International Tax Competition

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Dhammika Dharmapala

University of Chicago

Tax Competition

- The world has experienced growing economic integration over the last few decades
- One consequence is thought to be that governments' tax policies have become increasingly interdependent
  - Cross-border mobility of investment
  - Tax competition: lowering of tax rates
- **Central insight of the theory of tax competition:** tax competition among governments can make all countries worse off, relative to a coordinated policy

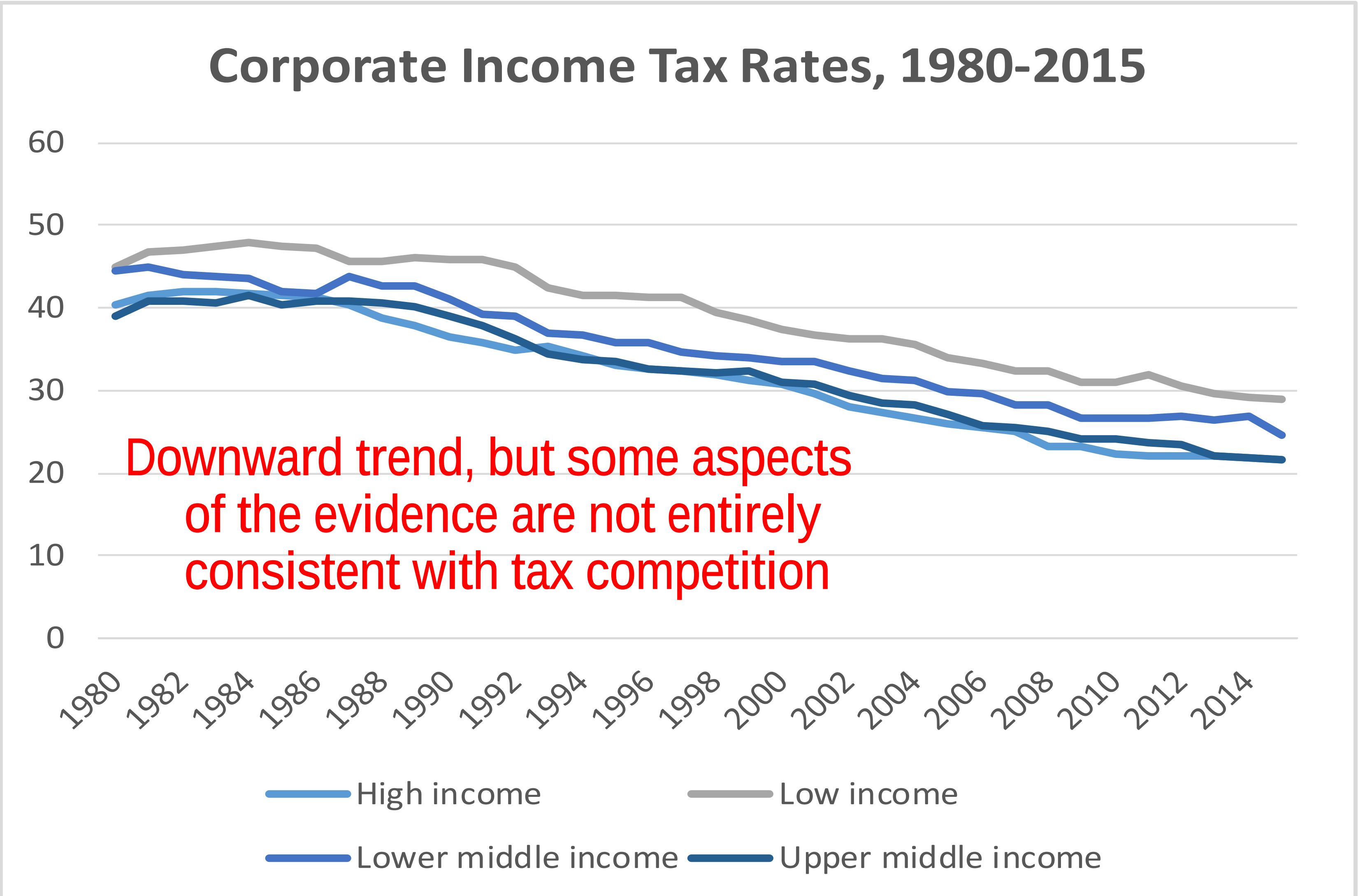
Tax Competition

		Country B	
		High tax rate	Low tax rate
Country A	High tax rate	High revenue High investment	Low revenue Low inv. (A) High inv. (B)
	Low tax rate	Low revenue High inv. (A) Low inv. (B)	Low revenue High investment

