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Avenue des Arts 40, 1040 Brussels
www.ecipe.org — info@ecipe.org

ECIPE PRESS RELEASE - NEW OCCASIONAL PAPER

Unintended and Undesired Consequences: The Impact of OECD Pillar I and II Proposals on Small Open Economies

By Matthias Bauer, Senior Economist at ECIPE

Brussels, Belgium, 8th September 2020 - The OECD's corporate tax reform proposals officially aim to address "corporate tax avoidance" and "unfairness in taxation". With its Pillar I and II proposals, the OECD claims to evenly distribute among the 137 member countries of the Inclusive Framework an additional tax revenue of some 100bn USD annually. Yet, solid economic impact assessments of the current proposals are scarce. Individual governments have so far failed to conduct impact assessments or are hesitant to make their assessments available to the general public.

This ECIPE paper highlights that the proposed reforms would shift taxing powers (tax sovereignty) and economic activity away from small open economies to the world's largest countries, of which most (currently) apply very high statutory corporate tax rates. Estimates show that inward FDI in today's high-tax countries would increase and outward FDI would decrease. Symmetrically, inward FDI in today's low-tax countries would decrease and outward FDI would increase. Overall, the shift in effective taxing powers would undermine small countries' relative attractiveness to international businesses and, on top of that, would induce domestic businesses to relocate to larger countries with the gravity of larger markets.

The implementation of Pillar I and II proposals would also punish governments that embrace free international trade and investment by transferring fiscal funds away from small economies to many of the world's worst-performing governments with respect to economic openness, acceptance of the rule of law, corruption, state interventionism, and the recognition of basic human rights (e.g. Argentina, Brazil, China, India, Indonesia and Russia). Conversely, the OECD's proposed corporate tax reforms would punish the world's best-performing economies with regard to economic freedoms, trade and investment openness and the rule of law (e.g. Estonia, the Czech Republic, Ireland, the Netherlands, Slovakia, Slovenia, Switzerland, including small city and island states, such as Hong Kong, Luxembourg and Singapore).

Contrary to claims made by the OECD, the implementation of Pillar I and II proposals would not improve the global allocation of capital. Global trade and investment flows would still be subject to tax competition and prevalent trade and investment barriers. The OECD's current proposals would likely incentivise the governments of large countries with protectionist institutions to maintain long-standing barriers to trade and investment. The economic gravity of large countries may even incentivise large country governments to erect additional barriers that would restrict market access for companies from small open economies.

For small open economies that are home to research- and knowledge-intensive companies, the OECD's proposed tax reforms would undermine future investments in R&D, innovation and business expansion, with adverse implications for existing research clusters, education systems and the quantity of high value-added jobs. Policymakers globally should reconsider whether taxes on corporate income contribute to overall social and economic policy objectives, such as economic development, income redistribution and citizens' perceptions about fairness in taxation.

Replacing tax systems that include taxes on corporate income by systems that rely more or exclusively on taxes on labour income, capital income and consumption expenditures (VAT/sales taxes) would increase transparency about the distributional effects of taxes and significantly improve governments' tax manoeuvrability in response to citizens' preferences for fairer taxation. Generally, 'a regime change towards greater use of VAT/sales taxes would also have a positive impact on global capital allocation' argues Matthias Bauer, author of this ECIPE study. 'Companies would no longer have to pay attention to corporate tax rate differentials, while governments would have additional invectives to embrace foreign trade and investment, materialising in lower barriers to trade and investment and a more efficient allocation of global capital respectively.'

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Media Contact: info@ecipe.org at +32 2 289 13 50