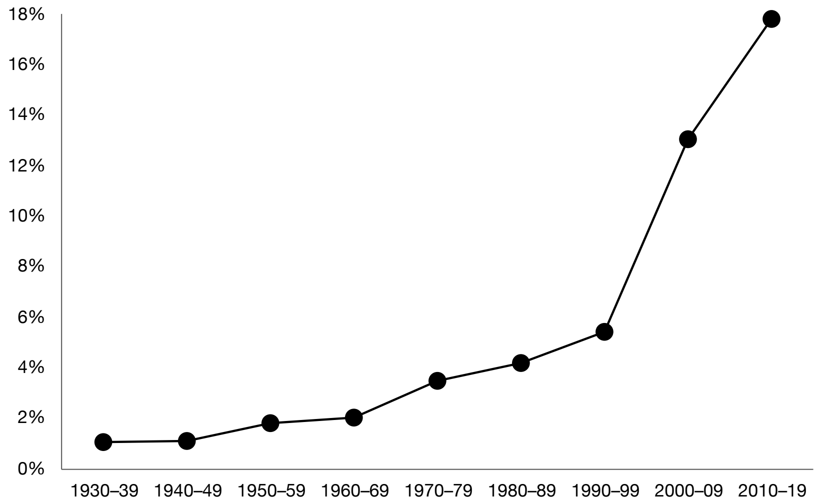
To see how we could escape our current predicament, we must start by understanding why we have failed, so far, to address the fiscal challenges presented by globalization.

There are, to start with, a number of relatively benign and circumstantial explanations. Financial globalization is a recent phenomenon. Close to 20% of the world's corporate profits are made by companies outside of the country where they are headquartered today.[2] Before the 2000s, that figure was less than 5%. Whether this modest amount of profits was appropriately taxed or not didn't matter much for public coffers, and so few people—in academia or in the policy world—cared. That's how the surge in multinational profits caught people off guard. In ministries of finance, the default assumption was that the 1920s-era system of transfer pricing would hold up. This assumption, as we saw in the previous chapter, was far too optimistic. But few people had thought about which system could replace it. This cluelessness allowed firms to exploit frailties in the law with quasi-impunity.

It also took time for the scale of corporate tax dodging to become clear, for the simple reason that the activities of multinational corporations are opaque. Companies are generally not required to publicly disclose in which countries they book their profits. In its annual report to the US Securities and Exchange Commission, Apple provides information on its worldwide consolidated profits. But the Cupertino-based giant doesn't publicly reveal *where* it books these profits—how much are booked in its Irish subsidiary (and thus taxed in Ireland), in Germany, or in Jersey. There is no way for the public to know how much money Apple shifts to tax havens. The same is true of most other giant multinationals.

6.1 THE RISE OF MULTINATIONAL PROFITS

(Percentage of global profits made by firms outside of the country where they are headquartered)



Notes: The figure depicts the evolution of the share of global corporate profits that are made by corporations outside of the country where they are headquartered. Decades ago, this share was small (less than 5%) but it has grown over the last two decades to about 18% in the 2010s. Complete details at *taxjusticenow.org*.

Ignorance is too convenient a culprit, however. No enhanced data sources or special wisdom are needed to realize the dramatic decline in corporate tax rates. Beyond simply not knowing, there are less benign explanations for the choices that were made.

First among these is successful lobbying by the tax-dodging complex. The transfer pricing industry lives by the system of corporate taxation created in the 1920s; it has a vital stake in preserving it. For example, if companies, instead of being taxed subsidiary by subsidiary, were taxed as consolidated entities, there would be no point in computing the prices of transactions between subsidiaries. The transfer pricing industry would become obsolete overnight.

The stakes are huge: today, 250,000 people work as transfer pricing professionals in private firms, either in the Big Four or as direct employees of multinationals.[3] It would be naïve to think that they are passive bystanders when it comes to the policies that condition the existence of their livelihoods.

The tax-dodging industry also has a vested interest in ensuring as little international coordination as possible. If all countries had the same tax rate, after all, firms would not care about shifting profits from one place to the other; there would be no point in moving patents across subsidiaries; no reason to borrow money from affiliates in Luxembourg. The corporate tax policy of Bermuda is a bane for the world, but it is a boon to PricewaterhouseCoopers. The Big Four would rather have you believe that tax competition is inevitable, or good, or both. Without tax competition their business wouldn't be much of a business.