Tax competition: the two countries are “trapped” here

Coordination can make them both better off

Tax Competition: Evidence

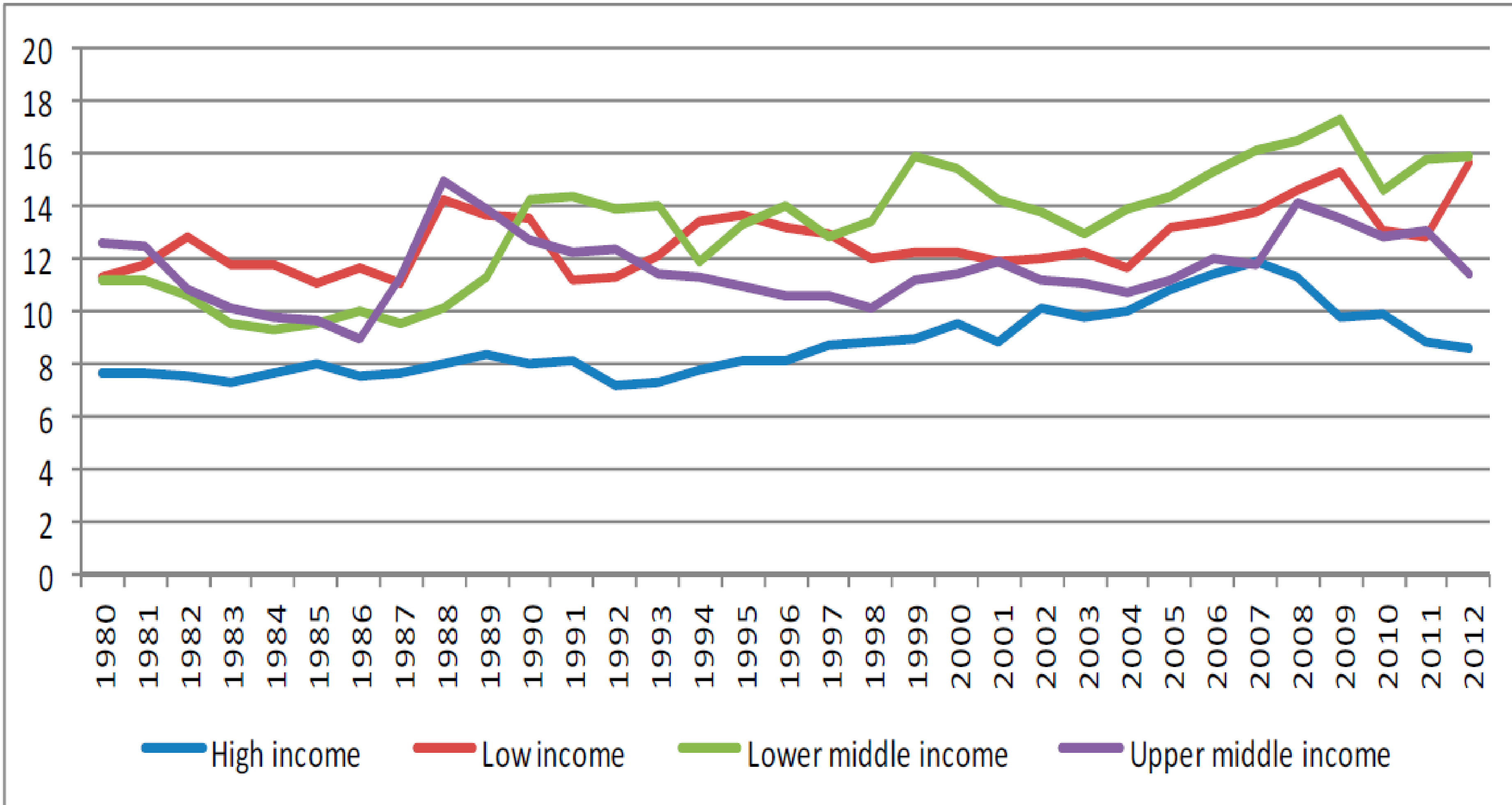


Downward trend, but some aspects of the evidence are not entirely consistent with tax competition

Tax Competition: Caveats

- Corporate income tax revenue is relatively small in many countries
  - . . . and has been robust, despite tax competition
