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OECD BEPS: RECONCILING GLOBAL TRADE, TAXATION PRINCIPLES AND THE DIGITAL ECONOMY

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SUMMARY

Following media reports on the low tax rates paid by some of the world's largest multinational corporations (MNCs), international tax reform has moved to the top of policy-makers' agendas across the world. At the request of the G20, the OECD has designed an action plan to address what it calls BEPS, Base Erosion and Profit Shifting. The OECD and EU member states are targeting the digital economy as the main culprit for the alleged erosion of corporate tax income, arguing that its reliance on highly mobile intangibles and multi-sided business models makes it highly elusive for national tax systems.

This paper argues that the reform options that are currently on the table in the OECD BEPS process, in particular digital presence and virtual PE, would in essence create a separate tax regime for the digital economy, despite reported intentions to the contrary. This would not only contradict the OECD's own technology neutrality principle in taxation, it would also contradict the free movement of services on the EU's single market. Moreover, requiring online services to always establish a local presence would imply reneging on commitments made in multi- and bilateral free trade agreements on cross-border services trade. Furthermore, given the impact of ICT on productivity, international trade and ultimately economic growth, the cure could end up being worse than the disease.

INTRODUCTION

Taxation has always been a topic of much public controversy throughout history. The economic downturn and recent media attention have provided a rare opportunity for policy-makers to engage in relevant reforms or to exploit it for political purposes. An internationally coordinated fiscal policy has returned to the policy agenda, thanks to riveting pieces of journalism such as the NY Times' Pulitzer Prize winning series "But Nobody Pays That", which laid out how the multinational corporations (MNCs) make use of tax exemptions in different countries (so-called hybrid mismatching) to decrease their tax burdens.[1]

At the behest of the G20, the OECD has now come up with an action plan to address what it has dubbed BEPS, an acronym for Base Erosion and Profit Shifting. Profit shifting herein refers to the practices of multinational companies, who play off national taxation rules against each other and shift profits (and costs) between jurisdictions to ultimately achieve non-taxation of their income. Base erosion refers to the resulting effect on tax bases – simply put, that they erode – which is an assumption that OECD itself admits it cannot prove.

One of the main targets in the OECD members' line of sight is the digital economy. Given their high reliance on intangibles, internet and technology companies are assumed to be particularly apt at optimising their corporate structures by navigating between national tax regimes. In some contexts, this is even characterised as "unfair" competition between traditional industries and companies that have embraced new technology.

This paper questions this narrative and critically assesses some reform options that have been put forward in the debate, in particular with respect to globalisation, trade and productivity – three notions that are intricately connected, and deeply affected by the digital economy. These perspectives are lost in the tax debate, which tends to be legalistic, and value or principle-based – whereas the school of public finance economics tends to look at maximising the benefits through efficiency, distribution and stability.