Their lobbying has been legitimized by the view that tax competition in and of itself is a good thing—without it, governments would be too big. According to this world view, defended by political scientist Geoffrey Brennan and economist James Buchanan among others,[4] democratically elected majorities tend to overtax property owners, who then become victims of the tyranny of the majority. To prevent this risk, governments need to be subject to powerful constraints, such as the one imposed by international competition. The idea fits into a long intellectual tradition that seeks to curtail democracy—especially the democratic regulation of property—via nondemocratic institutions, such as constitutional rules and courts.

At its core, the notion that the power to collect taxes needs to be subject to checks and balances is not absurd. We can debate the proper way to design tax policy, and constitutional and legal constraints certainly have a role to play. The view that tax competition is a boon, however, pushes mistrust in democracy to a new level: Courts, constitutions, checks and balances—none of them are enough. We need Bermuda to protect us from the tyranny of the majority and tame the Leviathan; even rules frozen in constitutional marble might risk falling short of safeguarding property. According to this view, when it comes to taxation, people are unable to govern themselves rationally.

Although it can be tempting to dismiss this theory as a fringe libertarian fantasy and an American oddity, it would be a mistake to underestimate its influence. The ideology has made an impression beyond America, including in the European Union. By requiring the unanimity of all member states for any common tax policy, the Treaty on European Union—the closest thing the European Union has to a Constitution—casts tax competition in stone. Any country, no matter how small, can block efforts at harmonizing tax rates within the union. Luxembourg (population: 600,000) can dictate its will to 500 million Europeans. Given the divergent economic interests of small and large European nations (with the smaller ones having a lot to win from tax competition), this rule de facto prevents any form of tax coordination. Although it's rarely formulated explicitly, the underlying rationale appears to be that the European welfare states are too large and that tax competition is required to make them more frugal. Democracy, in this world view, is insufficient to the task. Even the elaborate post-democratic European institutions (the unelected, impartial policymakers of the European Commission) would be unable to rein in social spending. Italy needs Malta to become more sparing; France needs Luxembourg; Greece needs Cyprus.

In the real world, the costs of tax competition far outweigh its supposed benefits. As we've seen, there is no progressive income tax possible without a strong enough corporate tax, because with low corporate rates, rich people morph into companies and transform the income tax into a (hardly enforceable) consumption tax. And without progressive income taxation, our chances to address rising inequality are close to nil. There are certainly an array of policies that can help reduce inequality, from raising the minimum wage to reforming corporate governance, equalizing access to higher education, better regulating intellectual property, and curbing the excesses of the finance industry. But the progressive income tax has historically been the most potent tool to curb the concentration of riches.[5]

As peoples, and as interconnected nations, we're at a crossroads. Down the path of tax competition, tax injustice will prosper and inequality will keep rising. Fortunately, there are other, equally feasible paths. Halting the spiral of tax competition is possible: it is anything but utopian to expect that big multinational corporations will pay a decent amount of tax soon. An effective action plan has four pillars: exemplarity; coordination; defensive measures; and sanctions against free riders.

EACH COUNTRY MUST POLICE ITS MULTINATIONALS

Exemplarity, first, means that each country should police its own multinationals. The United States should make sure that US companies, if they don't pay enough abroad, at least pay their dime in America. Italy should do the same with Italian firms, and France with its own national champions.

To understand how this could work, let's consider a concrete example. Imagine that, by shifting intangibles and manipulating intragroup transactions, the Italian automaker Fiat had managed to make $1 billion in profits in Ireland—taxed at 5%—and $1 billion in Jersey, one of the Channel Islands—taxed at 0%. There's a problem here: Fiat pays much less tax than it should; much less, in particular, than domestic Italian businesses. We call this a *tax deficit*. The good news is that nothing prevents Italy from curbing this deficit itself, by collecting the taxes that tax havens choose not to levy. Concretely, Rome could tax Fiat's Irish income at 20%. It could tax its Jersey bounty at 25%. More generally, it could easily impose *remedial taxes* such that Fiat's effective tax rate, in each of the countries where it operates, equals 25%.