- More important revenue sources – VAT, PIT, social insurance contributions – are much less subject to international tax competition
- The wider benefits of global economic integration should not be forgotten
  - Growing global prosperity
  - Decreasing global inequality

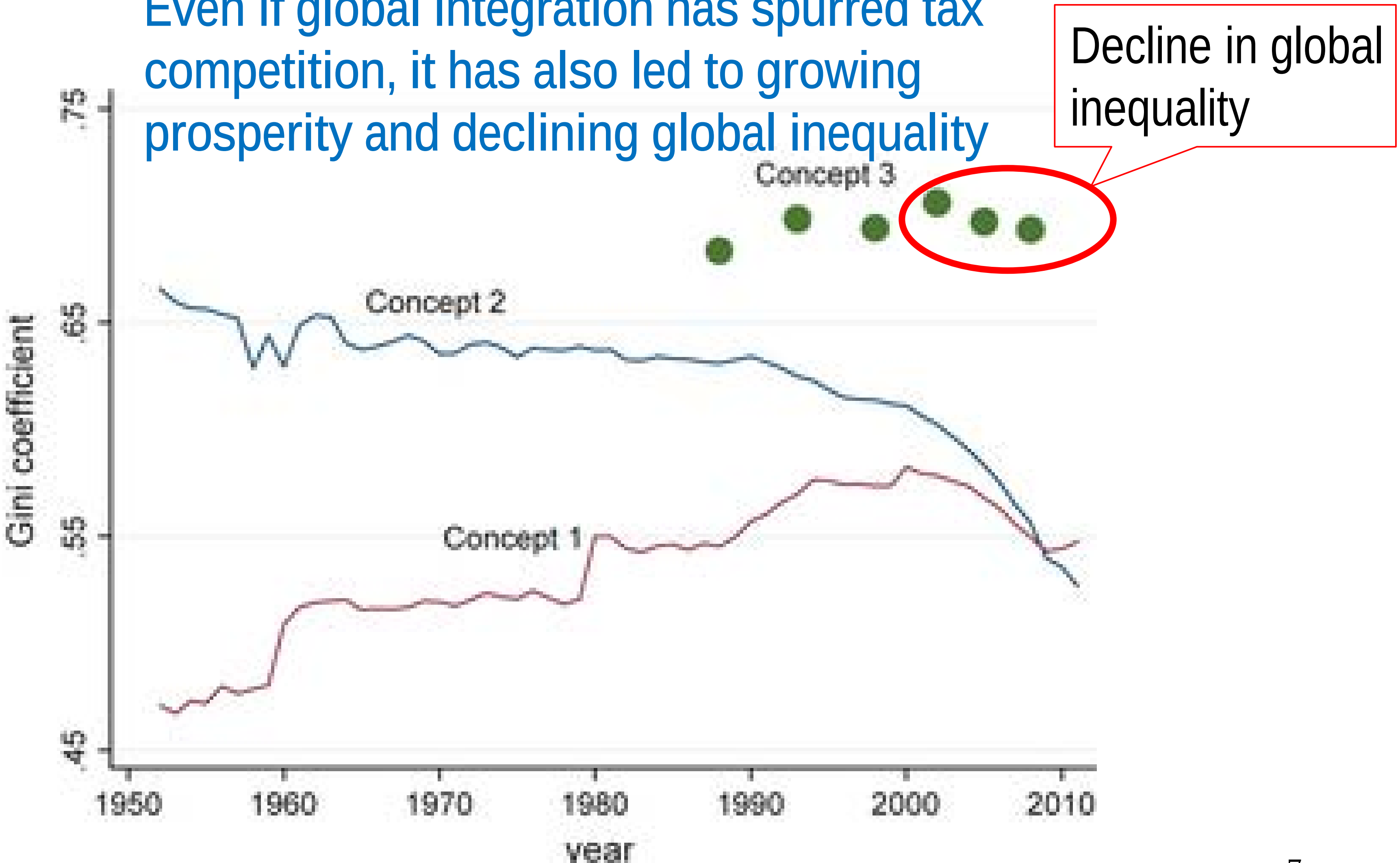
Figure 1. Revenue from the Corporate Income Tax in Percent of Total Revenue



