G7: Promising more from less*

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In early June Finance Ministers and central bank governors of the G7 met over two days in London, as a prequel to the meeting of heads of states of the grouping a week later. The meet was of special significance. Global leaders now hope that the slow and hesitant vaccination roll-out will help tame the coronavirus. So, their attention increasingly turns to addressing the many economic challenges that preceded the pandemic and were aggravated by it. Before the pandemic, inter- and intra-country inequality, intolerable deprivation, a battered environment and changing climate had forced nations to jointly commit to achieving a set of sustainable development goals (SDGs) in diverse areas. The pandemic and its collateral damage amplified the crises in many of those areas while driving home the need to urgently address them. Governments, especially of the most advanced nations, which had dragged their feet in the journey to realising those goals were expected to step up the pace and scope of action and promised to do so. The role of finance ministries from the advanced nations in mobilizing the resources needed and appropriately allocating them make them lead agents in what must be a cooperative global endeavour with differentiated responsibilities. Attention was therefore focused on what they would say and signal on the contribution that governments of some of the world's leading economies would make in advancing a wide-ranging agenda.

The headlines the morning after were, however, surprisingly one-sided. Almost all attention was devoted to the agreement arrived at that meeting—labelled variously as being 'historic', 'unprecedented' or 'transformative'—to press ahead with implementing a global minimum corporate tax. The proposal is not new. The case for such a tax was being discussed for quite some time by a group coordinated by the OECD Secretariat of around 135 countries working on an Inclusive Framework on Base Erosion and Profit Shifting (BEPS). The aim is to put in place a set of global fiscal rules that could serve two objectives. One is to prevent loss of revenues to governments when firms registered in their jurisdictions shift profits to low or no-tax locations to avoid paying the higher tax rate that would apply if profits are recorded in the home country or their country of actual operation. The other is to allow governments to garner tax revenues and profits from firms that service clients in their jurisdiction through digital service provision and without a physical presence, to ensure a fair distribution of taxes levied on global firms. The principle is that transnationals must pay a fair share of taxes on profits they earn and the taxes mobilised must be fairly shared among countries that are the jurisdictions in which those profits are made. Needless to say, such a framework cannot be implemented only by G7 governments if it is to be effective. But agreement within the powerful G7 is an important first step towards the needed global consensus.

The overwhelming focus on this element of the discussions that took place in the summit of G7 finance ministers was not because the communique released after the meeting in London did not cover other issues. Rather, the communique was wide in scope, even touching on issues that were not the remit of ministries of finance. The G7 finance ministers, recognising the need to "ensure a strong, sustainable, balanced and inclusive global recovery, that builds back better and greener from the Covid-19 pandemic", promised "to sustain policy support as long as necessary and invest to promote growth, create high-quality jobs and address climate change and inequalities". Noting that the "Covid-19 pandemic can only be overcome when it is brought under control everywhere", the communique recognised that there is "an overwhelming moral, scientific and economic case for ensuring equitable, safe, effective and affordable access to Covid-19 vaccines, therapeutics and diagnostics across the world". Finally, the G7 ministers committed "to a multi-year effort to deliver the significant structural change needed to meet (our) net zero commitments and environment objectives in a way that is positive for jobs, growth, competitiveness and fairness," and "to properly embed climate change and biodiversity loss considerations into economic and financial decision-making". That ticks most boxes.

However, given the tone and language in which these commitments were made, it is not surprising that they did not attract much attention. Those commitments appeared to be mere reiterations of what had been said before, and other than for the specific instance of the Covid-19 vaccines, remained at a level of generality that does not signal advance. For example, the reference to net zero commitments, without specifying the path in terms of actual emissions reduction, as opposed to carbon removal options that are expensive, biodiversity harmful or unproven, does not take the discussion further. More so because nationally determined contributions in terms of emission reduction are woefully inadequate to ensure progress towards the 1.5-2°C temperature rise limitation goal, with pledges from many developed countries short of their fair share. And the recognition of the need for global access to affordable vaccines is not convincing given the vaccine nationalism that has characterized actual policy in the advanced nations.

But these, it could be argued, are areas in which finance ministers cannot be expected to make new commitments. That must be left to other ministries or the heads of state. But even in areas that fall under the remit of finance ministries, the London declaration does not have much to offer, beyond supporting the already agreed additional allocation of $650 billion of SDRs to boost global reserve assets. In a small step forward, it merely encourages the IMF to explore options for channelling the new SDRs allocated to the developed countries, which in most cases do not need them, to support recovery in countries, especially low income countries, that lack the resources needed to finance health expenditures (including vaccination drives) and push for recovery from the Covid-induced crisis.

Beyond that new commitments are sparse. Consider for example the annual $100 billion climate finance goal the developed countries committed to achieve by 2020 and then scale up significantly by 2025. There are a number of problems in this area. The goal has not been achieved. The actual sum, estimated by the OECD in 2019 to have touched $71 billion in 2017, includes a substantial contribution that comes from the private sector. So, government provisions are lower and the question of 'additionality', or whether the reported sum is in addition to pre-existing development aid commitments, remains unanswered. That matters because, relative to the 2019 GDP of the rich countries, the $100 billion figure is just 0.2 per cent, less than a third of the 0.7 per cent of GDP target for development aid set by the United Nations. It can be folded into or made a substitute for previously committed development aid. Yet, the G7 communique does not go beyond reaffirming the collective goal to mobilise $100 billion annually and vaguely commits to increasing and improving climate finance contributions in the years to 2025. Given past experience that hardly instils confidence. Moreover, while the document cites IMF estimates that, between now and 2025, low income countries will need around US$200 billion to finance an adequate response to the pandemic and “an additional US$250 billion in investment spending to resume and accelerate their income convergence with advanced economies,”, it says little on how that can be financed. It merely commits to “supporting the poorest and most vulnerable countries as they address health and economic challenges associated with Covid-19.”