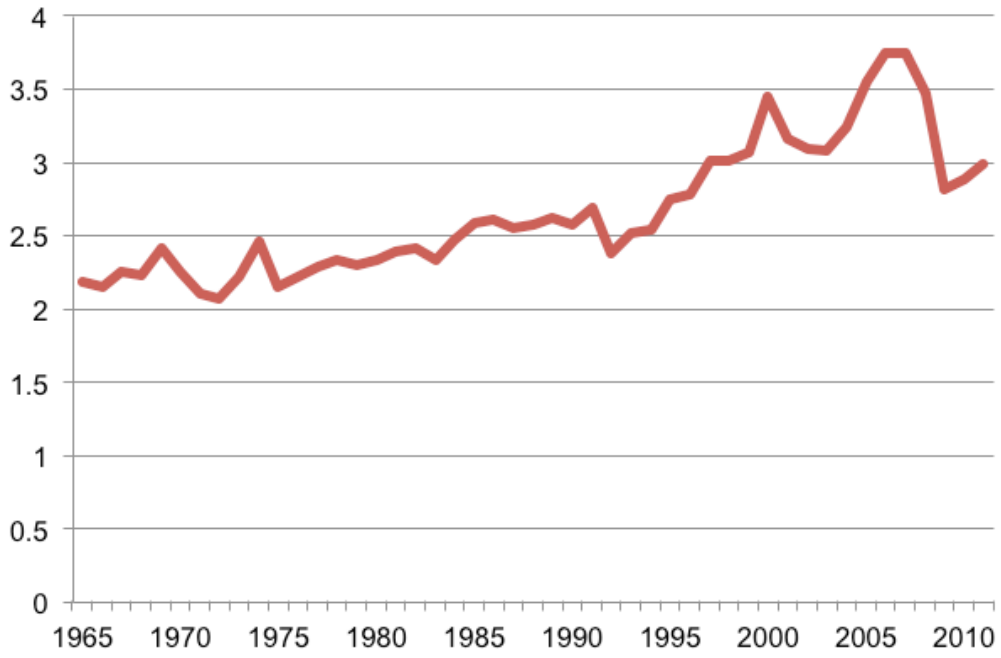
While many stakeholders agree that the digital economy should not and cannot be covered

by a separate regime, the proposals currently under consideration would in essence achieve exactly that. Given the importance of the internet for the global economy, there is a danger that the cure could end up being worse than the disease.

FIXING A NON-EXISTING PROBLEM?

The OECD BEPS Action Plan is centred on the assumption that government's tax bases are eroding due to the aggressive tax planning strategies of multinational firms. The evidence for base erosion is however ambiguous at best, with the OECD itself conceding that further research is required.[2] The existing evidence rather seems to suggest that the corporate tax base across OECD member countries has remained stable and that no actual base erosion has taken place (Figure 1).

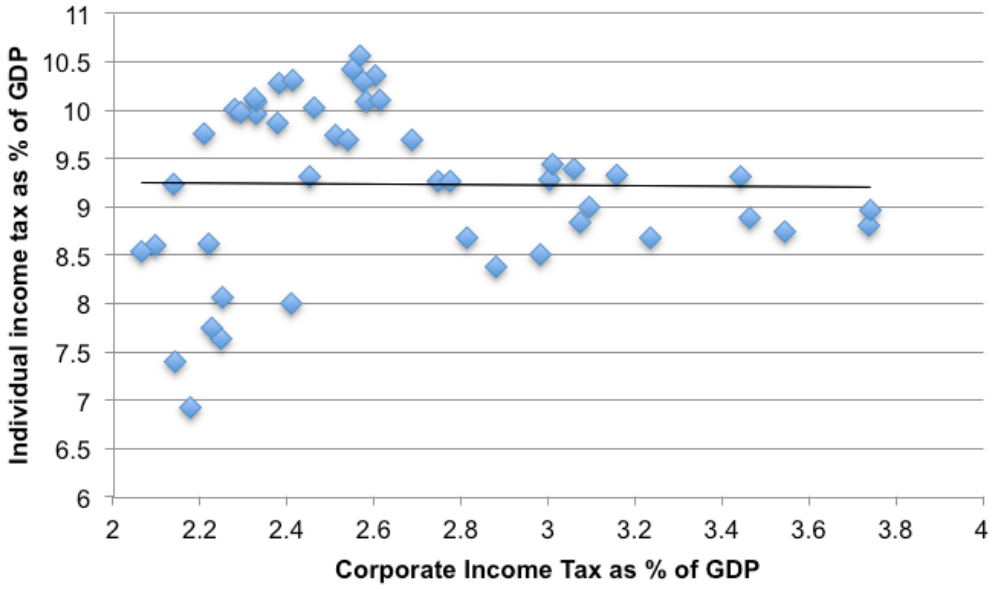
FIGURE 1. CORPORATE INCOME TAX REVENUE AS % OF GDP (OECD COUNTRIES, 1965-2011)



Source: OECD, 2013.