Source: IMF staff estimates.

Milanovic (2013)

Even if global integration has spurred tax competition, it has also led to growing prosperity and declining global inequality



Tax Competition and Tax Incentives

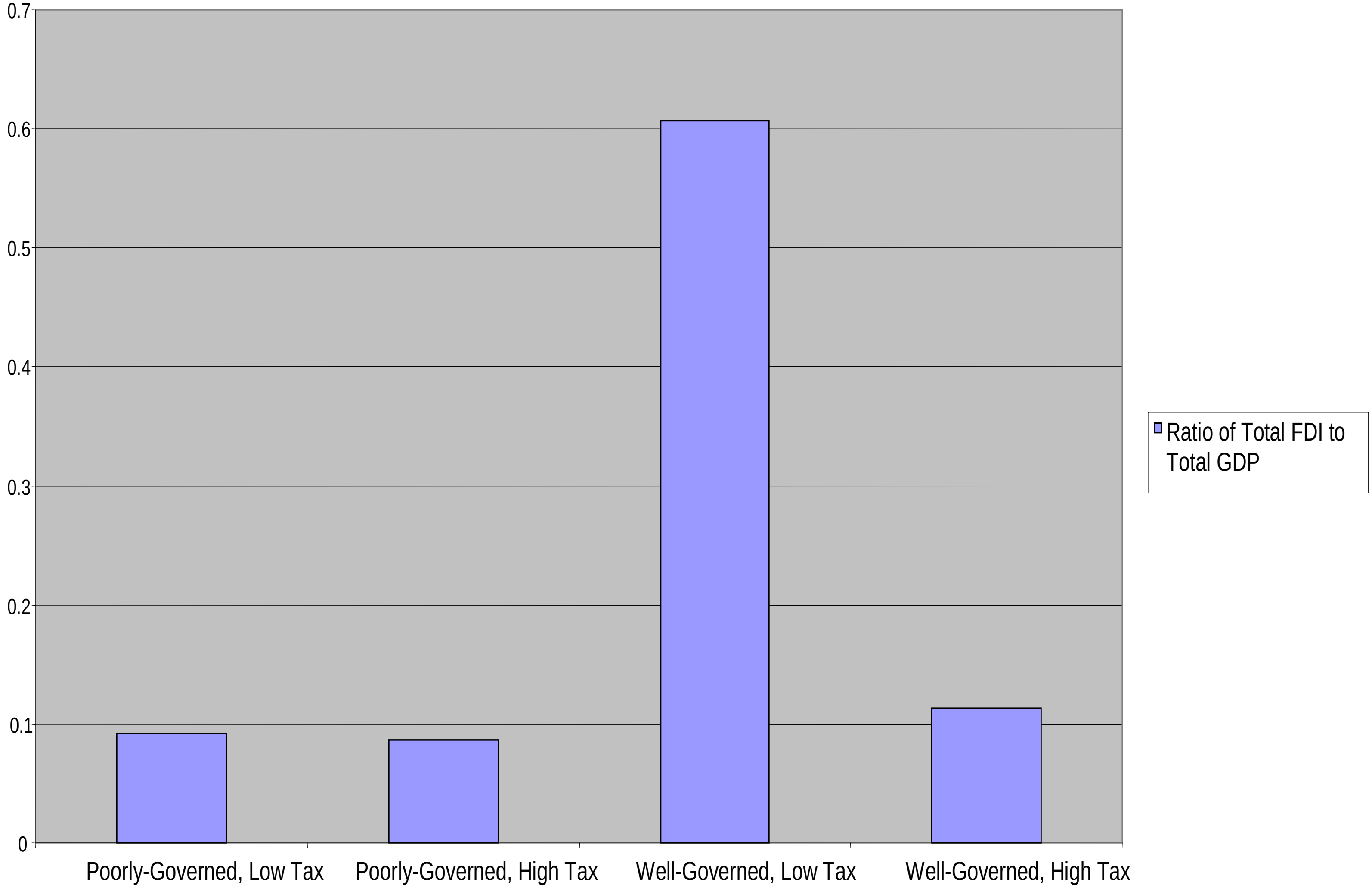
- Developing countries often offer tax incentives to MNCs to encourage inbound FDI