Such a reduction of Fiat's tax deficit would not violate any international treaty. It does not require the cooperation of tax havens. And what's perhaps more surprising, it doesn't even require new data: the necessary information exists. Under the pressure of civil society organizations, the veil of secrecy surrounding the activities of multinational companies has started to lift. As part of the OECD's base erosion and profit-shifting initiative, big companies are now required to report their profits and taxes on a country-by-country basis. Oh, we're still far from total financial transparency: these country-by-country reports are not public; they're only available to tax authorities. But they exist: Apple must now report to the IRS how much income it earns in each of the world's countries; L'Oréal must report similar information to France, and Fiat to Italy. About seventy-five countries have started collecting that information or promised to do so in the immediate future, including all large economies.[6]

This seems like a mundane tax administration issue until you realize that, thanks to this rich new information source, it has never been easier for big countries to police their own multinationals. The United States, France, Italy: any country could ensure its corporate champions pay a minimum tax rate of say 25% wherever they operate. Any country can in effect serve as the tax collector of last resort for its own multinationals. Apple pays 2% in Jersey? The United States could collect the missing 23%. The Paris-based luxury group Kering books profits in Switzerland, taxed at 5%? Paris could levy the missing 20%. Such a policy would immediately remove any incentive for multinationals to book profits in tax havens. They would still pay zero taxes on the profits booked in Bermuda, but it would be pointless since any tax saving would be fully offset by higher taxes at home.

Policing multinational companies this way would bring large sums home. Using tabulations of the 2016 country-by-country reports of US companies published for the first time by the IRS in 2019, we can compute how much America would collect if it levied remedial taxes on its multinationals. In 2016, large US companies made about $1.3 trillion in profits globally. On that sum they paid $262 billion in tax (to the United States and to foreign governments), corresponding to a global average effective tax rate of 20%. But in many countries they paid much less: 0% on the $22 billion they booked in the Bahamas, 0% too on the $24 billion booked in the Cayman Islands, 2% on the $39 billion shifted to Puerto Rico, etc. By imposing a 25% country-by-country minimum tax, the United States would have collected close to an extra $100 billion in revenue all else being equal in 2016—equivalent to increasing the global effective tax rate of US multinationals by seven points, from 20% to 27%.[7]

Of course, if such a remedial tax had been in place in 2016, US companies would have booked fewer earnings in Bermuda and more in high-tax countries (this is, after all, the whole point of this policy). Some of the Bermuda bounty would have been booked and taxed in the United States, increasing Uncle Sam's revenue. But some would also have been booked in Germany and France, which means that the United States would have collected less than $100 billion in extra revenue by applying the remedial tax we describe. The important point is that US firms—and ultimately their shareholders, the majority of whom are Americans—would have been compelled to pay $100 billion more globally. Moreover, the United States would benefit from remedial taxes imposed by other countries: if France tomorrow applied a minimum tax to its national champions, French firms would reduce their earnings in Luxembourg and report more income in the United States, boosting Uncle Sam's coffers.

Is it realistic to expect big countries to start policing their multinationals in the foreseeable future? Very much so, for it is in their interest. Unlike trade, tax competition makes some countries win and others lose, and all large economies are in the losers' camp. They have a clear incentive to stop this shell game. As we saw in Chapter 4, small countries that apply tiny tax rates collect a lot of corporate income tax revenue as a fraction of their national income. They benefit handsomely because they attract a huge amount of foreign profits relative to their domestic tax base. But large countries do not have anything to gain by emulating this strategy. Yes, they might attract foreign profits by slashing their rates. But unlike smaller countries, any gains from foreign profits would be swamped by the amount of tax revenue they lost after taxing their domestic business sector at the reduced rate. In the end, whenever they slash their rates, large countries are certain to collect less corporate tax revenue overall. For a striking illustration, look no further than the US tax cut of 2018, which reduced federal corporate income tax revenue by a whopping 45%.[8] Unlike Malta, the United States will never boost its government's coffers by becoming a tax haven.