These and other features of the communique perhaps explain why it is the agreement to work on a global minimum tax compact that has attracted much of the attention. But the preliminary contours of that compact are also deeply disappointing. In the discussions so far, it has become clear that there are two issues to be addressed. One is to deliver some tax revenues to countries which are the locations from which sales and profits are derived by multinational firms, even though these firms do not have a physical presence in those locations. This ability to garner revenues and profits that are not locations is especially true of the digital and e-commerce giants like Alphabet, Facebook and Amazon. Recognising this, countries have in recent years unilaterally imposed taxes on digital services to mobilise what they think are revenues legitimately due to them. The US has argued that these taxes discriminate against US multinationals and threatened to impose retaliatory tariffs on imports from countries like India that impose such digital taxes. The new compact would include in its Pillar 1 a proposal to share revenues with countries that are locations for sales and profits earned by multinational companies, in return for which those countries are expected to withdraw any prevailing digital taxes.

The second is the tendency for global companies to shift their profits to tax havens or low tax locations, depriving the country where the parent firm is headquartered of revenues from the taxation of those profits. Apple can, for example, set up a subsidiary in Ireland and transfer to it intangible assets and patents that bring in royalties and technical fees. The Irish subsidiary can market the use of those assets to subsidiaries selling Apple products in Europe and Asia, and through that mechanism transfer profits to Ireland which is a low tax location. Though headquartered in the US, Apple avoids paying taxes at the US rate to the US government on its globally earned profits. To prevent such profit shifting the advanced nations, led by the US, want countries to commit to imposing an agreed upon minimum rate of tax on profits of global corporations located in their jurisdictions. With a common minimum tax being imposed, country by country, the incentive to shift profits is weakened, helping governments in these advanced economies to get their transnational firms to report profits and pay taxes at home.

The G7 Finance Ministers meeting at London have agreed on the principal elements of a compact addressing these issues, paving the way for efforts to persuade the G20 group of countries and then the rest of the world to join the agreement. Not all required features of the framework have been spelt out, but what has been announced has left those arguing for globally coordinated taxation of transnationals disappointed. To start with, to win agreement, the floor of the proposed common minimum tax has been set at 15 per cent. That is extremely low, far below the current average global corporate tax rate of 25 per cent and not very much higher than that in the three OECD countries with rates lower than 15 per cent—Ireland (12.5 per cent), Chile (10 per cent) and Hungary (9 per cent). While a 15 per cent minimum tax will hit tax havens with zero or near-zero rates and prevent a race to the bottom in terms of corporate tax rates elsewhere, fears are that it would trigger a “race to the minimum”. The additional revenue garnered would be far short of potential. The EU Tax Observatory estimates that a 15 per cent minimum rate will only pull in around $100 billion in a year for the US and Europe. Moreover, much of the additional revenue would accrue in the advanced nations. Campaigners have long argued for a minimum rate of 25 per cent or more. With 15 per cent, the cause of making the world’s most profitable multinational firms contribute a far share to public revenues to finance a green and inclusive global recovery is unlikely to be advanced.

Pillar 1 of the proposal drafted by the G7 finance ministers, meant to appease and win the support of nations from which transnationals earn revenues and profits without a physical presence is even more disappointing. The proposal requires an undefined group of “the largest global companies” with profit margins of at least 10 per cent to allocate 20 per cent of their global profits in excess of that 10 per cent to countries where they make their sales, allowing the latter to tax that allocation. This reduces the scope of this source of tax substantially. The largest firms, when defined, may not exceed in number the top 100. Some of them, like Amazon do not even record a profit margin of 10 per cent. Others are likely to resort to accounting devices to reduce their margins to below 10 per cent. And taxes on one-fifth of the excess where profit margins exceed 10 per cent are unlikely to yield much. But in return for this “historic shift” away from taxation based on physical presence, countries imposing or planning to impose digital service taxes would have to give up ambitions to tax firms from abroad earning revenues and profits by providing digital services in their jurisdictions. The resulting loss can be large and significantly more than the gain from the new Pillar 1. For example, the office of the US Trade Representative estimates that India collects $55 million annually from the 2 per cent digital services tax it imposes on revenues of foreign e-commerce companies serving Indian buyers. That is almost equal to what the Pillar 2 minimum corporate tax is expected to generate globally.

Thus, while the global minimum tax proposal in the finance ministers’ communique is a step forward, that step too is disappointingly short of what is needed and possible. If yet the proposal has caught the media’s almost-undivided attention, it is because it speaks of a new effort by the richest nations to transform fiscal rules in search of revenues. Whatever that delivers would increase their own room for manoeuvre but leave relatively untouched the many challenges in the rest of the world. The rest must make do with a set of reiterated commitments with no evidence of moves to effective and concrete action.

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