- Justifications are based on positive externalities and information asymmetries, but remain controversial

- De Mooij and Ederveen (2003): Meta-analysis → tax rate elasticity of −3.3
  - i.e. a 1% point reduction in the host-country tax rate raises FDI in that country by 3.3%

- But, note the mediating role of institutions in this effect
  - Dharmapala and Hines (2009)

Ratio of US FDI to GDP for 4 Groups of Countries



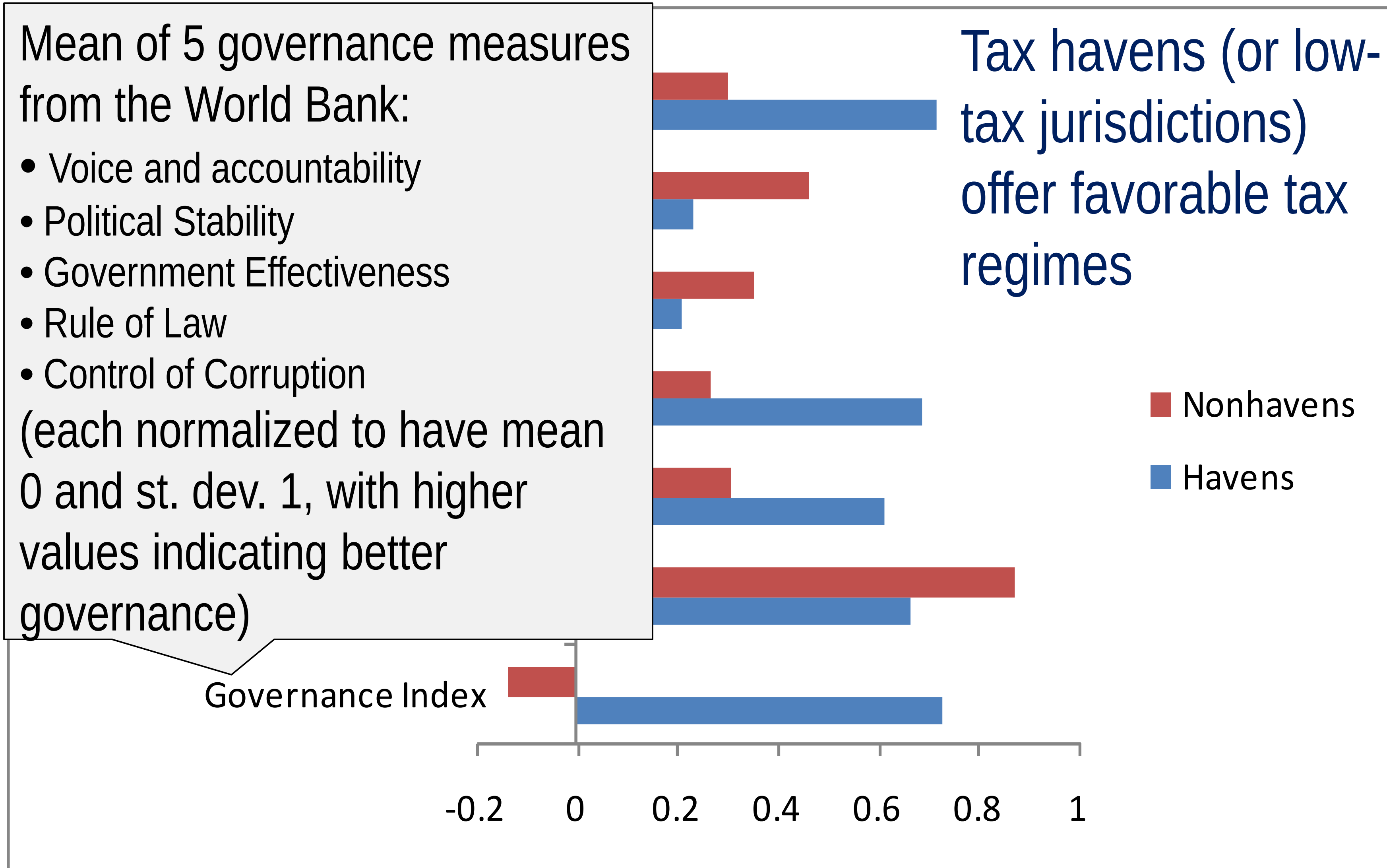
Tax Competition and Tax Havens

Mean of 5 governance measures from the World Bank:

- Voice and accountability
- Political Stability
- Government Effectiveness
- Rule of Law
- Control of Corruption

(each normalized to have mean 0 and st. dev. 1, with higher values indicating better governance)