And here's the catch: because almost all multinational companies are headquartered in large economies, lawmakers in Rome, Berlin, and Washington can whistle the end of the game by collecting remedial taxes on profits booked by their multinationals in low-tax countries.[9]

A first key lesson: the spiral of international tax competition can be stopped even if tax havens do not increase their tax rates. Small countries may have a gigantic interest in applying low rates, but that's not an obstacle to other individual countries raising the effective taxation of corporate profits here and now.

INTERNATIONAL COORDINATION, NOW!

At this point you probably want to know what would happen if big countries really did police their multinationals and started acting as tax collectors of last resort. Wouldn't Fiat, Apple, and L'Oréal move their headquarters to tax havens? Fortunately, there is more than one way to address this threat—most importantly through international cooperation.

As we have seen, most countries have already agreed to harmonize their laws to limit the most blatant forms of profit shifting. The obvious next step is for big countries to agree on a common minimum tax: G20 countries (which include all the world's largest economies) could all agree that they will apply a 25% minimum tax rate to their multinationals, wherever they operate. These countries already have the information necessary to apply this minimum tax. And it's in their interest to take up the job of tax collector of last resort. Strange as it may seem, and although tax competition has intensified in recent years, a solution appears within reach.

A mutually agreed minimum tax among G20 countries would not solve all the problems. Companies could still dodge taxes by moving their headquarters to tax havens. This issue looms in the public debate. In the United States, the specter of "tax inversions"—US firms merging with foreign companies in Ireland or other low-tax places, and in doing so adopting the nationality of their partner—haunts policymakers.

But the danger is exaggerated. For all the talk about tax inversions, very few firms have moved their headquarters to tropical islands. There have admittedly been some high-profile cases: the consulting company Accenture inverted from Chicago to Bermuda in 2001 (before moving to Ireland in 2009); the financial advisory firm Lazard moved its New York headquarters to Bermuda in 2005; and the dietary supplement company Herbalife has been a proud resident of the Cayman Islands since 2002. According to a tracker of tax runaways maintained by Bloomberg, in total, eighty-five US companies have expatriated between 1982 and 2017 (many of them in the pharmaceutical sector, and most of whom you have never heard of).[10] To that total we can add the handful of firms that have been headquartered in offshore financial centers from the start (or that moved long ago), the most notable of which is probably the oilfield service giant Schlumberger, headquartered in the southern Caribbean island of Curaçao.

All of this sounds pretty concerning, until you realize that it adds up to a drop in the ocean. Among the world's two thousand largest companies, only eighteen are headquartered in Ireland, thirteen in Singapore, seven in Luxembourg, and four in Bermuda today.[11] Close to a thousand are headquartered in the United States and the European Union, while most of the others are to be found in China, Japan, South Korea, and other G20 countries.

The reason few companies invert, despite the incentives to do so, is probably because a business's nationality is not easy to manipulate. The definition of a company's nationality is constrained by strict rules. For instance, once it has been incorporated in the United States, a company cannot simply move its headquarters abroad: any firm that does so continues to be treated as a US company for tax purposes. American firms can only change their nationality in the context of foreign acquisition; that is, by merging with a foreign company. And for these mergers to result in a legally valid inversion, certain conditions must be met—conditions that have been strengthened over time, in particular by President Barack Obama in 2016. Most importantly, there must be a meaningful change in ownership: a US firm cannot become Bermudian by merging with a shell company in the middle of the Atlantic. In practice, it has thus become impossible for American giants to relocate to unpopulated Caribbean Islands. Ever since the Obama regulations (so far preserved by Trump) inversions have come to a complete halt.

A second key lesson: Even with only a handful of big countries on board, international coordination can curb tax dodging. Should G20 countries tomorrow impose a 25% minimum tax to their multinationals, more than 90% of the world's profits would immediately become effectively taxed at 25% or more.

HOW TO COLLECT THE TAX DEFICIT OF TAX DODGERS

International coordination will take time and may remain limited in the foreseeable future. That's why the third aspect of our plan involves defensive measures against corporations headquartered in countries that refuse to take part in international coordination.

Let's take a concrete example: the Swiss company Nestlé. Assume that Switzerland refuses to police its multinationals, perhaps because it believes going rogue is in its national interest, or because its policymakers are captured by wealthy shareholders. Nestlé therefore is taxed at very low rates and Switzerland declines to apply the 25% country-by-country minimum tax. There you have it: a corporate behemoth that dodges taxes and can shift its profits to offshore havens with complete impunity. What should be done?