From the dubious assumption of base erosion follows another assumption that the taxes on individual income must increase. Immobile citizens would pay the price for the declining tax revenue caused by profit shifting by highly mobile corporations through rises in taxes on income from labour. Again, this assumption cannot be grounded in data. When comparing the share of GDP represented by individual income tax and corporate income tax across the OECD, there is no correlation to be found, with the correlation being -0,014.

FIGURE 2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE AS % OF GDP (1965-2011)
EVERY DATA POINT REPRESENTS A YEAR BETWEEN 1965 AND 2011.

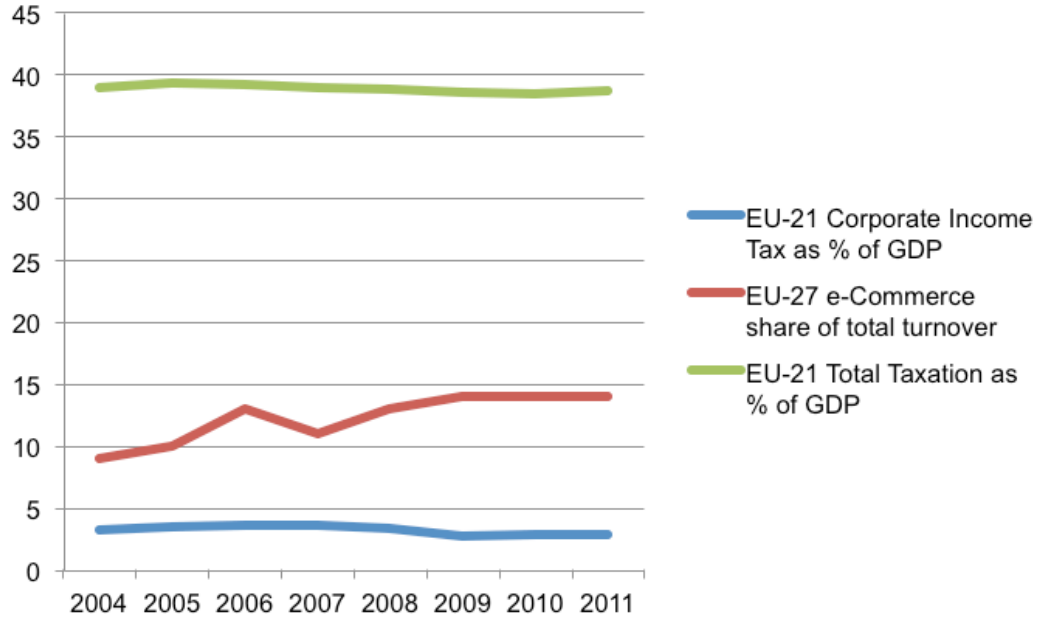


Source: OECD, 2013.

Another recurring point is that the Internet has contributed to or exacerbated base erosion and profit shifting, a misconception fuelled by popular media's coverage on the low effective tax rates technology and e-commerce companies such as Apple and Amazon pay. The underlying reasoning is that the Internet has increased the ability of businesses to engage in significant commercial activity in jurisdictions without establishing a physical presence, through the digitalisation of goods and services.

But as shown in Figure 3, there is no causal relationship between the relatively recent rise of e-commerce as a sales platform and the corporate income tax base. The decrease in corporate taxation in 2009 closely follows the falling share of total taxation of GDP as a result of the Eurozone's sovereign debt crisis.

FIGURE 3. CORPORATE INCOME TAX AS % OF GDP VS E-COMMERCE SALES SHARE OF TOTAL TURNOVER



Source: OECD; Own calculations

Comparing the global effective tax rates of the largest European companies with those paid by the US tech firms that are often ostracized in mainstream media reports, provides further perspective. The table below shows that the effective tax rate (income tax paid as a measure of pre-tax earnings) of Facebook or Amazon is actually higher than those of most major European MNCs. Even Google and eBay's average effective tax rates, at 19.91% and 16.32% respectively, can be found within the same range as those of European industrial champions such as Anheuser-Busch Inbev (Belgium), Volkswagen (Germany), Renault (France) and major telecom operators.

