A Tax Policy that could Work*

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The Indian government should now be desperate to raise more tax revenues. It missed its tax targets massively in the last fiscal year, largely because of poor goods and services tax (GST) collections. Its declared budgetary target for the current year requires tax receipts to increase by around 25%, when the first quarter increase was only 6% over the previous year. In the misplaced belief that what is required to address the current slowdown is more tax relief to corporates, it has offered tax rate reductions to 25% of profits to companies that do not avail of other concessions, and further rebates to new companies. So very significant tax shortfalls are likely even in the current year, unless the government takes proactive measures.

Looking at MNCs

But such measures need not — and should not — take the form of the tax terrorism that this government has been prone to, or increasing GST rates, which would be regressive and counterproductive in the slowdown. Fortunately, there are other measures that could provide significantly more tax revenues to the government. One obvious low-hanging fruit is a strategy to ensure that multinational companies (MNCs) actually pay their fair share of taxes.

It is well known that MNCs manage to avoid taxation in most countries, by shifting their declared costs and revenues through transfer pricing across subsidiaries, practices described as "base erosion and profit shifting" (BEPS). Matters have got even worse with digital companies, some of the largest of which make billions of dollars in profits across the globe, but pay barely any taxes anywhere. The International Monetary Fund has estimated that countries lose $500 billion a year because of this. Also, it creates an uneven playing field, since domestic companies have to pay taxes that MNCs can avoid.

How the idea works

The Organisation for Economic Co-operation and Development (OECD) has now recognised this through its BEPS Initiative, and has even attempted a belated attempt to include developing countries through what it calls its inclusive process. So far, this process has delivered a few benefits, but these are limited because it has continued to operate on the basis of the arm's-length principle of treating the subsidiaries as separate entities.

But this can change if there is political will. The basic idea is breathtakingly simple, and has been proposed by the Independent Commission for the Reform of International Corporate Taxation, or ICRICT (full disclosure: I am a member).

The idea is this: since an MNC actually functions as one entity, it should be treated that way for tax purposes. So the total global profits of a multinational should be calculated, and then apportioned across countries according to some formula based on sales, employment and users (for digital companies). This is something that is actually already used in the United States where state governments have the power to set direct and indirect tax rates.

Obviously, a minimum corporate tax should be internationally agreed upon for this to prevent companies shifting to low tax jurisdictions (ICRICT has suggested 25%). Then, each country can simply impose taxes on the MNCs operating in their jurisdictions, in terms of their own shares based on the formula.

It could be argued that this would only work if all countries agree, and certainly that is the ideal to be aimed at. But the beauty of this proposal is that just some large countries can move the debate and make it less advantageous for global companies to shift their profits around. If the big markets such as the United States and the European Union together decided to tax according to this proposed principle, there would be little incentive for many MNCs to try and shift reported profits to other places. Indeed, the Indian government has already proposed in a white paper that it could take such a unilateral initiative for digital companies.

The OECD BEPS Initiative will be meeting on October 19 to set out its own proposal, and for the first time, it is willing to consider the possibility of unitary taxation. But there are some stings in the tail that may well render the proposed measures practically impotent. These concerns are set out clearly in a new report from ICRICT.

Key concerns

The biggest problem is the arbitrary separation between what OECD calls “routine” and “residual” profits, and the proposal that only residual profits will be subject to unitary taxation. This has no economic justification, since profits are anyway net of various costs and interest.

The proposal does not clearly specify the criteria for determining routine profits, instead suggesting that the “arm’s-length principle” will be used to decide this, which defeats the entire purpose. As it happens, there is no system of corporate taxation anywhere in the world that makes such a distinction — so why should an international system rely on this?

Another concern is about the formula to be used to distribute taxable profits. The OECD suggests only sales revenues as the criterion, but developing countries would lose out from this because they are often the producers of commodities that are consumed in the advanced economies. Instead, the G24 group of (some of the most influential) developing countries has proposed that a combination of sales/users and employment should be used, which makes much more sense.

It is important for the Indian government to look at this issue seriously and take a clear position at the OECD meeting, because the outcome will be very important for its own ability to raise tax revenues. A government that is currently ineffective in battling both economic slowdown and declining tax revenues cannot afford to neglect this crucial opportunity. But more public pressure may be required to make the government respond.

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