Myths, Lobbies Block International Tax Cooperation

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Too many have swallowed the myth that lowering corporate income tax (CIT) is necessary to attract foreign direct investment (FDI) for growth. Although contradicted by their own research, this lie has long been promoted by influential international economic institutions.

'Beggar-Thy-Neighbour' Policies

The economic 'counter-revolution' of the early 1980s impacted on the Washington Consensus of the US federal government and the two Washington-based Bretton Woods institutions (BWIs)—the International Monetary Fund (IMF) and the World Bank.

Thus, the rise of 'supply-side' economics in the US, which advocated lower direct taxes on income and wealth, influenced the world. Without evidence, IMF researchers justified that institution's policy advice thus: 'The complete abolition of CIT would be the most direct application of the theoretical result that small open economies should not tax capital income.'

Noting that capital is highly mobile and can more easily evade taxes than labour, IMF economists even recommended that 'small countries should not levy source-based taxes on capital income'. Meanwhile, the Bank's highly influential but dubious *Doing Business Report* recommended tax incentives without evidence. To get BWI approval, developing-country governments undertook tax reforms, reducing progressive direct taxation. Instead, they favoured more regressive indirect taxes, such as the value-added tax (VAT), sometimes dubbed the' goods and services tax'.

Consequently, IMF tax policy recommendations to sub-Saharan African (SSA) countries between 1998 and2008 reduced corporate and personal income tax rates while promoting VAT. And following Bank advice, Tanzania—Africa's third-largest gold producer—ended up subsidising, not taxing, foreign mining companies!

Evidence Contradicts Advice

World Bank research and surveys have long found that tax incentives do not really attract FDI inflows. A Bank report in 2017 found no strong evidence that tax incentives attracted non-resource 'greenfield' or additional new FDI.

It also found that 'tax incentives impose significant costs on the countries using them', including fiscal losses, rent-seeking, tax evasion, administrative costs, economic distortions and 'retaliation against new or more generous incentives' by competitors.

An earlier Bank brief noted that 'tax incentives are not the most influential factor for multinationals in selecting investment locations. More important are factors such as basic infrastructure, political stability, and the cost and availability of labor.'

The brief also argued that tax incentives do not compensate well 'for negative factors in a country's investment climate'. Meanwhile, the 'race to the bottom … may end up in a bidding war, favoring multinational firms at the expense of the state and the welfare of its citizens'.

Researchers have unearthed no strong evidence that tax incentives are beneficial. While some incentives may attract FDI, they crowd out other investments; hence, overall investment and growth do not improve.

An IMF report in 2015 noted, 'Tax incentives generally rank low in investment climate surveys in low-income countries … investment would have been undertaken even without them. And their fiscal cost can be high, reducing opportunities for much-needed public spending … or requiring higher taxes on other activities.'

Even Organisation for Economic Cooperation and Development (OECD) research in 2008 confirmed BWI findings that tax incentives hardly attracted FDI. *The Economist* also found a weak relationship between tax rates and business investment as well as growth rates.

A UK government report in 2018 cast more doubt: 'effectively attracting FDI needs public spending, so narrowing the tax base works with tax incentives for low-income countries could be contraproductive'.

Race To Bottom Hurts All

IMF findings confirm that 'beggar-thy-neighbour' tax competition worsens avoidable revenue losses. Such ill-advised efforts to attract investment inevitably accelerate CIT rates' 'race to the bottom'.

BWI advice to governments has undoubtedly lowered CIT rates. But despite lower CIT rates, transnational corporations (TNCs) still minimise paying tax—for example, by shifting profits to tax havens and exploiting loopholes.

CIT rate averages for high-income countries (HICs) have dropped twenty percentage points since 1980, falling from 38 per cent in 1990 to 23 per cent in 2018. Meanwhile, they fell from 40 per cent to 25 per cent in middle-income countries, and from over 45 per cent to 30 per cent in low-income countries (LICs).

Cut-throat competition has especially hurt developing countries, which rely much more on CIT than developed economies. IMF research found that a one-point average CIT rate cut in other countries reduces a developing country's CIT revenue by two-thirds of a point.

Such tax cuts induce other concessions, further eroding the base for corporate taxation. Thus, tax revenue is doubly lost by both rate and base cuts. Fund staff estimated revenue loss at 1.3 per cent of GDP in developing countries, due to base erosion and rate reductions—much worse than in developed countries.

The UK government estimated global revenue loss due to TNC tax minimisation at USD 500–650 billion annually. Such adverse effects were two to three times higher in LICs than in HICs. SSA countries lost the most revenue relative to GDP, followed by Latin America and the Caribbean, and South Asia.

A third of global revenue loss—USD 167–200 billion—is from low- and middle-income countries (LMICs), costing them 1.0-1.5 per cent of national income. With better tax administrations and larger formal sectors, HICs can replace such losses more easily than LMICs, which generally have weaker tax systems and larger informal sectors.

Tax Breakthrough

The IMF and other institutions now agree that an international minimum CIT rate can stop this race to the bottom and TNC profit-shifting. In 2021, the Group of Seven largest rich countries (G7) agreed to a minimum 15 per cent rate, rejecting US Treasury Secretary Janet Yellen's proposed 21 per cent. Even *The Economist* agrees that the G7 proposal favours rich countries.

Earlier, the Independent Commission for the Reform of International Corporate Taxation (ICRICT) had recommended a 25 per cent minimum and fairer revenue distribution to developing countries.

Finance ministers from Indonesia, Mexico, South Africa and Germany joined Yellen in welcoming the G7 agreement for a minimum global CIT rate, while expressing confidence 'that the rate can ultimately be pushed higher than 15 percent'.

An influential piece in 2021 claimed that 'A Global Minimum Corporate Tax Is a Bad Idea', again citing the myth that low taxes will attract FDI. Invoking new Cold War fears, it claimed that China and Russia would also gain an unfair advantage in luring 'even more' FDI.

Trump-appointed Bank president, David Malpass, opposed the agreement, claiming it would undermine poor countries' ability to attract investment despite Bank research showing otherwise. Pro-Trump governments in Hungary and Poland also objected to the G7 deal. Developing countries cannot allow such tax-cutters to speak for them.

Developing-country members of the G20 must insist on a higher minimum and fairer revenue distribution at its forthcoming finance ministers meetings. If the G7 refuses to start with anything more than 15 per cent, an agreed rate-increase schedule of an additional one per cent annually would get to 25 per cent in a decade.

International tax rules are currently set by rich countries through the OECD. Developing countries participate at a disadvantage. Instead of allowing the OECD to control the process, these countries must urgently insist on an inclusive, balanced and fair multilateral process for international tax cooperation.

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