FIGURE 4. AVERAGE FIVE YEAR EFFECTIVE TAX RATES (ETRS) OF MAJOR EUROPEAN MNCS

Company	2009-2013
UniCredit Group	126,73%
ENI	60,11%
Carrefour	55,41%
Facebook	53,92%
Total	51,94%
Royal Dutch Shell	44,60%
Repsol YPF	40,38%
France Telecom	40,09%
Saint-Gobain	38,12%
ENEL	38,08%
Aegon	37,73%
Amazon.com	37,39%
EDF	37,16%
BMW Group	36,58%
Ericsson	32,77%
GDF Suez	30,25%
Allianz	30,08%
Yahoo	29,91%
BNP Paribas	29,87%
Siemens	29,34%
BASF	28,40%
RWE Group	28,17%
L'Oreal Group	27,63%
ING Group	26,35%
Apple	26,34%
Danone	26,27%
EADS	26,05%
Volvo Group	25,94%
Continental	25,93%
SAP	25,80%
Unilever	25,71%
E.ON	25,03%
Bayer	24,95%
Schneider Electric	24,03%
AXA Group	23,63%
Swedbank	23,48%
Daimler	21,99%
Schlumberger	21,34%
Volkswagen Group	20,88%
Renault	20,81%
Heineken Holding	20,47%
Banco Santander	20,41%
Telefonica	20,31%
TeliaSonera	20,13%
Google	19,91%
Anheuser-Busch InBev	18,67%
Sanofi	17,96%
Ebay	16,32%
Deutsche Post	14,05%
Société Générale	11,86%
BBVA-Banco Bilbao Vizcaya	5,69%
Munich Re	5,41%

Source: Company annual reports 2009-2013, Ycharts.com

In sum, persistent myths surrounding the global taxation debate can easily be rebuked by looking at simple data. These suggest firstly that it is far from certain that the corporate tax base is eroding. Secondly, there is no correlation between decreases in the corporate tax base and individual income tax revenue. Thirdly, the Internet and e-commerce do not seem to be harming governments and taxpayers, contrary to popular belief and media reports.

What follows from the above is that it is not justified to depict the Internet and the companies that make up the so-called digital economy as the main culprits of global tax avoidance problems. The phenomenon of profit shifting and the use of corporate tax havens is much older than the Internet; and practices such as transfer pricing and hybrid mismatching are rather consequences of increased international capital mobility and capital account liberalization.

Governments create incentives and mismatching opportunities in their tax systems – this is in part 'healthy' tax competition that will only disappear through tax harmonisation. For example, Ireland did make a clear choice in the 1980s to lower its corporate tax rate in an effort to attract foreign direct investment (FDIs), notably in the knowledge-intensive parts of the economy, such as the pharmaceutical industry. In addition, as surfaced in Apple's hearing in front of the US Senate's Subcommittee of Investigations, the Irish government has not

shied away from negotiating even lower preferential rates with individual companies. The inescapable reality for corporations is that investors expect them to maximize their post-tax earnings, not their pre-tax earnings – hence, MNCs are merely responding to the incentives as intended by the OECD governments.

