Institute for Public Policy Research

ENDING THE RACE TO THE BOTTOM

WHY THE UK SHOULD SEIZE THE OPPORTUNITY TO SUPPORT A GLOBAL MINIMUM CORPORATION TAX

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INTRODUCTION

Since taking office, President Joe Biden and his administration have put forward bold reform proposals for international cooperation on how to stop tax avoidance by multinational companies (U.S. Department of the Treasury 2021). These proposals will curb the practice of unfairly shifting profits to tax havens. The current set-up allows large companies to undercut small businesses. Moreover, the proposals will stop countries seeking to undercut each other with ever-reducing rates of corporation tax and will instead prompt a race-to-the-top in investment in education, skills, infrastructure – the things businesses look for when choosing where to locate their operations. Finally the proposals will also raise additional tax revenue in the UK (Tax Justice UK, 2021).

The UK is the only member of the G7 not to support the Biden proposals. This opportunity will likely not come again. The UK government should support these proposals for global alignment on corporation tax and prioritise an agreement at the G7 meeting hosted in Cornwall in June.

In this briefing we argue that:

- The Biden proposal would start to address the injustice that multinational firms can avoid paying taxes by shifting profits abroad.
- There is currently a risk of the minimum tax rate being set too low – 15 per cent has been proposed. To be effective, the global minimum tax rate should be at least 21 per cent, as in the original proposal, rather than being watered down.
- Once in place, this will mean the UK corporation tax rate (once raised in 2023) is above the international minimum, so there would be no change for businesses taxed in the UK. However, it would mean that profits shifted abroad to avoid corporation tax would be effectively recouped.
- It would address this market failure in the system, benefitting the economy and creating substantial revenue in the order of £14.7 billion for the exchequer. This is more than would be required to fix the NHS funding shortfall.

WHY DO WE NEED TO WORRY ABOUT OFFSHORING TAX?

Modern economies rely on strong public services and investment. Without government expenditure on education, infrastructure, health, social care, and policing, companies would be less profitable, and the economy as a whole would be worse off. Taxes shape the structure of the economy, incentivise desired behaviour and help fund current expenditure. They are therefore vital to the economy. Taxes should be set in such a way as to be progressive – so that those with the greatest ability to pay contribute the most – as well as transparent and efficient (IPPR Commission on Economic Justice 2018).

Since 2008, the main rate of corporation tax paid by businesses on their profits in the UK has been dramatically reduced, from 30 per cent to 19 per cent. In 2019/20, corporation tax in the UK raised £50 billion of revenue, or 6 per cent of the total £828 billion of UK tax receipts (Keep 2021), yet there is mounting evidence that many multinational corporations are able to avoid corporate income taxation. According to the National Audit Office, 50 per cent of the largest 800 businesses in the UK paid less than £10 million each in corporation tax in 2012–13, with 20 per cent paying none at all (NAO 2013). Of course, a low or zero tax liability may be a genuine reflection of low profits earned. But it is clear that international ‘profit shifting’, where a company’s accounts are organised so as to show profits occurring in the lowest tax jurisdictions, has become widespread (Kadet et al 2021, Ylönen and Teivainen 2015).

Globally profit shifting to tax havens is estimated to cause $500 billion in losses to public coffers each year – a number that has sharply increased over recent decades (Tax Justice Network 2020). It is within the business community that this is perhaps most widely considered unfair, since it effectively leaves domestic firms that cannot avoid tax paying more to compensate for the foregone revenues. Profit shifting is a global problem, requiring international tax cooperation to solve it. It is essential for the fairness and effectiveness of tax systems that companies pay a fair rate of tax on their profits.

THE BIDEN PLAN EXPLAINED

So what are the Biden administration's plans, and how would they work? For several years, the Organisation for Economic Cooperation and Development (OECD) has been working on plans for international tax cooperation, but consensus has been challenging and negotiations had stalled towards the end of the Trump presidency. With a new president, the USA has now made new proposals to the OECD, restarting talks. There are two interlocked areas of discussion called 'Pillar 1' and 'Pillar 2'.

Pillar 1 proposals address *where companies pay tax*, particularly looking at large digital multinationals which may make money from a UK customer, be headquartered in the USA, but be domiciled in Ireland or Luxembourg for tax purposes. Pillar 1 proposals aim to set new rules about how different activities are taxed focussing particularly on location of sales. Ultimately the country where the company is headquartered would be responsible for computing the respective shares, with some mechanism for countries to dispute it. Though not perfect, this approach will make it harder for businesses to shift their profits to other jurisdictions – a practice where companies make profits in one country (eg the UK) and then "offshore" them by shifting them to a low-tax location.