In a nutshell, high-tax countries should collect the taxes that Switzerland refuses to collect. The simplest mechanism involves apportioning Nestlé's global profits to where the Swiss giant makes its sales. If Nestlé makes 20% of its global sales in the United States, then—whatever the countries where Nestlé employs its workers or has its factories, wherever its headquarters are located, wherever it holds its patents—the United States can assert that 20% of the company's global profits have been made in America and are taxable there. If 10% of Nestlé's global sales are made in France, then Paris can similarly consider that 10% of Nestlé's global profits are taxable in France.

Is this idle fantasy? Not at all, for this is already how most US states collect their own corporate tax revenues. Forty-four states have their own state corporate tax (at a rate of up to 12%, in Iowa) which adds to the federal corporate tax. To determine how much of Coca-Cola's profits are taxable in California, the Golden State's tax authority apportions Coca-Cola's US-wide profits to where the company makes its sales. A few states, such as Kansas, Alaska, and Maryland, use more complicated apportionment formulas that take into account not only the geography of sales, but also the location of firms' properties and employees. But over time the majority of US states have converged on a formula based only on the location of sales. The apportionment of profits is a time-tested mechanism, which is also used by Canadian provinces and German municipalities.[12] Nothing prevents countries (and not only local governments) from applying this system.

In practice, an even more robust mechanism can be used to fight tax dodgers. Instead of apportioning Nestlé's global profits, high-tax countries could apportion Nestlé's tax deficit. Concretely, the United States (and any other nation that wished to do so) would compute Nestlé's global tax deficit—that is, the extra tax that Nestlé would pay if it were subject to an effective tax rate of 25% in each of the countries in which it operates. Then if the Swiss giant made 20% of its global sales in the United States, Uncle Sam would collect 20% of Nestlé's global tax deficit. In effect, the United States and the other countries where Nestlé sells its products would take up the role that Switzerland refuses to play—tax collector of last resort.

This solution, which to our knowledge has never been proposed before, has many advantages.

First, it's immediately doable. As we've seen, information about the country-by-country profits, taxes, and sales of multinational companies already exists. In the case of Nestlé, it's gathered by the Swiss tax authority, but since 2018 it has been automatically exchanged with foreign countries. As of February 2019, according to the OECD, there were over 2,000 pairs of countries exchanging country-by-country reports automatically.[13] France, the United States, and most other countries where Nestlé sells its products already have the information in hand to compute Nestlé's global tax deficit and collect their share of these unpaid taxes. Even if they didn't have the information, they could easily request it. In granting firms access to domestic markets, countries already set all sorts of conditions, such as safety regulations. Nothing prevents adding a bare minimum of accounting transparency to the list.

The second advantage of our solution is that it doesn't violate an existing international treaty. Over the years countries have signed myriad conventions to prevent the risk that firms would be taxed twice. In practice these treaties—and the inconsistencies therein—have opened the floodgates to all sorts of tax dodging. Despite that, many governments and the OECD are still attached to them, and other attempts at reforming corporate taxation have been blocked on the grounds that they would infringe these sacrosanct conventions. But since the defensive tax we propose is collected only to the extent that a firm pays less than the minimum standard of 25%, our solution by construction does not introduce any form of double taxation. As a result, it does not violate double-taxation treaties.

All countries would have an incentive to apply the defensive tax we describe, for the simple reason that each has an interest in being among the tax collectors of last resort. Not doing so would mean leaving money on the table for others to grab! If the countries where multinationals make the bulk of their sales all applied this defensive tax, the tax deficit of each company would be fully apportioned.

Even firms headquartered in Bermuda would face a minimum effective tax rate of 25%. There would be no place to hide.

SANCTIONS AGAINST TAX HAVENS

We should, of course, not underestimate the ingenuity of the tax-dodging complex. Lawyers may find new loopholes in the future. That's why any effective plan of action has a fourth component: sanctions for the tax havens that sell their sovereignty and enable tax dodgers.