THE INTEGRITY OF THE TRADING SYSTEM

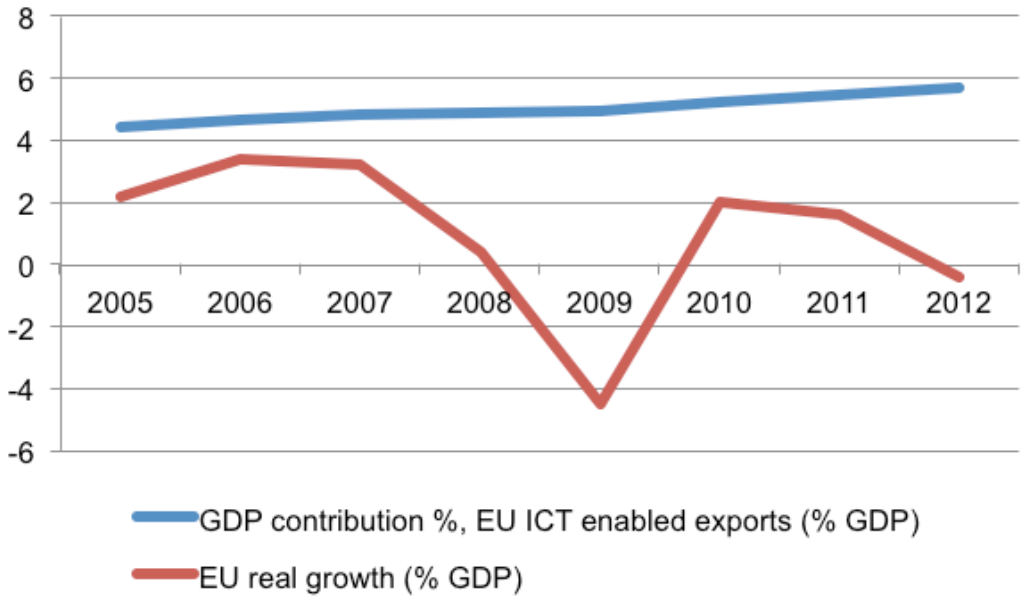
THE FACTS POINT to a conclusion that there is less economic rationale to considering BEPS as a policy problem than it may seem. Also, online business is not a new challenge in itself – but a consequence of MNCs trading across borders. Nevertheless, there is hardly any shortage of policy papers that make broad and sweeping comments about how the digital economy has transformed commerce through its new business models and global outreach.

In the context of taxation and trade, the key change is not that it changed the actual nature of commerce. The internet opened up new revenue streams that were previously too narrow or prohibitively costly to explore – yet the underlying nature of the transactions – be it advertising, mail order or communication – are often transactions that either pre-date the internet, or simple amalgamations of existing ones. The real economic impact of the internet comes from increased efficiencies and removal of transaction costs. The most obvious savings are concentrated to the physical delivery and transports, whereas additional efficiencies are now even obtained in relatively high value-adding processes or market adaptations, or even translations that enabled unprecedented economies of scale. In short, the internet has opened up international trade to an unprecedented degree, and especially in services trade, where the EU is the undisputed world leader.

Unlike commodities that are exported in crates, the service industry (e.g. logistics, construction, banks, retailers and consultants) trades across borders through different 'modes' of delivery, which are described in various trade commitments that the EU is bound to, most notably in the World Trade Organization, but also in an increasing number of bilateral free trade agreements (FTAs). The most common form of delivery takes place via various methods of communication (mode 1) nowadays often meaning the internet, where service provider and client remain in each other's jurisdictions, or where the client temporarily or virtually visits the provider (mode 2). Retail, entertainment or personal services (e.g. bookstores or cinemas) often rely on a physical presence in the customer's territory (mode 3) that requires large-scale capital investments – this here is where the internet has significantly reduced the cost of cross-border trading.

This is in particular true for developing countries with little access to capital that cannot jump the investment hurdle. The UN Conference on Trade and Development (UNCTAD) estimates that half of services trade is only enabled through ICT technology – for the EU, the number is higher given the higher value-added in European services production. As a result, the GDP contribution from pure export revenues alone for ICT enabled services exceeds 5% for the EU. In addition, there are goods that are developed, shipped and exported using the internet – such as automobiles, infrastructural equipment or medical devices that are major sources of the EU trade surplus.

FIGURE 5. EU SERVICES TRADE ENABLED BY ICT, AS SHARE OF GDP



Source: Eurostat, authors' own calculations.