Pillar 2 proposals address *how much companies are taxed*, specifically to set a minimum international level of corporation tax. The mechanism that Biden announced is simple but ambitious: in the first instance it seeks global cooperation to implement at least a 21 per cent corporate tax rate in every country. Companies will be allowed to transfer revenues and profits between countries who comply with the minimum global tax. But if a firm were to move profits to a country with a tax rate below this minimum level, the country in which the business is headquartered (eg the UK or the US) will be able to tax those profits for their own revenue. This would stop the race to the bottom, in which tax havens undercut the rates in other countries.

Solving offshoring of profits is a collective action problem and will require international agreement and cooperation, but the US's return to the negotiating table as the world largest economy is welcome, and the fact that Treasury Secretary Janet Yellen is prioritising these proposals sends an important signal. Of all the G7 economies meeting in Cornwall in June 2021, the UK is currently isolated as the only nation to not openly support the proposals.

THE CASE FOR CHANGE

We address some of the main concerns around these proposals below, but to summarise, the UK should support proposals to address tax offshoring and focus on proposals to further strengthen them (Kadet et al 2021) through international negotiation at the OECD, the G7 and the G20. The UK should seize this opportunity for coordinated global reform – it may not come again – and to pass it by would be to miss the chance to fundamentally shift the economy onto a fairer and more equitable footing.

To summarise, the UK should support the Biden plan for global corporation tax because:

- It is fair
- It will not harm growth
- It is targeted at those already avoiding tax
- It will raise vital revenue

Reform would be fairer and raise revenue in the UK

The main change under these proposals would be that large, multinational firms which currently pay very little in corporation tax will have to start paying the same rate as small- and medium-sized firms unable to move their profits overseas. This will have two benefits. Firstly, the UK government will receive an **increase in tax revenue**. The latest modelling by Garcia-Bernardo and Jansky (2021) of a 21 per cent minimum tax rate shows that the UK government will raise £14.7 billion more revenue in corporation tax, whilst if the rate were set at 15 per cent the additional revenue would be lower at £7.9 billion. These proposals would thus generate substantially more revenue that the UK could use for the benefit of its citizens, including the Johnson administration's priorities of "levelling up" regions across the UK, achieving net zero CO_2 emissions by 2050, and grasping new scientific and technological opportunities.

Secondly, and perhaps more importantly, it will lead to **a fairer economy where companies can compete on a level playing field**, and in which investment, risk-taking, and profit are fairly rewarded. The UK has also been at the forefront of a global trend, reducing its own corporation tax rate in an attempt to undercut other countries and make the UK a more attractive destination for investment. This model has failed on its own terms; despite plunging corporation tax rates in the UK (falling from 30 per cent in 2008 to 19 per cent in 2020), the UK has continued to languish at the bottom of international league tables for private sector investment (TUC, 2019).

The Biden proposals would **stop this international race-to-the-bottom** on tax. Instead, this would be **replaced by a race-to-the-top** on the things that companies' base investment decisions on and that also tend to benefit citizens: effective transport systems, good broadband and digital connectivity, a strong university system, a well-trained and skilled workforce, good systems of technical education and apprenticeships, and economically thriving towns, cities, and regions.

Finally, the UK oversees some of the largest tax havens in the world; of the top 10 tax havens identified by Tax Justice Network (2019), four are UK territories or crown dependencies, including all of the top three.[1] The UK is not currently acting as a responsible global citizen. These proposals, if agreed, would put a

[1] Tax Justice Network identify the "top ten" tax havens, which are collectively responsible for 52 per cent of global tax offshoring, as: 1 - British Virgin Islands (British territory), 2 - Bermuda (British territory), 3 - Cayman Islands (British territory), 4 - Netherlands, 5 - Switzerland, 6 - Luxembourg, 7 - Jersey (British dependency), 8 - Singapore, 9 - Bahamas, and 10 - Hong Kong.

stop to this overnight. This is an opportunity for the UK to take the lead on global cooperation towards a fairer and more efficient system of tax. Furthermore, as it is likely that this will be part of the negotiation of a US-UK trade deal, addressing these issues sooner rather than later is in the UK's interest.