Tax havens (or low-tax jurisdictions) offer favorable tax regimes

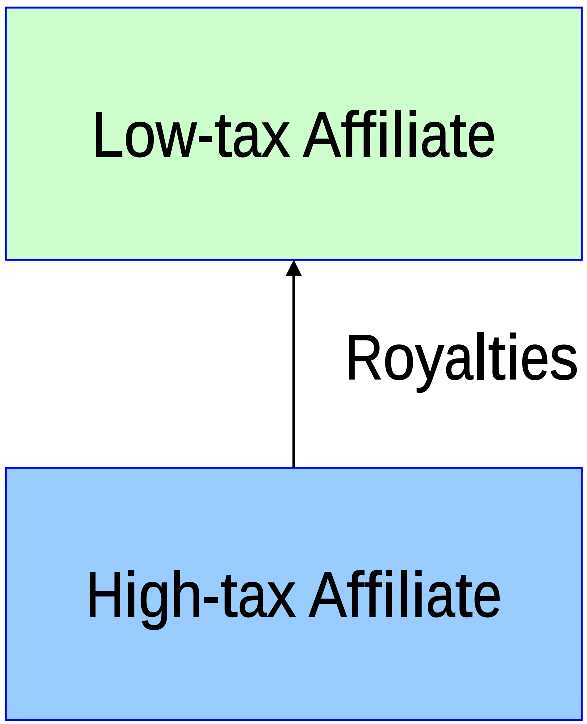


Tax Competition and Tax Havens

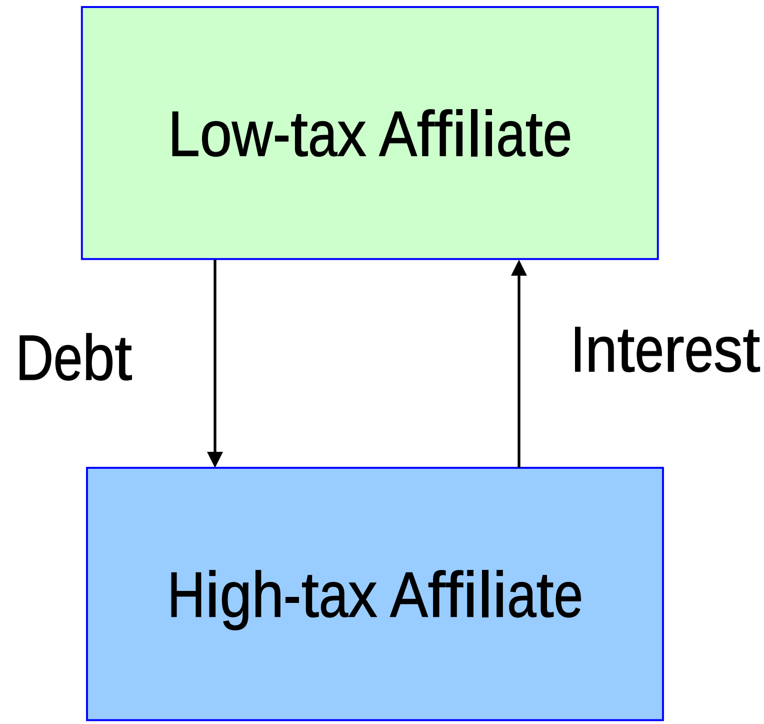
- Tax havens offer low (often zero) tax rates, and so would seem to exacerbate tax competition
- Alternative view: tax havens can *mitigate* tax competition:
  - Facilitate multinational firms' income-shifting, which reduces the shifting of real investment
  - May allow governments to impose higher effective tax rates on immobile firms, without driving away mobile firms (which can shift income to havens)
    - Analogous to Keen (2001) on preferential tax regimes

Base Erosion and Profit Shifting (BEPS)

Transfer Pricing



Debt Shifting



Empirical Evidence on BEPS

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Assume observed pretax income is the sum of:

- "True" income
- "Shifted" income

→ attribute unexplained income to BEPS

?

Affiliate (Low-tax)

Parent (High-tax)

Income-shifting:

Suppose that the tax rate falls by 1 % point; how much more income will be reported by this affiliate?

"Consensus" estimate: semi-elasticity ≈ 0.8 (Dharmapala, 2014)

i.e. a 10 % point decrease in country i's tax rate (e.g. from 35% to 25%) is associated with an 8% increase in reported income (e.g. from $100,000 to $108,000)

Gains from Multilateral Cooperation

In principle, there are potential gains from the BEPS initiative and other forms of cooperation:

- Reduced deadweight costs of tax planning
- Increased revenue
  - A social gain only to the extent that the revenue is more valuable in the hands of the govt than of the taxpayer
- But there are also potential unintended consequences of multilateral tax reform
  - Foreclosing profit-shifting opportunities may intensify tax competition along other dimensions
    - Devereux and Vella (2014)

Towards a Different International Tax Architecture?

"Destination-based cash flow tax" (DBCFT)

(Auerbach, 2010; Auerbach, Devereux and Simpson, 2010)

- Change corporate tax base from income to cash flow
  - Full "expensing" of investment
- Switch from source and/or residence to destination basis
  - Border adjustment (as with destination-based VAT)
- Equivalent to a subtraction-method VAT with a deduction for wages
  - Remitted by firms, but burdens consumption out of pure profits