DIGITAL PRESENCE AND THE TRADING SYSTEM

THE FACT THAT SMEs and multinationals alike are able to engage in services trade without physical presence is a productivity gain – and is not a novelty associated with the internet, nor does it provoke base erosion. All the parties involved in the mainstream debate around online taxation seem to concur that constructing a separate tax regime with specific rules for the digital economy is out of the question in accordance with the technological neutrality principle of the 1998 OECD Ottawa Declaration. But the question is whether this principle is upheld by all parties in practice – one of the major issues in the OECD Public Discussion Draft concerns a nexus for taxation based on 'digital presence' – a concept that reverses international principles on taxation for 'fully dematerialised' goods or services without any physical presence, or any physical elements, products and activities. In short, it entails that internet service providers (ISPs) should pay income taxes where consumption or data collection occurs.

Many observers have noted that this entails a violation of the fundamental principles of international taxation, namely that corporate taxation takes place where functions or assets are placed and business risks are taken. Firstly, the digital presence concept is justified by an assumption that the jurisdiction that has the right to determine the corporate tax under current rules gives up its rights while the incorporation and assets are placed in that jurisdiction. This is unlikely to happen, with either double-taxation, or a withdrawal by the services provider from overseas markets likely to take place.

Secondly, it assumes that the data itself has a value as a form of asset – whereas the ability to monetise market data is not the same as an asset that would constitute a presence or make it a permanent establishment. The absurdity can be illustrated by an analogy whereby a European financial information provider would be taxed in China because it partially uses market data from there and reports via the internet.

Thirdly, the concept of digital presence and the idea that online services must always be seen as establishing a local presence is in complete contradiction with cross-border trade in services. Blocking a mode of delivery in this manner, albeit only for ISPs, is an interpretation in violation with the commitments under free trade agreements and the WTO, where the EU has allowed full market access for various online processing services (generally interpreted as new Internet services). Moreover, it violates the free movement of services, which is a fundamental pillar of the European Single Market. Furthermore, such precedence would open a Pandora's box – if some or all ISPs are deemed as always trading through local presence or virtual permanent establishment (mode 3), all market access commitments made by countries like China on cross-border supply (mode 1) of online services would be deemed worthless. Meanwhile countries are more restrictive on market access via commercial presence (mode 3), with considerable geographic restrictions on where foreign businesses are allowed to invest, or foreign equity caps (FECs) to minority share holding, which immediately leads to loss of overseas markets.

PRODUCTIVITY CONTRIBUTION OF THE INTERNET

Further evidence to the idea that the main contribution of the internet is from increased efficiencies is not only supported by economic theory, but also supported by observed economic data.

The theory that the internet has an enabling effect on cross-border trade through removal of barriers and capital costs is proven also in empirical studies – the interactions between ICT and trade openness constitute another important driver of growth. Research by Meijers (2010) shows that Internet use has an indirect impact on growth by expanding international trade in accordance with the reasoning presented in the previous section. This effect is even stronger for developing countries, where an increase of internet use of 10 percentage points ultimately impacts growth by 0.27 percentage points.[3]

More importantly for OECD economies, a growing body of research points at the higher use of ICT as the main reason for productivity growth.[4] Since 1995, the rate of US productivity growth accelerated while it fell in Europe. The productivity growth rate in the US (2.5%) was nearly 80% higher than in the EU during the period observed for the overall economy, while in the ICT using industries it was close to 200%. This productivity differential resulted in a GDP per hour worked in the EU that was about 10 percentage points lower than the US level.[5] In addition, most firm level research arrives at the same result: a positive and significant association between ICT and productivity growth. Bertschek et al (2006) for instance established that firms deciding to use business-to-business (B2B) e-commerce employ their input factors more efficiently than non-B2B users, and labour productivity in particular increasing.