The increased revenue is more than enough to support IPPR's blueprint for reform of the NHS and care system

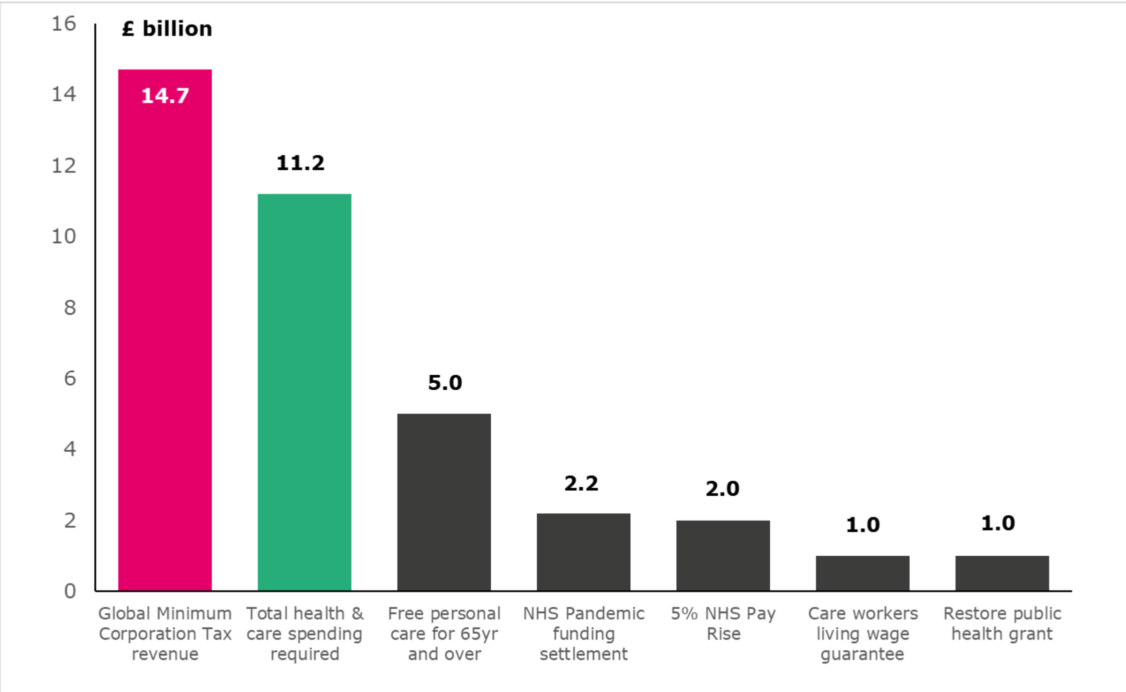
Through 2020 and 2021, the Covid-19 pandemic has shone a spotlight on the weaknesses of the UK welfare system and the NHS. IPPR have set out elsewhere how the restoration of public services is needed across the country to achieve the government's "levelling up" agenda (Roberts and Jung, 2020). We also need to support and reform the health and social care system (Patel, Thomas, and Quilter-Pinner, 2021). Stopping the unfair tax avoidance by large multinational corporations could help address these social and economic needs.

Projections from Garcia-Bernardo and Jansky (2021) show that a global minimum corporation tax at 21 per cent would result in an additional tax revenue in the UK of £14.7 billion per annum. Comparing this to IPPR's blueprint to "build back better" for the NHS and care system, shows that the increased revenue from the Biden tax plan would more than cover the additional day-to-day spending required for the entire recovery plan (Figure 1).

FIGURE 1

Additional tax revenue every year from a global minimum corporation tax would cover the entire annual cost of IPPR's blueprint for NHS and care reform

Additional tax revenue projections and policy costs in £ billion



Source: Garcia-Bernardo and Jansky 2021, Patel et al 2021.

The effect on businesses would be small and focused on those most able to pay

In the Biden plan, the **minimum corporation tax rate of 21 per cent is *below* the UK corporation tax rate of 25 per cent** set by Rishi Sunak at the 2021 budget and effective from 2023. A minimum international corporation tax would affect only those firms currently benefiting from moving profits made in the UK overseas, which tend to be large multinational corporations. Whilst some of this may represent legitimate commercial activities, its estimated that across the world, companies shift $1.38 trillion out of their home countries solely to pay less tax (Mansour 2020).