Imposing sanctions on uncooperative tax havens is well-founded in economic reasoning. Each country is entitled to its laws, but when these laws have a major negative externality, victims are entitled to retaliate. Refusing to take part in a minimal global standard such as an effective tax rate of 25%, which is not particularly high in international or historical perspective, should be seen for what it is: an extreme form of dumping that fills the coffers of some small states (and more importantly of global shareholders) at the expense of everyone else. Practices of this type must be discouraged, for instance by imposing taxes on financial transactions with uncooperative havens. As we have seen in Chapter 3, the United States has successfully used the threat of taxes on financial transactions to force tax havens to share bank data automatically with the IRS, paving the way for a new form of global cooperation deemed impossible by many. The same approach could be used to convince holdouts to join the common corporate tax standard.

The main argument against this approach has been that taxation is a national prerogative and that pressuring a country to increase its corporate tax rate infringes upon its sovereignty. This is exactly how Switzerland used to defend its bank secrecy and lack of cooperation with other countries' tax agencies, before changing course under American pressure. The United States started pressuring Switzerland after a series of scandals made the scale of offshore abuse apparent. What is key for change to happen is to quantify the size of the negative externality imposed by tax havens on other nations. Now that data are finally becoming available on the amount of profits booked by multinationals in each of the countries where they operate, it becomes possible to estimate by how much, exactly, Ireland's tax policy reduces the tax collection of the United States and France. There is no excuse anymore for ignoring the fiscal externalities that some countries impose on others.

FROM THE RACE TO THE BOTTOM TO THE RACE TO THE TOP

What's a politically realistic path forward? It is probably too optimistic to expect that all G20 countries will agree to police their own multinationals, join the club of tax collectors of last resort, and apply sanctions against tax havens. But it is not unreasonable to hope that at least some will. About half of the world's multinationals are headquartered in the United States and the European Union; these two economies together also account for more than 50% of the world's consumption. If they jointly adopted the system we propose, up to 75% of the world's profits would be taxed at 25% or more: all the profits made by US and European multinationals (50% of global profits), plus up to half of the profits made by all other firms (25%). In our view, an agreement of this nature should be the primary goal for all proponents of transatlantic cooperation in the years to come.

More broadly, the way to make progress politically involves putting tax matters at the center of trade policies. Future trade deals should not be signed unless they contain an agreement on tax coordination. What sense does it make to sign treaties that go to great lengths to protect the property rights of foreign investors—which is what most of free-trade agreements are these days—while ignoring taxes entirely? Ownership cannot come with only rights and no tax duty.

With a high enough tax floor, the logic of international competition would be turned on its head. Once taxes are out of the picture, companies would go where the workforce is productive, infrastructure is high quality, and consumers have enough purchasing power to buy their products. Instead of competing by slashing rates, countries would compete by boosting infrastructure spending, investing in access to education, and funding research. Instead of primarily improving the bottom line of shareholders, international competition would contribute to more equality within countries.

Moreover, nothing would prevent countries from increasing their corporate tax rate above a minimum rate of 25%. To take one example, imagine the United States unilaterally adopts a 50% corporate tax rate tomorrow. Historically, very few US companies have inverted to avoid taxation, even when the US tax rate was significantly higher than the tax rate of other OECD countries, as was the case from the late 1990s until 2018. But let's imagine that, facing a 50% rate, many US firms would be tempted to move their headquarters abroad. Taking it one step further, what if all newly created firms were formed exclusively outside of the United States? In either case Uncle Sam could still collect significant revenues by deploying a defensive tax at a rate of 50%. There is nothing that firms can do to avoid this measure: to the extent that they have sales in America and pay less than 50% abroad, they would have to pay in the United States.

Contrary to what the experts polled by the IMF may believe, globalization does not prevent countries from taxing corporations at high rates. Those who profess that the race to the bottom in corporate income tax rates is natural, that imposing sanctions against tax havens is a crime against free-trade—they are not the defenders of globalization. What will make globalization sustainable is not the disappearance of capital taxation, but its reinvention. It is not competition; it is coordination. It is not free-trade agreements that ignore fiscal issues, but international deals that advance tax harmonization. When people embrace these ideas, it will become apparent that progressive taxation is not doomed to disappear—but that it can be reinvented and expanded in an integrated global economy.