There are both theoretical and empirical foundation that shows that much of the productivity growth in the OECD countries can be attributed to the use of ICT technologies and the internet in particular. Europe's productivity gap vis-à-vis the US can be explained by openness and use (meaning consumption and use in inputs) of the internet and ICT, rather than production of devices and online services. The numbers give a very strong indication that almost all of labour productivity growth (which is what effectively allows the EU to compete with other means than lowering wages) can be attributed to technology.

The creation of a separate taxation regime for the digital economy could lay waste to an extremely important source of productivity growth, that Europe in particular needs to close the productivity gap with the US and to avoid having to lower wages to return to competitiveness. The evidence of both personal and corporate income taxes having a negative effect on productivity is relatively well established, including by OECD research. It is important to note that the research refers to corporate income taxation in general – the negative effects from taxing the use of productivity-improving technology are even larger. If a country taxes productivity, it is practically taxing growth. Growth leads to profits, which expands the tax base. This is why discriminatory taxation on productivity-improving activities only contributes to base erosion, rather than stopping it.

CONCLUSION

The question of how to design a minimally efficiency-distorting tax system has pre-occupied economists for over half a century. While it is true that the era of globalisation and economic interdependency have tied civil and commercial freedoms to the mast of liberalisation, they have also put a constraint on the policy space for domestic regulators. The challenge for the sovereign is to govern for maximizing benefits in spite of these irreversible processes, not to maximise their power. Nostalgia should not inspire public finance economics, especially when trade and investment barriers are guaranteed to lead to sub-optimal outcomes. The lessons learned from previous attempts in the 1930s and 1970s are daunting: every attempt to insulate European economies has always led to productivity losses and backfired, leading to market exits and production loss in the EU.

Contrary to common conviction, globalisation and the digitalisation of the economy do not cause unemployment or structural deficits, but have made the costs from poor governance and inefficiencies more immediate. The express intention of most European governments may be to maximise growth (and an equitable redistribution of it), but quick political wins are often too tempting for frail governments backed by vested interests that call for the promotion of national champions at the expense of consumers.

Despite the assurances from various EU interest groups within the OECD BEPS project that the Ottawa taxation principles are still valid as a framework, or that a separate tax regime for the digital economy is not a possible outcome, the concepts of digital nexus and virtual PE are just that: a specific tax regime for the internet, overruling the technology neutrality principle. It either opens the door for double taxation, or disputes of jurisdiction where the "strongest wins". For Europe, it is also a deviation from Single Market rules, even on VAT, where taxation occurs at the establishment of the supplier. Hybrid mismatches and other taxation arbitrage opportunities are part and parcel of the FDI competition between different tax regimes. Companies merely act upon the incentives that were intentionally designed by policymakers in several EU member states.

The political economy of taxation (or elections) is such that profitable internet companies are easy targets – the links between the internet and base erosion and profit shifting is simply counterfactual, while the evidence points at a strong causality between data and economic productivity. The question is not whether to tax a few 'internet' companies, but whether a highly essential production input should be taxed differently than other classes of inputs. But taxing productivity is the same as rewarding stagnancy instead of a more efficient use of resources. Misallocations created by poorly designed tax disincentives take many years, if not decades, to undo – and once accepted, become a permanent feature of the tax codes.

As we have seen, base erosion and profit shifting are a result of globalization, and the only remedy is blocking international capital mobility – which would have a devastating impact on economic activity, and quickly erode the tax base. BEPS would only cease to exist in a world where governments do not provide tax incentives – meaning actual harmonisation of tax levels. The solution is already on the table, at least in the EU – a proper fiscal union with common corporate income taxation and harmonised VAT rates. Profit shifting and mismatching is a relatively minor price that the EU members pay for having an internal market without tax harmonisation. Today, this inconsistency does not only occur across borders but also inside them – the current tax directive does not allow for lower VAT rates for electronically surprised services, whereas they are allowed for physical equivalents, leading to different tax rates on digital and physical cultural products. Aligning tax rates for digital content with their physical equivalent is an action point of the Digital Single Market (item 106), which is yet to be delivered.

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ENDNOTES

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