OECD modelling of the effects of a lower level of international minimum tax[2] confirms that the this will fall on large firms with large profits that have been able to shift these abroad to avoid tax. It finds that the impact is expected to "fall predominantly on … [multinational entities] engaging in profit shifting", which tended to be highly profitable (OECD, 2020). The OECD also found that these firms' investment was less sensitive to taxes (ibid). When considering whether or not firms will move away from the UK, we should bear in mind the wealth of issues that underlie such a decision. As described above, the change in the system will drive a beneficial race-to-the-top in wider economic conditions.

A minimum tax rate of 21 per cent is fairer and raises more revenue than one set at 15 per cent

There have been recent attempts to water down the proposed level of global minimum tax and the US has offered a compromise of 15 per cent (Rappeport, 2021). This would seriously undermine the goal to end the global tax race to the bottom, as tax havens could still operate at about half the rate of corporation tax of many OECD countries. Additionally the lower minimum rate it would only bring in about £7.9 billion for the exchequer, compared to the £14.7 billion for the 21 per cent proposal (Garcia-Bernardo and Jansky 2021). We therefore argue that the minimum rate should be at least 21 per cent as in the initial proposal, and ultimately negotiations should target 25 per cent as proposed by ICRICT (2019).

25 per cent is the average GDP-weighted corporate tax rate across OECD economies. It will also be the UK's corporation tax rate by 2023. A proposed rate significantly below this would incentivise tax havens to attract tax-avoiding multinationals by offering the minimum rate.

Moreover, developing countries, which are currently some of the main losers from tax-avoiding multinationals, will continue to lose out if the rate is set too low. Compared to richer countries, they rely more heavily on corporate tax as an income source and tend to have higher rates (ibid). The 15 per cent proposal currently on the table would therefore be bad news for some of the poorest countries in the world.

[2] A legacy proposal of 12.5 per cent rather than the Biden proposal of 21 per cent.

Until offshoring is addressed, the UK does not have sovereignty to set tax policy

Some worry that a global minimum corporation tax would represent a loss of sovereignty, as the UK would no longer have the discretion to set its own corporation tax rates. But this rests on the flawed assumption that we are able to effectively decide how companies are taxed *now*. If the largest multinational firms are free to offshore their profits to tax havens, the UK has no sovereignty to tax them effectively. Addressing this issue should be a priority to ensure that Westminster is able to tax *all* firms.

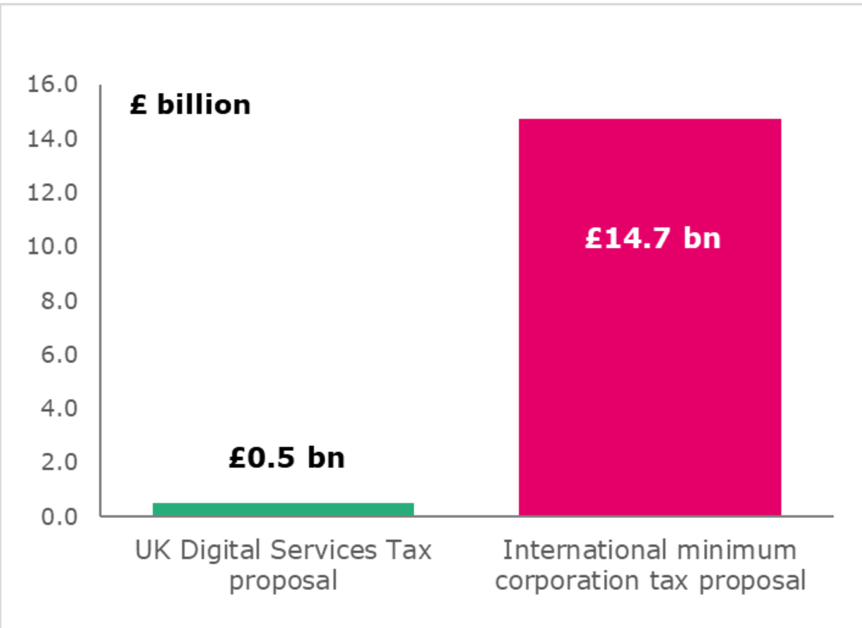
The UK's proposals for a Digital Services Tax should not get in the way of stopping profit offshoring

It has been reported that the UK government's negotiating priorities lie not in the pillar 2 proposals on a minimum corporation tax, but in addressing how digital economic activity is taxed through the pillar 1 proposals (FT, 2021). In 2018, given the lack of progress and difficulty reaching consensus at the OECD on pillar 1, the UK developed its own proposals for a Digital Services Tax to address the issue unilaterally. According to Seely (2021), "The Government has said it would disapply the DST if an appropriate global solution was successfully agreed and implemented".