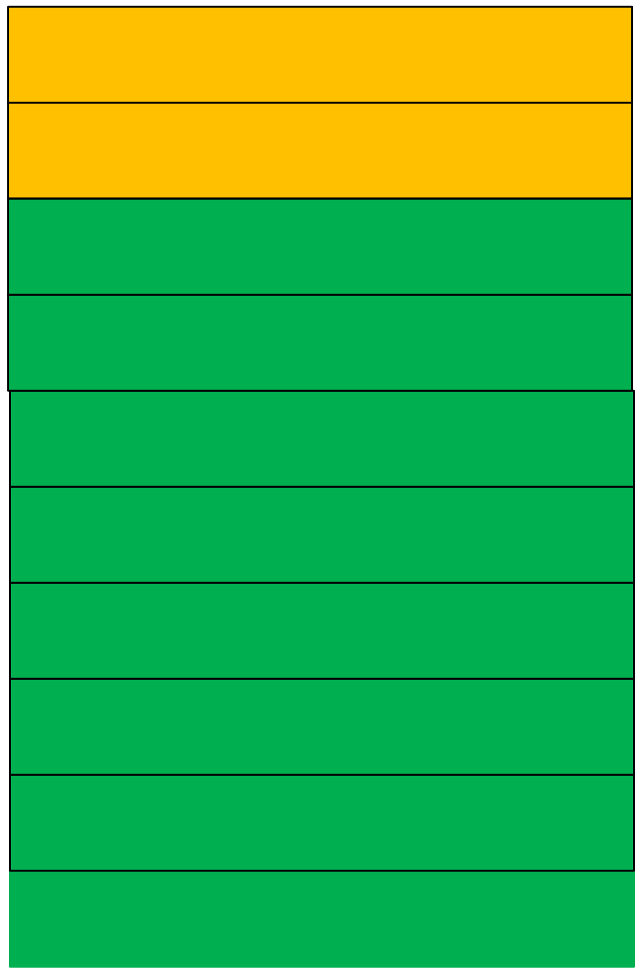
Distortions from Corporate Income Taxation

- Payout
- Organizational form
- Debt bias
- Locational choices
- Location of IP
- Income shifting
- Asset ownership
- M&A
- Portfolio investment
- Lockout

Destination-Based Cash Flow Tax

But there are serious concerns about unilateral adoption . . .

Payout
Organizational form
Debt bias
Locational choices
Location of IP
Income shifting
Asset ownership
M&A
Portfolio investment
Lockout



Depend on whether the PIT is retained

The most natural approach would pair a DBCFT (or VAT) at the business level with a (potentially graduated) wage tax at the individual level
→ multilateral adoption would provide an attractive alternative tax architecture

Brady Plan

Consumption

Savings

PIT – individual level
CIT – entity level

→

PIT – individual level: retained
CIT – essentially abolished
(zero rate on the normal return to capital)

Border adjustment tax ("BAT") ≈ a modified DBCFT

Structural coherence? Inconsistency between PIT on dividends and capital gains v. consumption-type taxation at the firm level → opportunities for deferral of PIT (no country has an effective PIT without a CIT); BAT lacks invoices

Brady Plan: Spillovers

Some commentators argue that the plan entails potentially catastrophic “tail risks”

- *If US $ appreciates to eliminate any trade distortions from the BAT*:
  - Arbitrary redistribution of wealth from holders of non-US assets to holders of US assets
  - Global financial crisis due to sovereign default?
- *If US $ does not fully appreciate*:
  - Trade distortions
- Collapse of the WTO-based trade regime?

Brady Plan: Spillovers

Tax rate = 35% (initially)
“BAT” reform → zero CIT

Tax rate = 35%

US Affiliate

$28

(using “consensus” 0.8 semi-elasticity)

F Affiliate

True Income = $100
Reports $128

True Income = $100
Reports $72

Spillover: loss of tax revenue for non-US govts
↑ transfer pricing activity and ↑ deadweight costs of tax planning
Effects on “real” investment?

But, the consequences are very difficult to predict

- US would be a tax haven of unprecedented size and economic importance

Brady Plan: Some (Minor?) Suggestions

- BAT: Eliminate the wage deduction
  - Price v. currency adjustment
- BAT: introduce a credit-invoice system
  - WTO-compliant border adjustment
- Either:
  - Eliminate PIT on nonwage income

    or

  - Retain CIT (albeit at a lower rate)

Tax Competition: Some General Lessons

- International tax competition is potentially harmful, but the evidence on its consequences is unclear
  - Robust corporate tax revenues
  - Wider benefits of global economic integration
- There are potential gains from a different (and more consumption-type) global tax architecture, **but note:**
  - Need a coherent tax structure
  - Need a tax system that promotes global integration
  - Importance of multilateral adoption
  - Would-be reformers: **First, do no harm**