Whilst it is right that taxation needs to fairly address how digital profits are dealt with, this shouldn't get in the way or act as a block on this narrow opportunity to address the wider issue of tax havens and profit offshoring.

FIGURE 2

An international minimum corporation tax is set to raise 29 times as much tax revenue in the UK as a proposed Digital Services Tax



Source: Garcia-Bernardo and Jansky 2021, Seely 2021

A comparison between the projected revenues raised from the global minimum corporation tax and the DST gives an idea of the relative scale of the issues. The UK's proposals on a Digital Services Tax are forecast to raise just £500 million in additional tax revenue (Seely 2021), compared to £14.7 billion in revenue from a minimum global corporation tax (Figure 2). Yet even disregarding their revenue raising potential, allowing proposals on pillar 1 to get in the way of progress on pillar 2 makes little sense. As long as companies are able to offshore their revenues and profits, fair taxation in one country will not be possible. By prioritising an attempt to ensure that the digital "giants" are fairly taxed in the US and the UK, the UK government are ensuring that they are fairly taxed in *neither*, by ensuring the continued operation of tax havens.

Instead of insisting on a DST, the government should propose other improvements to pillar 1 proposals. This should include widening its scope to more multinational firms, as currently only roughly the 100 largest companies in the world would be covered (Politico 2021). Moreover, pillar 1's focus on the location of sales is an important start, but it would not stop some forms of profit shifting relating to other forms of business activity (eg payroll). For example, some developing countries play an important role in value generation but are not where the bulk of sales take place. To account for the contribution of these countries to profits, ultimately a more nuanced approach would be desirable, for example one that takes into account employment (ICRICT 2019a). Finally, the way in which profits are split between countries under the pillar 1 proposal gives an advantage to the host country of multinationals, as it is in these tax authorities where that division is determined. This introduces a power imbalance with respect to developing countries, and a more balanced approach would be desirable. Addressing these issues is key to making the design of pillar 1 more just in the future.

The reforms could benefit, not hinder, economic growth

As argued above, the UK's corporation tax will be above the 21 per cent proposed in the international Biden proposal. So for firms solely active in the UK, there would be no increase, and thus no impact on economic activity through this channel.

In fact, it would provide fewer incentives for diverting economic activities to countries that offer ultra-low tax rates, but less well-developed infrastructure. The current system lowers overall global allocative efficiency and thus global growth, which ultimately hurts all countries. In that sense, ending the race to the bottom could increase global efficiency by helping allocate activities to places that are genuinely the most productive, rather than to tax havens which artificially attract firms with ultra-low tax deals. If combined with increased investment in infrastructure and education, the UK could thus attract more economic activity, and so benefit in growth terms.

There is an entirely separate question of whether higher corporate taxes in the UK would hinder growth. As recent research has shown, lower corporate taxes are often associated with higher inequality but not with more business investment and growth, eg as with the case of the Trump tax cuts or the UK corporation tax cuts in the 2010s (Hanlon et al 2019, Blakeley 2018, OECD 2020). On the contrary, as we argue in Jung and Nanda (2020), there are significant growth benefits to making the tax system more efficient and fairer. There is thus a possibility that the optimal minimum corporation tax rate is higher than in the Biden proposal. But again, the Biden proposal would not raise the UK's effective corporation tax rate.

In the long-term, reform would make the tax base more sustainable

The practice of profit offshoring leads to revenue-starving and profit-hoarding, and has increased inequalities in income and power, a process that threatens the stability of our democracies. This trend has only been accelerated by the rise of the connected, international economy, where a company can be headquartered in Silicon Valley, make sales in Swindon, but book their profits in Switzerland. Leaving these issues unaddressed risks the stability of national and international economies as digitalisation accelerates in the 21st century.

Across developed economies, there has been a trend of decline in the share of national income going to labour, and growth in the share going to capital. This trend has multiple causes but is due in part to a failure to adequately tax capital gains, interest, dividends and corporate income, and the consequent increase in taxation of individual incomes. Furthermore, the financial returns on assets and capital have consistently outpaced the growth of the economy as a whole. As the ownership of assets is concentrated amongst the wealthiest in society, this trend exacerbates inequality. It also endangers the long-term sustainability of the tax base. Policies to address the international element of low corporate taxation are one step required to address this long-term trend.

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